

AN ANALYSIS OF CAPITAL MARKET REGULATION IN SAUDI ARABIA

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ABSTRACT

Only recently, in 2003, did the Saudi Arabian legislator issue a capital market law and create a regulator vested with its enforcement. This recently-created regulator, the Capital Market Authority (“CMA”), is still in the process of building the regulatory framework governing capital markets. Some regulatory instruments were actually issued as recently as December 2012 and other instruments are still under preparation.

This thesis provides an overview of the legal framework governing Saudi Arabian capital markets and evaluates its adequacy in the organization of capital market transactions and the protection of market participants. This thesis delivers a number of proposals for legal and institutional reforms. For instance, this thesis recommends that a greater role be given to international non-governmental Islamic organizations for the formulation and attempted harmonization of Sharia standards applicable to capital market transactions. This thesis contends that the CMA should interact more closely with the regulated sector and allow greater transparency regarding the rationale and process of development of legal rules. This thesis also contends that the CMA should cooperate more closely with other regulators on the national and international planes, so to control systemic risks more effectively and achieve greater market efficiency. In order to minimize systemic risks, this thesis suggests the diversification of sectors listed on the stock exchange.

Finally, this thesis describes the regulatory framework as a possibly effective socio-economic policy tool, which can be utilized in parallel, along other available policy tools. This thesis contends that the CMA should play a larger role in the pursuit of Saudi Arabia's socio economic priorities and should prioritize securities offers and investments with greater anticipated socio-economic yields.

TABLE OF ABBREVIATIONS

AAOIFI.....	Accounting and Auditing Organization for Islamic Financial Institutions
CG.....	Corporate Governance
CMA	Capital Market Authority
CRSD.....	Committee for the Resolution of Securities Disputes
CSR.....	Corporate Social Responsibility
EUR	Euros
FDI.....	Foreign Direct Investment
FCA.....	Financial Conduct Authority
FSA	Financial Services Authority
GCC	Gulf Cooperation Council
IDB.....	Islamic Development Bank
IFC	International Finance Corporation
IFRS	International Financial Reporting Standards
IFSB.....	Islamic Financial Services Board
IMF	International Monetary Fund
IRTI.....	Islamic Research and Training Institute
IOSCO	International Organization of Securities Commissions
IPO.....	Initial Public Offering
MEP	Ministry of Economy and Planning
MoCI.....	Ministry of Commerce and Industry
MoF.....	Ministry of Finance
NCCI.....	National Company for Cooperative Insurance
NGO.....	Non-Governmental Organization
OECD.....	Organisation for Economic Co-Operation and Development
OIC.....	Organization of the Islamic Conference
OSR.....	Offer of Securities Regulations of 2004
PRA.....	Prudential Regulation Authority
RCI.....	Responsible Competitiveness Initiative
SAGIA	Saudi Arabian General Investment Authority

SAMA.....	Saudi Arabian Monetary Agency
SAR.....	Saudi Riyals
SEC	Securities Exchange Commission (USA)
SSEC.....	Saudi Supreme Economic Council
SIDF.....	Saudi Industrial Development Fund
SIFMA	Securities Industry and Financial Markets Association
SME	Small and Medium Enterprise
SOCPA.....	Saudi Organization for Certified Public Accountants
SPV	Special Purpose Vehicle
SR.....	Saudi Riyals
UNCTAD.....	United Nations Conference on Trade and Development
UNIDO.....	United Nations Industrial Development Organization
USD	United States Dollars
WTO	World Trade Organization

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PART I - INTRODUCTION

1. ROLE OF CAPITAL MARKETS

Capital markets host transactions involving securities, either through the platform of a stock exchange or through the arranged connection of securities' buyers and sellers, off-exchange. If properly regulated, capital markets should act as great drivers of socio-economic development.¹ Indeed, capital markets generally extend financing to elite companies thereby allowing these to increase their productivity, service better their clientele base, and compete more effectively locally and internationally. In turn, such corporate performance results locally in increased employment opportunities and infrastructure development, increasing in so doing, quality of life.² Capital markets generally allow the public, of all social classes, to pool scattered savings and collectively benefit from a wide array of investment opportunities.³

¹ According to one article: "[b]y now there is quite compelling evidence that security market development not only correlates with economic growth, but also causes it". See Bharat N. Anand and Alexander Galetovic, 'Investment Banking and Security Market Development: Does Finance Follow Industry?' (IMF Working Paper 01/90, July 2001), 2

<http://papers.ssrn.com/sol3/papers.cfm?abstract_id=879632> accessed 22 October 2012. According to World Bank analysts, "much research has been conducted that shows that countries with better developed capital markets, markets that are deep and liquid and that operate smoothly and efficiently, [have] stronger overall economies and more rapid economic growth". See Felice Friedman and Claire Grose, 'Promoting Access to Primary Equity Markets: A Legal and Regulatory Approach' (April 2006) World Bank Policy Research Working Paper Number 3892, 3

<http://papers.ssrn.com/sol3/papers.cfm?abstract_id=913188> accessed 22 October 2012.

² Habib Faris, 'Infrastructure Investments: A Promising Strategy' *Arab News* (20 March 2006); Regarding the stock market's role in promoting industrial production, see Asli Demirgüç-Kunt and Ross Levine, 'Stock Markets, Corporate Finance, and Economic Growth: An Overview' (May 1996) 10(2) *The World Bank Economic Review* 223, 229.

³ Mohammed Mohsin, *Economics of Small Business in Islam* (Visiting Scholar Research Series No. 2, Islamic Research and Training Institute 1995) 28. See also, MEP, 'Fifth Development Plan (1990-1995)', 164

<<http://www.mep.gov.sa/inetforms/themes/clasic/file/download.jsp;jsessionid=E53F93774E5C56CF8A21EC47B8050187.alfa?FileAttribute=DownloadTranslation.Content&TableName=DownloadTranslation&DownloadTranslation.ObjectID=113>> accessed 4 May 2013.

Capital markets, through their exchange portals, can offer instantaneous intermediation between offer and demand and structure transactions in an organized and supervised manner. They provide a good monitor, through disclosure requirements, of the private sector's stability, its needs, and capacity for further growth. Furthermore, by offering local investment opportunities, capital markets can reduce flight of capital to foreign jurisdictions, keeping the benefit from such liquidity in the hands of the local population.⁴

2. SAUDI ARABIAN CAPITAL MARKETS

In 2003, the Saudi Arabian legislator issued the Capital Market Law which completely revamped and reformed the legal framework governing Saudi Arabia's capital markets.⁵

It is well established that this modernization was driven by the government's socio-economic agenda.⁶

⁴ Joseph Stiglitz and Amar Bhattacharya, 'Underpinnings for a Stable and Equitable Global Financial System: From Old Debates to New Paradigm', (Paper prepared for the Eleventh Annual Bank Conference on Development Economics, Washington D.C., April 1999) 1.

<<http://siteresources.worldbank.org/DEC/Resources/84797-1251813753820/6415739-1251814010799/bhatta.pdf>> accessed 7 September 2012.

⁵ The Capital Market Law, issued pursuant to Royal Decree No. M/30, dated 16 February 2003. The Saudi Arabian legal community sometimes refers to laws as regulations to emphasize that God is the ultimate legislator. See Nabil Saleh, *Unlawful Gain and Legitimate Profit in Islamic Law*, (2nd edition, Graham & Trotman 1992) 6. Also, Saudi Arabia uses the Islamic Hجري calendar. Conversions from the Hجري to the Gregorian calendar may contain slight errors in the range of one or two days. For the sake of clarity for Western readers, this thesis has distinguished between laws and regulations and has presented dates based on the Gregorian calendar.

⁶ Joseph Beach, 'The Saudi Arabian Capital Market Law: A Practical Study of the Creation of Law in Developing Markets' (2005) 41 *Stanford Journal of International Law* 306, 307-308.

The Capital Market Law of 2003 created a formal and independent regulator, the CMA. The CMA has to date issued twelve regulatory instruments, some as recently as 2011 and is scheduled to issue two further instruments in the near future.⁷

Legal reforms were not limited to capital markets. In 2005, Saudi Arabia acceded to the World Trade Organization ("WTO"). In the process of preparing for membership, Saudi Arabia engaged in massive scale reforms, which included the enactment of 42 new trade-related laws, the creation of nine new regulatory bodies and the conclusion of 38 bilateral agreements.⁸

Between 2003 and 2010, the market capitalization of the Saudi Arabian stock exchange doubled and the number of transactions performed increased five-fold.⁹ The expansion of Saudi Arabian capital markets is encouraged by a significant projected expenditure in infrastructure projects.¹⁰ Even though surpluses from oil revenues can finance a great portion of such expenditure, the Saudi Arabian government is wisely attempting to widen the role of the private sector.¹¹ The sustainable development of the Saudi Arabian economic and social environment is indeed a "*multi-dimensional challenge*" (i.e. a

⁷ See PART III - 3.3.

⁸ Tim Niblock, *The Political Economy of Saudi Arabia*, (Routledge 2007) 17.

⁹ MEP, 'Share Market Indicators',

<http://www.cdsi.gov.sa/english/index.php?option=com_docman&task=doc_download&gid=1169&Itemid=158> accessed 21 October 2012.

¹⁰ *Ibid*, 31.

¹¹ MEP, 'Ninth Development Plan (2010-2014)' 49

<<http://www.mep.gov.sa/themes/BlueArc/index.jsp?jsessionid=A7CDC575CCAA0769D93B7A001C82A3FF.beta?event=View&ViewURI=/inetforms/article/ArticleViewPage.jsp&Article.ObjectID=79>> accessed 20 October 2012.

challenge on the political, economic, legal, and social fronts).¹² It is nevertheless unequivocal that any sustainable development strategy must enhance the private sector's self-reliance, including its self-funding ability.¹³

Saudi Arabian capital markets are progressively evolving as an attractive alternative to bank financing.¹⁴ Capital markets are capable of not only catalyzing but also incentivizing the development of markets for products and services. Indeed, capital markets offer an opportunity for the public to become the partners (and not just the clients) of the entrepreneurs. By electing whether or not to invest, and by electing where to invest, average Saudis should gain leverage in the articulation of development priorities.

3. OBJECTIVES AND VALUE OF THIS THESIS

3.1. Objectives of the Thesis

This thesis will evaluate whether theoretically the legal framework governing Saudi Arabian capital markets, as currently designed and enforced, is sufficiently protective of the interests of all market participants and whether it can at all be employed towards the achievement of a greater socio-economic value.

3.2. Significance of the Thesis

¹² *Ibid*, 44; Similarly, stock market development was described as a "*multifaceted concept*". See Asli Demirgüç-Kunt and Levine, *supra* note 2, 231.

¹³ *Ibid*, 49.

¹⁴ Aljazira Capital, 'The Financing Role of the Saudi Capital Market: Promising Prospects' (March 2010) 1-2 and 7 <http://www.aljaziracapital.com.sa/jaziracapital/report_file/ess/ECO-4.pdf> accessed 20 October 2012.

The evaluation contained in this thesis is novel and unique in many ways. First of all, in the past few years, the CMA issued a number of new instruments and amended existing regulatory instruments. The regulatory framework is in rapid evolution and transformation, which implies that even practitioners must constantly verify and update their knowledge. Second of all, little research is available concerning the entire legal framework governing Saudi Arabian capital markets. One analyst observed in 2012 that almost nine years following the enactment of the new regulatory framework, "*not one comprehensive legal paper ha[d]been submitted to explain or discuss the law*".¹⁵ This is because, as generally observed by analysts:

*"[the] Saudi business environment lacks some essential components such as professional analysis community and financial databases."*¹⁶

Thirdly, in subjecting Saudi law to a detailed scrutiny, this thesis formulates strategies to direct capital towards more productive use, calculated in terms of anticipated socio-economic rewards. Fourthly, the Saudi Arabian business environment is of special interest to analysts due to the fact that it resembles that of both developed and developing countries.¹⁷ Fifthly, the Capital Market Law of 2003 and the CMA Regulations do not constitute the sole legal source impacting capital markets. Other enactments are also of immediate relevance to the success of Saudi Arabian capital markets and are therefore worthy of note. For this reason, this thesis has adopted a

¹⁵ Gouda Bushra Ali Gouda, 'The Saudi Securities Law: Regulation of the Tadawul Stock Market, Issuers, and Securities Professionals under the Saudi Capital market Law of 2003' (2012) 18 Annual Survey of International and Comparative Law 115, 116.

¹⁶ Christopher Robertson et al., 'An Analysis of Western Corporate Governance Principles in Saudi Arabia', (2012) 35(6) International Journal of Public Administration 402, 403.

¹⁷ *Ibid.*

somewhat holistic and inclusive approach in the definition of the legal framework governing the Saudi Arabian capital markets. Sixthly, this thesis mentions and describes a number of resources that are only available in the Arabic language and that hold valuable informative content to practitioners and researchers who do not read Arabic.

4. METHODOLOGICAL APPROACH

4.1. Saudi-Specific Primary Sources

This thesis intended a doctrinal methodological approach that:

"provides a systematic exposition of the rules governing a particular category, analyses the relationship between rules, explains areas of difficulty, and perhaps, predicts future development".¹⁸

Saudi Arabian legal doctrine simultaneously constituted the focus of this thesis and the primary source of research materials collected. Saudi Arabian legal doctrine consists of the laws, regulations, and judicial cases which govern or impact on Saudi Arabian capital markets.

A part of this thesis is descriptive and presents the relevant elements of doctrine as they are (or as they were, if repealed). The other part of this thesis is analytical. Although different elements of Saudi Arabian doctrine may at times serve to explain each other, the sole examination of elements of Saudi Arabian doctrine would not be sufficient to achieve the research objects of this thesis. As tools for the assessment of the

¹⁸ Terry Hutchinson, *Researching and Writing Law* (3rd ed., Thomson Reuters, 2010) 7.

effectiveness of elements of Saudi Arabian doctrine, and as tools for the formulation of reform proposals, this thesis has utilized and referred to:

- a) non-Saudi primary sources (i.e. laws, regulations, and case law from other jurisdictions); and
- b) secondary sources from the legal discipline;
- c) empirical information of relevance to capital market regulation.

The following Sub-Sections will elaborate on the above terms.

4.2. Non-Saudi Primary Sources

As mentioned in Section 3.2 of this Part, this thesis contains occasional comparisons between Saudi and non-Saudi doctrine. Comparative analysis provides benchmarking for Saudi doctrine. Since the legal framework governing Saudi capital markets is recent, comparative research in the systems of more established jurisdictions may help understand the rationale behind, and may even help trace the evolution of, Saudi Arabian doctrine. Comparisons were mainly drawn with the US and the UK since they have long-established capital markets and developed legal systems.

Benchmarking was also conducted against widely recognized regulatory standards issued by international standard-setting bodies such as the International Organization of Securities Commissions ("**IOSCO**"). These standards aim at the creation and preservation of an optimal regulatory environment and are derived from past regulatory

experiences and widely recognized rationales.¹⁹ Since it is reasonable to expect that Saudi Arabian laws and regulations would be tailored around such standards (e.g. where Saudi Arabia is a member of the standard-setting body), those standards can arguably be classified as primary sources (in the same way as international treaties for example).²⁰

4.3. Secondary Sources from the Legal Discipline

Secondary sources have a rich informative content that may not be available in primary sources.²¹ Firstly, secondary sources can serve to identify relevant primary sources. Secondly, they can help in understanding the background and motives behind the formulation of primary sources. Thirdly, they contain analysis of primary sources and offer insights regarding the different ways in which primary data can be processed.²²

As will be discussed in the Literature Review contained in Section 5 of this Part, very little secondary sources exist on the Saudi Arabian capital market regulatory framework.

4.4. Relevance of Empirical Information to Capital Market Regulation

The study of capital markets is by nature inter-disciplinary. The legal framework examined in this thesis is subordinated to, exists within, and serves larger dimensions

¹⁹ IOSCO, 'Fact Sheet' (February 2013) 3 <<http://iosco.org/about/pdf/IOSCO-Fact-Sheet.pdf>> accessed 8 April 2013.

²⁰ See Section 3.2 of Part III.

²¹ Hutchinson, *supra* note 18, 7.

²² *Ibid.*

(e.g. social, economical, political, etc.).²³ As shown in Sections 1 and 2 of this Part, capital market institutions are usually created to achieve, and are usually measured against the achievement of, socio-economic goals.²⁴

The measure of legal effectiveness should not be constrained to the black letter of the law, in isolation of relevant socio-economic findings. As described by one academic:

*"Empirical study has the potential to illuminate the workings of the legal system, to reveal its shortcomings, problems, successes and illusions, in a way that no amount of library research or subtle thinking can match."*²⁵

This thesis did not intend an analysis of the socio-economic empirical information itself, but rather an analysis of the significance and impact of such information on policies and ultimately on the enacted framework. As such, this thesis relied on the quantitative data retained, and the qualitative assessments made, by socio-economists. Reflection on the choice, utilization method, and intrinsic value of any effectiveness measurement tools from the socio-economic discipline falls beyond the scope of this thesis and requires

²³ Austin Sarat, 'Social Studies of Law: On the Unfortunate Persistence of a Research Tradition, (1985) 9 Legal Studies Forum 1, 23; See Lawrence Friedman, 'Legal Culture and Social Development' (August 1969) 4 Law & Society Review 1, 29; Regarding the fact that regulation is society's servant and not its master, see Eilis Ferran, 'The New Mandate for the Supervision of Financial Services Conduct' (2012) 65(1) Current Legal Problems 411, 412.

²⁴ Jan Torpman and Frederik Jorgensen, 'Legal Effectiveness: Theoretical Developments on Legal Transplants' (October 2005) 91(4) Archiv fuer Rechts- und Sozialphilosophie 515, 515 and 531; See also Awwad Awwad, 'Legal Regulation of the Saudi Stock Market: Evaluation, and Prospects for Reforms' (DPhil thesis, University of Warwick 2000) 5.

²⁵ Julius Getman, 'Contributions of Empirical Data to Legal Research', (1985) 35 Journal of Legal Education 489, 489; Unfortunately, specialists in legal education have observed a deficiency in, and an urgency for, the integration of empirical research into law and legal processes. See Paddy Hillyard, 'Law's Empire: Socio-Legal Empirical Research in the Twenty-First Century' (June 2007) 24(2) Journal of Law and Society 266, 268; See also Friedman, *supra* note 23, 40.

assessments of a non-legal nature.²⁶ The authors of socio-economic conclusions or inferences were presumed to have drawn on their own field of specialty and to have been diligent in their formulations. To illustrate, amongst other socio-economic contentions which this thesis has assumed to be valid and which were used to formulate legal inferences (including reform proposals):²⁷

- a) *stock market liquidity [...] is positively and significantly correlated with current and future rates of economic growth, capital accumulation, and productivity growth";*²⁸
- b) *"[financial] markets [are] the ideal mechanism for allocating resources";*²⁹
- c) *"complete and competitive markets represent an ideal allocation system characterized by the fundamental theorems of welfare economics";*³⁰
- d) *"stock market development goes hand-in-hand with other aspects of financial development";*³¹
- e) *"weaker corporate governance impedes effective resource allocation and slows productivity growth";*³²
- f) *"risk diversification through internationally integrated stock markets is another vehicle through which stock markets can affect economic growth";*³³ and

²⁶ Empirical indicators typically utilized for the measurement of stock market development include: size, liquidity, international integration measures, and volatility. See Ross Levine and Sara Zervos, 'Stock Markets, Bank, and Economic Growth' (June 1998) 88 *The American Economic Review* 3, 540-541; See also Demirgüç-Kunt and Levine, *supra* note 2, 223.

²⁷ Demirgüç-Kunt and Levine, *supra* note 2, 235.

²⁸ Ross Levine and Sara Zervos, 'Stock Markets, Bank, and Economic Growth' (June 1998) 88(3) *The American Economic Review* 537, 537; See also Demirgüç-Kunt and Levine, *supra* note 2, 224.

²⁹ Franklin Allen and Douglas Gale, *Comparing Financial Systems* (MIT Press 2001) 3.

³⁰ *Ibid*, 6.

³¹ *Ibid*.

³² Levine and Zervos, *supra* note 26, 538.

³³ Demirgüç-Kunt and Levine, *supra* note 2, 230 and 232.

g) *"the legal protection of investors in a country is an important determinant of the development of its financial markets".*³⁴

Collected socio-economic findings were not uncritically accepted. A reasonable (albeit subjective) effort was made to screen socio-economic contentions. Indeed, this thesis only referred to socio-economic contentions either when they appeared to be recognized (at least to some degree of consensus) by the socio-economic community or policy-makers, or when they appeared to hold common sense for ordinary persons with no specialization in socio-economics (as in the case of an average jurist). As observed by one academic:

*"Laymen are, according to our analysis, the appropriate level of research on the effectiveness of legal systems. Professionals are involved only after a conflict has been identified and interpreted in legal terms. The preliminary interpretation, the primary application of law, should determine what areas of law are used and what areas lie fallow. Effective norms should be such that are applied by laymen, applied in its broadest sense".*³⁵

Based on the confirmation by socio-economists of an ability for capital markets to promote welfare and economic growth, this thesis will assess the extent to which the Saudi Arabian capital market regulator is actually required or able to perform policy-making functions by employing the regulatory framework towards the achievement of socio-economic priorities. One academic described policy as follows:

"Policy' is an imprecise and flexible word [...] One might say that policy includes those decisions that advance 'some collective goal of the community as a whole" rather than those

³⁴ Rafael La Porta et al., 'Investor Protection and Corporate Valuation' (2002) 57(3) The Journal of Finance 1147, 1147.

³⁵ Torpman and Jorgensen, *supra* note 24, 534.

*decisions which secure some individual or group right. Policy-making involves 'making decisions about how to decide particular classes of case' and the making of important decisions which affect the distribution of values".*³⁶

Policy-making functions were considered by some academics as particularly appropriate for regulatory agencies and were even described as the "*zenith of administrative authority and expertise*".³⁷

Unfortunately, even though policy considerations can provide elements for the purposive interpretation of enacted rules, such considerations are often (as in the case at hand) veiled by secrecy and may not be accessible to the student of the regulatory process.³⁸ This thesis did reserve two of its Parts (Parts VIII and IX) to illustrate in practice and in context policy functions which capital markets may be able to accomplish.

4.5. Significance of the Broadness of the Research Topic

The topic of capital market regulation in Saudi Arabia is broad in nature. Since there are limits to the level of detail that can be allocated to each relevant issue, this thesis is constrained to the format of an overview. This study should contain valuable background information on all treated issues. Nevertheless, this thesis cannot, in respect

³⁶ Timothy Jones, 'Regulatory Policy and Rule-Making' (1991) 20 *Anglo-American Law Review* 131, 137.

³⁷ *Ibid.*

³⁸ *Ibid.*, 134.

of any treated issue, surpass the informative content of a study solely focused on that very issue.

5. LITERATURE REVIEW

5.1. Objective of the Chapter

This intention of this chapter is to describe the literature which was found to be of particular relevance to the research objectives and to position this thesis in relation to such literature. More detailed discussion of research findings and relevant literature is reserved for the later Parts of this thesis.

5.2. Positioning the Thesis in Relation to the General Literature on Capital Market Regulation

The literature is rich on the general prerequisites for the success of capital markets. Even though this literature was not written by academics from the same discipline, there did seem to be broad consensus on particular points.³⁹ This consensus characterized not only the academic community but also the community of specialists involved at the levels of governmental institutions and non-governmental organization ("NGOs"). Examples of issues over which there seemed to be consensus include:

- a) the need for good information about the value of businesses;⁴⁰ and
- b) the need to protect minority shareholders from such things as inside information.⁴¹

³⁹ For instance, see Abdullah Ibnrubbian, 'Effects of Regulation, Islamic Law and Noise Traders on the Saudi Stock Market' (DPhil thesis, Brunel University 2012).

⁴⁰ Bernard Black, 'The Legal and Institutional Preconditions for Strong Securities Markets' 48 (2000-2001) UCLA Law Review 781, 783.

⁴¹ *Ibid.*

Obviously, even though this analysis is of direct relevance to Saudi Arabian capital markets, the Saudi Arabian environment does have its own particularities. This requires the adaptation of the general research into the Saudi Arabian context.

5.3. *Positioning the Thesis in Relation to the General Literature on Saudi Capital Markets*

The research performed yielded only a small number of academic and institutional studies on Saudi Arabian Capital Markets. Examples include:

- a) a 2010 study prepared by Al Jazira Capital under the title: 'Financing Role of the Saudi Capital Market: Promising Prospects';⁴²
- b) a 2009 study conducted by the World Bank concerning the application of corporate governance practices in Saudi Arabia;⁴³
- c) a 2006 study conducted by the International Money Fund concerning the stability of Saudi Arabian financial system;⁴⁴
- d) a book chapter titled 'The Saudi Capital Market' written by Mohammed Ramady in his 2005 book 'The Saudi Arabian Economy: Policies, Achievements and Challenges'; and
- e) a 2002 conference paper written by Abdulaziz Al-Dukheil under the title: 'The Saudi Stock Market'.⁴⁵

⁴² Aljazira Capital, *supra* note 14.

⁴³ World Bank, 'Corporate Governance Country Assessment: Kingdom of Saudi Arabia' (Report on the Observance of Standards and Codes: Corporate Governance, February 2009) <http://www.worldbank.org/ifa/rosc_cg_saudia_arabia.pdf> accessed 20 October 2012.

⁴⁴ IMF, 'Saudi Arabia: Financial System Stability Assessment' (IMF Country Report No. 06/199, June 2006) <<http://www.imf.org/external/pubs/ft/scr/2006/cr06199.pdf>> accessed 19 September 2012

⁴⁵ Abdulaziz Al-Dukheil, 'Saudi Stock Market' (Conference on The Future Vision for the Saudi Economy, October 2002).

These studies can provide valuable background information on the evolution and current shape of Saudi Arabian capital market institutions or on the socio-economic realities surrounding those institutions. They however are generally not concerned with the doctrinal review of the regulatory framework.

5.4. Positioning the Thesis in Relation to other Literature on the Regulatory Framework Governing Saudi Capital Markets

5.4.1. Literature Treating the Overall Regulatory Framework

The research performed by the author of this thesis generated only three studies which treated the overall legal framework governing Saudi Arabian capital markets. These were:

- a) a PhD thesis submitted by Awwad Saleh Awwad in 2000 under the title: 'Legal Regulation of the Saudi Stock Market: Evaluation, and Prospects for Reforms';⁴⁶
- b) a journal article written by Joseph Beach in 2005 under the title: 'The Saudi Arabian Capital Market Law: A Practical Study of the Creation of Law in Developing Markets';⁴⁷ and
- c) a journal article written by Gouda Bushra Ali Gouda in 2012 under the title: 'The Saudi Securities Law: Regulation of the Tadawul Stock Market, Issuers, and Securities Professionals under the Saudi Capital Market of 2003'.⁴⁸

<<http://archive.mep.gov.sa/nadwah2020/ALL%20PAPERS/DAY3/The%20Financial%20Sector.%20Challenges%20and%20Opportunities/REVISED-SAUDI%20STOCK%20MARKET-05-10-2002-KM/REVISED-SAUDI%20STOCK%20MARKET-05-10-2002-KM.doc>> accessed 15 April 2013.

⁴⁶ Awwad, *supra* note 24.

⁴⁷ Beach, *supra* note 6.

⁴⁸ Bushra Ali Gouda, *supra* note 15.

Regarding the PhD thesis of Awwad, it was focused towards the same research objects as this thesis. A good portion of its content has however lost actuality since it was written over a decade ago and pre-dates the 2003 overhaul of the legal framework governing Saudi Arabian capital markets. That said, Awwad's thesis does continue to be valuable in some respect for the present-day researcher since it is one of the few materials that describe the former regulatory framework and its evolution. It also does tie between doctrinal and non-doctrinal materials and compares Saudi and non-Saudi doctrine. Interestingly, Awwad's data methodology involved field work and interviews with Saudi Arabian officials, which implied reliance on primary sources unavailable to other researchers (unless replicated). Also, this thesis and that of Awwad treated different aspects of the same overall topic. This is natural since both researches were conducted at entirely different, and much separated, points in time.

Regarding Beach's journal article, Beach was involved in the drafting of the Capital Market Law of 2003 and offers a first-hand historical account of the events that led to the issuance of the Capital Market Law of 2003. Beach explains the blueprints or source points underpinning the new instrument. Beach generally uses a descriptive stance rather than an analytical stance almost throughout the whole article. Also, many amendments were made to the regulatory framework since the publication of Beach's article in 2005, which implies that some of its content may no longer be up-to-date.

Regarding Bushra Ali Gouda's article, it appears to be by far the most (and possibly the only) comprehensive and up-to-date secondary source on the legal framework governing Saudi Arabian capital markets. However, it is worthwhile to note that Bushra

Ali Gouda presented himself in the article as an attorney at law practicing in NY, USA. The article appears to be directed at an audience of practitioners and focuses on the description and analysis of the black letter of the law. The article of Bushra Ali Gouda therefore contains very little or no discussion on the use of capital market institutions towards the pursuit of socio-economic goals, the pointing of the regulatory framework towards the achievement of those goals, or on the safeguard of systemic stability. The article of Bushra Ali Gouda is based on a very different set of secondary materials and for instance, makes no reference to the IOSCO standards, the five-year plans of the Ministry of Economy and Planning ("**MEP**"), or the annual reports of the CMA. Actually, the article of Bushra Ali Gouda and this thesis cover different aspects of the primary sources and place different focus on particular doctrinal elements.

In conclusion, all three of the above studies, although all prepared from the perspective of the legal discipline, and although all broadly-oriented, either did not share the same objects of this thesis or were based on a very different set of primary and secondary sources.

5.4.2. *Literature Treating Aspects of the Regulatory Framework*

Very few studies were concerned with the evaluation of the effectiveness of a specific aspect of Saudi Arabian capital market regulation. Examples include:

- a) a PhD thesis titled 'An Evaluation of Investor Protection in Secondary Securities Markets: A Comparative Study of Regulatory Regimes in the United Kingdom and Saudi Arabia', submitted in 2012 by Sultan Alabdulkarim;⁴⁹ and
- b) a PhD thesis titled 'Corporate Governance: The Saudi Arabian Capital Market and International Standards', submitted in 2010 by Mohammed Alsanosi.⁵⁰

Those studies were of a particular interest since they were prepared from a legal perspective and drew upon a set of primary and secondary sources similar to that collected for this thesis. Similitude also existed in the methodology, since those studies also involved empirical investigations. That said, those studies only shared part of the overall scope of this thesis and were ultimately concerned by different research objects.

6. STRUCTURE OF THE THESIS

This thesis is broken down in ten different parts, including this introduction and the conclusion. Part II of this thesis will explain the significance of Islamic law (or Sharia) on Saudi Arabian capital markets. As will be explained in Part II, contemporary Islamic law enactments take the form of interpretations of the Holy Quran and the sayings of the Prophet Mohamed. These interpretations ultimately are not exclusive to a government or a legislator and may be formulated by any academic, subject to the ability to reason and defend each interpretation derived. Part II will explore the debate and controversy which often occur and which cause obscurity regarding the actual rules to be followed.

⁴⁹ Sultan Alabdulkarim, 'An Evaluation of Investor Protection in Secondary Securities Markets' (DPhil thesis, Newcastle University 2012).

⁵⁰ Mohammed Alsanosi, 'Corporate Governance: The Saudi Arabian Capital Market and International Standards' (DPhil thesis, University of Leicester 2010).

This obscurity may impede on the healthy development of Saudi Arabian capital markets, especially that capital market transactions draw a number of concerns relating to the prohibition of certain debt-based transactions involving usury. Part II will explain the importance of attempting to harmonize legal interpretations. Part II will discuss the need to set minimum standards for the constitution and operation of Sharia advisory committees appointed by financial institutions to advise on investment strategies, policies, and structures. Amongst other things, Part II will suggest establishing requirements for minimal scholarly proficiency to act as a Sharia scholar. Finally, Part II will argue that specialized NGOs should be further relied upon to set the conditions for Sharia-compliance and for the oversight of such compliance.

Part III of this thesis will introduce the legislative and regulatory instruments enacted at governmental level regarding capital market transactions and will present the main institutions created for such purpose. Part III will argue that the CMA needs to interact more vividly and openly with the regulated sector. Part III will also argue that the CMA needs to allow a fluid exchange of ideas regarding the objectives of the law and the measures adopted for the accomplishment of those objectives. Part III will then describe and analyze the role, functions, internal setup, level of autonomy, and the level of accountability of the CMA. Finally, Part III will explore the possibility of widening the role of the CMA from mere transactional oversight to the encouragement and facilitation of transactions that could have associated socio-economic rewards.

Part IV will explain the difference between different types of securities, equity-based and debt-based. This Part will describe the different methods available to offer

securities and conduct capital market transactions and will explain the procedure involved for each such method. This Part will show how securities can be offered and transacted upon. Capital market transactions could take place through listing on the Stock Exchange, by way of a public offering. They could also take place privately and directly, without the Stock exchange's intermediation, by way of a private placement. Finally, they could take place through collective investment-pooling schemes or investment funds managed by financial professionals. Socio-economic, legislative, and regulatory objectives relating to capital markets, can only be achieved if the processes utilized are reasonable and sensible. These are evaluated in Part IV.

As in the context of direct contractual relationships, capital market transactions, even if conducted indirectly through the medium of the Stock Exchange, need to incorporate provisions to dissuade market participants from carelessness, default, or abuse. The availability of judicial relief cannot be relied on as the sole source of deterrence for improper practices. Any carelessness, default, or abuse on the part of any capital market participant would undermine the objectives of the capital market and must therefore be contained. Part V will present the rules and regulations governing issuers, investors, intermediaries, and the consultants who usually take part in structuring or organizing capital market transactions.

Certainly, the ability of capital markets institutions to realize desired socio-economic objectives is threatened by systemic risks. These risks must be constantly monitored and controlled. Financial crises must be avoided to the extent possible or at least their impacts must be mitigated. Part VI will explain the defenses and corrective measures

which could be adopted by Saudi Arabian capital markets in that regard, based on the experiences acquired from the recent financial crisis. Amongst other things, this Part will explain the importance of strengthening the aptitudes of the regulatory apparatus to go through and understand increasingly bulky and complex information and to recognize events that justify regulatory intervention. As explained in Part VI, the regulator should explore and promote agents that could reinforce the market's self-correction ability. For instance, the promotion of investor education could help boost the market's ability to recognize and reject unsound or fraudulent investment opportunities. Part VI will then explain the importance of: (a) simplifying product design structures so to facilitate their evaluation and trading, (b) promoting diversification not only in terms of individual investment portfolios but also in terms of listed sectors, (c) raising financial reporting and auditing standards so to build more accurate profiles of financial worth, performance, and risks, and (d) aligning the incentives of managers with long-term objectives. Part VI will describe the capital adequacy requirement recently imposed on Saudi Arabian securities firms.

Part VII will discuss the proposal to integrate the Saudi Arabian capital markets with those of other Gulf Cooperation Council ("GCC") countries. This proposal is part of a wider bid to create a single market and a common currency for the region. As will be shown in this Part, there are different levels of harmonization and integration depending on the level of fusion desired and preparedness to give up national sovereignty. Part VII offers a brief overview of the experience of the European Union with capital market integration. The European Union has adopted over time more imposing and improved

models of integration. Part VII will explain the integration efforts adopted to date by GCC member states.

In order to understand the distinctive ability of capital markets to advance not only economic but also social considerations, it is important to compare capital market-based finance and bank-based finance. Part VIII will offer such comparison and will describe how only market-based finance is able to improve the business sophistication of proposed issuers and widen their ownership and stakeholders' base. Part VIII will explain how both, bank-based finance, on one hand, and, market-based finance involving debt-based securities, on the other hand, create a creditor/debtor relationship that requires similar modes of securitization, which are still not fully available in Saudi Arabia. Part VIII will also explain how capital markets, and especially equity-based transactions, can help improve the performance and maintain the continuation of certain companies, especially family businesses and small and medium enterprises. Part VIII will also explain how the privatization efforts present very attractive opportunities to Saudi Arabian capital markets and Saudi Arabian society.

Part IX will demonstrate that capital markets are only one of numerous policy-making tools available to improve economic performance and raise economic welfare. Part IX will discuss some of those policy-making tools. This discussion aims to show how the socio-economic objectives sought from capital markets can only be achieved as part of a comprehensive policy plan.

Finally, the main conclusions of this thesis will be set out in Part X.

PART II - THE SIGNIFICANCE OF ISLAMIC LAW

1. INTRODUCTION

Ab initio, the study of the laws and regulations relating to the Capital Market Law requires the comprehension of relevant particularities relating to the Saudi Arabian legal system. As will be shown in this Part of the thesis, Islamic law (or Sharia law) is the highest source of law in the Saudi Arabian legal system and constitutes the equivalent of constitutions in Western legal systems. Sharia law therefore acts as the foremost body of law governing capital markets, to the extent relevant.

While other Parts of this thesis will describe certain Sharia commandments that markedly impact on capital market transaction, this Part will focus on the sources of Sharia and how:

- a) Sharia revolves around social justice and the preservation of human dignity, which principles should be considered the core objective of all governmental institutions, including the CMA;
- b) broader rules of Islamic law must be contemporized and how different scholars may differ on applicability criteria and implementation methods;
- c) capital market products at times contain certifications of Sharia compliance, to comfort observing investors, and how those certifications may not be fully reliable; and how
- d) the CMA is currently not legally required to oversee the Islamic law aspect of the capital market, but could directly or indirectly assume such a role.

2. GENERAL FRAMEWORK

2.1. Source and Definition of Sharia

Islamic law or 'Sharia' takes source primarily from the Quran, the book believed by Muslims to have been divinely descended onto prophet Mohamed through Angel Gabriel, as well as the sayings and actions of the prophet Mohamed.⁵¹ Secondary and subordinated sources include the interpretations and elaborations delivered by scholars in relation to the primary sources.⁵² Secondary sources are subject to debate.⁵³

Sharia was described by some as a "*way of life*" since it governs not only the public but also the private aspects of a Muslim's day-to-day life, including faith, worship, body care, and interactions with other (including commercial interactions).⁵⁴ From the perspective of Muslim society, Sharia's scope extends to economic, political, cultural and social matters.⁵⁵

Sharia commandments are broad for the great part, save for a few precise ones. Broad commandments include those related to the respect of the rights and property of others, the honoring of commitments, sincerity in transacting, etc. To illustrate, Verse 2:188 of the Quran states that:

⁵¹ See IOSCO, 'Report of the Islamic Capital Market Task Force of the International Organization of Securities Commissions' (July 2004) 5 <<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD170.pdf>> accessed 21 September 2012.

⁵² *Ibid.*

⁵³ Ahcene Lahsasna and Kabir Hassan, 'The Shariah Process in Product Development and Approval in Islamic Capital Markets' in Kabir Hassan and Michael Mahlkecht, *Islamic Capital Markets: Products and Strategies* (John Wiley & Sons Ltd. 2011) 27.

⁵⁴ *Ibid.*; See also Jean-Benoît Zegers, 'The Legal Framework in Saudi Arabia', in Anthony Shoult, *Doing Business with Saudi Arabia* (GMB Publishing Ltd. 2006) 87.

⁵⁵ IOSCO, *supra* note 51, 5.

"And devour not each other's property among yourselves wrongfully, nor seek to gain access to that by bribing judges so that you devour a part of the property of men wrongfully while ye know".

As for more specific commandments, the prohibition of *riba* has unequivocally remained the most important religious restraint affecting commercial transactions.⁵⁶ Such restraint is repeated in various parts of both the *Quran* and the *Hadith*. Even though there is not full consensus amongst scholars regarding the exact meaning of *riba*, there is a common understanding that it constitutes interest.⁵⁷ More broadly, it could be defined as usury or increase, or as *"an unlawful gain derived from the quantitative inequality of the counter values in a transaction"*.⁵⁸ Interest is described as being abusive, a cause for unjust enrichment, and social injustice and disequilibrium.⁵⁹ The prohibition of interest precludes conventional-style banking, where interest is applied on both deposits and loans. It follows that, for practicing Muslims, capital markets should be preferred over conventional banking as a source of finance and as an investment outlet.⁶⁰

⁵⁶ Umer Chapra and Habib Ahmed have stated that: *"interest-based system of financial intermediation is believed to have been responsible for aggravating not only inequities but also a number of other difficult economic problems"*. See Umer Chapra and Habib Ahmed, *Corporate Governance in Islamic Financial Institutions* (IDB 2002) 7.

⁵⁷ Nangi Sardehi, *Islamic Capital Markets: Developments and Challenges* (VDM Verlag Dr. Muller 2008) 10.

⁵⁸ *Ibid*, 10 and 64.

⁵⁹ It is stated in the *Quran*: (i) *"God has made buying and selling lawful and usury unlawful"* (*Quran* 2:275); (ii) *"Give up all outstanding gains from usury if you are [truly] believers [in Allah]"* (*Verse* 2:278); *"Devour not usury, doubled and multiplied"* (*Quran* 3:130).

⁶⁰ IOSCO, *supra* note 51, 15.

Sharia expressly makes it clear that each human is a regulator and custodian over the parameters and issues falling within such human's control.⁶¹ On a broad level, good regulation would mandate an attempt to exploit any margin for the extraction of additional benefit in the interests of society.⁶² This must be the preoccupation of every righteous regulator and must form the guiding principle behind any reform measure.⁶³

2.2. Relevance to the Saudi Arabian Legal System and on Financial Products

The Saudi Arabian legal system is described by academics as 'bifurcated' or in 'duality', since it is part man-made and part commanded directly by God.⁶⁴ Although the Government of Saudi Arabia enjoys legislative powers, the constitution incorporates Sharia by reference and places it on a higher platform than any man-made law.⁶⁵ Saudi society in its entirety must observe Sharia, including its governmental bodies (legislative, executive and judicial). No legal transaction, court judgment, policy, law,

⁶¹ Prophet Mohamed was quoted as saying: "[e]ach of you is a Sheppard, and each of you will be accountable for his flock" (Muslim, 20:4496).

⁶² As described by Ali Adnan Ibrahim: "Islamic finance embraces the philosophy of risk sharing and the promotion of social and economic welfare which extends beyond profit maximization. [...] Islamic finance is based on an understanding of economic justice." See Ali Adnan Ibrahim, 'The Rise of Customary Business in International Financial Markets: An Introduction to Islamic Finance and the Challengers of International Integration' (2008) 23 American University International Law Review 661. See also Bjorn Sorenson, 'Ethical Money: Financial Growth in the Muslim World', (2008) 23(4) American University International Law Review 647, 649.

⁶³ Prophet Mohamed said: "Every one of you is a guardian, and responsible for what is in his custody. The ruler is a guardian of his subjects and responsible for them". Omar Ibn Al-Khatib, the second Caliph following the death of prophet Mohamed, said: "If a mule stumbled in Iraq, I will be responsible for that before Allah: Why I had not repaired the road for it". Ekrem Erdem, 'The Functions of State in Determining Economic Policies in Islamic Tradition', (2010) Erciyes University - Faculty of Economics 19, 23 <<http://iibf.erciyes.edu.tr/dergi/sayi35/erdem.pdf>> accessed 18 October 2012.

⁶⁴ Amr Marar, 'Saudi Arabia: The Duality of the Legal System and the Challenge of Adapting Law to Market Economies' (2004) 19(1-2) Arab Law Quarterly 91, 108.

⁶⁵ See Articles 1,7,8,11,23, and 48 of the Basic Law of Governance, issued pursuant to Royal Decree A/90, dated 1 March 1992. See also Art. 1 of the Law of Procedure before Sharia Courts, issued pursuant to Royal Decree M/21, dated 19 August 2000, and Article 1 of the Law of Criminal Procedure, issued pursuant to Royal Decree M/39, dated 3 November 2001.

or even constitution must contain any departure from the commandments of Sharia.⁶⁶ For this reason, the examination of any legal question pertaining to the Saudi legal system (e.g. the capital market institutions and transactions) will unavoidably involve assessment under Sharia.

To the extent that a financial product is not Sharia-compliant, it becomes prohibited (*haram*) for Muslims to subscribe therein, such prohibition being punishable in case of transgression, in the least, by loss of spiritual status in the afterlife.⁶⁷ Muslims are required to abstain from investing into products of doubtful compliance.⁶⁸ This generalized self-restraint and abstention has obliged financial institutions across the world to devise distinct products that cater for the values of the Muslim investor.⁶⁹

3. INTERPRETATION OF SHARIA

3.1. Sharia Elucidation and Harmonization

As it is the case with all legal texts, the Quran and the Hadith are also subject to interpretation and differing views regarding their meaning and practical application. Sharia may need to be applied in relation to situations that did not exist during prophet Mohamed's lifetime. As modern-day issues have grown increasingly complex, the formulation of Sharia rulings consistently requires an assessment of the impact on

⁶⁶ *Ibid.*

⁶⁷ Salman Syed Ali, *Islamic Capital Market Products: Developments and Challenges* (IDB 2005) 18.

⁶⁸ Prophet Mohamed said "[t]hat which is lawful is clear and that which is unlawful likewise. But there are certain doubtful things between the two from which it is well to abstain" (Bukhari 2:49). God ordered not to "entrust to those who are weak of judgment the possessions which God has placed in [one's] charge" (Quran 4:5).

⁶⁹ For a summary for the most commonly utilized criteria in the assessment of the Sharia compliance of financial products, see Ali, *supra* note 67, 18-22.

society and an assessment of the degree of compliance with those broad and fundamental commandments of Quran and Sunna.

Interpretative rulings must be reasoned and must succeed in attracting some consensus from a pluralistic and decentralized contemporary Muslim society. Traditionally, Muslims hold particularly in high regard the interpretative rulings of four main scholars: Imam Abu Hanifa, Imam Mohammad Shafei, Imam Malik Ibn Anas and Imam Ahmad Ibn Hanbal. Each of those scholars has amassed a significant level of recognition, to the extent that their individual teachings have each become considered a classical school of jurisprudence.⁷⁰ The said four schools of Islamic jurisprudence, although looked upon distinctively, concur and diverge in opinion on different issues. Within each school, in turn, minority and majority views exist amongst the scholars within them. The Saudi Arabian legal system focuses in great part on the school of Imam Ahmad Ibn Hanbal, although not exclusively. This gives somewhat more predictability to judicial processes, even though the absence of codification and the non-applicability of *stare decisis*, generally characterize the Saudi Arabian legal system as being somewhat unpredictable or 'discoverable'.⁷¹

Clearly, if on a particular matter, a minority view is adopted, one that is not supported by most of the schools of jurisprudence or by the views within each such school, then

⁷⁰ Zegers, *supra* note 54, 88.

⁷¹ On this, the securities regulations of Saudi Arabia, could be drafted in a manner that provides suggested approaches to judicial authorities (and hence a little more certainty to the judicial process). For example, Article 28(3) of the Financial Services and Markets Act of 2000 of the UK states that; "*If the court is satisfied that it is just and equitable in the circumstances of the case, it may allow [...]*". Article 28(4) of the [UK] Financial Services and Markets Act of 2000 adds: "*[i]n considering whether to allow [X or Y] the court must [...]*".

the adoption of such minority view must be clearly mentioned and justified.⁷² Certain Muslims today limit themselves to the rulings of one particular school of jurisprudence, whilst others, depending on the issue, will opt for the opinion with which they are most convinced. This does not prevent Muslims from seeking interpretative rulings from other sources, especially where today's transactional complexity does not seem to be properly addressed in classical writings.⁷³

As the interpretation of Sharia law is simultaneously taking place in many different jurisdictions, at the level of religious, governmental, academic, and corporate institutions, significant uncertainty persists, in the absence of a dominant legislator, as to how Islamic precepts should be applied to increasingly complex commercial transactions.⁷⁴

The value of Islamic financial assets around the globe was estimated at USD 1.3 Trillion in 2011.⁷⁵ With the persisting financial crisis, the interest in accessing Gulf liquidity has grown, entailing a rise in the popularity of financial products marketed under the label of Sharia-compliance.⁷⁶ Nonetheless, with the lack of consensus on applicable criteria, transactional uncertainty translates into transactional deterrence and

⁷² Sorenson, *supra* note 62.

⁷³ Robert Bianchi, 'The Revolution in Islamic Finance' (2006-2007) 7 *Chicago Journal of International Law* 569, 577.

⁷⁴ IOSCO, 'Analysis of the Application of IOSCO's Objectives and Principles of Securities Regulation for Islamic Securities Products' (September 2008) 17.
<<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD280.pdf>> accessed 29 June 2012.

⁷⁵ 'Global Islamic Finance Assets Hit \$1.3 Trillion - Study' *Reuters* (29 March 2012) <<http://www.reuters.com/article/2012/03/29/islamic-finance-growth-idUSL6E8ET3KE20120329>> accessed 15 April 2013.

⁷⁶ Arno Maierbrugger, 'Islamic Finance and Its Asean Dynamics' (6 April 2013) *Gulf Times* <<http://www.gulf-times.com/Mobile/Business/191/details/348210/Islamic-finance-and-its-Asean-dynamics>> accessed 6 April 2013.

financial innovation is generally received with distrust.⁷⁷ A number of scholars have criticized the slow pace of the process of the elaboration and setting of the criteria for the assessment of the Sharia compliance of products or the development of compliant products.⁷⁸ This pace can actually be significantly slowed down if national rule-setting bodies are not properly enabled or if the local transposition of rules set by international bodies is constrained. For this reason, local and international efforts towards the harmonization and conformity of Islamic thought are invaluable to the optimized investment of Islamic wealth.⁷⁹

3.1.1. *Local Efforts*

In 2009, King Abdullah Al-Saoud, issued statements describing the Muslim world as having been “*plagued*” by the great level of interpretations issued by “*unqualified*” individuals.⁸⁰ The Head of the Organization of the Islamic Conference made a similar statement.⁸¹ On 11 August 2010, a Royal Order was issued limiting the right to issue

⁷⁷ Amro Al Souadi, 'The Multitude of Opinions on [Islamic] Jurisprudence Weakens the Legal Certainty of Islamic Banking' *Al Eqtisadiyah* (20 November 2011) <http://www.aleqt.com/2011/11/20/article_599786.html> accessed 16 October 2012. See also Amro Al Souadi, 'The Departure of Fatwas from Sharia Constraints Requires an Intervention by Scholars to Fix What is Happening' *Al Eqtisadiyah* (14 August 2012) <http://www.aleqt.com/2011/08/14/article_569289.html> accessed 16 October 2012.

⁷⁸ Munawar Iqbal, et al., *Challenges Facing Islamic Banking* (IRTI 1998) 46-47.

⁷⁹ Michael McMillen, 'Islamic Capital Markets: Developments and Issues' (2006) 1(2) *Capital Markets Law Journal* 136,147.

⁸⁰ Meetings were also held at the level of both the Muslim World League ("MWL") and the Organization of Islamic Cooperation ("OIC"), to discuss the guidelines around the issuance of fatwa. See Badea, Abu Al Naja, 'Fiqh Academy to Set Guidelines for Fatwa' *Arab News* (15 January 2009) <<http://arabnews.com/?page=1§ion=0&article=118175&d=15&m=1&y=2009>> accessed 11 November 2009. 'King Receives Islamic Scholars' *Arab News* (22 January 2009) <<http://arabnews.com/?page=1§ion=0&article=118431&d=22&m=1&y=2009>> accessed 11 November 2009). See also Badea Abu Al Naja, 'Protect Society from Chaotic Fatwa-Givers: King Abdullah' *Arab News* (18 January 2009) <<http://arabnews.com/?page=1§ion=0&article=118271&d=18&m=1&y=2009>>, accessed 11 November 2009.

⁸¹ Wael Mahdi, 'Head of the OIC Says 'Fatwas Must be Regulated' *The National* (17 August 2010).

fatwas (other than personal fatwas) to those licensed, in addition to the Council of Muftis and the General Presidency of Scholarly Research and Ifta.⁸²

The initiative to regulate the issuance of fatwas has drawn controversy. On one hand, it is believed that since recent fatwas have at times been unreasonable and that, since *muftis* (those who issue fatwas) carry out what resembles legislative functions, it is important to ensure that they be competent. On the other hand, it is believed that restricting the freedom of expression on religious issues does not conform to Islamic values and teachings and may be utilized by governments as a mechanism for censorship and the manipulation of public opinion.

The 11 August 2010 Royal Order severely lacks detail. It does not discuss the requirements for the licensing of muftis. It also does not specify whether members of Sharia boards need to be approved by the Saudi Arabian government. It also does not clarify whether it is permissible to follow non-transposed fatwas issued by foreign religious authorities or even by international institutions of which Saudi Arabia may be a member, and that may be composed of scholars that do not meet local licensing requirements.

In order to prevent excessive control by the government of fatwas issued, it would be advisable that the requirements put in place to license scholars be tied to the fulfillment of clear and fixed criteria. This should help prevent unjustified discrimination by the

⁸² The General Presidency of Scholarly Research and Ifta <<http://www.alifta.net/default.aspx>> accessed 29 June 2012; See also 'Saudi King Limits Clerics Allowed to Issue Fatwas' 17 October 2010 *Al Arabiya News* <<http://www.alarabiya.net/articles/2010/08/12/116450.html>> accessed 15 April 2013.

government by limiting its ability to deny the recognition of scholars that have achieved the minimal required set of competences. The following may serve as inspiration for the type of licensing criteria that may be fixed:

"Indicating the complex nature of Mohammedan legal studies, the fourth stage of legal education, which resulted in the equivalent of our S.J.D. was divided into twelve grades. After finishing the eighth of these grades the student was qualified to become a mufli (jurisconsult) or a provincial judge".⁸³

Since religion touches on all aspects of the life of a believer, fatwas may pertain to a wide spectrum of unrelated domains. It would be preferable if any licensing regime that is put in place requires from the scholars experience in the very domain to which they are assigned. Not all scholars are familiar with the functioning of corporate entities and capital markets and therefore, may not fully understand the issues pertaining thereto.

3.1.2. *International Efforts*

Various influential and acclaimed institutions have taken an active role in the interpretation of Islamic texts and the setting of rules of Sharia. The Accounting and Auditing Organization for Islamic Financial Institutions ("**AAOIFI**"), the Organization of the Islamic Conference ("**OIC**"), the Islamic Financial Services Board ("**IFSB**"), and the Islamic Research and Training Institute ("**IRTI**") affiliated to the Islamic Development Bank ("**IDB**"), represent the most prominent examples.⁸⁴ These organizations have the credibility of being supposedly unconflicted and disinterested

⁸³ Rene Wormser, 'The Legal System of Islam' (1978) 64 American Bar Association Journal 1359, 1361.

⁸⁴ Reuters, 'Most Sukuk Not Islamic, Body Claims' *Arabian Business* (22 November 2007) <<http://www.arabianbusiness.com/most-sukuk-not-islamic-body-claims-197156.html>> accessed 26 November 2010. IOSCO itself has praised the standardization efforts of the AAOIFI. See IOSCO, *supra* note 74, 9; See also Lahsasna and Hassan, *supra* note 53, 35-37.

from the transactions affected from the Sharia issues under their study. The impartiality and accountability of international institutions would be naturally monitored by the continued support and participation of members and especially governmental bodies.⁸⁵ Formulations made at an international level should involve a greater number and variety of academic (and non-political) scholars and should draw from different schools of jurisprudence.

The government of Saudi Arabia should attempt to channel all formulations of Sharia rules and standards through these organizations in order to draw greater international consensus and in order to encourage and facilitate cross-border capital market transactions with other Islamic countries. For the purposes of comparison, the Central Bank of Bahrain has made all AAOIFI standards mandatory, by reference.⁸⁶ If Saudi Arabia is not ready to follow the Bahraini move, it could alternatively simply acknowledge the efforts of Islamic NGOs and transpose into national law only specific those rules and standards that it deems appropriate. Clearly however, Saudi Arabia needs to join more actively the international scholarly community and should disclose the reasoning behind the adoption or disregard of Sharia standards or rules developed at the community level.

4. **ESTABLISHMENT BY CORPORATIONS OF INTERNAL SHARIA COMPLIANCE BOARDS**

⁸⁵ First and foremost, devout scholars should feel accountable to God and should avoid any political or personal motivations in the formulation of religious rules and standards.

⁸⁶ Global Banking Corporation, 'Islamic Finance News: Bahrain Report' (2007) 4.

To attract more confidence in the Sharia compliance of their corporate activities, investments, and/or financial products, institutions certainly have an interest in creating and seeking certifications from Sharia compliance boards composed of individuals that are renowned in the Muslim community.⁸⁷ It has been observed that financial institutions tend to resort to the same small group of individuals for fatwas and board memberships.⁸⁸ Although this would result in greater predictability, it does however raise suspicion that this small group selection is often favored as a result of laxity in its compliance assessments.⁸⁹

The independence of Sharia scholars serving on advisory boards is currently a major concern, as there are often no detailed rules governing their selection or the accomplishment of their role. Surprisingly, Sharia scholars are at times paid, and possibly even employed, by the very entities that they are asked to scrutinize.⁹⁰ More alarming, it appears that the remuneration of Sharia scholars was in certain cases calculated as a percentage of the value of the product for which the opinion was rendered.⁹¹

⁸⁷ McMillen, *supra* note 79, 140.

⁸⁸ 'The Weakness in the Supervisory Authority Over Islamic Banks Have Resulted in the Banks' Loss of Its Competitiveness and Has Weakened its Sharia Compliance' *Al Eqtisadiyah* (21 August 2011) <http://www.aleqt.com/2011/08/21/article_571649.html> accessed 16 October 2012; See also KPMG, 'Frontiers in Finance' (October 2010) 4 <<http://www.algeria.kpmg.com/fr/Documents/Islamic-finance.pdf>> accessed 3 May 2013.

⁸⁹ 'Dr Kholā Alnōbānī, the Specialist Researcher in Islamic Finance: The Islamic Finance Industry Collides with the Self-Interest Thinking and the Neglect of the Underlying Intentions' *Al Eqtisadiyah* (19 June 2011) <http://www.aleqt.com/2011/06/19/article_550543.html> accessed 16 October 2012.

⁹⁰ Sorenson, *supra* note 62, 575.

⁹¹ *Ibid.*

As a solution to the aforementioned concerns, it was suggested to apply to members of Sharia boards the same rules of deontology that apply to auditors.⁹² In this context, safeguards would have to be put in place to ensure the independence, objectivity, and genuineness of the compliance verifications delivered. Otherwise, certain academics warn that many structures may wrongfully and possibly even fraudulently be labeled as Sharia-compliant, to the detriment of public credibility in such label and efforts to maximize investments by observing Muslims.⁹³

As an example of the above suggestion, the Central Bank of Malaysia (Bank Negara) has established the "*Guidelines on the Governance of Shariah Committee for the Islamic Financial Institutions*", applicable to all financial institutions regulated and supervised by the central bank.⁹⁴ All Islamic financial institutions in Malaysia have been required to establish a Sharia committee of at least three members. Appointment and reappointments of committee members are valid only for two years and require the prior approval of the central bank. The guidelines impose requirements relating to qualification, the need to establish a secretariat, the need to avoid situations of conflict, and contain a list of the duties and responsibilities for both the Sharia committee and the financial institution. These include the need for the financial institution to have a Sharia Compliance Manual that is endorsed by the Sharia Committee. Such measures should be replicated in Saudi Arabia, as they would set minimum organizational standards.

⁹² *Ibid*, 653.

⁹³ Bianchi, *supra* note 73, 573.

⁹⁴ Bank Negara Malaysia, *Guidelines on the Governance of Shariah Committee for the Islamic Financial Institutions*, BNM/GPS1, December 2004. See also, Rodney Wilson, 'Regulatory Challenges Posed by Islamic Capital Market Products and Services' (2007) 24 *Journal of Islamic Banking and Finance*, 2 <<http://www.sc.com.my/eng/html/iaffairs/ioscoislamicpdf/regulatorychanges.pdf>> accessed 26 November 2010, 13-14.

5. IOSCO'S RECOMMENDATIONS FOR ISLAMIC CAPITAL MARKETS

IOSCO has given consideration to the particularities of Islamic financial markets and the need for protection of the Muslim investor and has issued recommendations for regulators under whose oversight Sharia-compliant products are offered. Said recommendations do point to areas where the Saudi Arabian government still has not taken action and where attention and focus should be directed. According to IOSCO's recommendations to the regulators of Islamic capital markets, securities regulators should state whether their responsibilities include the regulation of Sharia-compliance, in which case, they should be transparent regarding the underlying rationale behind the rules and/or judgments which they issue.⁹⁵ Certain scholars have argued that the capital market regulator should not itself regulate Sharia-compliance and that it should only put in place the procedural rules governing compliance assessments.⁹⁶

The Capital Market Law of 2003 and the CMA Regulations (as presented in more detail in Section 3 of Part III) do not contain any express indication that any Saudi Arabian governmental body is entrusted in ensuring, directly or indirectly, the Sharia-compliance of products offered in Saudi Arabia's capital markets.⁹⁷ On the other hand, it is wrong to assume that Sharia-compliance forms part of the regular legal and financial due diligence examinations conducted in relation to proposed securities' offers. In reality, the Capital Market Law and the CMA regulations currently do not require the

⁹⁵ IOSCO, *supra* note 74, 5 and 21.

⁹⁶ Wilson, *supra* note 94, 1-2.

⁹⁷ Wilson, *supra* note 94, 1-2.

verification of the Sharia compliance of offered securities.⁹⁸ Such question is usually addressed at the discretion of the proposed issuer alone, if deemed relevant or important to targeted investors.

There are strong arguments for and against the monitoring of the Sharia compliance of securities transactions. The fact that Saudi Arabian law is subordinated to Sharia does create an expectation of some degree of monitoring. However, the CMA is obviously neither competent nor equipped to undertake Sharia compliance verifications. In order not to provoke unsettlement by the investor driven by religious considerations, it is preferable to entrust international non-governmental institutions with the task of monitoring of Sharia issues. International non-governmental institutions could be asked to formulate both Sharia standards and the rules for the selection and functioning of Sharia boards. As discussed in Section 3.1.2 of this Part, the setting of Sharia standards at the international level should help in harmonizing standards across jurisdictions and should help stimulate the fluidity of cross-border transactions.

6. CONCLUSION

This Part has explained the significance of Sharia in the study of capital market laws and regulations. Since Sharia is Saudi Arabia's highest-most constitution, it forms therefore an integral part of capital market laws and regulations. It must be observed not only by issuers, intermediaries, and investors, but also by the regulator itself.

⁹⁸ For instance, listing prospectuses typically contain no evaluation of the Sharia-compliance of the activities of issuers. See CMA, 'Prospectuses' <<http://cma.org.sa/En/Pages/Prospectuses.aspx>> accessed 21 April 2013.

The CMA and the Saudi Arabian government, generally, have adopted a passive stand on the monitoring of Sharia compliance in the corporate sphere. The monitoring task is left entirely to the courts, in case that a breach of Sharia is alleged and in case of a resulting harm. As recommended by IOSCO, the CMA should make it expressly clear whether it does monitor Sharia compliance or whether it does create any substantive rules in that regard. Obviously the CMA is not equipped to carry out either of those functions. Standards for Sharia compliance should ideally be formulated at the level of international NGOs since their formulations have the potential of drawing greater international consensus.

PART III - THE CAPITAL MARKET LAW AND

STRUCTURE

1. INTRODUCTION

Having explained that Saudi Arabian capital markets are primarily regulated by Islamic law, Sections 2 and 3 of this Part will explain the subordinated government-enacted (or ‘man-made’) legal framework and will describe the evolution of such framework. Since the concept of corporate bodies and stock exchanges evolved much later than the layout of the fundamental commandments of Sharia, Sharia cannot therefore be expected to contain the same degree of sophistication as government-enacted legislation and regulation. The success of Saudi Arabian capital markets is dependent on the conciseness and clarity of such government-enacted legal and regulatory framework and on the adequate empowerment, proper organization, and maturity of the regulatory and oversight agencies.

Section 3 will present this framework and will describe how it consists of the Capital Market Law of 2003 and various underlying regulatory instruments. Section 3 will also describe the importance of law setting and law elucidation in the proper organization of capital markets.

Section 4 of this Part will introduce the CMA, the sole regulatory authority vested with the task of overseeing the orderly functioning of Saudi Arabian capital markets and will describe its role, powers and internal setup. This Section will explain the need for the

CMA to preoccupy itself not only by the regulation of market players, but also by the adoption of policies that would allow capital markets to improve societal welfare. Through coordination and planning, it is possible for the CMA to play an important role in that regard, by the catalyzation of the right transactions and the canalization of a part of the derived benefits to prioritized societal segments. Section 4 will describe the importance of CMA accountability and the different levels of accountability. Section 4 will also demonstrate how the CMA could elucidate and improve its processes by borrowing from the experience of other regulators. Improving the dialogue between the CMA and the regulated sector would improve the CMA's ability to understand the market, including such market's needs, concerns, and ability to absorb and adapt to new regulations.

Finally, Section 5 will introduce the Stock Exchange and will explain what it means for the Stock Exchange to be given a separate and distinct legal personality, a process referred to as 'demutualization'. Section 5 will also explain how the demutualization of the Stock Exchange can improve or impede the achievements of the objects of the capital markets.

2. DEVELOPMENTS PRECEDING THE ENACTMENT OF THE CAPITAL MARKET LAW

2.1. Preliminary Observation: Research Limitations

At the start of this Section, it is important to underline that it is difficult for jurists and researchers in Saudi Arabia to locate and find copies of repealed laws.⁹⁹ Some paid

⁹⁹ Alabdulkarim, *supra* note 49, 349-350.

online legislation repositories do keep a database of repealed laws, but these are not comprehensive.¹⁰⁰ This situation is compounded by the fact that much of the legislative/regulatory developments concerning Saudi Arabia's capital markets occurred prior to the age of the internet and therefore kept little trace. That said, this Section relied to a greater extent than usual on secondary data, such as journal articles, academic, and research papers, rather than primary data, such as laws, and regulations.

2.2. Legislative and Regulatory Perspective

Share trading has been possible in Saudi Arabia since 1935 when the first public joint stock company, Arab Automobile Company, was created.¹⁰¹ This company eventually failed.¹⁰² Arab Cement Company, which is still in existence today, was the second company to go public in 1954.¹⁰³ Until the eighties, the market was informal and unorganized.¹⁰⁴ Share trading was only formally regulated in 1984, when a Royal Decree formed a Ministerial Committee consisting of the Minister of Finance and Economy (now referred to as the Ministry of Finance, "MoF"), the Minister of Commerce (now referred to as the Ministry of Commerce and Industry, "MoCI"), and the Governor of the Saudi Arabian Monetary Agency, to develop the necessary capital market rules and regulations and monitor the proper implementation thereof (the

¹⁰⁰ See for example: <<http://mohamoon-ksa.com>> and <<http://www.saudilaws.net/>> accessed 6 April 2013.

¹⁰¹ Mesfer Al-Ajmi, 'Gulf Equity Markets: A Comparison of the Structure and Performance' (DPhil thesis, University of Warwick 1994) 43.

¹⁰² Ibid.

¹⁰³ Mohammad Al-Suhaibani, 'Three Essays on the Market Microstructure of the Saudi Stock Market' (DPhil thesis, University of Concordia, 1998) 7-8 <<http://spectrum.library.concordia.ca/521/1/NQ39618.pdf>> accessed 5 April 2013.

¹⁰⁴ Aljazira Capital, *supra* note 14, 1.

"**Ministerial Committee**").¹⁰⁵ The MoF was responsible to set the overall policies and objectives of the stock market. The MoCI was responsible to set the rules governing the incorporation, capitalization, internal management, and conversion of companies (i.e. conversion from a closed to a public form).¹⁰⁶ These rules were principally contained in a few number of provisions of the Companies Law of 1965. Finally, SAMA was assigned the day-to-day operation and control of market activity and it established for such purpose the Shares Control Administration Division.¹⁰⁷ It was estimated that, immediately prior to the creation of the tripartite committee in 1984, the market consisted of fifty public companies and eighty unregulated brokers.¹⁰⁸

Local banks became the only authorized brokers in such market.¹⁰⁹ In 1984, the Saudi Registration Company ("SSRC") was established amongst the banks, which acted as an exchange between them and carried out settlement and clearance operations.¹¹⁰ Banks did not have to trade through the SSRC central exchange but were required however to

¹⁰⁵ Andrea Pampanini, *Saudi Arabia: Moving Towards a Privatized Economy* (Turnaround Associates Inc. 2005) 102; see also Mohammad Al-Suhaibani and Lawrence Kryzanowski, 'Limit vs. market Order Trading on the Saudi Stock Market' (EFMA 2001 Lugano Meetings, 26 April 2001) 3 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=271450> accessed 5 April 2013.

¹⁰⁶ Royal Decree No. 1320/8. Osama Alatiki, 'Identifying the Information Dissemination Technology Used in the Saudi Stock Market', (M.Sc. research paper, University of Wisconsin Stout 2003) 6-9, <<http://www2.uwstout.edu/content/lib/thesis/2003/2003alatikio.pdf>> accessed 5 April 2013; See also Ibrahim Onour, 'Testing Weak-Form Efficiency of Saudi Stock Exchange Market' (School of Management Studies, University of Khartoum, 26 October 2004) 4-5 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=611209> accessed 5 April 2013; See also Mohamed Ramady, *The Saudi Arabian Economy: Policies, Achievements and Challenges* (Springer 2005) 154.

¹⁰⁷ Al Ajmi, *supra* note 101, 51.

¹⁰⁸ Kirt Butler and S.J. Malaikah, 'Efficiency and Inefficiency in Thinly Traded Stock Markets: Kuwait and Saudi Arabia' (1992) *Journal of Banking and Finance* 199. Al Ajmi, *supra* note 101, 50.

¹⁰⁹ MEP, *supra* note 3, 164.

¹¹⁰ See Ayed Al Ayed, 'Historical Development of the Electronic Trading System and Technology', (Third Quarter, 2007) *Tadawul*, 24.

report transactions to the SSRC.¹¹¹ In turn, the SSRC reported trades on a daily basis to SAMA.¹¹² It actually appears that banks often chose to themselves match buyers and sellers within their own client base, instead of resorting to the SSRC forum.¹¹³ This may have been justified by a pursuit of higher commission margins. Perhaps this was the reason why SAMA imposed a maximum brokerage commission of 1% of transaction value.¹¹⁴ Perhaps also the commission cap was placed to reduce overall transaction costs which observers claim were high and contributed to operational inefficiency.¹¹⁵

Interestingly, banks were not allowed to own stocks. Only cash settlements were permitted and bidders had to deposit in advance the value of solicited shares.¹¹⁶ This situation is believed to have resulted in the creation of a group of some 50 active investors, described as 'market makers'.¹¹⁷ The literature does not clarify whether some of those investors were amongst the unlicensed brokers operating prior to the first regulation of the stock market. These investors apparently had their own bid and ask prices and traded stock for their own account and that of others (through banks).¹¹⁸

Mutual funds were available to investors. It appears however that, prior to the enactment of the Capital market Law of 2003, only nine mutual funds were in existence

¹¹¹ Butler and Malaikah, *supra* note 108, 199.

¹¹² *Ibid.*

¹¹³ *Ibid*; See also Al Ajmi, *supra* note 101, 53.

¹¹⁴ *Ibid*; Mohammed Al-Dohaiman, 'Capital Structure in Saudi Arabian Listed and Unlisted Companies' (DPhil thesis, University of Sterling 2008) 112.

¹¹⁵ Butler and Malaikah, *supra* note 108, 210.

¹¹⁶ *Ibid.*, 199.

¹¹⁷ *Ibid.*, 200.

¹¹⁸ *Ibid.*

with total combined assets of not more than SR 422 million.¹¹⁹ The government also issued bonds in 1988 while SAMA issued treasury bills in 1991 as an attempt to further develop the capital market.¹²⁰

A study conducted in 1992 claimed that the Saudi stock exchange's operational inefficiency impacted adversely on its allocational efficiency as well as overall economic growth.¹²¹ Operational inefficiency was confirmed in another study conducted in 2001 which observed that stock prices were not reflective of the true economic value of public companies.¹²² As acknowledged in 1989 by Saudi Arabia's former Minister of Finance himself: "*the [Saudi] stock market is still, to a large extent, fragmented and lags far behind the growing needs of the country*".¹²³ In its Fifth Development Plan (1990-1995), the Ministry of Economy and Planning described an even more distressing situation:

*"The current stock exchange mechanism is rather slow and very complicated, as the processing of a stock issue can take up to two years. Individual stock transactions require between one week to two months to complete and, more often than not, the buyer must reach the seller by his own means. Thus, blocks of shares may not be broken up to match the needs of buyers. These obstacles result in significant gaps between bid and asking prices".*¹²⁴

¹¹⁹ Beach, *supra* note 6, 310.

¹²⁰ Albatel, *supra* note 128, 171.

¹²¹ Butler and Malaikah, *supra* note 108, 210.

¹²² Abuzar Eljelly and Khalid Alghurair, 'Performance Measures and Wealth Creation in an Emerging Market: The Case of Saudi Arabia' (2001) 11 *International Journal of Commerce and Management* 3/4, 65.

¹²³ Obaid Almotairy et al., 'The Saudi Equity Investor: A Descriptive Survey' (1995) 5 *International Journal of Commerce and Management* 3, 76.

¹²⁴ The Fifth Development Plan's underlying goal was to mobilize domestic savings towards the industrialization of Saudi Arabia. It therefore emphasized the importance of developing Saudi Arabia's stock exchange. See MEP, *supra* note 3, 164; See also Aljazira Capital, *supra* note 14, 1.

Approximately 75 out of 80 investors surveyed in December of 1993 and January of 1994 felt that the Saudi Arabian stock market was neither efficient nor effective.¹²⁵ They indicated that insufficient market information was being disseminated to them.¹²⁶ Prospectus requirements were actually insignificant and covered only basic corporate information.¹²⁷

The government had adopted measures to incentivize investments in the stock market. Newly issued shares were offered at par value in order to share with the public a greater part of the gains achieved by the private sector.¹²⁸ Public offerings did help in attracting investor interest.¹²⁹ In fact, the Saudi stock market had by 1996 the greatest capitalization amongst GCC markets.¹³⁰ In a bid to further improve the trading environment, the Ministerial Committee issued in 1997 disclosure rules that imposed continuing secondary market disclosure obligations on issuers.¹³¹ The disclosure rules of 1997 were described as broad and "*lack[ing] concern for sensitive information likely to have an effect on share prices of listed companies*". Also, they did not address the issue of listing disclosures which constituted a weakness that was yet to be addressed.¹³² The

¹²⁵ Almotairy et al., *supra* note 123, 77, 83-85.

¹²⁶ *Ibid*; See also Monica Malik, 'The Private Sector and the State in Saudi Arabia' (DPhil thesis, Durham University 1999), 244 and 252-254.

¹²⁷ Article 55 of the Companies Law of 1965; See also Beach, *supra* note 6, 315.

¹²⁸ Abdullah Albatel, 'Financial Development and Economic Growth in Saudi Arabia' (December 2000) 16 *Journal of Economic and Administrative Sciences* 170.

¹²⁹ *Ibid*.

¹³⁰ Beach, *supra* note 6, 310.

¹³¹ Awwad, *supra* note 24, 242-250.

¹³² *Ibid*, p. 50.

disclosure rules of 1997 also prohibited trading based on non-public information, but it was argued by academics that, in this respect, the rules lacked clarity and conciseness.¹³³

Even if the Saudi stock market was the most capitalized in the GCC region, it was nevertheless believed that it performed poorly.¹³⁴ As acknowledged by the MEP in the Seventh Development Plan:

"Market capitalization at about 40 percent of GDP by the end of 1417/18 (1997) is low by international standards. Only 74 companies are listed in the stock market, while trading of shares, which takes place through commercial banks, is below target levels and is dominated by transactions in a few companies. Since 1415/16 (1995), the volume of investment in new stock issues has been low compared to the total value of market capitalization, and below the saving potential of individuals and their manifest interest in stock market investments."¹³⁵

As acknowledged by the MEP, the lack of investor confidence in the local capital markets resulted in significant capital outflows.¹³⁶ According to the MEP's estimation, the size of assets held by Saudi investment funds abroad exceeded by tenfold the size of the assets that they held locally.¹³⁷ Obviously, the government was aware of an urgent need to reform the capital market regulations.¹³⁸ As observed by Beach:

"[...] the Regulations for Companies [of 1965] were inadequate to the task of establishing a formal stock exchange in Saudi Arabia. Such an institution was outside the scope and authority of the Regulations. Only new legislation tailored to the capital markets and addressing, among other items, the gaps existing in the Regulations, would be sufficient. This statement was

¹³³ *Ibid.*, 288 and 334.

¹³⁴ Al Ajmi, *supra* note 101, 285.

¹³⁵ Section 7.5.2.3 of the MEP's Seventh Development Plan.

¹³⁶ Section 7.5.2.6 of the MEP's Seventh Development Plan; See also Beach, *supra* note 6, 311.

¹³⁷ *Ibid.*

¹³⁸ Section 7.5.3 of the MEP's Seventh Development Plan

*especially true in light of the arbitrary and ad hoc nature of Saudi government enforcement of existing regulations".*¹³⁹

Regulatory gaps included issues that are now widely considered as prerequisites for effective systemic functioning. For instance, there were no adequate rules and there was no adequate supervision concerning deceptive practices or the conduct of intermediaries.¹⁴⁰

2.3. Technological Perspective

From a technological perspective, SAMA introduced a new trading platform in 1990 for the processing of sale and purchase orders through a centralized system operated by SAMA and named 'Electronics Securities Information Systems' ("ESIS"). Both the bank trading units and the CRSC's depository and registration records were linked into ESIS, which permitted the clearance, settlement, and registration of transactions.¹⁴¹

In 2001, ESIS was upgraded and renamed Tadawul.¹⁴² In 2005, the CMA purchased a new software system capable of clearing over 2 million transactions a day.¹⁴³ Technology of the sort is essential to preserve the legal rights of market participants and to organize the relationships between them. Technology of the sort may also help

¹³⁹ Beach, *supra* note 6, 314 and 317.

¹⁴⁰ *Ibid.*

¹⁴¹ Beach, *supra* note 6, 313; See also Al-Suhaibani and Kryzanowski, *supra* note 105, 3; See also Al-Dohaiman, *supra* note 114, 112.

¹⁴² Beach, *supra* note 6, 310.

¹⁴³ *Ibid.* See also 'The New Tadawul System, A Total Transition Which Would Satisfy the Future Requirements of the Capital Market', (Third Quarter, 2007) *Tadawul*, 18-19.

palliate the under-development of the regulatory structure, since the implementation of the trading software would imply protocols for the organization of transactions.¹⁴⁴

Investor confidence is dependent on the systemic ability to efficiently process the large amount of legal transactions occurring simultaneously and to ensure these are carried out smoothly. It was estimated in some exchanges that a move to computerized trading from verbal outcry trading (i.e. verbally conveyed bids and offers) can achieve savings of at least forty percent in the costs of the running of the exchange. Since these costs are usually passed on to investors, computerized trading should therefore reduce transactional costs.¹⁴⁵ Actually, computerized trading can also help in lengthening trading hours, in improving market accessibility for investors (especially the retail, non-institutional clients), and in enhancing transactional fluidity since transactions are made without lag and from remote environments.¹⁴⁶

3. THE ENACTED LEGAL AND REGULATORY FRAMEWORK

3.1. The Capital Market Law

In 2003, the Saudi Arabian legislator issued the Capital Market Law, as a response to the calls for reforms.¹⁴⁷ It is now clear that:

¹⁴⁴ Beach, *supra* note 6, 311.

¹⁴⁵ John Board, et al., *Transparency and Fragmentation: Financial Market Regulation in a Dynamic Environment* (Palgrave MacMillan 2002) 56.

¹⁴⁶ *Ibid*, 21, 45-46, 266-267. See also Scott McCleskey, *Achieving Market Integration: Best Execution, Fragmentation and the Free Flow of Capital* (Butterworth – Heinemann 2004) 92.

¹⁴⁷ Awwad, *supra* note 24, 337-338.

"[...] the CML, almost in its entirety, [was] transplanted from the American system. The provisions are identical; the language is the same and the bureaucratic structure is the same."¹⁴⁸

The data set out below adds considerable support to the notion that the Capital Market Law of 2003 invigorated the market:¹⁴⁹

Year	General Index	Number of Transactions (millions)	Number of Traded Shares (billions)	Value of Traded Shares (SR billions)	Market Capitalization (SR billions)
1999	2,028.5	0.44	0.53	56.6	228.59
2000	2258.3	0.45	0.56	65.3	254.47
2001	2430.1	0.60	0.70	83.6	275.66
2002	2,518.1	1.03	1.73	133.8	280.73
2003	4,437.6	3.76	5.56	596.5	589.93
2004	8,206.2	13.31	10.29	1,773.9	1,148.60
2005	16,712.6	46.60	70.81	4,138.7	2,438.20
2006	7,933.3	96.09	72.74	5,261.9	1,225.86
2007	11,038.7	65.66	61.73	2,557.7	1,946.35
2008	4,803.0	52.13	60.82	1,962.9	924.53
2009	6,121.7	36.46	57.34	1,246.0	1,195.51
2010	6,620.7	19.54	33.01	759.18	1,325.39
2011	6,417.7	25.55	48.26	1,098.84	1,270.84
2012	6,801.2	42.11	82.54	1,929.32	1,400.34

¹⁴⁸ Bushra Ali Gouda, *supra* note 15, 169-170; See also Beach, *supra* note 6, 307-308.

¹⁴⁹ Table 15.3, Section 15.2.4 of the MEP's Eight Development Report, <<http://www.mep.gov.sa/inetforms/themes/clasic/file/download.jsp;jsessionid=7E899213206AF3C2663A38174C395FEB.alfa?FileAttribute=DownloadTranslation.Content&TableName=DownloadTranslation&DownloadTranslation.ObjectID=173>> accessed 30 May 2013; See also Table 17.2, Section 17.2.3 of the MEP's Ninth Development Report, <<http://www.mep.gov.sa/inetforms/themes/clasic/file/download.jsp;jsessionid=C37941E6E547D26DF39A4DD258BB866E.alfa?FileAttribute=DownloadTranslation.Content&TableName=DownloadTranslation&DownloadTranslation.ObjectID=615>> accessed 6 April 2013. See also Saudi Stock Exchange, 'Annual Statistical Report - 2008' 23-26 <http://www.tadawul.com.sa/static/pages/en/Publication/PDF/Annual_Report_2008_English.pdf> accessed 6 April 2013; See also Saudi Stock Exchange, 'Annual Statistical Report - 2009' 2 <http://www.tadawul.com.sa/static/pages/en/Publication/PDF/Annual_Report_2009_English.pdf> accessed 30 May 2013; See also Saudi Stock Exchange, 'Annual Statistical Report - 2010' 2 <http://www.tadawul.com.sa/static/pages/en/Publication/PDF/Annual_Report_2010_English.pdf> accessed 30 May 2013; See also Saudi Stock Exchange, 'Annual Statistical Report - 2011' 2 <http://www.tadawul.com.sa/static/pages/en/Publication/PDF/Annual_Report_2011_English.pdf> accessed 30 May 2013; See also Saudi Stock Exchange, 'Annual Statistical Report - 2012' 2 <http://www.tadawul.com.sa/static/pages/en/Publication/PDF/Annual_Report_2012_EN.pdf> accessed 30 May 2013; See also Al-Dukheil, *supra* note 45, 21.

It should be noted that the 2006 decline was attributed to a "*correction*" of unjustified rises in stock prices resulting from dominance by uneducated and "*irrational*" retail investors.¹⁵⁰ As for the 2008 decline, it was attributed to the "*overwhelming state of doubt and uncertainty*" caused by the global financial crisis and also to the decline of international oil prices.¹⁵¹

The Capital Market Law of 2003 is what some refer to as a primary enabling statute.¹⁵² The main object of the Capital Market Law of 2003 is to: (i) define the main governmental bodies responsible for the regulation, supervision, and enforcement of capital market transactions, (ii) define the powers and roles of said bodies and divisions, (iii) broadly describe the mechanics of the new trading platform created, and (iv) define the minimum standards to be followed by capital market participants. The capital market institutions created comprise the CMA, the Stock Exchange, the Securities Depository Center, and the Committee for the Settlement of Securities Disputes.¹⁵³

3.2. *The International Organization of Securities Commissions*

¹⁵⁰ MEP, 'Ninth Development Report', *supra* note 149, 300; See also, SAMBA, 'The Saudi Stock market: Structural Issues, Recent Performance and Outlook' (December 2009) 5 <http://www.samba.com/GblDocs/Saudi_Stock_Market_Eng.pdf> accessed 30 May 2013; See also Ibnrubbian, *supra* note 39, 5.

¹⁵¹ MEP, 'Ninth Development Report', *supra* note 149, 301.

¹⁵² Beach, *supra* note 6, 320.

¹⁵³ Articles 4, 20, 25, and 26 of the Capital Market Law of 2003.

The CMA is a member of the Union of Arab Securities Authorities and IOSCO.¹⁵⁴ IOSCO considers that, generally, a system of securities regulation is proper and effective if it achieves the three following objectives (the "**IOSCO Objectives**"): (i) the investors are protected, (ii) the markets are fair, efficient, and transparent, and (iii) systemic risk is contained. 38 principles (the "**IOSCO Principles**") have been identified which, if properly applied, can help achieve the IOSCO Objectives. IOSCO Principles are mainly aimed at systemic efficiency.¹⁵⁵

As confirmed by the IMF, the Saudi Arabian capital market laws and regulations "*fully or broadly implement most of the IOSCO Principles*".¹⁵⁶ However, the difficulty is not in the replication (or the pasting) into the national laws of provisions taken from whatever source. The real challenge is to be able to elucidate these provisions to those to whom they apply and to ensure their observance and efficacy. The efforts of the CMA in this regard will be presented in the later Sections of this Part.

3.3. *The CMA Regulations*

¹⁵⁴ IMF, 'Saudi Arabia: Reports on the Observance of Standards and Codes' (IMF Country Report No. 12/93, April 2012) 12 <<http://www.imf.org/external/pubs/ft/scr/2012/cr1293.pdf>> accessed 17 October 2012. See also CMA, 'Annual Report 1432/1433 H. (2011)' 14 <http://cma.org.sa/En/Publicationsreports/Reports/CMA_Annual_Report_2011_EN.pdf> accessed 21 September 2012.

¹⁵⁵ IOSCO, 'Objectives and Principles of Securities Regulation' (June 2010) <<http://iosco.org/library/pubdocs/pdf/IOSCOPD323.pdf>> accessed 1 September 2011.

¹⁵⁶ IMF, 'Saudi Arabia: Financial System Stability Assessment - Update' (IMF Country Report No. 12/92, April 2012) 34 <<http://www.imf.org/external/pubs/ft/scr/2012/cr1292.pdf>> accessed 17 October 2012. For a detailed report on the Saudi Arabia's implementation of the IOSCO Principles, see IMF, *supra* note 154, 10-18. Regarding the compliance of the Corporate Governance Regulations of 2006 with international standards, see Mohammed T. Alsanosi, 'Corporate Governance: The Saudi Arabian Capital Market and International Standards' (DPhil thesis, University of Leicester 2010) 240 and 246.

Based on the powers conferred to it pursuant to Article 6(2) of the Capital Market Law of 2003, the CMA has issued the following regulations in implementation of the Capital Market Law of 2003 (the "**CMA Regulations**"):

- 1) the 2004 Glossary of Defined Terms Used in the Regulations and Rules of the Capital Market Authority, which define the key terms utilized in the Capital Market Regulations (the "**Glossary**");¹⁵⁷
- 2) the Offer of Securities Regulations of 2004, which distinguish between the various types of offers (public offers and private placements) and present the eligibility criteria and procedure for each;¹⁵⁸
- 3) the Listing Rules of 2004, which describe the criteria and procedure for listing of securities on the Stock Exchange;¹⁵⁹
- 4) the Securities Business Regulations of 2005, which distinguish between the different categories of securities business activities and subject any such activity to licensing;¹⁶⁰
- 5) the Authorized Persons Regulations of 2005, which describe the criteria and procedure for the licensing of securities firms and which describe the different professional obligations to which they are bound in the carrying out of their activities;¹⁶¹
- 6) the Market Conduct Regulations of 2004, which prohibit certain acts and practices which would impede the fairness and transparency of the market;¹⁶²

¹⁵⁷ issued pursuant to Resolution No. 4-11-2004, dated 4 October 2004.

¹⁵⁸ issued pursuant to Resolution No. 2-11-2004, dated 4 October 2004.

¹⁵⁹ issued pursuant to Resolution No. 3-11-2004, dated 4 October 2004.

¹⁶⁰ issued pursuant to Resolution No. 2-83-2005, dated 28 July 2005.

¹⁶¹ issued pursuant to Resolution No. 1-83-2005, dated 28 July 2005.

¹⁶² issued pursuant to Resolution No. 2-11-2004, dated 4 October 2004.

- 7) the Investment Funds Regulations of 2006, which list the conditions for the licensing, establishment, and management of an investment fund and the offer of units therein;¹⁶³
- 8) the Real Estate Investment Funds Regulations of 2006, which list the conditions for the licensing, establishment, and management of a real estate investment fund and the offer of units therein;¹⁶⁴
- 9) the Corporate Governance Regulations of 2006, which describe the various internal controls that listed companies must observe to ensure the protection of shareholders' rights;¹⁶⁵
- 10) the Merger and Acquisition Regulations of 2007, which define the rules applicable in the case of a proposed takeover involving any listed company;¹⁶⁶
- 11) the 2011 Regulating Procedures for Resolution of Securities Disputes, which define the rules governing the procedure, evidence, and appeal of cases brought before the Committee for the Resolution of Securities Disputes;¹⁶⁷ and
- 12) the Prudential Rules of 2012, which specify the requirement for the financial prudence of securities firms.¹⁶⁸

3.4. Elucidation of the Law

3.4.1. Absorptive Capacity for Set Rules

¹⁶³ issued pursuant to Resolution No. 1-219-2006, dated 24 December 2006.

¹⁶⁴ issued pursuant to Resolution No. 1-193-2006, dated 15 July 2006.

¹⁶⁵ issued pursuant to Resolution No. 1-212-2006, dated 12 November 2006.

¹⁶⁶ issued pursuant to Resolution No. 1-50-2007, dated 3 November 2007.

¹⁶⁷ issued pursuant to Resolution No. 1-4-2011, dated 23 January 2011.

¹⁶⁸ issued pursuant to Resolution No. 1-40-2012, dated 30 December 2012.

Since the legal profession in Saudi Arabia has not yet reached the organizational sophistication of Western jurisdictions, it is important that law-makers ensure the ability for legal practitioners to themselves comprehend the laws put in place.¹⁶⁹ Capital market laws are by nature fairly detailed and complex. For this reason, they must be laid down in a manner that does not unduly discourage transactional activity and innovation.¹⁷⁰ The Capital Market Law of 2003 and the CMA Regulations were generally well tailored to the sophistication and absorption ability of the legal practitioners at the time of enactment. This is largely due to the fact that a number of Saudi Arabian firms have been working in association with Western firms and lawyers who had strong experience in the typical tasks involved with capital market transactions.¹⁷¹

As an attempt to elucidate the meaning of the technical terms employed in the Capital Market Law of 2003, the legislator incorporated a definitions' section in the Capital Market Law of 2003.¹⁷² The CMA has done a similar effort by issuing the Glossary.¹⁷³ Despite this fact, there remained a number of grey areas which had created considerable confusion. Examples of grey areas, now elucidated, are presented in the later sections of this thesis, such as those relating to the requirement for limited liability companies to

¹⁶⁹ Actually, the first Saudi Arabian Code of Legal Practice, setting out the requirements to practice the legal profession, was only enacted in 2001. The Code of Legal Practice, issued pursuant to Royal Decree No. M/38, dated 15 October 2001.

¹⁷⁰ See Alan Rechtschaffen, *Capital Markets, Derivatives and the Law*, (Oxford University Press 2009) xxvii.

¹⁷¹ For an overview of the Saudi Arabian legal market, see The Legal 500 <<http://www.legal500.com/c/saudi-arabia>> accessed 29 June 2012.

¹⁷² Chapter 1 of the Capital Market Law of 2003.

¹⁷³ The 2004 Glossary of Defined Terms Used in the Regulations and Rules of the Capital Market Authority.

abide by the offering requirements of the Offer of Securities Regulations of 2004.¹⁷⁴ It used to be wrongfully argued by some market professionals that the Offer of Securities Regulations of 2004 did not apply to limited liability companies and that shares issued by limited liability companies could be offered without CMA oversight. This interpretation was based on the misunderstanding of Article 3(b) of the old version of the Offer of Securities Regulations 2004 which stated that: “*Securities issued by a company in the Kingdom may not be offered unless the company is a joint stock company*”. This provision was removed by the CMA in its 2008 amendment of the Offer of Securities Regulations of 2004.

3.4.2. Interpretative Reports and Bulletins

The CMA should, in the same way it is done by the U.S. Securities and Exchange Commission (“SEC”), publish interpretative legal bulletins to facilitate the comprehension and elucidate the spirit of regulatory instruments.¹⁷⁵ The website of the SEC contains ‘Staff Legal Bulletins’ which summarize the interpretations and policies followed by the various divisions of the commission.¹⁷⁶

Even if the CMA did issue bulletins expressed to be non-binding, these bulletins would nevertheless be valuable.¹⁷⁷ Saudi is a jurisdiction operating mainly on recently enacted

¹⁷⁴ Article 3(b) of the Offer of Securities Regulations of 2004 (as on 21 December 2004).

¹⁷⁵ Amelia Fawcett, ‘Examining the Objectives of Financial Regulation’, in Ellis Ferran and Charles Goodhart (eds), *Regulating Financial Services and Markets in the Twenty First Century* (Hart Publishing 2001), 46-48. See also IMF, *supra* note 154, 19.

¹⁷⁶ SEC, ‘Staff Legal Bulletins’ <<http://www.sec.gov/interps/legal.shtml>> accessed 22 August 2009.

¹⁷⁷ Julia Black et al., ‘Making a Success of Principles-Based Regulation’ (May 2007) *Law and Financial Markets Review* 191, 197 <http://www.lse.ac.uk/collections/law/projects/lfm/lfmr_13_blacketal_191to206.pdf> accessed 15 June 2013.

laws, where uncertainty often translates into either loss of opportunities or the unintended breach of intended restrictions. As an example, the Offer of Securities Regulations of 2004 at one point referred to “exempt offers” as a category of offers distinct from public offers and private placements. Contrary to what the term suggested, offers categorized as being exempt still required the CMA’s approval (in the same way as public offers and private placements) and therefore enjoyed no practical exemption. Eventually, the CMA amended the Offer of Securities Regulations of 2004 so to remove the exempt offer category and to clarify that all offering forms, without exception, required the CMA’s approval.¹⁷⁸

3.4.3. *Consultative Initiatives*

For the regulator to efficiently discharge its functions, it must have an ‘ear against the ground’ and must be able to understand business dynamics so not to unduly interfere therewith. Rule formation, application, and enforcement require continuous monitoring of the comprehension level and the concerns of the regulated and the affected. The CMA should avoid abruptness and overregulation and may, in certain circumstances, find it preferable to gradually introduce rules over phases. The regulator should verify that regulated parties have the ability to comply with enacted rules and that the conditions required for such compliance are not overwhelming. Overregulation could cause distress at the level of the regulated in case penalties are applied against unavoidable breaches. Overregulation could alternatively cause a loss of influence and

¹⁷⁸ See PART IV - 5.1.

command at the level of the regulator if the rules of this latter remain unenforced.¹⁷⁹ As explained below, the CMA should engage in regular consultation processes either through the setup of consultative committees or the invitation of consultative papers.

Consultative Committees - Apart for the requirement, under Article 22(b) of the Capital Market Law of 2003, that four members from licensed brokerage companies form part of the Board of Directors of the Exchange, the Capital Market Law of 2003 does not integrate any requirement on the CMA to conduct consultations with licensed firms, issuers, or investors. For comparative purposes, Articles 8-11 of the Financial Services and Markets Act of 2000 requires the Financial Services Authority (“FSA”) to establish and maintain firm and investor panels, and to consider and respond, in writing, to all representations communicated by such panels.¹⁸⁰ The CMA should replicate such a practice so to adapt to and increase the level of sophistication of the regulated sector.

Consultative Papers - It is unimaginable to expect the regulated to achieve high levels of compliance, if they are not properly notified of amendments to regulations. Practitioners cannot rely on the printed copies of regulatory instruments and must often consult the CMA's website to verify whether any changes have been integrated. The CMA should invest in educational campaigns when introducing new provisions so to notify the regulated sector of those provisions and so to explain the rationale therefor. For

¹⁷⁹ OECD, ‘OECD Principles of Corporate Governance’ (OECD 2004) 30 <<http://www.oecd.org/dataoecd/32/18/31557724.pdf>> accessed 1 September 2011.

¹⁸⁰ Section 10 of the Financial Services and Markets Act of 2000 (Act of the Parliament of the United Kingdom, c. 8, Royal Assent on 14 June 2000) <<http://www.legislation.gov.uk/id?title=Financial+Services+and+Markets+Act+2000>> accessed 23 October 2012.

comparative purposes, the FSA acknowledged, in its experience, the importance and usefulness of educational campaigns when introducing new laws.¹⁸¹

Article 5(b) of the Capital Market Law of 2003 expressly states that the CMA “*may publish a draft of regulations and rules before issuing or amending them*”. It is definitely valuable that the CMA has been using this discretion to post on its website the text of proposed regulatory provisions (new instruments or amendments). For instance, the CMA has, in December 2012, published on its website the draft of the Credit Rating Agencies Regulations and has invited comments from the public, to be sent by email.¹⁸²

The CMA should however also publish the comments that it receives from the industry as well as the CMA’s response to these. Less sophisticated players in the industry would benefit from the dialogue that would be published and would understand the type of issues that are normally encountered by more sophisticated peers. The comments received would also help identify stakeholders, understand how they would be affected by contemplated enactments, and safeguard and integrate their interests more effectively.

In the case of amendments to draft or existing regulations, regulators and law-makers must use stylistic support. Though it may appear to be trivial, the manner in which amendments are presented can help accommodate practitioners' busy schedules and help

¹⁸¹ FSA, ‘Listing Regime Review’ (Consultation Paper 09/24, October 2009) 4. <http://www.fsa.gov.uk/pubs/cp/cp09_24.pdf> accessed 27 November 2009.

¹⁸² CMA, ‘An Announcement Regarding the Publication of the Draft Credit Rating Agencies Regulations for Public Consultation’ (10 December 2012), issued by way of CMA Resolution No. 1-38-2012 dated 10 December 2012 <http://cma.org.sa/En/News/Pages/CMA_N_1244.aspx> accessed 15 April 2013.

them quickly see what changes the regulator is attempting to introduce. The FSA and the Autorité des Marchés Financiers (“AMF”), the securities regulator of France, for example present changes in 'blackline' form, with changes shown in a different colour and deletions appearing as crossed out.¹⁸³ A greater service for the community of practitioners would be to explain the rationale behind the amendments made.

The FSA's interaction with the regulated is conducted on an open-basis. The FSA publishes all consultation papers on its website. As the FSA wrote in one of its consultations papers:

*"This dialogue between the regulator and market participants is one of the key elements in helping us to ensure an appropriate balance between the interests of issuers and investors and contributes to the uniqueness of the London capital markets."*¹⁸⁴

The CMA should also publish consultation papers on its website so to invite dialogue and raise the levels of understanding and sophistication of the regulated sector.

3.4.4. Reviews

Although not expressly required in the Capital Market Law of 2003, the CMA should review its regulatory approach and performance through periodic reviews, including terrain and field studies. It is normal for regulators, when issuing new rules, or when enforcing existing rules, to evaluate the level of success in the implementation of regulatory objectives. Borrowing from the UK experience, it could be observed that

¹⁸³ See for example, FSA, 'UCITS IV Directive Instrument 2011' (FSA 2011/39) <http://media.fsahandbook.info/Legislation/2011/2011_39.pdf> accessed 19 September 2012.

¹⁸⁴ FSA, *supra* note 181.

reviews may be ordered and conducted at various levels, such as by the UK Chancellor, the Supervisory Enhancement Programme (the "SEP"), or at the level of the FSA itself.¹⁸⁵ The Capital Market Law of 2003 states expressly that the CMA is empowered to conduct studies.¹⁸⁶ The CMA should therefore dedicate a budget for the periodic evaluation of the strengths, weaknesses, opportunities, and threats relating to the functioning of Saudi Arabian capital markets.

4. ROLE AND FUNCTIONS OF THE CMA

4.1. Role of the CMA

The CMA has been assigned with the duty, and was vested with all necessary authorities, to discharge the following functions:¹⁸⁷

- (a) regulate and develop the Stock Exchange;
- (b) seek to develop and improve methods of systems and entities trading in securities;
- (c) develop the procedures that would reduce the risks related to securities transactions;
- (d) regulate the issuance of securities and monitor securities and dealing in securities;
- (e) regulate and monitor the works and activities of securities firms;
- (f) protect citizens and investors in securities from unfair and unsound practices or practices involving fraud, deceit, cheating or manipulation;
- (g) seek to achieve fairness, efficiency and transparency in securities transactions;
- (h) regulate and monitor the full disclosure of information regarding securities and their issuers, the dealings of informed persons and major shareholders and investors, and

¹⁸⁵ See, for instance: HM Treasury, 'Reforming Financial Markets' (July 2009) 55-56 <http://www.hm-treasury.gov.uk/d/reforming_financial_markets080709.pdf> accessed 20 November 2009.

¹⁸⁶ Article 6(a)(1) of the Capital Market Law of 2003.

¹⁸⁷ See Article 5 of the Capital Market Law of 2003.

- define and make available information which the participants in the market should provide and disclose to shareholders and the public; and
- (i) regulate proxy and purchase requests and public offers of shares.

Clearly, the Capital Market Law of 2003 does not require the CMA to reach to non-investors or to extend the benefits of capital markets (and not only the Stock Exchange) onto the general society and beyond capital market participants. Since the list of the CMA-objectives enumerated in the Capital Market Law of 2003 is exhaustive, it could therefore have been useful to integrate a socio-economic dimension therein, as a means of sensitizing CMA-officials to the importance and ultimate benefits aspired from their functions. Such an integration would have formally activated a policy-making role and unlocked a policy-making discretion at the level of the CMA. As discussed in Section 4.4 of Part I, the value of such a role and discretion to the economy is empirically supported.

To the extent possible, the benefits of Saudi Arabian capital markets should surpass even its participants and reach prioritized social sectors and projects. This is not an idealistic objective, but actually stands as a legal duty and a core objective. Pursuant to Article 1 of the Law of the Supreme Economic Council of 1999:¹⁸⁸

“The economic policy of the Kingdom [of Saudi Arabia] is based on the tenet of comprehensive social welfare and the concept of free economy, open markets for capital, products, services, and goods, and aims at the achievement of the following objectives: (i) the security, welfare, and

¹⁸⁸ The Law of the Supreme Economic Council, issued pursuant to Royal Decree No. A/111, dated 29 August 1999.

prosperity of society with the preservation of Islamic values, and the preservation of the environment, and natural resources, with a balance between present and future needs, [...] (vi) Ensuring the fair distribution of income, investment and work opportunities, [...]" (emphasis added)

Saudi Arabian capital markets are legally bound by the above-described principle and must therefore thrive towards the pursuit of societal welfare. Resources pooled by capital markets have unlimited potential uses, and their allocation must strike a balance between systemic stability and normative equity. The matter is of focal relevance, especially at these times of regional social unrest (i.e. as manifested by the Arab spring). Despite the recent statement by the IMF that Saudi Arabia has succeeded over the past few decades in raising social development indicators to close to G-20 levels, it remains clear that numerous challenges remain.¹⁸⁹ For instance, Saudi Arabia still suffers from high unemployment, housing shortages, and a deficiency in infrastructural services which has at times translated not only in deterioration of the quality of life, but also in human loss.¹⁹⁰ With some ingenuity at the governmental level, Saudi Arabian capital markets could have been and should have been better utilized to fund required infrastructural projects and avoid and/or mitigate crises.

¹⁸⁹ IMF, 'IMF Executive Board Concludes 2011 Article IV Consultation with Saudi Arabia', Public Information Notice No. 11/114, (23 August 2011).

<<http://www.imf.org/external/np/sec/pn/2011/pn11114.htm>> accessed 1 September 2011.

¹⁹⁰ For example, hundreds of people drowned in Jeddah in November 2009, as a result of the absence of drainage systems that can absorb even relatively low-levels of rain. See 'Flood Deaths in Saudi Arabia Rise to Around 100' BBC News (28 November 2009) <<http://news.bbc.co.uk/2/hi/8384832.stm>> accessed 19 October 2012.

The Capital Market Law of 2003 could have been asked not only to protect citizens and investors of capital market transactions but also to protect them through capital market transactions. An additional paragraph could have been added to that end, for instance entrusting the CMA with the function to assist in the implementation of economic and social development plans established by the government of Saudi Arabia pursuant to Article 22 of the Basic Law of Governance of 1992. Such wording would have been sufficient to prompt CMA officials to devote efforts towards understanding the country's socio-economic priorities and to feel that they are expected and able to perform their functions in the manner that best helps in fulfilling them.¹⁹¹ To this end, the CMA should, in tandem with other governmental bodies, set agendas and strategies based on the wider economic realities of the country and the region.

Article 6(a)(4) of the Capital Market Law of 2003 states that the CMA has the power to:

“give advice and make recommendations to government authorities in respect of matters that would contribute to the development of the Exchange and the protection of investors in Securities”.

Article 18 of the Capital Market Law of 2003 states that:

“Government agencies and other persons must provide the [CMA] with the documents and information it requires for the purposes of carrying out its duties in accordance with the provisions of this Law”.

¹⁹¹ The Prophet Mohamed said that: “A believer to another believer is like a building whose different parts enforce each other” (Bukhari 43:626).

The aforementioned Articles suggest the possibility of interaction between the CMA and other governmental authorities for the proper performance of the CMA's duties. Nothing prevents this interaction to touch specifically on the overall socio-economic impact of capital market regulation.

Some analysts have criticized the absence of formal procedures for the exchange of information between Saudi Arabian regulators.¹⁹² Liaison and coordination between CMA officials and different government departments can be achieved at numerous governmental levels. Firstly, both the Council of Ministers and the Shoura (Consultative) Council, amongst other roles, are entrusted with the review of all internal and public affairs of the State, including the review of, and follow-up on, the State's socio-economic development plan, as published by the MEP.¹⁹³ Liaison and coordination by the Council of Ministers and the Shoura (Consultative) Council is however strenuous on said bodies since they are in charge of a whole spectrum of other issues, such as internal security, foreign policy, regional stability, etc. It is therefore essential that liaison and coordination be undertaken by a lower-level body that has the time and resources to dedicate for such role. In 1999, the Supreme Economic Council ("SSEC") was created specifically to fulfill such role. According to the Law of the Supreme Economic Council of 1999, the SSEC is vested with the task of:

- a) determining the optimal economic policy (including the rules concerning financial markets);

¹⁹² See IMF, 'Saudi Arabia: Financial System Stability Assessment' (IMF Country Report No. 06/199, June 2006) 31 <<http://www.imf.org/external/pubs/ft/scr/2006/cr06199.pdf>> accessed 19 September 2012.

¹⁹³ Article 24 of the Council of Ministers' Law, issued pursuant to Royal Decree No. 13, dated 21 August 1993. Article 15 of the Shoura Consultative Council Law, issued by Royal Decree No. 91, dated 2 March 1992.

- b) assisting governmental organs in drafting laws and regulations involving economic issues;
- c) reviewing the draft socio-economic plan prepared by the Ministry of Economy and Planning; and
- d) linking together the different governmental organs with functions involving economic issues and affairs (e.g. the CMA), so to enhance coordination in the decision-making process.¹⁹⁴

Regardless of whether the liaison is direct or channeled through the Supreme Economic Council, governmental bodies such as the Ministry for Social Affairs ("**MoSA**") and the Ministry of Labour ("**MoL**") should inform the CMA of any preoccupations and opportunities available and the CMA should verify whether these preoccupations could be resolved or those opportunities seized without compromising durable systemic efficiency. For instance, the MoSA could inform the CMA of the availability of high unemployment in certain sectors and the CMA could prioritize listings in those sectors, provided that fundamental listing criteria are fulfilled.¹⁹⁵

4.2. Regulatory Autonomy

4.2.1. General Comments on Regulatory Consolidation or Bifurcation

There has been a debate amongst scholars as to whether capital markets should be regulated and supervised by a single or multiple regulatory authorities.¹⁹⁶ It has been

¹⁹⁴ Article 2 of the Law of the Supreme Economic Council of 1999.

¹⁹⁵ Mohammad Umar Chapra, *What is Islamic Economics?* (2nd ed., IRTI 2001) 13-15.

¹⁹⁶ Kenneth Mwenda has explained that there is a difference between the terms regulation and supervision and that while the regulator sets the rules, enforcement functions are undertaken by the

advanced that a single regulator enjoys economies of scale and provides greater user-friendliness, efficiency, coherence, and consistency in the performance of its functions.¹⁹⁷

If we compare Saudi Arabian and American regulatory systems, American regulatory powers are bifurcated based on product lines between the Commodity Futures and Trading Commission and the SEC, with overlap (or a need to co-regulate) in certain instances. According to a report by the US Committee on Capital Markets Regulation, the fragmentation of regulatory powers “*narrow[s] and dissipate[s] supervisory resources through contests over jurisdictional boundaries. Such a system also impairs our ability to coordinate supervision internationally.*”¹⁹⁸ On the other hand, it is claimed that regulatory concentration may create excessive bureaucratic red tape and would not provide sufficient checks and balances for the identification and avoidance of corruption instances.¹⁹⁹

Looking at the UK experience, the FSA was split in early 2013 into the Financial Conduct Authority (“FCA”) and the Prudential Regulation Authority (“PRA”). According to the HM Treasury, the restructure will be accompanied by:

supervisor. For more elaboration on this point and for a discussion on the preferability of the concentration or bifurcation of regulatory powers, see Kenneth Mwenda, *Legal Aspects of Financial Services Regulation and the Concept of a Unified Regulator* (The World Bank 2006) 5 and 38-44. See also Markus Lederer, *Exchange and Regulation in European Capital Markets*, (Lit Verlag 2003) 160-164.¹⁹⁷ *Ibid.*, 41. See also Fawcett, *supra* note 175, 48-49.

¹⁹⁸ Committee on Capital Markets Regulation, ‘Recommendations for Reorganizing the US Financial Regulatory Structure’ (14 January 2009) 7-8 <http://www.capmktreg.org/pdfs/01.14.09_CCMR_Recommendations_for_Reorganizing_the_US_Regulatory_Structure.pdf> accessed 18 October 2012. See also OECD, ‘The Financial Crisis: Reform and Exit Strategies’ (2009) 29-31. <<http://www.oecd.org/dataoecd/55/47/43091457.pdf>> accessed 19 October 2012.

¹⁹⁹ Mwenda, *supra* note 196, 43.

"a fundamental change in the way that the new regulatory authorities carry out their functions, to deliver a more judgment-led, focused and effective regulation of the financial sector".²⁰⁰

It is perhaps too early to evaluate the success or failure of the bifurcation since it just took place. It is worthwhile to note however that some observers did not welcome this restructure.²⁰¹ For example, law firm Pinsent Masons head of the financial services regulatory team Tim Dolan believed that the restructure was unnecessary and that the change of focus could have been achieved under the former regulatory framework.²⁰² Another observer argued that the restructure will negatively impact on interaction with other European regulators.²⁰³ The restructure has resulted in the resignation of a great number of FSA staff members. By the end of 2011, it was reported that 889 permanent employees had resigned between 2009 and 2011. As observed by one analyst, high staff turnover *"means the FSA's corporate memory and all its regulatory experience has gone out the window"*.²⁰⁴ It was also observed that unless the FCA and PRA coordinate so to make sure that the regulatory burdens on firms are proportionate and kept to a minimum, such burdens would *"eat into firms' profit"*.²⁰⁵ Actually, the HM Treasury itself has acknowledged that *"the fragmentation of responsibilities has had a number of dysfunctional results"*, including the FSA's loss of focus on stability issues.²⁰⁶

²⁰⁰ HM Treasury, 'A New Approach to Financial Regulation: Building a Stronger System' (February 2011) 6 <http://www.hm-treasury.gov.uk/d/consult_newfinancial_regulation170211.pdf> accessed 19 April 2013.

²⁰¹ Natalie Holt, 'Restructure Mean FSA Has Lost Sight of Europe' (20 September 2012) *Money Marketing* 3.

²⁰² *Ibid.*

²⁰³ *Ibid.*

²⁰⁴ Natalie Holt, 'Staff Exodus Gathers Pace At the Regulator' (26 April 2012) *Money Marketing* 1.

²⁰⁵ Steve Tolley, 'Minimise Regulatory Burden on Firms' (3 August 2012) *Money Marketing* 3.

²⁰⁶ HM Treasury, *supra* note 200, 4.

Clearly, the Saudi legislator must keep a watchful eye on developments in other jurisdictions to see if any concerns in such jurisdictions are also of relevance to the Saudi context and whether the Saudi regulatory architecture is optimal at all times.

4.2.2. *The Case of the CMA*

When benchmarked, the structure and powers of the CMA meet internationally recognized standards, such as those recommended by the IOSCO. Indeed, the CMA is autonomous, enjoys well-defined functions and is adequately empowered to accomplish these (i.e. inspection, investigation, and supervisory powers).²⁰⁷

The CMA was granted "*legal personality and financial and administrative autonomy.*"²⁰⁸ This concentration of regulatory powers into the body of the CMA grants the CMA a complete overview of the local market and facilitates intervention in case of necessity.²⁰⁹ The Saudi Arabian legislator purported to remove from the Saudi Arabian Monetary Agency ("SAMA") all responsibilities and authorities to supervise and regulate Saudi Arabian capital markets from a transactional perspective. The only reference to the SAMA in the Capital Market Law of 2003 is contained in Article 6(b) which states that:

"[...] the [Capital Market] Authority shall coordinate with the Saudi Arabian Monetary Agency in connection with the procedures that it intends to undertake and which may have an impact on the monetary situation."

²⁰⁷ Pursuant to Article 5(c) of the Capital Market Law of 2003, "*the members of the CMA and its employees designated by the CMA's Board are empowered to subpoena witnesses, take evidence, and require the production of any books, papers, or other documents which the CMA deems relevant or material to its investigation [...]*".

²⁰⁸ Article 4(a) of the Capital Market Law of 2003.

²⁰⁹ *Ibid.*

This direction seems vague and does not define what is meant by the term ‘monetary situation’. It seems necessary for the CMA to verify with the SAMA whether its regulatory policies and whether ongoing or planned capital market transactions are exerting or are likely to exert inflationary pressure on the local currency. It also seems necessary for the CMA to coordinate with the SAMA its efforts and policies for the combat of money laundering and the finance of criminal activities. Overall, SAMA's role seems only indirectly relevant to capital markets and the authority of SAMA should not practically interfere with that of the CMA.

4.3. Internal Controls

4.3.1. Adequate Staffing

Given that its role is to scrutinize all offers and to regulate all aspects of the Saudi Arabian capital market, it is fundamental for the CMA to be well-structured internally and well-staffed.²¹⁰ As it was said to describe the British regulator:

*"Rules and regulations are proposed, considered, promulgated, interpreted, applied and enforced by people. Ultimately, the quality of the regulation provided by the FSA will be a function of the people it is able to attract and retain."*²¹¹

The CMA has imposed on itself in the capital market regulations a commitment to complete certain tasks within a specified timeframe, which assumes the existence of adequate human resource capabilities for such purpose. For instance, applications for

²¹⁰ Bernard S. Black, ‘The Legal and Institutional Preconditions for Strong Securities Markets’, (2000-2001) 48 UCLA Law Review 781, 790.

²¹¹ Fawcett, *supra* note 175, 53-54.

private placements are considered approved if the CMA does not respond within one month from the receipt of the application.²¹² Although a longer period could be more convenient to the CMA, it would negatively impact on the proper conduct of transactions. In turn, a shorter time period would put at risk the thorough scrutiny of the CMA.

The Capital Market Law of 2003 anticipated and clearly mentioned the need for the CMA to establish, for its personnel, rules and standards of professional conduct and means for the enhancement of performance.²¹³ Some fundamental rules of professional conduct were placed directly into the Capital Market Law of 2003 itself. For example, Article 8 of the Capital Market Law of 2003 imposes on the directors, employees, and agents of the CMA an obligation to disclose all securities that they own, either directly or through relatives, and to declare any changes on such ownership, within three days. Such imposition probably aims at identifying conflicts of interests, or the existence of any factors that may affect the impartiality and independence of CMA officials. As a further example, Article 9 of the Capital Market Law of 2003 prohibits directors and employees of the CMA to engage in any other profession or job, and prohibits them even of providing advice to companies and private institutions.

These Articles are certainly a step in the right direction, however they need to be complemented by a complete Code of Conduct. For comparative purposes, the FSA has

²¹² Article 12 of the Offer of Securities Regulations of 2004.

²¹³ See Article 19 of the Capital Market Law of 2003.

published on its website the Code of Conduct which its staff must abide with.²¹⁴ The FSA's Code of Conduct contains detailed restrictions on situations of conflict of interests, dealings and the acceptance of gifts and hospitality. The CMA should publish the rules of conduct that it applies for its staff, so to draw scrutiny on the same and to raise the level of standards applied.

4.3.2. *The Board of the CMA*

Article 7 of the Capital Market Law of 2003 requires the CMA to have a board of directors responsible to set forth the internal regulations of the CMA, including the organization of the CMA's functions, responsibilities and operations amongst its divisions and departments.

The board is composed of five members, appointed by Royal Order. Board members must all be natural Saudi Arabian nationals, dedicated to their role on a full-time basis and professionally qualified.²¹⁵ The decision to solely allow the appointment of Saudi Arabian citizens on the board is protectionist and may even be considered discriminatory. The policy, however, contains an element of wisdom. If one assumes that patriotism carries with it a greater sense of responsibility, the policy should then cause board members to apply greater vigilance when treating issues affecting national stability. Examples of risks involved with inadvertent policy-making include outward flights of capital and investments into doubtful products abroad.

²¹⁴ FSA, 'Code of Conduct', <http://www.fsa.gov.uk/pubs/staff/code_conduct.pdf> accessed 20 November 2009.

²¹⁵ Article 7(a) of the Capital Market Law of 2003.

The term of board members is specified at five years and may only be renewable once.²¹⁶ The rotation of board members or the limitation of their office term is sensible. It should help ensure the constant influx of new ideas and the constant re-evaluation of past decisions and existing beliefs.

4.3.3. Organizational Structure

In early 2010, the CMA rebuilt its organizational structure and is now composed of five core divisions:²¹⁷

- a) the Legal Affairs Division, responsible for the preparation and review of internal resolutions, contracts between the CMA and external parties, as well as regulations, rules, and instructions related to the CMA's functions;
- b) the Enforcement Division, responsible for the investigation and prosecution of violations of the Capital Market Law of 2003 and the settlement of disputes among market participants;
- c) the Market Supervision Division, responsible for the implementation of the compliance of listed companies with their continuing obligations;
- d) the Capital Markets Institutions Supervision Division, responsible for the examination of applications to conduct securities business and the inspection of the compliance of authorized persons with their continuing obligations; and
- e) the Corporate Finance and Issuance Division, responsible for the review of applications for the offering of securities and for the supervision of the compliance

²¹⁶ Article 7(b) of the Capital Market Law of 2003.

²¹⁷ CMA, *supra* note 154, 16-18.

of listed companies with their initial disclosure obligations and those of investment funds with applicable legislative and regulatory provisions.

The above core divisions are complemented by the two supporting divisions:²¹⁸

- a) the Strategy and Research Division, responsible for the preparation and execution of the CMA's annual business plan and annual report, conducting periodical and occasional research and surveys, and strengthening the ties of the CMA with relevant international organizations and regulators.
- b) The Corporate Services Division, responsible for the supervision of internal CMA matters, including financial, human resources, and procurement matters.

The above structure was not imposed by the legislator and is entirely architected by the CMA. At first sight, the title of the core and support divisions appears as somewhat abstract but their described scope of responsibilities is clear and shows no overlap.

4.4. Accountability

4.4.1. Public Accountability

Within ninety days from the end of each year, the chairman of the Board of the CMA must present to the President of the Council of Ministers an annual report on the CMA's activities and its financial position during the previous year.²¹⁹ The CMA has been publishing its annual report directly on its website. Such publication will help understand the assumptions, concerns, objectives, priorities, and accomplishments of

²¹⁸ *Ibid*, 18.

²¹⁹ Article 16 of the Capital Market Law of 2003.

the CMA. It will also invite constructive criticism from the public and the formulation of questions in case of any obscurities. The transparency associated with the regulator's reporting should actually help reduce the probabilities of corruption and government capture.²²⁰ Government capture and corruption act as some of the factors impacting on the regulator's performance and should to some extent be resolved as part of the regulator's attempts to rectify performance deficiencies.

The IMF has recommended further increases to the CMA's regulatory transparency by "*disclosing all enforcement actions, interpretation, and funding rules*".²²¹

4.4.2. Administrative Accountability

Pursuant to Article 4 of the Capital Market Law of 2003, the CMA "*shall directly report to the President of the Council of Ministers.*" This Article supposes that the President of the Council of Ministers would share with the Council of Ministers any reports received from the CMA. This Article also supposes that the Council of Ministers would, by law or customary practice, actually assess the performance of the CMA. The Council of Ministers Law of 1993 does not make clear what process would be followed for the examination by the Council of Ministers of the CMA's reports. Since Article 16 of the Council of Ministers' Law of 1993 specifies that the deliberations of the Council are confidential, it becomes difficult to even confirm whether such a process has been customarily defined or whether one exists at all. There is actually little incentive for

²²⁰ Regulatory capture was defined as meaning: "*the process by which vested interests bias the incentives of regulators and governments to act in their interests rather than the broader public interest*". See Dieter Helm, 'Regulatory Reform, Capture, and the Regulatory Burden' (2006) 22(2) Oxford Review of Economic Policy 169, 174.

²²¹ IMF, Saudi Arabia: 2012 Article IV Consultation' (IMF Country Report No. 12/271, September 2012) 31 <<http://www.imf.org/external/pubs/ft/scr/2012/cr12271.pdf>> accessed 17 October 2012.

scrutiny at the level of the Council since the Ministers are not accountable to any electorate or opposing political party and since the confidentiality of deliberations eliminates accountability to the general public. Internally, it is possible that Council members would be discouraged from actively scrutinizing each other's performance so not to draw scrutiny on their own performance. The CMA's Chairman holds the rank of Minister and is therefore a peer to those who are supposed to scrutinize his office's report.

The Council of Ministers Law of 1993 allows the Council to setup committees responsible for the investigation of the conduct and the performance of ministerial offices.²²² The Council has actually ordered the establishment of an internal audit unit in each government agency and public institution to verify adherence to the law.²²³ Obviously, these committees and internal audit departments are only meaningful if they can refer to and apply fixed performance measurements and if their findings will be acted upon diligently. The Saudi Arabian government should be more transparent about the measures taken to establish a formal administrative accountability.

It was affirmed in the Saudi press that a number of Shoura Council members met with the Chairman of the CMA and requested that the CMA deploys greater efforts in the monitoring of the financial performance of listed companies, while at the same time

²²² Article 24 of the Council of Ministers Law of 1993.

²²³ Council of Ministers Resolution No. 129, dated 24 April 2007.

deepening the market's capitalization.²²⁴ Pursuant to Article 15 of the Shoura Council Law of 1992, the Shoura Council is entitled to study the annual reports of ministries and governmental organs and to propose any measure or improvements that it deems appropriate.²²⁵ The Shoura Council also has authority to summon government officials and to request any document or data concerning any governmental organ.²²⁶ The Shoura Council constitutes arguably the most rigorous monitor of the activities of the CMA. Although it has no authority to issue sanctions, it can aggressively recommend and push for them at the level of the Council of Ministers or the King, directly.²²⁷

4.4.3. *Judicial or Quasi-Judicial Accountability*

Article 25 of the Capital Market Law of 2003 established the Committee for the Resolution of Securities Disputes (“CRSD”) and vested it with the authority to hear claims against decisions and actions taken by the CMA. The CRSD has the right to award damages against the CMA, overturn contested CMA decision, and issue alternative decisions that safeguard the rights of aggrieved parties.²²⁸ For the CMA’s accountability to be fully reliable, there needs to be guarantees of the independence of the CRSD from the CMA. Such independence is however made questionable for two reasons. First of all, Article 25(b) of the Capital Market Law of 2003 states that the members of the CRSD are appointed by the CMA's Board for renewable terms of three years. This poses serious concerns as to their independence since the personal interest of

²²⁴ 'The Shoura Council Requests a Greater Role by the CMA in the Supervision of Companies', *Al Eqtisadiyah* (Riyadh, 17 June 2012) <http://www.aleqt.com/2012/06/17/article_667605.html> accessed 15 October 2012.

²²⁵ The Shoura [Consultative] Council Law, issued pursuant to Royal Decree No. 91, dated 2/3/1992.

²²⁶ Articles 22 and 24 of The Shoura Council Law of 1992.

²²⁷ Article 23 of The Shoura Council Law of 1992.

²²⁸ Article 25(c) of the Capital Market Law of 2003.

members of the CRSD in retaining their position might prevent them from adopting strict stances against the CMA.²²⁹ The fact that the members of the Appeal Panel are appointed by the Council of Ministers and can overrule the decisions of the CRSD does not eliminate concerns about the CRSD's lack of independence.²³⁰ As a second concern regarding the insufficiency of the CRSD's independence, neither the Capital Market Law of 2003 nor the 2007 Regulating Procedures for Resolution of Securities Disputes describe the resources available to the CRSD in the context of cases brought against the CMA. Most probably the CRSD utilizes the CMA's resources to carry out its investigative powers and probably does not have dedicated resources for such task. In any case, even if such dedicated resources were available to the CRSD, they would probably draw their funding from the CMA's general budget, which again poses concerns of conflicts of interests.²³¹

According to decision number No. 145/L/D1/2007, issued by the CRSD in the context of a claim brought against the CMA, the CMA must have discretion and enjoy flexibility in determining the most appropriate ways to perform its duties, subject to the confines of the law.²³² All actions of the CMA are presumed to have been taken for the preservation of the general interest, and are presumed to have been adopted for a just

²²⁹ IMF, *supra* note 154, 18.

²³⁰ IMF, *supra* note 154, 21.

²³¹ Article 6(a)(19) of the Capital Market Law of 2003.

²³² CRSD Decision No. 145/L/D1/2007, dated 25 August 2007

<http://crsd.org.sa/En/Disputes/Decisions%20of%201428%20H/Microsoft%20Word%20-%202028-145%20E.pdf> accessed 15 April 2013. The case was administrative in nature and relates to the grievance of a stock exchange investor against a decision issued by the CMA to suspend his investment account. While the CMA argued that the suspension occurred as a result of the plaintiff's violation of the Market Conduct Regulations of 2004, the plaintiff argued that such violation was disputed in another case. The CRSD ruled in favor of the CMA and concluded that the CMA acted within the scope of its discretionary powers and in implementation of the duties assigned to it under the Capital Market Law of 2003.

cause, unless the contrary can be evidenced. Harm caused to individual interests would be considered as tolerable collateral, and would not trigger the liability of the CMA, if caused by an attempt to protect the greater public interest. Despite the aforementioned, Decision No. 145/L/D1/2007 confirmed the CRSD's preparedness to consider arguments against the "*appropriateness*" of a contested CMA action. The mention in Decision No. 145/L/D1/2007 of "*appropriateness*" implies that the CMA's liability would be engaged, to the extent that the objective sought could have been achieved through solutions involving lesser collateral damage. The "*appropriateness*" examination however, as conducted in Decision No. 145/L/D1/2007, was limited only to whether the ultimate purpose of the contested CMA action was justified. Decision No. 145/L/D1/2007 did not go to the extent of analyzing whether the suffered harm could have been mitigated through an alternative solution. Yet again, the claimant in that particular case did not argue that any such alternative solutions did exist. It is hoped that the publication of additional administrative CRSD decisions would shed light on the degree of the CMA's accountability and the circumstances triggering the liability of the latter. In Decision No. 145/L/D1/2007, had the CRSD not subjected the discretion of the CMA to an "*appropriateness*" test, such discretion would have practically equated to immunity.

Generally, no governmental Saudi Arabian body enjoys immunity rights and governmental bodies remain exposed to any administrative claim that may be brought against them. Exceptionally, Article 48(c) of the Capital Market Law of 2003 does seem to provide the CMA a certain immunity in narrow circumstances:

“The [Capital Market] Authority shall have no responsibility for the omission in prospectuses, periodical reports, advertisements, or any other document filed with it by any party of any important information or data or for including misleading information or data.”²³³

The CMA actually imposes on financial intermediation firms an obligation to publish a disclaimer in offering prospectuses, stating that:

“[T]he [Capital Market] Authority and the Saudi Stock Exchange do not take any responsibility for the contents of this prospectus, do not make any representation as to its accuracy or completeness, and expressly disclaim any liability whatsoever for any loss arising from, or incurred in reliance upon, any part of this document”²³⁴

The immunity granted by the legislator to the CMA is contestable.²³⁵ On the one hand, it may be argued that such immunity undermines the obligation contained in Article 5(a)(6) of the Capital Market Law of 2003 for the CMA to “*monitor the full disclosure of information regarding Securities and their issuers [...] and make available information which the participants in the market should provide and disclose [...]*”²³⁶

According to dissidents against immunity, remedies available to investors should not be limited in case they are harmed by evidently false, misleading, or incomplete marketing information. It should therefore be trusted that the CRSD will actually engage the

²³³ Out of comparison, Article 27(g) of the Capital Market Law of 2003 stipulates that the Depository Center shall be liable “*for any monetary damage suffered by an investor and resulting from the proven negligence or misconduct of the Depository Center’s employees that causes an error in the registration process*”.

²³⁴ See Article 25(d)(8) of the Listing Rules of 2004 and see Annex 4 of the Offer of Securities Regulations of 2004.

²³⁵ For a discussion regarding whether regulatory immunity may violate the human right to court access, see Alan Page, 'Regulating the Regulator - A Lawyer's Perspective', in Ferran and Goodhart, *supra* note 175, 145-147.

²³⁶ See also Article 42(b) and (d) of the Capital Market Law of 2003 which state that prospectuses must contain any information required by the CMA to describe adequately the securities offered and to assist the investors evaluate the investment opportunity before them.

CMA's liability in the event of gross negligence on its part.²³⁷ Turning to the opposing view, it may be argued that the absence of immunity could affect the performance by the CMA of its assigned duties and could mean a loss of regulatory control, in favor of a judicial system which enjoys far lesser technical expertise and sophistication. The absence of immunity could encourage frivolous claims. It could also lead to carelessness by issuers if they get comforted by the idea that the regulator would itself share the blame for any deficiencies in disclosures.

It is clear that even if the CMA enjoys judicial immunity in certain circumstances, such immunity should not practically be absolute. It would be interesting to read the future administrative decisions of the CRSD to deepen the public's understanding of this issue.

4.4.4. Accountability to Supranational Authorities

Certainly, the CMA must open itself to the scrutiny not only of higher governmental bodies but also specialized international institutions such as the IMF and IOSCO. This specialized evaluation would help the CMA improve its processes and performance.

Article 19(b)(6) of Annex 1 of the Listing Rules of 2004 and Annex 2 of the Offer of Securities Regulations impose on the directors of applicant issuers a duty to sign a declaration authorizing the CMA to “*exchange any relevant information with the authorities, agencies or bodies having responsibility for the supervision of financial*

²³⁷ Kenneth Mwenda argues that immunity is important to a regulator so to allow it to properly discharge its powers and that it acts as an incentive to perform diligently, without fear of liability, even if they had acted in good faith. For a discussion on the advisability of immunity being given to the regulator, see Mwenda, *supra* note 196, 13.

services or any other relevant authorities.” This declaration clears any confidentiality issues connected with the disclosure by the CMA of information regarding the applications and proposed transactions it has studied. This declaration is broad and does not make clear what authorities specifically are referred to.

4.5. Avoidance of Capture

Attention must be given to regulatory capture, where the supervisory role of the regulator becomes compromised as a result of the regulator's staff becoming excessively preoccupied by the interests of a particular class of the regulated.²³⁸ In the context of capital market regulators, regulatory capture may primarily take place by professionals associated with securities firms.

One of the measures proposed by the Organisation for Economic Cooperation and Development ("**OECD**") to prevent capture would be to ensure parity between the remuneration of the staff of the regulator and the regulated. An additional measure proposed would be to impose restrictions on the mobility of staff between the regulator and the regulated. It is for example suggested to restrict the staff of the regulator from joining a regulated entity, for a period of 12 months following resignation.²³⁹ This would preserve their dedication to their position in the regulatory entity without being influenced by promises or hopes of a more lucrative career in a regulated entity.

²³⁸ Ernesto Dal Bo, 'Regulatory Capture: A Review' (2006) 22(2) Oxford Review of Economic Policy 203, 203.

²³⁹ OECD, supra note 198, 34-35.

In the United States, the Dodd-Frank Act of 2010 created three new bodies to increase the influence and protection of investors, and with the same token, help equalize the leverage of securities firms on policy-making and reduce the likelihood of regulatory capture.²⁴⁰ Indeed the Dodd-Frank Act of 2010 created the Office of the Investor Advocate, the Investor Advisory Committee, and the Ombudsman.²⁴¹ The Investor Advocate is appointed by the SEC Chairman in consultation with the SEC Commissioners. As for the Investor Advisory Committee, it has the right and power to advise and consult with the SEC. The Investor Advisory Committee is composed of the Investor Advocate, a representative of the State securities commissions, a representative of the interests of senior citizens, and not fewer than 10 or more than 20 members representing individual equity and debt investors and institutional investors who are knowledgeable about investment issues and have a reputation of integrity.²⁴² As a second layer of useful protection against regulatory capture, the SEC and the

²⁴⁰ Dodd-Frank Wall-Street Reform and Consumer Protection Act of 2010 (111th Congress Public Law 203, 124 Stat. 136, signed into effect 21 July 2010) <<http://www.gpo.gov/fdsys/pkg/PLAW-111publ203/html/PLAW-111publ203.htm>> accessed 23 October 2012; See also Robert Kuster, 'International Securities and Capital Markets 45(1) The International Lawyer 253, 266 <<http://www.dentons.com/import/~media/0B73F39A5B494D64B16F6552D4A8CCA1.ashx>> accessed 21 April 2013; See also Chelsea Ferrette, 'The Myth of Investor Protection: The Dodd-Frank Act and the Office of the Investor Advocate' (2011) 9 ExpressO <http://works.bepress.com/chelsea_ferrette/1/> accessed 21 April 2013.

²⁴¹ Sections 911, 915, and 919(D) of the Dodd-Frank Law of 2010. According to SEC Commissioner Luis A. Aguilar: "*[t]he simple truth is that investor voices are often few and less organized than other interested parties, and their points of view can be sidelined. As a result, the Commission has to make it an imperative that investors' perspectives are always represented*" See Luis A. Aguilar, 'An Insider's View to Guide Reform', Speech to the Berkeley Center for Law, Business and the Economy, University of California at Berkeley, Berkeley, California, October 15, 2010, <http://www.law.berkeley.edu/files/bclbe/Speech_by_SEC_Commissioner_10.15.10.pdf> accessed 29 June 2012.

²⁴² Section 911(B) of the Dodd-Frank Law of 2010. See also Dustin Hall, 'Regulatory Protections in the Dodd-Frank Regulatory Reform Bill' (Bryan Cave Bank, 1 July 2010) <<http://bankbryancave.com/2010/07/investor-protections-in-the-dodd-frank-regulatory-reform-bill/>> accessed 29 June 2012.

Comptroller General conduct periodic studies regarding the adequacy of consumer protection controls imposed on securities firms.²⁴³

The CMA or the Saudi Arabian legislator should consider introducing some of the above-described measures to ensure an increase in the leverage of investors and reduce that of securities firms on policy-making processes.

5. DEMUTUALIZATION OF THE STOCK EXCHANGE

There has been a significant worldwide tendency to transform exchanges from public or non-profit structures into private lucrative companies that may be listed at times.²⁴⁴ This transformation process is referred to in the literature as 'demutualization'.²⁴⁵ There is ample literature regarding the benefits which demutualization can be expected to yield.²⁴⁶ Most benefits described are tied to the fact that private-sector stock exchange operators would be motivated by profit and would therefore be willing to cover more distance than a governmental body in order to attract and maintain customers (i.e. listed companies). To this end, private-sector operators should make greater attempts towards the improvement of services and the cutting of costs and should benefit from greater agility than public-sector counterparts, due to lesser bureaucratic restrictions.²⁴⁷ It was

²⁴³ Sections 918, 919, 930 of the Dodd-Frank Law of 2010. See also Hall, *ibid.*

²⁴⁴ Reena Aggarwal, 'Demutualization and Corporate Governance of Stock Exchanges' (2002) 15(1) *Journal of Applied Corporate Finance* 105, 105.

²⁴⁵ *Ibid.*

²⁴⁶ Board, et al., *supra* note 145, 56-57.

²⁴⁷ Ruben Lee, 'Changing Market Structures, Demutualization, and the Future of Securities Trading', in Robert Litan, et al. (eds), *The Future of Domestic Capital Markets in Developing Countries* (Brookings Institution Press 2003), 296-301.

observed that the revenues generated by operators of demutualized exchanges present new opportunities for investment in technology.²⁴⁸

That said, demutualization also draws concerns and "*might not be the answer for all exchanges in all countries*".²⁴⁹ First of all, there are concerns of a conflict of interests between the exchange's profit-oriented and its regulatory functions.²⁵⁰ For instance, a demutualized exchange may not be inclined to take action and apply penalties against major providers of revenue if they commit a violation.²⁵¹ To reduce such a risk, the company operating the demutualized exchange may be required to have both a regulatory subsidiary and a commercial trading arm (as in the case of the Nasdaq).²⁵² Secondly, there are concerns about the insolvency of the private company operating the exchange and the impact that this may have on both listed companies and investors.²⁵³ Demutualized exchanges may be required to maintain stricter financial ratios than ordinary companies and may need to report falling below such ratios.²⁵⁴

Research performed did not yield any secondary sources that treat the topic of the demutualization of the Saudi Stock Exchange. Theoretically, the demutualization of the Saudi Stock Exchange may not yield the same benefits as those achieved by demutualized European or American exchanges. This is because, as discussed in Section 3.3 of Part V, the Saudi Stock Exchange does not currently allow foreign

²⁴⁸ Aggarwal, *supra* note 244, 113.

²⁴⁹ *Ibid.*

²⁵⁰ *Ibid.*, 106.

²⁵¹ *Ibid.*, 109.

²⁵² *Ibid.*, 110.

²⁵³ *Ibid.*, 109.

²⁵⁴ *Ibid.*

investment or the listing of foreign equity. In other words, since the Saudi Stock Exchange is not in competition with any other exchange, it is therefore probably not pursuing competitive efficiency as would a European exchange.

Article 20(a) of the Capital Market Law of 2003 states that the Saudi Stock Exchange shall have the legal status of a joint stock company. The Capital Market Law of 2003 does not expressly state whether such company would be state or private owned. Article 22 of the Capital Market Law of 2003 indicates that, regardless of the ownership form ultimately adopted, the Stock Exchange's managerial body would remain composed by both private-sector and public-sector representatives, appointed by a Council of Ministers' resolution, following nomination by the chairman of the Board of the CMA. The Board of Directors of the Stock Exchange must have the following composition:

- a) A representative of the MoF;
- b) A representative of the MoCI;
- c) A representative of the SAMA;
- d) Four members representing licensed brokerage companies; and
- e) Two members representing the joint stock companies listed on the Exchange.

Article 22 of the Capital Market Law of 2003 provides sufficient comfort of the representativeness of the main stakeholder groups interested in the Stock Exchange.

6. CONCLUSION

As demonstrated in this Part, the Saudi Arabian legislator and the CMA appear to comply, at least on paper, with practically all IOSCO Principles relating to the regulator and the enforcement of securities regulations. Indeed,

- a) The responsibilities of the CMA are indeed "*clear and objectively stated*";
- b) The CMA is operationally independent in the exercise of its functions and powers;
- c) The CMA has "*adequate powers, proper resources and the capacity to perform its functions and exercise its powers*";
- d) The CMA has adopted "*clear and consistent regulatory processes*";
- e) The staff of the Regulator has been required to "*observe the highest professional standards, including appropriate standards of confidentiality*";
- f) The CMA's mandate does integrate a process to "*monitor, mitigate and manage systemic risk*";
- g) The CMA does have "*comprehensive inspection, investigation and surveillance powers*";
- h) The CMA does have "*comprehensive enforcement powers*"; and
- i) The CMA is ensuring an "*effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance program*".²⁵⁵

As discussed, further effort should be deployed to increase the CMA's accountability in the exercise of its functions and powers. Further effort should also be deployed towards

²⁵⁵ IOSCO, *supra* note 155.

the establishment of "*a process to review the perimeter of regulation regularly*" as recommended by IOSCO.²⁵⁶

This Part discussed the possibility of delegating to the CMA an obligation to ensure that, to the extent possible, the benefits of capital markets reach all social layers. Such obligation may be implied through the implicit obligation for all governmental authorities to cooperate with the Supreme Economic Council towards the fulfillment of the objectives stated in the Economic Plan. It should nonetheless be expressed more explicitly.

The CMA, though so far has been diligent in formulating the processes for the proper conduct of capital market transactions, could improve its performance by engaging in more regular dialogue with the regulated and by being more transparent regarding its internal logistical and structural policies.

Finally, regarding the idea of the demutualization of the Saudi Arabian Stock Exchange, this is not of immediate relevance. The Stock Exchange is not currently facing competition with other exchanges. Therefore, even if it were demutualized, it would not likely merge with other exchanges, since neither foreigners can directly acquire listed shares, nor is there a noted tendency for Saudi Arabian companies to seek listing on foreign exchanges.

²⁵⁶ *Ibid.*

PART IV - THE REGULATION OF THE OFFERING OF SECURITIES

1. INTRODUCTION

The efficiency of the Saudi Arabian capital markets rests on the straightforwardness of the transactional processes which it imposes and on the ability of such processes to capture all eventualities which could jeopardize protected interests. As explained in the previous Part, the legislator has devised the institutional foundations and mechanisms required to process transactions (i.e. the Stock Exchange and the Depository Center). These institutions are not relevant for all categories of securities' offers, and are only relevant to the public offer of listed shares. Other categories of securities' offers include private placements and investment funds, which are conducted through different channels, under different rules and independently from the mechanism of the Stock Exchange.

The below Sections will explain what is generally meant by an 'offer' of securities, how the regulator defines the term 'securities', the different categories of offer, and the requirements and role of the parties involved in each such category. Precisely, this Part will explain the differences between public offers, private placements, and investment funds and will propose ways to modify the CMA's approach and regulations for the more efficient conduct of regulated transactions and the achievement of the objectives stipulated in the Capital Market Law of 2003.

2. GENERAL DEFINITION OF THE TERM 'OFFER'

The offer of securities is defined in simple terms in the very first article of the Offer of Securities Regulations of 2004. The offer of securities consists of the:

"issuing securities, inviting the public to subscribe therefor or the direct or indirect marketing thereof, or any statement, announcement, or communication that has the effect of selling, issuing or offering securities, but does not include preliminary negotiations or contracts into with or among underwriters."

The offer of securities is further defined when read in conjunction with the definition of the term 'offeror', which includes whoever:

"makes an offer or invites a person to make an offer which, if accepted, would give rise to the issue or sale of securities by him or by another person with whom he has made arrangements for the issue or sale of the securities."²⁵⁷

This definition is the heart of the Capital Market Law of 2003 and the CMA Regulations. As will be shown in the following Sections, the CMA has pinpointed the sort of transactions which it monitors and regulates. This should not be understood as meaning that the definition of what constitutes an offer is not wide and encompassing. Quite to the contrary, Article 3 of the Offer of Securities Regulations of 2004 emphasizes that:

"[s]ecurities may not [altogether] be offered in [Saudi Arabia] except in accordance with the [Offer of Securities Regulations]".

²⁵⁷ Article 4 of the Offer of Securities Regulations of 2004.

There is therefore no doubt that the Offer of Securities Regulations of 2004 intend to provide the CMA with scrutiny over all offer types, except for preliminary negotiations or contracts with or between underwriters. The CMA's tone is strict and clearly indicates that any interpretative doubts regarding the role of the CMA must be settled in favor of a greater scrutiny role over certain types of offers. According to a warning published by the CMA on the home page of its website:

"It will not be allowed to raise funds for the purpose of investment in securities business, including portfolios management or promotion of securities such as shares, debt instruments, investment funds, etc., or to [...] issue shares, debt instruments, or offer them for subscription, or promote them, directly, or indirectly or make any statement that may imply sale or issue or offer of securities, without prior consent of the CMA.

Who may practice any of these activities without license or approval, shall be deemed in violation of the CMA law and its implementing regulations, and shall be subject to punishment under the applicable laws."

As the warning indicates, the CMA reflects a rigid stance, which is important for the proper protection of investors. The CMA actually adopted the latest electronic surveillance systems to detect any unauthorized promotion of securities. In 2011, the system had generated 3,071 automatic e-surveillance alerts, which culminated into 28 cases of suspected violation.²⁵⁸

2.1. Types of Offers

²⁵⁸ CMA, *supra* note 154, 68.

The Offer of Securities Regulations of 2004 were amended twice, once on 21 December 2004 (the "**2004 OSR Version**") and once on 18 August 2008 (the "**2008 OSR Version**"). In the 2008 OSR Version, the CMA substantially shuffled and redefined categories of offer. As explained in Section 5 of this Part, while the 2008 OSR Version now only provides two types of offers: public offers and private placements, the 2004 OSR Version had allowed a third category of offer, the exempt offer, now inexistent.²⁵⁹

The common denominator between public offers and private placements, under both the 2004 OSR Version and the 2008 OSR Version, is the need to receive the CMA's approval as a condition to the solicitation of investments.²⁶⁰ As logic would dictate, the level of CMA scrutiny and the level of difficulty in receiving the CMA's approval, in relation to an offer, are correlated to the value of funds solicited and the proposed number of offerees. Accordingly, public offers entail a larger volume of disclosures and CMA scrutiny, followed by private placements.

Although Article 2(c) of the 2008 OSR Version has expressly removed units in investment funds from the application of the 2008 OSR Version, it is nevertheless clear that, in practice, investment funds constitute a form of offer. After all, units in investment funds are defined by the CMA as securities.²⁶¹ Moreover, while securities firms act as the arrangers for issuers in public offers and private placement, securities

²⁵⁹ See Article 6 of the 2004 OSR Version and of the 2008 OSR Version.

²⁶⁰ See Articles 12 and 17 of the 2004 OSR Version and Article 12 of the 2008 OSR Version.

²⁶¹ See the definition of the term 'securities' in the Glossary. See also Article 2(c) of the Capital Market Law of 2003.

firms are themselves the issuers in the context of investment funds. Investment funds are explained and discussed in Section 6 of this Part.

3. TYPES OF SECURITIES

The term ‘securities’ is defined by the legislator in Article 2 of the Capital Market Law of 2003, as meaning:

“(a) convertible and tradeable shares of companies; (b) Tradeable debt instruments issued by companies, the government, public institutions or public organisations; (c) investment units issued by investment funds; (d) any instruments representing profit participation rights, any rights in the distribution of assets; or either or the foregoing; (e) any other rights or instruments which the Board determines should be included or treated as Securities if the Board [of the CMA] believes that this would further the safety of the market or the protection of investors. The Board [of the CMA] can exercise its power to exempt from the definition of Securities rights or instruments that otherwise would be treated as Securities under paragraphs (a, b, c, d) of this Article if it believes that it is not necessary to treat them as Securities, based on the requirements of the safety of the market and the protection of investors.”

The same term was defined again in the Glossary as meaning:

“(a) shares, (b) debt instruments, (c) warrants, (d) certificates, (e) units in an investment fund, (f) options, (g) futures, (h) contracts for differences, (i) long-term insurance contracts; and (j) any right or interest in anything which is specified by any of the items (a) through (i) above.”²⁶²

The CMA amended the Glossary on 28 June 2005, 18 August 2008, and 22 January 2012 to add, elaborate, or correct terminology. As an example of corrections made, the early versions of the Glossary defined the term ‘share’ as including ‘sukuk’. In turn,

²⁶² See also the definitions in Articles 2 and 3 of the Capital Market Law of 2003.

'sukuk' were described as having the characteristics of equity. This is not accurate, since, as shown in Section 3.2.1, sukuk may not necessarily have the characteristics of equity (i.e. may not represent an ownership stake in a company) and may rather be structured as debt-instruments. The reference to sukuk was therefore rightfully removed from the definition of the term 'share'.

If broken down by type, securities which are most known and utilized by the market consist of shares, debt instruments, and units in investment funds.²⁶³ Units in investment funds, in turn, are generally composed of either shares or debt instruments.²⁶⁴ A more general categorization of securities could be made on the basis of those securities that are equity-based and those that are debt-based. The following Sections will explain the significance of such a categorization.

3.1. Equity-Based Securities

Equity-based securities refer to instruments which grant a share in, or an ownership right over, the issuer itself, more specifically its profits and/or assets (i.e. corporate shares). Depending on the class of shares at hand, such type of securities may be either regular, prioritized, or subordinated. Article 103 of the Companies Law of 1965 makes that distinction between share classes in what relates to joint stock companies:

“[...] [t]he general assembly may, if there is no prohibitive stipulation in the Bylaws, decide to issue preferred shares or decide to transform common shares into preferred shares. The preferred shares may ensue to its owner priority in receiving certain profit or priority in

²⁶³ CMA, *supra* note 154, 12 and 68.

²⁶⁴ CMA, *supra* note 154, 46.

recovering what have been paid from the capital upon liquidation, priority of either matters or any other privilege.”

Islamic scholars seem to be in consensus that it is usurious for preferred shareholders to receive a guaranteed fixed dividend, payable despite the non-achievement of profits.²⁶⁵ Interestingly, certain scholars (including the AAOIFI) find that preferred shares are contrary to Sharia altogether, claiming that no shareholder class should be prioritized over another in the distribution of dividends and liquidation proceeds.²⁶⁶ This general prohibition however is debatable, and other scholars have argued that it is lawful for common shareholders to willingly subordinate their rights to those of preferred shareholders.²⁶⁷ Article 103 of the Companies Law of 1965 does clearly support this last view.

Undoubtedly, common shares are the most attractive and complete type of securities, from an investor's and from a socio-economic perspective.²⁶⁸ They spread the ownership base and grant the owners thereof not only a right in investment revenues or ownership in an asset which may appreciate, but also grant a more encompassing legal entitlement in the continuous steering of the decisions of the issuer and in the overall profit, rights, and assets of the issuer. As corporate bodies do not have, *a priori*, a

²⁶⁵ Kabir Hassan and Michael Mahlknecht, *Islamic Capital Markets: Products and Strategies* (John Wiley & Sons 2011) 405; See also Amir Kia, 'Speculative Activities, Efficiency and Normative Stock Exchange' (2001) 13 *Journal of King Abdulaziz University: Islamic Economics* 35 <http://www.kau.edu.sa/files/320/researches/50968_21105.pdf> accessed 30 May 2013.

²⁶⁶ Hassan and Mahlknecht, *supra* note 265, 405.

²⁶⁷ Malaysia Islamic Financial Center, 'Capital Market Products According to 'Islamic Jurisprudence' 92-93 <[http://www.mifc.com/sift_09/content/othpub/6ICMbook2\(4\).pdf](http://www.mifc.com/sift_09/content/othpub/6ICMbook2(4).pdf)> accessed 31 May 2013.

²⁶⁸ Umer Chapra, 'The Case Against Interest: Is it Compelling?' (2007) 49(2) *Thunderbird International Business Review* 161, 175.

limited life, it is theoretically conceivable for corporate shares to be existing and transmissible perpetually (for example by inheritance, one generation after another).

Many investors in listed companies anticipate a gain on the trading price but overlook the probably more modest, but more continuous, expectation of dividend. Where a company develops and markets a product that has become a necessity or that has been made a symbol of quality, it can be logically expected that such company will continue to be stable and profitable in the future.

3.2. Debt-Based Securities

The term debt financing refers typically to transactions where the relationship between the issuer/offerror and the investor/offeree is akin a straightforward loan between a lender and a borrower. Despite Sharia's prohibition on interest, it is tolerated for banks and issuers in Saudi Arabia to engage in conventional, for-interest, lending.²⁶⁹ Although general courts will not usually recognize interest elements, the SAMA has created a committee specialized in the resolution of disputes involving banks and their clients.²⁷⁰ It is notorious in the Saudi Arabian legal community that, although this committee has no power to issue rulings, its recommendations are generally enforceable. It is also notorious that this committee has indirectly showed willingness to recognize interests, by requesting the parties to the dispute to adhere to their respective contractual obligations.²⁷¹

²⁶⁹ Iqbal, *supra* note 78, 53.

²⁷⁰ Council of Ministers Resolution No. 729/8, dated 10 March 1987.

²⁷¹ Marar, *supra* note 64, 114-115.

While banks can engage in lending transactions based on their general banking license, issuers need to file an application and seek the CMA's approval for every different product they wish to launch.²⁷² This means a greater negative impact on issuers as opposed to banks in the event that interest-based transactions fail to attract sufficient borrower/investor response.

Typically, securities that are recognized as being debt-based consist mainly of bonds, which can be structured either in a conventional (i.e. for interest) or in an Islamic manner. The IMF observed that Saudi Arabia's debt markets are underdeveloped.²⁷³ In 2011, there were only two issuances of debt-based securities, but these had a value of 5.5 billion Saudi Riyals.²⁷⁴ In 2010, there was only one issuance of debt-based securities, but it represented a value of seven billion Saudi Riyals.²⁷⁵ In all instances, debt-securities issued were structured in an Islamic manner.

3.2.1. Bonds

In the same way as corporate shares, bonds are another category of securities that may be traded on the Stock Exchange or offered by way of private placement. In one instance, the Securities Industry and Financial Markets Association (“SIFMA”) defined the term 'bond' as meaning:

²⁷² Article 2(b) and 19 of the Listing Rules of 2004 and Article 3 of the Offer of Securities Regulations of 2004. See also Article 2 of the Banking Control Law, issued pursuant to Royal Decree No. M/5 dated 12 June 1966.

²⁷³ IMF, *supra* note 156, 14.

²⁷⁴ CMA, *supra* note 154, 42.

²⁷⁵ *Ibid.*

*[t]he written evidence of debt, bearing a stated rate or stated rates of interest, or stating a formula for determining that rate, and maturing on a date certain, on which date and upon presentation a fixed sum of money plus interest (usually represented by interest coupons attached to the bond) is payable to the holder or owner..*²⁷⁶

SIFMA defined the same term, in another instance as meaning:

*A bond is a debt security, similar to an I.O.U. When you purchase a bond, you are lending money to a government, municipality, corporation, federal agency or other entity known as an issuer. In return for that money, the issuer provides you with a bond in which it promises to pay a specified rate of interest during the life of the bond and to repay the face value of the bond (the principal) when it matures, or comes due.*²⁷⁷

Unfortunately, both of the above definitions are oversimplified and incomplete. Indeed, the entitlements of bond-holders may take many different forms, other than a conventional I.O.U. For instance, the bond-holder may, instead of acting as a mere lender, actually assume the role of a partner, a lessor, a service-provider, etc.²⁷⁸ The increasing interest in Islamic bonds has shed light on a new range of possible bond structures. Islamic bonds are referred to in Arabic as a 'sak', in the singular form or as 'sukuk' in the plural form. The term 'sak' is actually the origin of the term 'cheque'

²⁷⁶ The Securities Industry and Financial Markets Association (SIFMA) <<http://investinginbonds.org>> accessed 1 December 2010.

²⁷⁷ SIFMA, 'What Are Bonds' <<http://www.investinginbonds.com/learnmore.asp?catid=46&id=2>> accessed 20 September 2012.

²⁷⁸ Khalid S. Alsaeed, 'Sukuk Issuance in Saudi Arabia: Recent Trends and Positive Expectations' (DPhil thesis, Durham University 2012) 27-28.

which means a promise to pay, the concept of which had flourished during the period referred to as medieval Islam.²⁷⁹

The Accounting and Auditing Organisation for Islamic Financial Institutions (“AAOIFI”) suggested the following definition for the term ‘sukuk’, which actually also serves as a more detailed and complete definition for ‘bonds’:

“certificates of equal value representing after closing subscription, receipt of the value of the certificates and putting it to use as planned, common title to shares and rights in tangible assets, usufructs and services, or equity of a given project or equity of a special investment activity.”²⁸⁰

Since interest is forbidden in Islam, the profit element in sukuk must not be the product of a conventional loan, which therefore disqualifies the commonly used I.O.U. bond model. Sukuk are typically based on one of the following structures:²⁸¹

- 1) Ijara (Leasing): The sukuk-holders purchase the asset which the issuer desires to acquire and then lease such asset to the issuer, with a transfer of ownership to the issuer at the end of the lease period and for a nominal value.
- 2) Murabahah (Cost-plus, Mark-up): The sukuk-holders purchase any asset at market price, sell it to the issuer with a profit margin and against deferred payments, and then sell it on behalf of the issuer at market price.

²⁷⁹ Yahya Abdul Rahman, *The Art of Islamic Banking: Tools and Techniques for Community-Based Banking* (Wiley Finance 2010).

²⁸⁰ 'Sukuk Under Development' (1 September 2009) IFLR <<http://www.iflr.com/Article/2283704/Sukuk-under-development.html>> accessed 21 September 2012.

²⁸¹ See IOSCO, 'Report of the Islamic Capital Market Task Force of the International Organization of Securities Commissions' (July 2004) 10-13 <<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD170.pdf>> accessed 21 September 2012.

- 3) Mudaraba (Entrepreneurship): The sukuk-holders act as the funding passive partner and the issuer acts as the working partner in a project where profit is shared between the sukuk-holders and the issuer.
- 4) Musharakah (Partnership): The sukuk-holders invest in the project of the issuer against a share in the profits generated by such project.
- 5) Salam (Commodity-based spot payment/Deferred Payment): A forward sale with immediate payment by the sukuk-holders for an asset to be delivered in a future point in time, and which may then be exploited for the common interest of the sukuk-holders (e.g. through resale).
- 6) Istisna (Manufacturing-based/Spot Payment/Deferred Delivery): A contract whereby the bond holders pay or get paid for the manufacturing of an asset, to be delivered in a future point in time, and which may then be exploited through lease or otherwise.
- 7) Hybrid: Any structure combination.

3.2.2. *Sophistication and Risks*

Although bonds in Western jurisdictions are fairly straightforward, these tend to be very detailed and sophisticated when structured Islamically as sukuk. A sukuk may only be evaluated, in terms of investment prospectivity, following a careful read of the marketing material relating thereto. All typical sukuk structures require a substantial amount of descriptive information and the provision of comfort regarding the titles and performance ability of the parties involved (e.g. the title of the owner in an ijara transaction, the nature of the project in a mudaraba or a musharaka transaction, the know-how of the manufacturer in an istisna transaction, etc.). This level of detail and

complexity increases the risk of misunderstandings, disputes, and plain failure.²⁸²

Western bonds are usually securitized simply by the credit worthiness of the issuer. In the case of sukuk, risk factors are more significant and may include such things as the risk of loss of the underlying asset (in the case of ijara, murabaha, or istisna) or the loss of title (e.g. the ownership or leasehold title in the case of ijara).²⁸³ Caution is mandated in the following verse of the Quran: "*Spend your wealth for the cause of Allah, and be not cast by your own hands to ruin, and do good. Lo! Allah loveth the beneficent*".²⁸⁴

The CMA's Tadawul website describes sukuk and bonds as having "*periodic returns and lower risk than equity investment*".²⁸⁵ A number of recent defaults on issued sukuk have illustrated how such statement might be false and how sukuk and bonds can be just as vulnerable and risky.²⁸⁶

3.2.3. Validity Requirements for Sukuk

²⁸² Lahasna and Hassan, *supra* note 53, 25-26; See also Salman Ali, *Islamic Capital Market Products: Developments and Challenges* (IDB 2005), 10.

²⁸³ *Ibid*, 43-44; IOSCO, *supra* note 281, 10-13.

²⁸⁴ Quran, Verse 2:195.

²⁸⁵ Tadawul, 'Sukuk & Bonds Information Guide'

<http://www.tadawul.com.sa/wps/portal!/ut/p/c0/04_SB8K8xLLM9MSSzPy8xBz9CP0os3g_A-ewIE8TIwN3vwBLA09vM1dPT5cgAwNvI_3g1Dz9gmXHRQAzJ-Ag/> accessed on 20 July 2012.

²⁸⁶ Regarding the failure of Million East Cameron Gas Sukuk, see Michael J. T. McMillen, 'An Introduction to Shari'ah Considerations in Bankruptcy and Insolvency Contexts and Islamic Finance's First Bankruptcy (East Cameron)', (17 June 2012) 21 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1826246> accessed 21 September 2012; Ayman Abdel-Khaleq and Christopher Richardson, 'New Horizons for Islamic Securities: Emerging Trends in Sukuk Offerings', (2006-2007) 7 Chicago Journal of International Law 409, 422-424; Regarding the failure of Sukuk Al Manafa'a issued in May 2007 by Saad Trading, Contracting, and Financial Services Co. Ltd., see Mushtak Parker, 'Saad Trading launches \$ 650 Million Sukuk' (London, 16 June 2007) *Zawya* <<http://www.zawya.com/story.cfm/sidZAWYA20070616040157>> accessed 22 August 2009; See also Saudi Saad's Sukuk Investors Mull Setting Up Committee, (14 July 2009) <http://sukuk.net/news/articles/7/Saudi_Saad's_sukuk_investors_mull_setting_up_committee.html> accessed 22 August 2009.

Acting on its estimation that 85% of sukuk failed to meet the requirements of Sharia, the AAOIFI had issued a statement in February 2008 advising Islamic financial institutions and Sharia Boards to adhere to the following six principles:²⁸⁷

- a) Sukuk may only be traded if they assume an underlying title to tangible assets, usufruct rights, or services, and where such title is capable of being sold. The sukuk manager must be able to certify the transfer of the underlying title and must not have a personal interest therein;
- b) To be tradable, it is not sufficient for sukuk to represent receivables or debts, except in the case of a trading or financial entity selling all of its assets or a portfolio with a standing financial obligation, in relation to which an incidental debt was unintentionally included;
- c) It is not permissible for the sukuk manager, whether the manager acts as mudarib (investment manager), a sharik (a partner) or a wakil (agent), to undertake to offer loans to sukuk holders, when actual earnings fall short of expected earnings. However, a reserve may be created to cover for such shortfall, provided it is mentioned in the offering documentation;
- d) It is not permissible to structure sukuk so to grant, in advance, a right to repurchase at nominal (or face) value those assets in which sukuk-holders have a right. Such repurchase may however be based on the assets' net value, market value, fair value, or a price agreed upon at the moment of repurchase;

²⁸⁷ AAOIFI, 'Shari'a Board Resolutions on Sukuk' (February 2008)
<http://www.aaofi.com/aaofi_sb_sukuk_Feb2008_Eng.pdf> accessed 21 September 2012.

- e) It is permissible for a lessee in a sukuk al-ijara to undertake to repurchase the leased assets for its nominal value, upon the expiration of the sukuk, provided that said lessee is not also a mudarib, partner, or investment agent;
- f) Sharia supervisory committees should not limit their scrutiny to the overall permissibility of the structure but must also oversee all underlying documentation, at the moment of its signing and all throughout its implementation.

The AAOIFI's initiatives, generally, and its sukuk guidelines, specifically, have been rather well received by the Islamic community, although with a few diverging opinions from certain scholars. Some have claimed that the principles advanced by the AAOIFI have "*virtually crippled the [sukuk] market, which has been the industry's fastest growing segment*"²⁸⁸ However, as the AAOIFI has emphasized, the objectives of Sharia entail the promotion of true partnerships with shared profit and loss, as opposed to conventional debt instruments.²⁸⁹ Accordingly, the above principles aim only at verifying the authenticity of the stipulations relating to profit and risk sharing between the sukuk issuer and the sukuk holder. As previously explained in 2.1 of Part II, Sharia is not concerned with the deprivation of the interest element and the consequent opportunity loss faced by issuers and investors. Sharia contends that the societal harm caused by such interest element would outweigh any personal benefit derived.

4. PUBLIC LISTINGS

²⁸⁸ 'Islamic Finance Body Backs Divisive Sukuk Ruling' *Reuters* (Kuala Lumpur, 19 November 2008) <<http://www.reuters.com/article/2008/11/19/islamic-finance-ruling-idUSKLR39989020081119>> accessed 29 June 2012.

²⁸⁹ AAOIFI, *supra* note 287, 4.

As will be explained in detail in the following Sections, the Listing Rules of 2004 clearly describe the criteria and process for the public offer of shares and debt instruments, amongst other types of securities.²⁹⁰ At the end of 2011, there were 150 issuers of listed shares and five ongoing issuers of debt instruments.²⁹¹ The Listing Rules of 2004 also describe the continuing disclosure obligations of issuers and the circumstances under which trading may be suspended.²⁹²

Although the Listing Rules of 2004 also stipulate the conditions for the listing of contractually based securities, warrants, and convertible debt instruments, these will not be treated in this thesis since such types of securities have not yet been listed on the Stock Exchange.²⁹³

Furthermore, the Listing Rules of 2004 do not apply to the public offer of units in investment funds.²⁹⁴ Nonetheless, units in investment funds can be publicly offered. The conditions for the public offer of units in investment funds are contained in Article 5 of the Investment Funds Regulations of 2006, and will be described in Section 6.1 of this Part.

4.1. Listing Requirements

4.1.1. Requirements Regarding the Issuer and the Securities

²⁹⁰ Article 13 and 15 of the Listing Rules of 2004.

²⁹¹ CMA, supra note 154, 40 and 43.

²⁹² Parts 7 and 8 of the Listing Rules of 2004.

²⁹³ CMA, supra note 154, 41-42.

²⁹⁴ Article 2(c) of the Listing Rules of 2004.

Part 3 of the Listing Rules of 2004 imposes a number of general conditions for listing. A distinction is made between those general conditions pertaining to the listing applicant and those pertaining to the securities to be listed by that applicant.²⁹⁵

In order to qualify for listing, securities must, amongst other conditions, be freely transferable and tradable and must be registered and settled through the Depository Centre.²⁹⁶ Article 26 of the Capital Market Law of 2013 stipulates that the Depository Centre shall first be established as a department within the Stock Exchange and may be converted into a company with the approval of the board of the CMA. The Board may give requirements regarding the structure and operation of such company as it deems appropriate for the safety of the market and the protection of the investors.²⁹⁷ As of May 2013, registration and settlement functions were still carried out internally by the Saudi Stock Exchange.²⁹⁸

Pursuant to Articles 11(a) and 11(b) of the Listing Rules of 2004, it is a condition precedent for a listing applicant to fulfill the following:

- a) to be structured as a Saudi joint stock company;
- b) to have carried on, either by itself or through a subsidiary, a main activity for at least three financial years and under substantially the same management; and

²⁹⁵ Articles 11 and 12 of the Listing Rules of 2004.

²⁹⁶ Articles 12(b) and 12(c) of the Listing Rules of 2004; Article 27 of the Capital Market Law of 2003.

²⁹⁷ Articles 26(a) and 26(b) of the Capital Market Law of 2013; See also Bushra Ali Gouda, *supra* note 15, 146.

²⁹⁸ Tadawul, 'Depository'

<http://www.tadawul.com.sa/wps/portal!/ut/p/c0/04_SB8K8xLLM9MSSzPy8xBz9CP0os3g_A-ewIE8TIwMLf3czA0_vIKegIBN_QwMzQ_3g1Dz9gmXHRQCYEEF4/> accessed 21 April 2013.

- c) At least one financial year must have elapsed since any restructuring undergone by the applicant or any capital alteration using external finance.²⁹⁹

The above conditions may be waived by the CMA and have been waived in a number of cases.³⁰⁰ Waivers, were granted for example for insurance and telecommunication companies which, by law, had to be created as public companies (through pre-incorporation initial public offering ("IPO") and the listing of newly issued shares) and therefore could not produce the CMA-required three-year track record.³⁰¹

Those proposed issuers not already structured as a joint stock company need to convert into such form as a condition for listing. Previously, it was mandatory for limited liability companies desiring to convert into joint stock companies to fulfill a specified set of criteria set out in a regulatory instrument titled the 'Controls Regulating the Conversion of Companies into Joint Stock Companies'.³⁰² These criteria for conversion had included the following:

- a) the company had to be existence for over five years;
- b) the company's net assets had to be no less than fifty million Saudi Riyals;

²⁹⁹ Article 119(d) of the Listing Rules of 2004.

³⁰⁰ Article 11(h) of the Listing Rules of 2004.

³⁰¹ As per Article 3(1) of the Cooperative Insurance Companies Control Law, issued pursuant to Royal Decree No. M/32, dated 31 July 2007, insurance and reinsurance activities may only be licensed to public joint stock companies. Article 4 of the Communications Law, issued pursuant to Royal Decree No. 12, dated 4 June 2001 states that: "[I]t shall be impermissible to provide fixed and mobile telephone communication services, except through joint stock companies that put their shares to public subscription."

³⁰² Issued pursuant to the Resolution of the Minister of Commerce and Industry No. 495 dated 30 July 1997.

- c) the proceeds of the shareholders' rights had to be greater than seven percent, in any of the three years preceding the conversion;
- d) the company had to have a qualified administrative organ that is capable of effectively and efficiently managing its operations and had to have the ability to compete in the market;
- e) the company had to produce an economic feasibility study demonstrating the viability of its projects, and containing a calculation of expected financial returns for the three years following conversion as well as a calculation of the anticipated capitalization for the converted entity, as well as the share value thereof; and
- f) the company had to produce an auditors' report confirming the absence of important litigation against the company.

The above controls, which were presumably aimed at the protection of investors, applied equally to both closed and public joint stock companies. The cancellation of the conditions for conversion constituted a positive step as they impacted negatively on:

- a) foreign direct investment, especially when a listing exit was contemplated; and on
- b) the continuation of family enterprises, as their continuation may be safeguarded by conversion into the joint stock corporate model for its greater flexibility in trading and the transfer of ownership.

Ultimately, it is not logical that the requirements for conversion into a closed joint stock company be stricter than the requirements for the creation of a new closed joint company. This would seem as an unjustified discrimination against the shareholders of existing limited liability company (interested in conversion) who have more at stake

than the founders of new corporations. This would also seem as an unnecessary interference with and constriction of the natural growth of existing corporations.

4.1.2. *Application Process*

Companies seeking the listing of their securities on the local stock exchange must submit an application containing, most importantly, a prospectus.³⁰³ Annex 4 of the Listing Rules of 2004 describe the content for prospectuses for shares while Annex 5 of the Listing Rules of 2004 describe the content for prospectuses for debt instruments and convertible debt instruments. *Grosso modo*, a prospectus must contain:

*"all information which is necessary to enable an investor to make an assessment of the activities, assets and liabilities, financial position, management, and prospects of the issuer and of its profits and losses".*³⁰⁴

The CMA will seek to review the prospectus within 45 days of receiving all information and documentation required.³⁰⁵ The CMA may carry out any enquiries and may require the applicant or third parties to provide any additional information that it considers important.³⁰⁶ Should the CMA determine that the offer would not be in the interest of investors or may result in a breach of the Capital Market Law of 2003, then it may, after giving the issuer a suitable opportunity to be heard, issue a notification to the issuer stating that the prospectus has not been approved or publish a notice prohibiting the

³⁰³ Article 40 of the Capital Market Law of 2003. Article 19(b)(9) of the Listing Rules of 2004.

³⁰⁴ Article 21(a) of the Listing Rules of 2004.

³⁰⁵ Article 22(c) of the Listing Rules of 2004.

³⁰⁶ Article 22(d) of the Listing Rules of 2004.

offer, sale or transfer of the securities to which the prospectus relates.³⁰⁷ Rejected applicants have the right to appeal the CMA's decision to the CRSD.³⁰⁸

On the other hand, should the CMA be satisfied with the prospectus, the issuer must then publish it and must ensure that it is made available to the public at least fourteen days preceding the start of the offering.³⁰⁹

4.1.3. Listing of Shares

Pursuant to Article 13 of the Listing Rules of 2004, there must be a sufficiently liquid market for any shares to be listed. In order for shares to be eligible for listing, and as a continuing process, the issuer must list at least thirty percent of the class of shares that are the subject of the application.³¹⁰ Similarly, the listing process must result in at least two hundred public shareholders and the aggregate market value of all listed shares must be at least SR 100 million.³¹¹

4.1.4. The Listing of Debt Instruments

As a condition for the listing of debt instruments, the aggregate value of listed debt instruments must be no lesser than SR 50 million, if the issuer already has listed securities, or SR 100 million, if the issuer does not have any listed securities.³¹²

4.1.5. General Remarks

³⁰⁷ Article 22(e) of the Listing Rules of 2004.

³⁰⁸ Article 1(c) of the Listing Rules of 2004.

³⁰⁹ Article 25(a) of the Listing Rules of 2004.

³¹⁰ Article 13(a)(2) of the Listing Rules of 2004.

³¹¹ Articles 13(a)(1) and 13(e) of the Listing Rules of 2004.

³¹² Article 15(a) and 15(b) of the Listing Rules of 2004.

Requesting that a prospectus be submitted as part of the application may discourage certain potential issuers. Indeed, the cost of retaining a fleet of consultants (e.g. financial, legal, technical, and market consultants) to prepare the prospectus is quite exorbitant, with no assurance of CMA approval. However, the consultants (especially the financial advisor who is licensed by the CMA) are expected to gauge interested issuers and prepare for them a track towards listing, which could be spread in time over months or possibly years. The financial consultants would therefore serve as a first screen of the listing feasibility and advisability of a proposed offer.

The crux of the application process is simply the verification of the adequate disclosure of the status and affairs of the issuer and the verification that any issues of concern are adequately highlighted, moderate, and do not unreasonably place at risk the public's investment. Even though the Saudi Arabian capital market law and regulations intend that the market be disclosure-based, a number of market analysts have remarked that the average Saudi Arabian investor does not give sufficient importance to various market disclosures.³¹³ The CMA therefore must exercise vigilance, at the listing application stage, in the selection of good investment opportunities and 'pick winners'. As shown in Section 4.1 of Part III, Sections 4.4 and 5 of Part V, there are various considerations which could affect the CMA's decision to approve or prioritize the public offer of particular securities.

³¹³ Ramady, *supra* note 106, 153.

Where a proposed issuer is a company existing within a group structure, it must be carefully evaluated whether another company in such group is better placed to carry out an offer. For example, where a holding company owns numerous companies, specialized in one single or diversified activities, the public would benefit in participating in the highest level of the group's hierarchy, considering that such level is likely to act as the consolidated management of the group's activities and as the end-beneficiary of dividend distributions. Where the proposed issuer exists alongside other sister companies, practicing similar activities, the regulator should ensure that these sister companies would not be diverting profit away from the proposed issuer.

5. PRIVATE PLACEMENTS

The 2008 OSR Version divided private placements in three categories:

- a) Offer of securities issued by the government of Saudi Arabia or a supranational authority recognized by the CMA;
- b) offers to sophisticated investors³¹⁴; and
- c) limited offers³¹⁵.

³¹⁴ The 2008 OSR Version defined the newly introduced 'sophisticated investors' as comprising: "(a) Authorized persons acting for their own account; (b) clients of persons authorized by the CMA to conduct managing activities, provided that the offer is entirely made through the authorized person and the authorized person has been engaged on terms which enable it to make decisions concerning the acceptance of private offers of securities on the client's behalf, without reference to the client; (c) the government of Saudi Arabia, any supranational authority recognized by the CMA, the Saudi stock exchange, any other exchange recognized by the CMA, or the Depository Centre; (d) institutions acting for their own account; (e) Professional investors; or (f) any other person prescribed the CMA".

³¹⁵ Pursuant to Article 11(a) of the 2008 OSR Version, "an offer of securities is a limited offer if: (a) it is directed at no more than 60 offerees excluding sophisticated investors; and b) the minimum amount payable per offeree is not less than SR 1 Million or an equivalent amount. An issuer may not treat an offer of its securities as being exempt more than or an equivalent amount. The minimum amount payable per offeree may be less than SR 1 Million or an equivalent amount where the total value for the securities being offered does not exceed SR 5 Million or an equivalent amount; (b) the offeree is an employee of the issuer or its affiliate; (c) the offeree is an affiliate of the issuer; or

5.1. Major Changes From the 2004 OSR Version to the 2008 OSR Version

The categorization of offers under the 2004 OSR Version was illogical in some ways since it had established an ‘exempt’ category of offers, alongside public offers and private placements.³¹⁶ Exempt offers were possible if the securities to be offered were issued by a governmental or supranational authority, if they were lesser than five million Saudi Riyals in value, if the offer was directed to a restricted number of offerees, for a minimum payable amount of one million Saudi Riyals, or if the offeree was affiliated to the offeror.³¹⁷ Exempt offers required the CMA’s approval, just like any regular private placement, but did not require the submission of a thorough offering memorandum.³¹⁸

The 2008 OSR Version completely removed the ‘exempt’ category of offers.³¹⁹ It appears that the market may have misinterpreted exempt offers as not requiring notification to the CMA and, consequently, transactions were carried out without any CMA scrutiny. Contrary to public offers (which imply listing), private placements

(d) the offer complies with any other requirement prescribed by the CMA”.

³¹⁶ Article 6 of the 2004 OSR Version.

³¹⁷ Article 16 of the 2004 OSR Version.

³¹⁸ Article 16 of the 2004 OSR Version.

³¹⁹ Under the 2004 OSR Version, offers were categorized as exempt, “in any of the following circumstances:

- (a) If the securities are issued by the government of Saudi Arabia;*
- (b) If the securities are issued by a supranational authority recognized by the CMA;*
- (c) If the securities are offered to no more than 60 offerees in Saudi Arabia and the minimum amount payable per offeree is not less than SR 1 Million or an equivalent amount. An issuer may not treat an offer of its securities as being exempt more than once in a 12-month period;*
- (d) If the total value of the securities offered by the issuer is less than SR 5 Million or an equivalent amount. An issuer may not treat an offer of its securities as being exempt more than once in a 12-month period;*
- (e) If the issuer of the securities is a member of a group of companies and the issuer offers the securities to a member of the same group”.*

(including exempt offers) can be carried out discretely, without alerting authorities. It is difficult therefore to ascertain how many exempt offers were conducted without the knowledge of the CMA.

Article 3(b) of the 2004 OSR Version was the source of other interpretative difficulties, also resolved in the 2008 amendments. According to Article 3(b) of the 2004 OSR Version:

“Securities issued by a company in the Kingdom may not be offered unless the company is a joint stock company.”

Obviously, Article 3(b), as it used to read, cannot be interpreted as meaning that the shares in limited liability companies cannot be transacted upon or offered altogether, neither upon first subscription nor upon later trading. It would be completely absurd to state that the shares in limited liability companies are or should be completely restricted from transferability. Logically, the aforementioned Article only intended a mere reinstatement of Article 11(a) of the Listing Rules of 2004, which limits listing on the Stock Exchange to joint stock companies. Unfortunately, such a reinstatement was practically useless and resulted in the erroneous understanding that the offerors of shares in limited liability companies were not bound by the Offer of Securities Regulations of 2004 and did not need to notify the CMA of intended private placements. According to such understanding, the requirements of the Offer of Securities Regulations of 2004 would apply only to transactions involving the shares of closed joint stock companies. Such a deduction or interpretation would actually mean that the law could easily and flagrantly be circumvented and that capital market

transactions may be conducted, without regulatory protection of the rights of proposed investors, by the mere utilization of a limited company as the corporate vehicle for a call for funds. Obviously, this interpretation is unfounded and erroneous. As described in Section 3 of this Part, securities are defined as including shares. Shares, in turn have been defined as comprising "*the shares of any company, incorporated or unincorporated*". This definition obviously relates to shares of both limited liability and closed joint stock companies and, if broadly interpreted, could even include the contribution of partners in general partnerships that do not enjoy legal personality.

Following the 2008 amendments to the Offer of Securities Regulations of 2004, it should have become clear that limited liability companies are subject to the private placement requirements of the Offer of Securities Regulations of 2004 in the same way as closed joint stock companies.

5.2. Attractive Aspects of Private Placements

Private placements present an attractive financing opportunity given their informal nature and given the absence of rigid regulatory requirements similar to those related to stock exchange listings. This flexibility is justified by the fact that, while the public which the listing regulations aim at protecting, includes the unsophisticated and inexperienced who are most vulnerable to reach unsound investment decisions, private placement investors, on the other hand, are presumed to have institutional capabilities and resources. Additionally, while a private placement transaction involves a small number of parties, IPOs affect an immensity of parties, which accentuates the possible damages that lack of oversight may have.

For proposed offerors, private placements provide more confidentiality and flexibility in the negotiation of transactional terms and conditions, and also facilitate the financing's formalization. Proposed offerors in a private placement context do not absolutely need to be structured as joint stock companies, as would normally be required for public offerors, nor are they required to offer out a minimum percentage of shares, nor target a minimum number of investors. Therefore, shareholders seeking an exit strategy may find it more convenient to opt for a sale of shares to private investors rather than applying for an IPO.

5.3. Difficult Application of the Private Placement Rules

If the Offer of Securities Regulations of 2004 are to be applied to the strictest extent, then it could be made a prerequisite to obtain the CMA's approval as a condition to the incorporation of any limited liability or closed joint stock company or to any transfer of shares therein. Although such a requirement would better safeguard the interests of investors, it would however constitute a heavy burden on the private sector. Obviously it would be extremely cumbersome to complete a private placement each time an individual wishes to incorporate or sell shares in a limited liability or closed joint stock company. It is, for instance, extremely costly for the average individual to retain a financial advisor and prepare an offering memorandum prior to soliciting interest in the incorporation of a company or the purchase of a share. It is therefore important to devise ways to alleviate those burdens while continuing to safeguard the protection of investors. For instance, the CMA could exempt from the general private placement process (or alleviate the requirements for) transactions involving offerings lower than a

certain value. A parallel effort should be made to reduce the costs of financial advisors so to ensure that compliance remains affordable.

6. INVESTMENT FUNDS

6.1. Relevance

Investment funds can efficiently palliate the lack of investor awareness and investor dedication to the monitoring of trading activity. The advantage of investment funds lies in the delegation of the investment decisional process to more experienced and time devoted experts. This delegation therefore protects not only those with little familiarity in capital markets but also those who are too busy to follow market developments and manage their portfolio. Investment funds are offered in a wide array of types and leave the investor with the choice of making only broad determinations such as risk level and nature of the fund. Investment funds are not limited to publicly-listed companies and may invest in a wide spectrum of closed corporation, of any size, both onshore and offshore.³²⁰

The Tadawul website contains a comprehensive list of all CMA-approved investment funds, and provides, for each such fund, a mini-prospectus, detailing the fund's objective and policy, with a mention of the base currency, the inception date, and classification.³²¹

³²⁰ For a list of categories of investment funds established in Saudi Arabia, see Tadawul, 'Mutual Funds' <http://www.tadawul.com.sa/wps/portal!/ut/p/c1/04_SB8K8xLLM9MSSzPy8xBz9CP0os3g_A-ewIE8TIwMDDw9nA09vE3cXI3c3QwMDA_3g1Dz9gmxHRQA0r9G4/> accessed 24 September 2012.

³²¹ Tadawul, 'Mutual Funds' <http://www.tadawul.com.sa/wps/portal!/ut/p/c1/04_SB8K8xLLM9MSSzPy8xBz9CP0os3g_A-ewIE8TIwMDDw9nA09vE3cXI3c3QwMDA_3g1Dz9gmxHRQA0r9G4/> accessed 27 October 2012.

According to the IOSCO's principles on collective investment schemes, the regulatory system should:

- a) *“set standards for the eligibility and the regulation of those who wish to market or operate a collective investment scheme.*
- b) *provide for rules governing the legal form and structure of collective investment schemes and the segregation and protection of client assets.*
- c) *require disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value if the investor's interest in the scheme.*
- d) *ensure that there is a proper and disclosed basis for asset valuation and the pricing and the redemption of units in a collective scheme.”³²²*

The CMA issued two separate instruments governing investment funds. The first, the Investment Funds Regulations of 2006 governs funds investing in securities. The second, the Real Estate Funds Regulations of 2006, governs funds investing in real estate. Both instruments are fairly well-detailed and should meet IOSCO's principles on collective investment schemes.³²³ Prior to the issuance of these instruments, the legal framework governing investment funds was limited essentially to a number of circulars addressed by the SAMA and the MoF to Saudi Arabian banks, which, at the time, were the only entities authorized to act as fund managers.³²⁴

³²² IOSCO, supra note 155, ii and 27-31.

³²³ See PART III - 3.1.

³²⁴ The MoF was previously referred to as the Ministry of Finance and National Economy. Examples of circulars issued by SAMA include the Regulations for Investment Funds and Collective Investment Schemes, issued in June 1993, <<http://www.sama.gov.sa/sites/samaen/RulesRegulation/BankingSystem/Pages/BankingSystemFD07.aspx>> accessed 20 October 2012.

The regulatory framework governing real estate investment funds is described in the next Section. As for the framework governing funds investing in securities, the Investment Funds Regulations of 2006 mention that investment fund units may be offered either by way of a public offer or a private placement.³²⁵ Both types of offer require the CMA's approval and involve substantially the same application process.³²⁶ The Investment Funds Regulations of 2006 specify in great detail the obligations of the fund manager towards investors. For instance, Article 15 of the Investment Funds Regulations of 2006 requires the execution of a formal contract between the fund manager and the investors.³²⁷ Article 19 of the Investment Funds Regulations of 2006 mentions that the fund manager must avoid conflicts between its own interests and those of funds under its management or conflicts between the interests of the different funds under its management. Article 31 of the Investment Funds Regulations of 2006 requires the segregation of the monies and assets belonging to each particular fund. Article 39 of the Investment Funds Regulations of 2006 places on fund managers certain investment limitations. Amongst other limitations, an investment fund cannot have an exposure of more than five percent to the shares of any issuer and cannot have an exposure to a single issuer exceeding fifteen percent of its net asset value.³²⁸ Part 9 of the Investment Funds Regulations of 2006 specify the redemption rights of investors and describe the obligations of the fund manager in that regard.

6.2. *Real Estate Funds*

³²⁵ Article 3(b) of the Investment Funds Regulations of 2006.

³²⁶ Articles 4(d), 5(a), and 6 of the Investment Funds Regulations of 2006.

³²⁷ Part 3 of the Investment Funds Regulations of 2006.

³²⁸ Articles 39(c) and 39(d) of the Investment Funds Regulations of 2006.

The adequacy of real estate infrastructure and especially housing units, is one of the core objectives of the MEP's development plan.³²⁹ It is therefore important for the legislative and regulatory framework not to contain any unnecessary obstacles to real estate investment and development.

Pursuant to Article 2(d) of the Capital Market Law of 2003, the CMA has jurisdiction over offers of "*instruments representing profit participation rights*" and/or any "*rights in the distribution of assets*" in any particular real estate project.

There exists regulations relating to the off-plan sale of real estate units, but these do not mention or seem to involve the CMA.³³⁰ This is because these instruments contain adequate protections of the rights of off-plan real estate purchasers. Indeed, any payments that they make are deposited in a trust account and can only be withdrawn and expensed against actual construction costs.³³¹ Although it could be argued that any investment in a real estate unit under construction constitutes a "*right in the distribution of assets*" and hence a security as per the meaning of Article 2(d) of the Capital Market Law of 2003, there indeed seems to be no practical utility in involving the CMA in such type of sale. Instruments relating to the off-plan sale of real estate will therefore not be studied in this thesis.

³²⁹ MEP, *supra* note 11, 353.

³³⁰ The Organizational Rules Governing the Off-Plan Sale of Real Estate Units, issued pursuant to the Minister of Commerce Resolution No. 983, dated 17 January 2010. The Council of Ministers Resolution No. 73 dated 9 March 2009 regarding the Conditions Governing the Off-Plan Sale of Residential, Commercial, Office, Service, or Industrial Units.

³³¹ Part 2 of the 2010 Organizational Rules Governing the Off-Plan Sale of Real Estate Units.

One the other hand, there exists two other instruments relating to real estate investment and which do involve the CMA:

- (a) The Real Estate Subscription Regulations of 2005, issued by the Council of Ministers,³³² and
- (b) The Real Estate Investment Funds Regulations of 2006, issued by the CMA.

As will be explained in the following Sub-Sections, the two above instruments are intertwined.

6.2.1. *Real Estate Subscription Regulations of 2005*

The Real Estate Subscription Regulations of 2005 were issued as a result of the loss of tens of billion Saudi Riyals in failed real estate funds.³³³ Following the issuance in 2010 of the regulations governing the off-plan sale of real estate, it could be assumed that the Real Estate Subscription Regulations of 2005 would only be relevant in the context of the offer of "*profit participation rights*" in real estate projects.

It is a condition for the call of real estate investments that the investment campaign be licensed by the MoCI.³³⁴ Such licensing is subject to a set of prerequisites such as the registration of the land in the name of the applicant for licensing, the issuance of a municipal construction permit, and the preparation of a study by a certified consultant

³³² The Real Estate Subscriptions Regulations, issued pursuant to Council of Ministers' Resolution No. 220 dated 26 September 2005. See Fahd Alkhufair, 'Real Estate Contributions and Units' (August 2006) 1 *The Law* 26, 26. See also Fahd Alkhufair, 'Subscription of the Organizer of a Real Estate Subscription' (June 2007) 6 *The Law* 24, 24.

³³³ 'The Completion of the Liquidation of 200 real estate Funds in Saudi Arabia: Failures Deprive the National Economy of SR 56 Billion' *Al Arabiya News* (30 August 2012) <<http://www.alarabiya.net/articles/2012/08/30/235106.html>> accessed 20 October 2012.

³³⁴ Article 6 of the Real Estate Subscriptions Regulations of 2005.

on project implementation and costs.³³⁵ Moreover, Article 2(2) of the Real Estate Subscription Regulations of 2005 requires the applicant to fund twenty percent of the development capital.

Once preliminary approval is given by the MoCI for the call for investments, the applicant must request from the office of the Notaries Public (or the competent court) to record on the title deed a mention that: (i) the land represented by such deed will be the object of a call for subscriptions and development, (ii) the land cannot be transacted upon during the entire subscription period; and that (iii) in the event of the death or incapacitation of the applicant, a licensed securities firm will be replacing the applicant in transactions involving such land.³³⁶ Once the above has been recorded, the applicant must then arrange the establishment of a real estate investment fund, pursuant to the requirements of the Real Estate Investment Funds Regulations of 2006.³³⁷

It is positive and vigilant to have subjected the call for subscription phase to the monitoring of the CMA, since it is the governmental authority that is most competent and experienced to safeguard and protect the interests of investors.³³⁸

6.2.2. *Real Estate Investment Funds Regulations of 2006*

Article 3(a) of the Real Estate Investment Funds Regulations of 2006 specifies that only securities firms licensed to conduct managing business can apply to the CMA for the

³³⁵ Article 3 of the Real Estate Subscriptions Regulations of 2005.

³³⁶ Article 5 of the Real Estate Subscriptions Regulations of 2005.

³³⁷ Article 4 and 6 of the Real Estate Subscription Regulations of 2005.

³³⁸ Articles 4 and 6 of the Real Estate Subscriptions Regulations of 2005.

establishment of a real estate investment fund. The Real Estate Investment Funds Regulations of 2006 specify the requirements for the establishment of a real estate fund and describe the continuing duties of the fund manager.³³⁹

The Real Estate Investment Funds Regulations of 2006 contain a number of measures to protect the rights of investors. For instance, the fund manager must disclose to the investors, in advance, the terms and conditions of the fund. These must describe, amongst other things, the fees, charges, and commissions to be paid by the investors.³⁴⁰ Furthermore, any real estate property to be acquired must be represented by a formal deed.³⁴¹ Likewise, at least once every six months, the fund manager must evaluate the fund's assets, based on an evaluation to be prepared by at least two evaluators, and must calculate the benchmark price of a fund unit.³⁴²

7. CONCLUSION

The success of capital markets rests on the ability of the CMA to monitor and supervise all capital market transactions without undue impediments. Vigilance with unlicensed offers will help preserve the full potential of capital markets. The CMA has done well by having drafted a wide and encompassing definition for the term offer and to have imposed an application process for all types of securities offers. The different offering regimes put in place by the CMA are quite elaborate. Strict criteria must be fulfilled

³³⁹ See for example Article 20 of the Real Estate Investment Funds Regulations of 2006 regarding the requirement on fund managers to avoid conflicts of interests and Article 23 of the Real Estate Investment Funds Regulations of 2006 regarding the need to produce periodic reports.

³⁴⁰ See Article 5 of the Real Estate Investment Funds Regulations of 2006.

³⁴¹ See Article 10 of the Real Estate Investment Funds Regulations of 2006.

³⁴² See Articles 22 and 23(b) of the Real Estate Investment Funds Regulations of 2006.

before being able to solicit investments. The public listing process cannot go unmonitored since all Stock Exchange transactions are ultimately visible and recorded. The investment funds process is conducted privately between the fund manager and the investor, with some comfort that the fund manager is expected to act diligently, in pursuance and in compliance with the provisions of the Authorized Persons Regulations of 2005. The main fear of abuse, however, lies in unlicensed private offerings, since it is difficult for the CMA to track and monitor them, in light of their great number and their private nature. As recommended in this Part, the CMA should consider exempting from notification and the private placement requirements, private offerings below a certain amount.

PART V - THE REGULATION OF MARKET

PARTICIPANTS

1. INTRODUCTION

Securities markets cannot operate without trust amongst market participants.³⁴³ It is well established that, even though well-functioning markets enjoy self-correcting abilities, a laissez-faire approach at the transactional level would undermine the sustained effectiveness of capital markets.³⁴⁴ For instance, private actors do not have the authority required to investigate, prosecute, and penalize misconduct.³⁴⁵ The imposition of standards and penalties is therefore detrimental and not only desirable, although not to levels that would stifle the market.³⁴⁶ As will be shown in this Part, the regulator must identify transactional threats and must palliate these through the establishment and enforcement of the appropriate rules.

Apart from the regulator which was presented in Part III, participants in capital-market transactions consist of the issuers, the investors, and the intermediaries (i.e. the securities firms). We may add to this list ratings agencies. We may also add to this list independent consultants, such as lawyers, accountants and auditors, involved in guiding the aforementioned parties.

³⁴³ Adam Pritchard, 'Self-Regulation and Securities Markets' (2003) 26(1) Regulation 32, 39 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=501627> accessed 15 June 2013.

³⁴⁴ *Ibid*, 38.

³⁴⁵ *Ibid*.

³⁴⁶ Robert A. Feldman and Manmohan S. Kumar, 'Emerging Equity Markets: Growth, Benefits, and Policy Concerns' (1995) 10(2) The World Bank Research Observer 181, 197.

Section 2 discusses the regulation of issuers. While Part IV of this thesis has described the obligations of issuers at the offering stage, Section 2 of this Part will concentrate on those obligations which go beyond the offering stage and which remain continuing for the duration of the relationship between the issuer and the investors. As will be explained in this section, continuing obligations may relate to the functioning of the issuer, in which case these are governed by the Companies Law of 1965. The Corporate Governance Regulations of 2006 are also applicable in the case of listed companies. Continuing obligations may also relate to the functioning of the stock exchange's secondary market, in which case they are primarily governed by the Listing Rules of 2004.

Section 3 discusses the regulation of investors. Section 3.1 starts by discussing the importance of refining investor skills in assessing and choosing investment opportunities. The refinement of investment skills should help in fending off unsound products and in improving systemic efficiency. Section 3.1 will describe and evaluate the efforts made by the CMA to educate investors and refine their decision-making processes. This Section will also describe the rationale behind the CMA's initiatives relating to the disclosure of the identity of substantial shareholders, the limitation of trading hours, the limitation of transaction commissions, and will explain the impact of such initiatives on investment decisions. Section 3.2 will describe prohibited market conducts such as market manipulation, insider trading, and the dissemination of untrue statements and will assess whether the CMA's regulatory framework and approach are sufficient to deter those crimes. Section 3.3 will describe how the CMA has restricted direct foreign investment into listed securities and has only allowed indirect investment

through swaps. This Section will argue that although the prohibition of direct foreign investment in listed stocks may have underlying justifications, the permissibility of indirect investment through swap arrangements does raise issues and concerns.

Section 4 discusses the regulation of securities firms. This Section will demonstrate that the CMA has successfully transposed IOSCO's recommendations relating to the registration, establishment, and organization of new securities firms. This Section will also describe and evaluate the CMA's inspection program.

Section 5 discusses the regulation of other market facilitators such as lawyers, auditors, and ratings agencies and describes the importance of monitoring the performance of their work, up to a minimal standard level to be set by the CMA and/or other regulatory bodies of relevance.

2. THE REGULATION OF THE ISSUERS

2.1. Continuing Obligations Relating to the Internal Functioning of Issuers

2.1.1. Significance and Definition of Corporate Governance

Corporate governance, or *hawkamah*, in Arabic, can be narrowly defined as the proper management and control of a commercial entity, in the manner that achieves the highest level of financial profitability. As will be discussed in more detail in this section, financial profitability is not meaningful unless it can also benefit the collective interest and unless it is made durable through the safeguard of underlying drivers. Chapra and Ahmed observed that corporate governance rules form a value system which prioritizes

justice and fairness and protects collective interests in an equitable fashion.³⁴⁷ Studies indicate that investors in emerging markets are willing to pay as much as thirty percent more for shares in companies applying proper corporate governance.³⁴⁸ It is believed that managers in environments with stronger corporate governance systems raise lesser agency problems, maximize shareholder wealth more effectively, attract greater investor confidence, and access lower financial costs.³⁴⁹ In turn, it is believed that globalization improves corporate governance systems, in the long run, by intensifying the monitoring of managers.³⁵⁰

The International Finance Corporation ("IFC") has described corporate governance as the foundation of corporate citizenship and as a "*commitment to ethical behavior in business strategy, operations and culture*".³⁵¹ In turn, the World Bank has observed that corporate governance helps improve transparency, fairness and accountability. The World Bank has credited corporate governance for its ability to build investor trust, improve self-regulation, exploit resources more efficiently, improve the dynamics of price discovery, reduce speculation and volatility, and decrease vulnerability to systemic failures and financial crises.³⁵² That said, analysts have observed that the

³⁴⁷ See Chapra and Ahmed, *supra* note 56, 14.

³⁴⁸ See Patricia J. McCall, 'Overcoming Barriers to Private Investment in the Middle East and North Africa Region' (Arab Financial Forum, Bahrain, 22 November 2004) 7.

³⁴⁹ René Stulz, 'Globalization, Corporate Finance, and the Cost of Capital', (1995) 1(1) *Journal of Applied Corporate Finance* 8, 9.

³⁵⁰ *Ibid*, 13-16.

³⁵¹ IFC, 'Corporate Governance: The Foundation for Corporate Citizenship and Sustainable Businesses' (Global Corporate Governance Forum, 2009)

<http://www.unglobalcompact.org/docs/issues_doc/Corporate_Governance/Corporate_Governance_IFC_UNGC.pdf> accessed 29 June 2012.

³⁵² World Bank, 'Corporate Governance Country Assessment: Kingdom of Saudi Arabia' (Report on the Observance of Standards and Codes: Corporate Governance, February 2009) 1

<http://www.worldbank.org/ifa/rosc_cg_saudia_arabia.pdf> accessed 20 October 2012.

conceptualization of corporate governance should not be narrowed to just the resolution of the managerial agency problem and the maximization of shareholder value.³⁵³ The Enron case is cited as an emblematic example of how corporations are complex adaptive systems and how corporate governance is more meaningful if built on broader paradigms.³⁵⁴ As an example, it was advanced that corporate governance may create greater accountability and develop stronger social capital if managers are considered as trustees of the assets of the company rather than the agents of the shareholders.³⁵⁵

According to an OECD study, corporate governance was a totally nascent concept in the Middle East ten years ago.³⁵⁶ According to the study, the concept started gaining interest with the desire to attract foreign investments but only seriously mobilized initiative in GCC countries following a market crash that occurred in 2006.³⁵⁷ Eleven corporate governance codes were introduced in the MENA region between 2005 and 2009.³⁵⁸ The OECD study notes that corporate governance is still met by significant resistance from family-owned companies, although to a diminishing extent.³⁵⁹

³⁵³ Thomas Clarke, 'Accounting for Enron: Shareholder Value and Stakeholder Interests' Corporate Governance' (2005) 13 Corporate Governance: International Review 598, 604-605.

³⁵⁴ *Ibid*, 603.

³⁵⁵ *Ibid*, 607.

³⁵⁶ Alissa Koldertsova, 'The Second Corporate Governance Wave in the Middle East and North Africa' (February 2011) 2 OECD Journal: Financial Market Trends, 1
<<http://www.oecd.org/finance/financialmarkets/47071021.pdf>> accessed 20 October 2012.

³⁵⁷ *Ibid*, 3-4.

³⁵⁸ *Ibid*, 4.

³⁵⁹ *Ibid*, 6. See also Salim, Chahine, 'Activity-Based Diversification, Corporate Governance, and the Market Valuation of Commercial Banks in the Gulf Commercial Council' (2007) 11 Journal of Management and Governance 353, 354 .

Under Saudi Arabian law, the three principal sources of corporate governance rules are Sharia, the Companies Law of 1965, and the Corporate Governance Regulations of 2006. Additional sources could be found in certain laws and regulations that are sector-specific, such as the Banking Control Law of 1966, in the case of banks, the Cooperative Insurance Companies Control Law of 2007, in the case of insurance companies, or the Authorized Persons Regulations of 2005, in the case of securities firms.

Certain scholars have identified in the body of Sharia rules that are relevant to corporate governance. For example, as explained by Robert Bianchi:

"When international regulators demand greater honesty and disclosure, genuine Islamic bankers should not just comply, they should over-comply because their religion holds them to a higher standard."³⁶⁰

Sharia is rich indeed in rules regarding the duties of agents towards their principals, and the duty to exercise individual rights in moderation, without unduly affecting the rights of others.³⁶¹ These rules however are not inscribed in the context of corporations and their internal management and control. As a result of this, Sharia rules are too broad to constitute a practical, stand-alone, and clear source for corporate governance rules. This is indirectly confirmed in a 2009 study conducted by the World Bank on corporate governance in Saudi Arabia (the "**WB Study**"), which concluded that awareness is still emerging in the Saudi Arabian business culture on the need to adopt proper governance

³⁶⁰ Bianchi, *supra* note 73, 573.

³⁶¹ Wael B. Hallaq, *Sharia: Theory Practice, Transformations* (Cambridge University Press 2009) 261-264.

rules.³⁶² Obviously, the reality would have been much different had the long-existing body of Sharia been sufficient to regulate corporate governance, as it is and without elaboration. Reliance is therefore necessary on enacted legislation and regulation to clarify the practical requirements and implementation mechanics of such corporate rules.

No definition of corporate governance is contained in the Companies Law of 1965, although said law contains basic rules on the topic. In the context of listed companies, the CMA has described the foremost objective of the Corporate Governance Regulations of 2006 as “*the protection of shareholders’ rights as well as the rights of stakeholders*”.³⁶³ The CMA has defined the term stakeholders very widely as including “[a]ny person who has an interest in the company, such as shareholders, employees, creditors, customers, suppliers, community”.³⁶⁴ The reference by the CMA to the term community suggests that the definition of stakeholders is not exhaustive. Indeed, the term community may actually incorporate all affected persons, on a micro-level, and may also incorporate, on a high macro-level, Saudi Arabia’s general socio-economic interests. After all, the failure of any Saudi Arabian company has definite impact on Saudi Arabia’s society and economy.

The CMA has not prioritized any stakeholders over others but it is obvious that macro-level stakes should generally be far more consequential than micro-level stakes and,

³⁶² The World Bank, *supra* note 352, 3.

³⁶³ Article 1(a) of the Corporate Governance Regulations of 2006.

³⁶⁴ Article 2 of the Corporate Governance Regulations of 2006.

therefore, should in practice be naturally prioritized. Put differently, competition or discords between different classes of stakeholders should only be resolved following the identification of the best collective interest. Two different Sharia maxims, recognized by Islamic scholars, can be cited in favor of the prioritization of the collective interest: "*Private prejudice can be tolerated to avoid public prejudice*" and "*When confronted with two evils, the greater must be given precedence*".³⁶⁵

The WB Study benchmarked the level of implementation of corporate governance in Saudi Arabia against the six principles of good governance established by the OECD. The main highlights of these principles are detailed below:³⁶⁶

- i) "*Ensuring the Basis for an Effective Corporate Governance Framework*". As discussed in Part III, it is necessary to put in place a clear legal and regulatory operative framework. The framework must be flexible to accommodate companies working in different circumstances. The framework must be enforced by institutions that enjoy clearly delineated scopes of responsibilities.
- ii) "*The Role of Shareholders and Key Ownership Functions*". It is necessary to protect basic shareholder rights. This includes the existence of methods to secure their ownership rights, the right to obtain information, participate in the adoption of fundamental decisions and the selection of directors, either in person or through proxy, and the right to receive dividends.
- iii) "*The Equitable Treatment of Shareholders*". It is necessary to protect minority shareholders from the potential abuse of the majority shareholders and to protect

³⁶⁵ Ahmad Al Zarqa, *Explanation of the Sharia Maxims* (2nd ed., Dar Al Qalam 1993) 197 and 201.

³⁶⁶ The World Bank, *supra* note 352, 11-12. OECD, *supra* note 179, 17-25.

them from insider trading and potential conflict of interests at the level of controlling shareholders, directors, and managers.

- iv) "*The Role of Stakeholders in Corporate Governance*". It is necessary to identify stakeholders (e.g. owners, employees, suppliers, and customers) and recognize their rights by law or by mutual agreements and to encourage issuers to cooperate with them in order to preserve their rights, especially in the case of insolvency.
- v) "*Disclosure and Transparency*". Issuers must ensure the prompt and detailed disclosure of all material information regarding their business affairs, financial situation and performance, and their ownership and governance.
- vi) "*The Responsibilities of the Board*". Issuers must ensure that their managers perform their duties efficiently and that such performance is properly monitored, with proper accountability in case of breach.

It is worthwhile to note at this stage that the OECD's classification of its principles of corporate governance may reveal to be too complex to be used in the context of emerging markets such as those of Saudi Arabia. For the sake of simplicity, these principles were reclassified in two main categories: (a) the rules of corporate governance relating to management and control by shareholders, and (b) the rules of corporate governance relating to management and control by the directors and executives. Section 2.1.2 will examine the first category, while the second category will be examined under Section 2.1.3.

Although the objectives and spirit of corporate governance rules must be pursued by both shareholders and managers, it is important to realize that the day-to-day

governance of an issuer is undertaken by its directors and executives and that the shareholders' control typically is not as extensive or intensive as that of the directors and executives. In the context of public companies, the shareholders will entrust the directors and executives with the duty of ensuring the compliance of the issuer with applicable laws and regulations, including the Corporate Governance Regulations of 2006. That said, it is the managers of an issuer rather than its shareholders that would oversee liaison with and the protection of the general body stakeholders. It is also the managers who would oversee the issuer's compliance with its disclosure obligations.

2.1.2. Rules of Corporate Governance Relating to Management and Control by Shareholders

At first, it is worthwhile to note that a number of market professionals and even the OECD tend to consider market abuse as an issue of corporate governance, regardless of the fact that market abuse violations may be considered as criminal offences in particular jurisdictions.³⁶⁷ Although the issue of market abuse is of relevance to the protection of investors and the system, it however does not pertain to the internal management and control of a corporation but rather to transactional ethics.

Saudi Arabia does not have a criminal code and therefore market abuse must be principally addressed in the capital market laws and regulations. Actually, the CMA has not treated the issue of market abuse in the Corporate Governance Regulations of 2006, and has tactfully instead organized it under the Market Conduct Regulations of 2004, as discussed Section 3.1.

³⁶⁷ OECD, *supra* note 179, 20 and 44.

The WB Study concluded that, in Saudi Arabia, the basic rights of shareholders are adequately protected, primarily by the Companies Law of 1965.³⁶⁸ The Companies Law of 1965 grants the shareholders in limited liability and joint stock companies the right to access information, attend meetings, vote, and receive a share of dividends. Similar rights are granted in the Corporate Governance Regulations of 2006 in the case of public companies..³⁶⁹

Perhaps the most sensitive corporate governance issue in the context of management and control at the level of the shareholders is the protection of minority shareholders. As discussed in Section 4.1 of Part IV, applicants for listing only need to float a minimum of thirty percent of their aggregate share capital, listed issuers usually float only that proportion, although there are some issuers who have listed as much as fifty percent of their shares.³⁷⁰ Where the proportion of listed shares is itself a minority one and where such minority share is subscribed by a large number of shareholders, each such shareholder, alone, is non-influential and vulnerable to abuse by the majority shareholders.³⁷¹

It should not be assumed that majority shareholders will always exercise their control over the affairs of a company, in the best interests of this latter.³⁷² Majority shareholders

³⁶⁸ The World Bank, *supra* note 352, 3.

³⁶⁹ Articles 83-95, 107-108, and 171 of the Companies Law of 1965; Articles 4-7 of the Corporate Governance Regulations of 2006.

³⁷⁰ Article 13(a)(2) of the Listing Rules of 2004.

³⁷¹ Stulz, *supra* note 349, 14, 16.

³⁷² *Ibid.*

may have conflicting interests, such as investments in competing companies, which may lead to disinterest in the financial performance of a particular company. In such a situation, minority shareholders would be amongst those stakeholders that are most affected by such disinterest. Studies have shown that, generally, the development of stock markets is correlated with such market's ability to protect the rights of minority shareholders.³⁷³ Minority shareholders are probably the best placed stakeholders to question the proposals brought forward by majority shareholders, or their appointees on the board of directors, and to try to prevent unreasonable decisions from being adopted in the first place.

It is very difficult for minority shareholders to exercise any valuable influence unless they succeed in consolidating their voting rights. The Corporate Governance Regulations of 2006 impose on issuers a duty to make all arrangements necessary "*for facilitating the participation of the greatest number of shareholders in the General Assembly*".³⁷⁴ Since minority shareholders, especially those coming from the general public, are likely to be less familiar with the procedures applicable at general assemblies, the Corporate Governance Regulations of 2006 oblige issuers to brief the shareholders "*about the rules governing the meetings and the voting procedure*".³⁷⁵ The Corporate Governance Regulations of 2006 protect the right of minority shareholders to raise questions not only with the company's directors, but also with its auditors.³⁷⁶

³⁷³ Gerd Hausler et al., 'Trends in Developing-Country Capital Markets Around the World' in Litan, et al., *supra* note 247, 34.

³⁷⁴ Articles 4 and 5(d), 5(e), 5(g), and 5(h) of the Corporate Governance Regulations of 2006.

³⁷⁵ Article 5(d) of the Corporate Governance Regulations of 2006.

³⁷⁶ Article 5(g) of the Corporate Governance Regulations of 2006.

Minority shareholders holding as little as five percent of the company's shares can actually add items to the agendas of general assembly meetings.³⁷⁷

Perhaps the most useful tool for the consolidation of the influence and voting powers of dispersed minority shareholders would be the possibility to appoint a representative or proxy.³⁷⁸ Although members of the general public would, at a personal level, gain a valuable learning experience from the first-hand exercise of their assembly rights, delegation could facilitate the consolidation and help attribute greater weight to such rights at the level of the company. For the delegation to be most effective, minority shareholders should agree to nominate the same person to represent their rights, and should probably also dictate to the representative specific objectives to be pursued. The Corporate Governance Regulations of 2006 make it a requirement for the representative to be a shareholder of the company and expressly disqualify directors and employees of the company from such role.³⁷⁹ Such a disqualification is justified since shareholders should not delegate powers to individuals who are accountable to them. Indeed, the interests of directors and employees may be conflicting with those of shareholders, even minority ones. For example, it may be in the interest of the company and the general body of shareholders to reduce the operating costs of the company by laying-off personnel or reducing the size of the board. A shareholder representative may not strongly advocate such a solution if his directorship or employment position is at stake.

³⁷⁷ Article 5(f) of the Corporate Governance Regulations of 2006.

³⁷⁸ Article 6(c) of the Corporate Governance Regulations of 2006.

³⁷⁹ *Ibid.*

Recently, the MoCI required joint stock companies to adopt the 'cumulative voting method' in the election of directors.³⁸⁰ This approach is believed to strengthen the voting power of minority shareholders and should provide them with a representation level on the board that is in rough proportion to their aggregate shareholding.³⁸¹ Under such a method, each single shareholder gets a block of votes equivalent to the number of shares she/he owns multiplied by the number of candidates to be elected. The shareholder may then cast his entire block for a particular candidate or may divide such block among different candidates.³⁸² This method is new not only to Saudi Arabia's corporate community but also to its legal community. It will be interesting to monitor how the method will be implemented and to assess its ability to advance corporate governance objectives.

Finally, it has been observed that in the context of corporate governance, laissez-faire and natural market forces cannot be relied upon to resolve conflicts.³⁸³ The intervention of the CMA is therefore essential in the monitoring, investigation and reprimand of obvious violations of rules of corporate governance. Leaving enforcement entirely to the judicial system would be time-consuming and inefficient. Section 2.2 provides good examples of obligations that are actively enforced by the CMA.

³⁸⁰ Mohamed Salameh, 'Cumulative Voting for the Election of Board Members Presents Opportunities for Minority Shareholders' *Al Eqtisadiyah* (Riyadh, 25 January 2012) <http://www.aleqt.com/2012/01/25/article_619510.html?related> accessed 24 October 2012.

³⁸¹ Richard S. Dalebout, 'Cumulative Voting for Corporation Directors: Majority Shareholders in the Role of a Fox Guarding a Hen House' (1989) *Brigham Young University Law Review* 1199, 1205 <<http://www.law2.byu.edu/lawreview4/archives/1989/4/dal.pdf>> accessed 24 October 2012.

³⁸² *Ibid*, p. 1200. SEC, 'Cumulative Voting' <<http://www.sec.gov/answers/cumulativevote.htm>> 24 October 2012.

³⁸³ Chapra and Ahmed, *supra* note 56, 19.

2.1.3. *Rules of Corporate Governance at the Managerial Level*

2.1.3.1. *Importance and Various Managerial Levels*

It is necessary to highlight that the existence of properly structured and positioned managerial levels is a fundamental condition to the success of companies and investments from a micro perspective and the success of capital markets from a macro perspective. This Section will present the typical governance issues intrinsic to managerial corporate levels and will explain the steps adopted by the legislator and the CMA to address those issues.

First of all, even though the shareholders are owners and enjoy ultimate control of a company's affairs, they nevertheless cannot regularly meet and are often mere investors with no technical or managerial expertise. Shareholders must therefore inevitably delegate administration to directors. While those directors act as the immediate representatives of the shareholders and assume "*ultimate responsibility for the Company*", they are often not employed by the company and are not involved in its affairs on a day-to-day basis.³⁸⁴ Day-to-day management is therefore in turn delegated to executives, who are primarily subordinated and accountable to the board of directors.

2.1.3.2. *Selection and Formation Requirements*

It is of primordial importance for the success of a company to place balanced selection criteria for its directors and executives. The CMA has, pursuant to Article 11(e) and Paragraph 13(1) of Annex 4 of the Listing Rules of 2004, required applicants for listing to disclose the qualifications of all directors and executives. The Listing Rules of 2004

³⁸⁴ Article 11(a) of the Corporate Governance Regulations of 2006.

however do not impose a continuing obligation on issuers to employ qualified and experienced directors and executives. Such a continuing obligation was anticipated in the Corporate Governance Regulations of 2006. Prior to the issuance of the Corporate Governance Regulations of 2006, the Listing Rules of 2004 used to contain a provision stating that:

*"The [CMA] may, as it considers necessary for the protection of investors, require the issuer to comply with any corporate governance rules that it deems appropriate whether in relation to the qualifications of the directors, senior management, audit committee or external auditor of the issuer, or the competency of any of them, or in relation to the responsibilities or powers of any of them or in relation to the decision making processes or otherwise."*³⁸⁵

The Listing Rules of 2004 now only require applicants for listing to disclose information on their status of compliance with the Corporate Governance Regulations of 2006.³⁸⁶ Surprisingly, the Corporate Governance Regulations of 2006 make no express mention of the need for directors and executives of listed companies to be qualified. The Corporate Governance Regulations of 2006 only require the creation of a Nomination and Remuneration Committee that would determine the qualification requirements for directors and recommend changes to the board structure.³⁸⁷ However, this determination does not comprise executives. Furthermore, the fact that the directors are responsible for the setting up of the Nomination and Remuneration Committee does raise conflict of interest concerns. Finally, the Corporate Governance Regulations of 2006 do not contain a mechanism for the verification of the actual implementation of

³⁸⁵ Article 29 of the Listing Rules of 2004, prior to the amendments on 1 April 2012.

³⁸⁶ Article 11(1)(k) of Annex 4 of the Listing Rules of 2004.

³⁸⁷ Articles 15 of the Corporate Governance Regulations of 2006.

recommendations made by the Nomination and Remuneration Committee. The CMA should have placed express safeguards in the Corporate Governance Regulations of 2006 in this regard.³⁸⁸

Article 41(b)(5) of the Listing Rules of 2004, on the other hand, does require the notification by issuers to the public of changes in the composition of directors and executives. The Listing Rules of 2004 however do not expressly require the disclosure of the qualifications held by new directors and executives. To remedy this gap, the CMA has just recently taken steps to ensure minimum qualifications at the level of directors. First of all, it appears that the CMA will soon require new directors to pass aptitude examinations.³⁸⁹ Second of all, the CMA has issued a decision requiring listed companies, as of 1 January 2013, to disclose greater information regarding newly-appointed directors and executives.³⁹⁰ Directors are required to complete and deliver to the CMA a detailed declaration form describing their qualifications and experiences and disclosing any conflicts of interest and ongoing directorship duties held.³⁹¹ Such form resembles that required from directors of companies applying for listing, although it does not require the disclosure of past bankruptcies or convictions involving acts of fraud or dishonesty.³⁹² Since such issues are of prime importance, the declaration form

³⁸⁸ Article 15(c)(2) of the Corporate Governance Regulations of 2006.

³⁸⁹ Salman Al Jishi, 'Members of the Boards of Directors of Companies and Qualification Examinations' *Al Eqtisadiyah* (2 July 2012) <http://www.aleqt.com/2012/07/02/article_671641.html> accessed 15 October 2012.

³⁹⁰ CMA Decision 25 September 2012. See also Fahd Al Houimani, 'The Regulation of the Disclosures of Listed Companies' *Al Eqtisadiyah* (8 October 2012) <http://www.aleqt.com/2012/10/08/article_699625.html> accessed 15 October 2012.

³⁹¹ CMA, 'Disclosure' <<http://cma.org.sa/en/FormsSite/Pages/Disclosure.aspx>> accessed 24 October 2012.

³⁹² Annex 3 of the Listing Rules of 2004.

should be modified to include them. Moreover, the form should be made compulsory for senior executives as well since they play a focal managerial role and owe important fiduciary duties to both the company and its owners.

Since as discussed in Part V, Saudi Arabian companies tend to be family-owned, and since majority shareholders owe no express fiduciary duties to minority shareholders, it is essential to protect minority shareholders from any conflicts of interests at the level of majority shareholders. To this end, the Corporate Governance Regulations of 2006 require directors to represent the interests of all shareholders and not just the interests of those shareholders that selected them.³⁹³ Since it is questionable whether directors can practically avoid any bias towards the majority shareholders, the Corporate Governance Regulations of 2006 have also required that at least one-third a public company's directors and that at least two directors be totally independent.³⁹⁴ The CMA reports that, in 2010, 49.6% of directors were non-executive, 38.6% were independent, and 11.8% were executive.³⁹⁵

In order to safeguard the effectiveness of the accountability of the executives to the board of directors, the Corporate Governance Regulations of 2006 require that the majority of directors consist of non-executive members and prohibit that the position of the chairman be conjoined with any other executive position in the company.³⁹⁶

³⁹³ Article 11(d) of the Corporate Governance Regulations of 2006.

³⁹⁴ Article 2 of the Corporate Governance Regulations of 2006 defines the criteria for independence.

³⁹⁵ CMA, *supra* note 154, 82.

³⁹⁶ Articles 12(c) and 12(d) of the Corporate Governance Regulations of 2006.

2.1.3.3. *Powers and Duties*

Although it is not stated in any legal requirement, it is necessary for boards of directors in companies with dispersed ownership to enjoy broad powers, without the need to constantly call shareholders' meetings for the adoption of basic commercial decisions. It is actually preferable for shareholders to entrust the directors and executives with commercial decisions since they usually have a better understanding of the market in which they operate, the requirements and abilities of the business, and the technical issues of relevance.

Ultimately, the powers of the board of directors are not fixed by law but by the shareholders in the company's constitutional documents. Indeed, the first paragraph of Article 73 of the Companies Law of 1965 states that "*the board of directors shall enjoy full powers in the administration of the [joint stock] company*", although "*with due regard to the powers vested in the general meeting*". A similar provision is contained in Article 11(b) of the Corporate Governance Rules of 2006.

Pursuant to the second paragraph of Article 73 of the Companies Law of 1965 and Article 11(h) of the Corporate Governance Regulations 2006, directors cannot, without the shareholders' approval: "*contract loans for more than three years, or sell or mortgage the real property or the place of business of the company, or release the debtors of the company from their liabilities*". At any time, the shareholders may agree on constitutional provisions that further restrict the ability of the board of directors to enter into certain types of transactions without their consent. The restrictions placed in the Companies Law of 1965 and the Corporate Governance Regulations of 2006 are

sensible. They are important to prevent director abuse and do prompt shareholder involvement in decisions of utmost impact on the financial worth of the company.

2.1.3.4. *Fiduciary Duties*

Islamic law contains a great deal of scripture regarding fiduciary duties in the broad sense. Sharia clearly views directors as agents of the shareholders and, in that capacity, directors must safeguard the interests of the shareholders (e.g. by not deriving a personal benefit in the transactions concluded on their behalf).³⁹⁷ However, considering Sharia lacks a body of simplified and clear-cut obligations pertaining to directors specifically, the Saudi Arabian legislator should not rely on Sharia as the single source of standards relating to the fiduciary duty of directors. At present, the Saudi Arabian legal framework concerning the fiduciary duties of directors is actually quite poor. According to the WB Study on corporate governance in Saudi Arabia:

*"fiduciary duties are nascent concepts in Saudi Arabia", "[t]he Companies Law[of 1965] neither requires nor recommends companies to adopt codes of ethics", and "the Companies Law definition of board's role and functions is fairly broad".*³⁹⁸

The only significant rules regarding the fiduciary duties are contained in Articles 69 and 70 of the Companies Law of 1965, in the context of joint stock companies.³⁹⁹ Amongst other things, Articles 69 and 70 of the Companies Law of 1965 prohibit directors from having any interest in the company's business and contracts or from engaging in

³⁹⁷ Chapra and Ahmed, *supra* note 56, 40.

³⁹⁸ The World Bank, *supra* note 352, 31-32

³⁹⁹ These rules are repeated in Article 18 of the Corporate Governance Regulations of 2006, in the context of public joint stock companies.

activities that compete with those of the company, except with the authorization of the shareholders.

Surprisingly, the Companies Law of 1965 does not impose any fiduciary duties on directors of limited liability companies or those of partnerships. The Saudi legislator should actually be increasingly vigilant in the case of limited liability companies. Indeed, this corporate structure is commonly what the Saudi population deals and is familiar with, and any more complex corporate form is just another variation of the exact same concept (i.e. a company represented by shareholders whose individual liability is limited to the extent of their respective investments). Hence, attempts to improve corporate processes can only be effective if primarily directed at limited liability companies. Logically, one would only qualify for a position as director of a public joint stock company, after substantial experience in the boards of limited liability companies. Tolerating a casual attitude at the level of limited liability companies, may lead to difficulties in conformity with the stricter governance requirements of the public company level.

2.1.3.1. Remuneration

The Corporate Governance Regulations of 2006 require the Nomination and Remuneration Committee to draw policies regarding the remuneration of board members.⁴⁰⁰ The remuneration policy proposed by the Nomination and Remuneration Committee must remain in the confines of the requirements of the Articles of

⁴⁰⁰ Article 15(c)(6) of the Corporate Governance Regulations of 2006.

Association and the Bylaws which describe the manner for the remuneration of directors.⁴⁰¹ Remuneration can take the form of either a lump sum amount, an attendance allowance, rights *in rem*, a certain percentage of the profits, or any combination of the aforementioned.⁴⁰² Finally, the annual directors' report must disclose the remuneration ultimately paid to the directors.⁴⁰³

Although these measures are positive, they may not be sufficient to adequately protect shareholders. Indeed, as recommended by the various studies on the factors that contributed to the 2007 financial crisis, remuneration practices need to be built around certain parameters in order to keep managers positioned towards the right priorities. These parameters are explained in Part VIII of this thesis.

2.2. Protection of the Stock Exchange's Secondary Market

Practically all obligations of issuers towards the protection of secondary markets of a stock exchange are related to disclosure. Certain academics have observed that even imperfect disclosure can improve the functioning of markets, since it would help adjustments by market participants and by the regulator itself.⁴⁰⁴

Continuing obligations imposed on issuers are contained in Part 8 of the Listing Rules of 2004. Most importantly, issuers must disclose to the CMA and the public their financial results and any major developments in their sphere of activity which may lead

⁴⁰¹ Article 17 of the Corporate Governance Regulations of 2006.

⁴⁰² *Ibid.*

⁴⁰³ Article 9(e) of the Corporate Governance Regulations of 2006.

⁴⁰⁴ Stiglitz and Bhattacharya, *supra* note 4, 7.

to substantial movement in the price of their listed shares.⁴⁰⁵ Issuers must for instance disclose the purchase of assets, debts, or losses above a certain threshold or, for instance, significant transactions concluded outside of the ordinary course of business.⁴⁰⁶ Such disclosure obligations should reduce the instances of false rumors and insider trading and should help in placing the investors on an equal footing.

The CMA has been strict in enforcing the disclosure-related obligations of issuers and publishes announcements each time penalties are applied in case of a breach.⁴⁰⁷ This should send a strong signal to issuers and should boost the confidence of investors.

3. THE REGULATION OF INVESTORS

The Saudi Stock Market faced a significant crash in 2006, which wiped about USD 500 billion off the market's capitalization from its peak of USD 834 billion in that same year. Experts blamed this plunge on "speculative trading", and manipulation.⁴⁰⁸ It has been observed that investors lacked investment awareness and that transactions were generally irrational and based on rumors, without proper analysis of the documentation disclosed by issuers.⁴⁰⁹ Section 3.1 will describe the steps taken by the CMA to refine the investors' market conduct, while Section 3.2 will describe the steps taken by the legislator and the CMA to regulate such conduct. Section 3.3 will describe the rules set

⁴⁰⁵ Articles 41 and 42 of the Listing Rules of 2004.

⁴⁰⁶ Article 41 of the Listing Rules of 2004.

⁴⁰⁷ CMA, 'Announcements' <<http://cma.org.sa/En/News/Pages/default.aspx>> accessed 15 April 2013; The CMA reported 31 disclosure violations in 2011. See CMA, *supra* note 154, 114.

⁴⁰⁸ Andrew England, 'Market Insight: Saudi Arabia Applies the Brakes' *Financial Times* (4 April 2007). See also 'Saudi Arabia's Economy' *Economist Newspaper* (16 January 2007).

⁴⁰⁹ Ramady, *supra* note 106, 153. See also Nawaf Al-Gethami, 'Some Investors Urge the CMA to Act on Legislative and Organizational Loopholes in Stock Exchange Market' *Al Eqtisadiyah* (Makkah, 13 November 2006) 13.

by the CMA for investment by foreigners on the Saudi Stock Exchange and will discuss the advisability of such investment.

3.1. Refinement of Market Conduct

3.1.1. Investor Education

To raise investment culture and awareness, the CMA has, in 2011, distributed over 141,000 publications to targeted audiences and has organized road shows, awareness pavilions and school awareness visits that attracted millions of attendees.⁴¹⁰ The CMA has also created an interactive website, as well as webpages on Facebook, Twitter and YouTube.⁴¹¹ It is unclear to what extent these efforts have been successful, but they definitely constitute a step in the right direction.

The CMA also established an Awareness Center which publishes pamphlets that describe in few and simple terms:⁴¹²

- a) the various components of the market;
- b) the legal and regulatory framework governing the capital market;
- c) the importance, types, sources, and meaning of market-related information and disclosures;
- d) most-recommended investment strategies; and
- e) prohibited investor practices.

⁴¹⁰ CMA, *supra* note 154, 133-135.

⁴¹¹ *Ibid.*, 135.

⁴¹² CMA, *supra* note 154, 133-135. See, CMA, "Investors' Awareness Site" <<http://www.cma.org.sa/IA/index.html>> accessed 27 October 2012. See also, CMA, "The Smart Investor" <<http://www.smart-investor.net/>> accessed 27 October 2012

Probably the best way to protect investors, especially unsophisticated and non-institutional ones, would be to teach them how to refine their comprehension of disclosures. Such comprehension could help investors recognize and steer away from unwanted risks and could help them better assert their rights vis-à-vis issuers.⁴¹³

It is important to ensure that, within a corporate jurisdiction, all shareholders be actively involved in the corporation's life, through such things as the attendance of meetings, the study of directors' reports, financial documents, important corporate decisions, etc.

According to Alan Cameron:

*"[...] investors must be capable of understanding all [market] disclosure. This may be the greatest difficulty of all in both developed and emerging markets, yet regulators and others have been slow to recognize or address it in a meaningful way. The theory underlying a disclosure system is that investors are capable of using, and do use, the disclosures made by issuers to price securities efficiently, yet few investors even understand that they are expected to read the material."*⁴¹⁴

In a society which has placed the satisfaction of God above all considerations, shareholders, and especially stock market investors, should feel as though their society is directly concerned in each of the meetings which takes place and that they themselves have an influential role over the social values which the corporate objectives would ultimately integrate.

⁴¹³ Michael P. McLindon, *Privatization and Capital Market Development* (Greenwood Publishing Group 1996) 62-63.

⁴¹⁴ Alan Cameron, 'Supervision at the Micro-Level: Do Disclosure-Based Regimes Work?' in Litan, et al., *supra* note 247, 167.

One of the challenges that experts and academics had warned could slow the development of the Saudi capital market was the little understanding of most Saudi citizens of stock market operations. According to Mohamed Ramady:

*"transactions were based on rumours, because of a lack of analysis of companies' financial positions, profitability or other financial considerations".*⁴¹⁵

The CMA should try to educate the Saudi Arabian population about the inherent benefits of securities and their ability to provide what should be a life-long stream of dividends and to promote their long-term detention, rather than short-term trade and expectations of making a profit based on trade price margins.

3.1.2. Majority or Affluent Shareholders

The prevention of abuse by majority or affluent shareholders is a core objective of the Companies Law of 1965 and the CMA Regulations. This takes root in the principle: "use your property so as not to injure others", or as described otherwise:

*"As population, urbanization and congestion steadily increase, one man's consumptive use may become another man's privation. Enjoyment of consumptive use may depend upon facilities as well as regulations provided by the state."*⁴¹⁶

As discussed in Section 2.1.2 of this Part, stock exchange investors, even when institutional, are likely to be minority shareholders. The success of their investment will be tied therefore to the reputation and level of commitment of the majority shareholders. It is the right of investors to learn the identity of majority shareholders and assess

⁴¹⁵ Ramady, *supra* note 106, 153.

⁴¹⁶ Adolph A. Berle and Gardiner C. Means, *The Modern Corporation and Private Property* (Transaction Publishers 1991) xxiii, xxiv.

whether they pose any threat to the healthy growth of the company. For instance, majority shareholders may have significant stakes in a competing entity and may be inclined to advance the interests of such competitor over those of another company in which they are participating. Also, they may have had past convictions for market abuse or fraud. Obviously, attempts to protect the public from the influence of majority shareholders are met with the fear that protectionist measures could limit market capitalization and liquidity.

Pursuant to Article 45(a)(1) of the Listing Rules of 2004, investors owning five percent or more of the shares of a listed company, are considered to be 'substantial shareholders' and must notify the CMA of that position. Substantial shareholders must also inform the CMA if their shareholding increases or decreases by more than one percent.⁴¹⁷ Substantial shareholders must notify the CMA of, and are deemed to be themselves the owner of any shares held by a spouse or minor child, a nominee, or by any company over which they have thirty percent or more of total control (i.e. voting power at either the shareholders or the managerial level).⁴¹⁸

According to Article 45(c) of the Listing Rules, the CMA may disseminate any information that it receives regarding substantial shareholding. On August 13th, 2008, the CMA has announced that it would publish and update daily, on its website, the list of all investors holding five percent or more in any publicly-traded company.⁴¹⁹ The

⁴¹⁷ Article 45(a)(2) of the Listing Rules of 2004.

⁴¹⁸ Article 45(b) of the Listing Rules of 2004.

⁴¹⁹ See Tadawul, <<http://tadawul.com.sa>> accessed 29 June 2012. See also Khalil Hanware, 'Tadawul to Name Investors with 5% Stakes' *Arab News* (31 July 2008).

CMA-imposed 'veil lift' on investors holding over five percent of individual publicly-traded companies serves to warn potential investors of existing leverages which may be exerted over the control of such companies. It also serves to warn of potential triggers of share price volatility resulting from the sudden disinvestment by a significant investor.

Similar initiatives have been undertaken by other regulators such as the Securities and Futures Commission of Hong Kong which issues "High Shareholding Concentrations Announcements" with a warning in every announcement that:

*"In view of the high concentration of shareholding in a small number of shareholders, shareholders and prospective investors should be aware that the price of the Shares could fluctuate substantially even with a small number of shares traded, and should exercise extreme caution when dealing in the Shares."*⁴²⁰

As discussed above, it should be examined whether the protections sought from the naming of significant investors could result in disproportionate negative consequences. Certain large investors value anonymity and may be discouraged from making investments that would be disclosed to the public at large, including creditors, partners, and competitors. It could be argued that a five percent shareholding in a public joint stock company is not sufficient to exert any real corporate control or damage to the stock's trading value. As a counter-argument, it could be stated that, although a five percent shareholding is insufficient to exert control, constitute quorum at a general

⁴²⁰ The Securities and Futures Commission, 'High Shareholder Concentration Announcements' <<http://www.sfc.hk/sfc/html/EN/general/highshareholding/highshareholding.html>> accessed 22 August 2009.

assembly, or cause the issuance of a resolution, it is nevertheless sufficient to exert influence and that it therefore constitutes an investment risk that is of public relevance. Socio-economists should be asked to help calibrate the threshold for veil lifting to a level that attracts optimum investment levels by both large and small investors.

Another mechanism utilized by the Saudi Arabian legislator to safeguard the level of commitment of majority shareholders is to prevent them from disposing of their shares for a specified period of time, when the company requires the most support. Article 100 of the Companies Law of 1965 prohibits the founders of joint stock companies from selling their shares for a period of two complete financial years following incorporation. Similarly, and Article 49 of the Listing Rules of 2004 prohibits significant shareholders in listed companies from selling their shares for a period of six months following listing.

Companies are usually most vulnerable and transactionally active immediately following incorporation and/or listing. During these periods, companies usually commit funds, secure assets, and build contractual relationships with staff, lenders, suppliers, customers, contractors, lessors, etc. The leverage of large and reputed shareholders may be necessary to place the company in a preferential position. The company may actually be invited to transact with its substantial shareholders based on terms that are more advantageous than ones prevailing in the open market.

Since the public usually over-subscribes into shares placed for listing, there is a great probability that the shares of a newly listed company may be inflated during the first

few months.⁴²¹ A substantial shareholder may therefore be tempted to dispose of his shares during such period since it is usually characterized by more important profit margins. Interestingly, breaches of Article 49 of the Listing Rules of 2004 were discovered by the CMA, as some substantial shareholders had disposed of their shares without notifying the CMA.⁴²² The CMA should have been stricter in applying penalties against those who breached the law, since it appears that no sanctions were actually applied.

3.1.3. *Suspension of Trading*

Trading may be suspended by the regulator in order to pace down transactional activity to the speed of the dissemination of critical market information.⁴²³ In certain circumstances, rumors alone could result in panic and could cause severe volatility.⁴²⁴ Trading may also be suspended in case of the suspicion of fraudulent or manipulative activities, in case of an important failure by an issuer to meet its continuous listing obligations, or in case of the occurrence of an extraordinary event.⁴²⁵ IOSCO has examined the effectiveness of such intervention measures and has reported that these

⁴²¹ For example, the Sahara Petrochemical Company IPO on 22 May 2004 was oversubscribed 125 times, the Etihad Etisalat Company IPO ending on 16 October 2004 was oversubscribed 51 times and the Aldrees Petroleum & Transport Services Company IPO on 21 January 2006 was oversubscribed 12.8 times. See Javid Hassan, 'Sahara IPO Raise Record SR 37.5 Billion', *Arab News* (5 June 2004) <<http://www.arabnews.com/?page=6§ion=0&article=46290&d=5&m=6&y=2004>> accessed 26 November 2010.

⁴²² Abdul Aziz Al Qarari, 'With The Publication of the First List of Significant Shareholders, Tadawul Identifies Manipulation by Certain Families Who Have Sold Their Companies Beyond Their Market Value', *Al Riyadh* (15 August 2008) 1. See also Abdallah Al Zibiani, 'The List of Significant Shareholders Reveals the Disappearance of Short-Term Investment [Founders] and Gulf Acquisitions' *Al Eqtisadiyah* (15 August 2008) 7.

⁴²³ Articles 6(a)(5) and 6(a)(6) of the Capital Market Law of 2003 and Article 37 of the Listing Rules of 2004.

⁴²⁴ IOSCO, 'Report on Trading Halts and Market Closures' (October 2002) 1 and 8 <<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD138.pdf>> accessed 3 September 2011.

⁴²⁵ *Ibid.*

mechanisms are generally available to stock exchange regulators and can assist in restoring an equilibrium between supply and demand in the market.⁴²⁶

As examples of trading halts, the regulators of the major U.S. stock exchanges have suspended trading for four complete days following the 11 September 2001 attacks.⁴²⁷

On September 29th, 2008, the Brazilian Stock Exchange in Sao Paulo suspended trading for half-an-hour, as a result of a 10.6% devaluation of its Bovespa index. The devaluation was attributed to news of the rejection by the House of Representatives of the USD 700 Billion bailout plan proposed for the US economy.⁴²⁸

In a very surprising move, a Kuwaiti court has, on November 14th, 2008, obliged the suspension of trading on the Kuwaiti stock exchange, bypassing in so doing the administrative authority of the market regulator.⁴²⁹ This decision was rightfully criticized by the Kuwaiti Minister of Finance, amongst other politicians, as being dangerous.⁴³⁰ Decisions of the sort must be promptly taken and must be adapted to the immediate state of the market. Since courts lack expertise on the substance-matter, they

⁴²⁶ *Ibid*, 6. See also, IOSCO, 'Effectiveness of Market Interventions in Emerging Markets: Final Report' (October 2010) <<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD333.pdf>> accessed 17 October 2012, 22-23.

⁴²⁷ IOSCO, *supra* note 424, 9.

⁴²⁸ 'Brazilian Stock Exchange Suspends Trading After 10% Crash' *Monster & Critics* (September 29, 2008) <http://www.monstersandcritics.com/news/business/news/article_1433818.php/Brazilian_stock_exchange_suspends_trading_after_10_per_cent_crash> accessed 27 September 2012.

⁴²⁹ It appears that the court order was acting on a lawsuit brought by individual investors as a result of a market decline of about 7,000 points in the period of 5 to 6 months preceding the suspension and amidst demonstrations and walk-outs by share traders; See also Andre England, 'Court Orders Closure of Kuwait Stock Market' (13 November 2008) *Financial Times* <<http://www.ft.com/cms/s/0/64a99578-b18f-11dd-b97a-0000779fd18c.html#axzz2QY5fiJGa>> accessed 15 April 2013.

⁴³⁰ Andy Sambidge and Inal Ersan, 'Kuwaiti Market Trading Suspension Dangerous' *Arabian Business* (13 November 2008) <<http://www.arabianbusiness.com/kuwait-market-trading-suspension-dangerous--82941.html>> accessed 3 September 2011.

cannot act without underlying expert guidance. Even if the matter is examined on an expedited basis, it is not possible for courts to timely understand the background of the requests before them, understand the issues at stake, and contemplate the possible effects of their rulings. Preventive injunctions are not possible here as in regular private disputes, since the harm that such injunction may cause could radically outweigh its benefits. Courts are therefore simply not adapted to take over directly or indirectly the day-to-day regulation of an exchange and should not go beyond the remediation, *a posteriori*, of any harm suffered as a consequence of any negligence by the regulator.

The Capital Market Law of 2003 gives the CMA the power to suspend the trading of any security on the Stock Exchange and may even suspend trading for a period of not more than a day.⁴³¹ Acting on this discretion, the CMA has imposed an automatic trading suspension that is triggered if a stock price fluctuates abnormally and moves by more than 10% in any single day. For a short period of time, between 25 February 2006 and 1 April 2006 when the market crises was most severe, the maximum tolerable volatility rate was reduced to 5%.⁴³²

Some analysts criticized suspensions of trading with the argument that investors are most conscious of their best interest and that a *laissez-faire* approach, rather, would better allow stabilization.⁴³³ Some analysts have argued that suspension of trading sends

⁴³¹ Articles 6(5) and 6(7) of the Capital Market Law of 2003.

⁴³² Zaid Bin Kami, 'The CMA Reinstates a Volatility Rate of 10% and the Division of Share Value is to Start with [Companies] in the Agricultural Sector and End with Yansab Over 21 Days' *Al Sharq Al Awsat* (Riyadh, 28 March 2006).

⁴³³ Mohamad Al Abbas, 'Oh Capital Market Authority, My Patience Has Run Out, Hasn't Yours?' *Al Eqtisadiyah* (21 November 2008) 10.

out a negative message to market players and may trigger loss of confidence and panic, which may lead to even greater volatility upon resumption of trading. They further argue that blocking attempts of exiting investors to liquidate stocks from their portfolio may negatively impact on the economy. Indeed, the suspension of stock sales could impede the conclusion of transactions that were meant to be funded using the stock sale proceeds. Some argue, therefore, that trading should only be suspended in the event of war or natural disasters.⁴³⁴

The CMA has recognized that suspension of trading is an exceptional measure that is unlikely to be exercised in good economic conditions.⁴³⁵ Actually, it is because of the gravity of such a measure that, in Saudi Arabia, suspensions of greater than one day require the approval of the Minister of Finance.⁴³⁶

According to IOSCO, suspension of trading could give rise to concerns of arbitrage in case a stock is listed in more than one jurisdiction.⁴³⁷ However, given the improbability of multiple listings by Saudi Arabian companies in the near future (i.e. on the Saudi stock exchange and on foreign stock exchanges), this issue should not require any regulatory palliation by the CMA.

3.1.4. The Trading Hours 'Filter'

⁴³⁴ Habashi Al Shimary, 'Economists Warn: Suspension of Trading Would Be a Big Mistake' *Al Eqtisadiyah* (15 November 2008) 6.

⁴³⁵ Abdallah Al Bossaili, 'Suspension of Trading Only Upon Sever Crises and the Ten Percent Protects the Market' *Al Eqtisadiyah* (Riyadh, 8 October 2008) 6.

⁴³⁶ Article 6(5) of the Capital Market Law of 2003.

⁴³⁷ IOSCO, *supra* note 424, 2 and 14-15.

Analysts have blamed the 2006 downturn of the Saudi Stock Exchange on "*irrational exuberance*" by small individual investors.⁴³⁸ Some analysts have even claimed that share trading in Saudi Arabia had become a "*national pastime*".⁴³⁹ Shortly following the onset of the downturn, the CMA issued a decision to limit trading sessions between 11:00 and 15:30 Saturdays through Wednesdays.⁴⁴⁰ Prior to such decision, trading desks were opened in the morning from 8:00 until 12:00 and in the afternoon from 17:00 until 20:00 Saturdays through Wednesdays and in the morning from 8:00 until 12:00 on Thursdays.⁴⁴¹ Some analysts interpreted the CMA's decision as an attempt to discourage individual investors from distorting the market.⁴⁴² The trading sessions effectively came to coincide with the working hours of most individual investors, who no longer were able to trade.⁴⁴³ Some analysts observed that the measure should:

*"decrease the negative side-effects, whether on their family and social life or on their economic standings, of people spending their time and money unwisely in trading stock".*⁴⁴⁴

It appears that the CMA wanted to grant investors longer recesses to study the market and formulate more calculated trading decisions.⁴⁴⁵ The CMA may also have attempted to reserve a greater trading opportunity to institutional investors and restrict distortion

⁴³⁸ 'The Perils of Turning Share Trading Into a National Pastime' *The Financial Times* (13 April 2006).

⁴³⁹ *Ibid.*

⁴⁴⁰ CMA Decision No. 1-206-2006; Weekends in Saudi Arabia are Thursdays and Fridays.

⁴⁴¹ Maha Aboulola and Shahid Khan, 'Saudi Arabia: Straight Banking Hours' *Saudi Gazette* (3 December 2006).

⁴⁴² Maha Akeel, 'CMA Changing Trading Hours' (27 September 2006) *Arab News* <<http://www.arabnews.com/node/289617>> accessed 15 June 2013.

⁴⁴³ *Ibid.*

⁴⁴⁴ *Ibid.*

⁴⁴⁵ 'The Decisions of the CMA: Easements for Users and Achievement of a Greater Justice In the Trading Hours', *Al Eqtisadiyah* (2 June 2006) <http://www.aleqt.com/2006/06/02/article_42506.html> accessed 16 June 2013.

from unsophisticated individual investors.⁴⁴⁶ It is probable that the CMA wanted to encourage individual investors to resort to investment funds managed by market professionals instead of direct stock exchange trading. Obviously, any trading restrictions on individual investors could be gradually eased as investment educational campaigns start yielding results.

3.1.5. Limitations on Commissions (Minimum or Maximum)

Acting on the powers conferred to it pursuant to Article 6(8) of the Capital Market Law of 2003, the CMA has, on 16 June 2006, issued a resolution requiring trading commissions not to exceed 0.0012% of the trade value and to be no more than SR 12 for any executed order equal to or less than SR 10,000. Such limitation would serve to discourage the practice of churning (i.e. the fraudulent practice by securities firms to induce customers to transact for the sole purpose of generating commissions) while encouraging customer-ordered transactions and enriching market liquidity in the same token.⁴⁴⁷

Although the imposition of commission thresholds is usually aimed at limiting intermediary commissions, it may also hypothetically be raised to reduce the number of ‘unnecessary’ investor transactions by individual investors, who may still be ‘uneducated’, so to leave ground for more sophisticated transacting, by institutional investors. Analysts of the Saudi Arabian capital markets have observed a need for more

⁴⁴⁶ Regarding the positive role of institutional investors on markets, see IOSCO, 'Development and Regulation of Institutional Investors in Emerging Markets' (June 2012)

<<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD384.pdf>> accessed 17 October 2012.

⁴⁴⁷ Thomas McInish, *Capital Markets: A Global Perspective* (Blackwell Business 2000) 69.

trading based on specialized technical analysis, such as that performed by institutional investors.⁴⁴⁸ As shown in Section 3.1.3, such deterrence of ‘unnecessary’ transactions by small investors may actually be in their best interest so to protect their investments from the volatility risks that they may collectively create.⁴⁴⁹

It could be worthwhile to consider different commission rates depending on the subscription channel. In 2011, 33.4% of transactions were made through automated tellers, 16.8% through telephone banking, 36.1% through internet banking, and 6% through bank branches.⁴⁵⁰ Obviously, each channel represents different levels of overhead expenses for brokerage firms and commission rates could therefore be varied accordingly.

3.1.6. Warnings Against Illicit Soliciting of Investment

An effort undertaken by the SEC which the CMA should replicate, in the interest of protecting investors, is the publication of the names of entities which have extended offers without the CMA’s approval. As described by the SEC:

“[t]he SEC receives complaints from investors and others, including foreign securities regulators, about securities solicitations made by entities that claim to be registered, licensed and/or located in the United States in their solicitation of non-US investors, and entities not registered in the United States that are soliciting US investors. In some cases, the complaints are about entities claiming to offer investments endorsed by governmental agencies, including the SEC. These claims are important because when an entity claims to be registered with the SEC, it

⁴⁴⁸ Ramady, *supra* note 106, 170-171.

⁴⁴⁹ The CMA has acknowledged in its 2011 Report that one of its strategic goals is to increase the portion of institutional investors. See CMA, *supra* note 154, 9.

⁴⁵⁰ *Ibid*, 37.

is in effect claiming that it has made itself available for SEC regulation and oversight. Generally, US entities that solicit you to purchase or sell securities for your own account are required to register with the SEC. For this reason, it is important for you to consider whether the entity that solicits you is, in fact, registered with the SEC.”⁴⁵¹

3.2. Regulation of Market Conduct

It is worthy of note that investor regulation most often aims at the protection of the collectivity of investors from the wrongful actions of individual investors. The main source of law concerning investors is contained in Chapter 8 of the Capital Market Law of 2003 and in Parts 2, 3, and 4 of the Market Conduct Regulations of 2004. Although this is not expressly stated by the legislator or the CMA, practically all provisions regulating the conduct of investors relate to stock exchange transactions rather than private placement transactions. This is due to the fact that conducts prohibited in the public setting are not generally possible in the private setting. Investor-related prohibitions in the Market Conduct Regulations of 2004 are divided in three main parts: (i) market manipulation, (ii) insider trading, and (iii) untrue statements.

3.2.1. Market Manipulation

According to Article 49(a) of the Capital Market Law of 2003, it is prohibited to:

“intentionally [do] any act or [engage] in any action which creates a false or misleading impression as to the market, the prices or the value of any security for the purpose of creating that impression or thereby inducing third parties to buy, sell or subscribe for such security or to

⁴⁵¹ A similar initiative is undertaken by the FSA. See the warning by the FSA to report any solicitation of funds: <http://www.moneymadeclear.fsa.gov.uk/news/firm/2009/warning_merger_law.html_unauthorized_overseas_companies> accessed 21 November 2009.

refrain from doing so or to induce them to exercise, or refrain from exercising, any rights conferred by such security.”⁴⁵²

Article 3 of the Market Conduct Regulations of 2004 creates two categories of manipulative or deceptive acts or practices, but fails to clarify the rationale for such categorization. Under the first category, the CMA has stated that fictitious trades and trades involving no change in beneficial ownership shall "*be among those [acts or practices] considered as manipulative or deceptive*".⁴⁵³ This first category of violations is one of strict liability and only requires evidence of the *actus reus*. This is logical since fictitious trades and trades involving no change in beneficial ownership, in terms of *actus reus*, cannot occur ignorantly.

Under the second category of violations, the CMA has listed acts considered to be manipulative or deceptive, but only when committed for the purpose of creating a misleading impression of trading activity or for the purpose of creating an artificial price for a security. These acts include the following:

- a) *“entering [an order] for the purchase of a security with the prior knowledge that [an order] of substantially the same size, time and price for the sale of that security, has been or will be entered;*
- b) *entering [an order] for the sale of a security with the prior knowledge that [an order] of substantially the same size, time and price for the purchase of that security, has been or will be entered;*
- c) *[with ill-intent,] purchasing or making offers to purchase, a security at successively higher prices or in a pattern of successively higher prices;*

⁴⁵² A similar prohibition is contained in Article 2 of the Market Conduct Regulations of 2004.

⁴⁵³ Article 3(a) of the Market Conduct Regulations of 2004.

- d) [with ill-intent,] selling or making offers to sell a security at successively lower prices or in a pattern of successively lower prices; or
- e) entering [an order] for the purchase or sale of a security to (i) establish a predetermined sale price, ask price or bid price, (ii) effect a high or low closing sale price, ask price or bid price, (iii) maintain the sale price, ask price or bid price within a predetermined range, or (iv) entering an order or a series of orders for a security that are not intended to be executed.”⁴⁵⁴

The requirement for ill-intent or *mens rea* in the second category is sensible since a number of these acts could occur ignorantly, in all good faith. Good-faith investors should not be discouraged from transacting, for fear of committing unintended infractions. This would defy attempts to capitalize the market and widen the investor base.

Unfortunately, the decisions of the CRSD that contain a market manipulation verdict of culpability generally fail to explain how the evidence of *mens rea* was derived.⁴⁵⁵ Out of comparison, the Financial Services and Markets Act of 2000 does not require evidence of *mens rea* for market abuse convictions. It suffices to demonstrate that a reasonable investor would not have engaged in the reproached conduct and would have recognized its illicit character.⁴⁵⁶ In effect, such a reasonability test can serve as a simple and practical method to evidence *mens rea*. For cases relating to market manipulation, the CMA and the CRSD should clarify that ill-intent can be presumed and that convictions

⁴⁵⁴ Article 3(b) of the Market Conduct Regulations of 2004.

⁴⁵⁵ Decision No. 1013/Lam/Dal1/2012 dated 5 June 2012 <<http://www.crsd.org.sa/Ar/Pages/Announcementsaeed.aspx>> accessed 14 September 2012.

⁴⁵⁶ Elis Ferran, The Liberalization of Financial Markets: The Regulatory Response in the United Kingdom, in Rainer Grote and Thilo Marauhn (eds), *The Regulation of International Financial Markets: Perspectives for Reform* (Cambridge University Press 2006) 67-68.

can be made, using a reasonability standard alone. As shown in Sections 3.2.2 and 3.2.3 of this Part, market conduct infractions relating to insider trading and untrue statements do incorporate a reasonability test. The same should have been followed for market manipulation.

3.2.2. *Insider Trading*

According to Article 50(a) of the Capital Market Law of 2003:

“Any person who obtains, through family, business or contractual relationship, inside information (hereinafter an “insider”) is prohibited from directly or indirectly trading in the security related to such information, or to disclose such information to another person with the expectation that such person will trade in such security.”⁴⁵⁷

The above provision is complemented by Articles 4 to 6 of the Market Conduct Regulations of 2004 which define insiders, and inside information, and which elucidate the circumstances where violations are deemed to have occurred. Articles 5 and 6 of the Market Conduct Regulations of 2004 require evidence *mens rea* for indictment and incorporate a presumption of *mens rea* based on a reasonability test. As such, the disclosure or use of inside information is prohibited if a normal person should have recognized the privileged nature of such information and its potential impact on the value of a security. In one circumstance, the chairman of one of the listed companies, Bishah Agriculture Development Co., was found guilty by the Committee for the

⁴⁵⁷ Article 50(b) of the Capital Market Law of 2003 defines insider information as any “*information obtained by the insider and which is not available to the general public, has not been disclosed, and such information is of the type that a normal person would realize that in view of the nature and content of this information, its release and availability would have a material effect on the price or value of a security related to such information, and the insider knows that such information is not generally available and that, if it were available, it would have a material effect on the price or value of such security*”.

Settlement of Securities Disputes of having violated the prohibition of Article 50 of the Capital Market Law of 2003 against insider trading, and of having realized profit through transactions on stock based on information which was available to him as a result of his position on the board of Bishah Agriculture Development Co. He was sentenced to three months in prison, a fine of SR 100,000, and to a five-year ban from taking up employment in any listed company.⁴⁵⁸

3.2.3. Untrue Statements

Article 7 of the Market Conduct Regulations of 2004 prohibits any person from making a materially false statement or from failing to make a required disclosure, for the purpose of influencing the trading price of a security, inducing the carrying out of a transaction, or the exercise or the waiver from the exercise of any right relating to a security.

Article 8 of the Market Conduct Regulations of 2004 adds that even statements of opinion are prohibited if disseminated for the purpose of influencing the trading price of a security. The CMA has taken action against traders caught “spreading rumors” in internet chat-rooms.⁴⁵⁹

Article 56 of the Capital Market Law of 2003 sets the conditions for parties aggrieved by untrue statements to obtain damages. It is not necessary that a relationship exists between the issuer of the untrue statements and the party aggrieved. The aggrieved

⁴⁵⁸ See Khalil Hanware, 'Company Boss Jailed for Insider Trading' *Arab News* (19 August 2009).

⁴⁵⁹ Clare Dunkey, 'Correction Prompts Panic: Falls in the Price of Speculative Stocks Have Pushed Down the TASI' *MEED Middle East Economic Digest* (10 March 2006).

party must have ignored the fact that the statement were untrue and must have relied on that statement to enter into a transaction. The aggrieved party must also prove that the issuer of the untrue statements knew or should have known that the statements were untrue. In other words, conviction here require evidence of *mens rea*, but also authorizes the presumption of *mens rea* based on a reasonability test.

3.2.4. Identification of Violations and Filing of Claims

Article 11 of the Market Conduct Regulations of 2004 has cleverly required Authorized Persons to refuse the execution of, and to report, the orders of any clients that appear to be engaged in market manipulation or insider trading. Such a requirement should assist the CMA in the detection and prevention of such acts and would serve as a first screen.

Article 58 of the Capital Market Law of 2003 and Article 27 of the Resolution of Securities Disputes Regulations of 2011 have also cleverly imposed a statute of limitation of one year from the date when the claimant becomes aware that he had been the victim of a violation and five years from the occurrence of the violation in question.⁴⁶⁰ Even though it could be argued that the statute of limitation could result in injustice to claimants, claimants do nevertheless enjoy a sufficient period of time to bring claims and are not totally deprived from judicial remedies.

The statute of limitation does serve the general interest since persons alleged to have committed a violation in the distant past are likely to have forgotten the circumstances

⁴⁶⁰ The statute of limitation is limited to claims under Articles 55 (incorrect or deficient prospectus causing harm to investors), 56 (untrue statements causing harm to investors), and 57 (intentional price manipulation causing harm to investors) of the Capital Market Law of 2003.

surrounding such alleged violation.⁴⁶¹ Also, it is likely that they have lost or destroyed some of the evidence that they could have submitted in their defense.⁴⁶² Since it is reasonable to assume that the quality of evidence is eroded over time, it would also be reasonable to assume that the resources of the CRSD would be inappropriately occupied if it was responsible to settle disputes concerning transactions that occurred in the distant past.

3.2.5. Prosecution Process

Market conduct offences are investigated by and prosecuted before the CRSD pursuant to the Resolution of Securities Disputes Regulations of 2011. Usually criminal offences are investigated and prosecuted by the Commission for Investigation and Prosecution before the criminal circuits of the General Courts and pursuant to the Law of Procedure before Criminal Courts of 2001.⁴⁶³ Even though sanctions imposed by the CRSD can include imprisonment, the rules of procedure and the rules of evidence stipulated in the Resolution of Securities Disputes Regulations of 2011 are far less detailed than those stipulated in the Law of Procedure before Criminal Courts of 2001. Nevertheless, the CRSD provides a much greater flexibility in terms of procedure and evidence. For instance, Article 25(i) of the Capital Market Law of 2003 and Article 18 of the Resolution of Securities Disputes Regulations of 2011 state that all forms of evidence shall be acceptable (including electronic data, telephone recordings and electronic mail).

⁴⁶¹ Charles Callahan, 'Statutes of Limitation: Background' (1955) 16 Ohio State Law Journal 130, 133.

⁴⁶² *Ibid.*

⁴⁶³ Article 3(1) of the Law of the Commission for Investigation and Prosecution, issued pursuant to Royal Decree No. M/56, dated 30 May 1989.

3.3. Foreign Investment in Listed Shares

The CMA has permitted direct trading in listed Saudi Arabian shares solely to Saudi nationals and expatriates residing in Saudi Arabia. In 2008, the CMA has issued a circular (the “**2008 Circular**”) allowing foreign individuals and companies to receive the economic benefit of listed Saudi Arabian shares through swap agreements made with authorized persons, who would be licensed to engage in dealing and who would act as the registered owners of the underlying shares.⁴⁶⁴ The 2008 Circular denied the exercise by the parties to a swap agreement of any of the voting rights attached to the underlying shares. Furthermore, said circular has capped the duration of swap arrangements to a maximum duration of four years.

Another circular was issued in 2010 (the “**2010 Circular**”) replacing the requirement for the authorized person to own the underlying shares with the requirement for the said shares to only be placed in the custody of the authorized person.⁴⁶⁵ The 2010 Circular has confirmed that authorized persons must extend to foreign investors the protections contained in Part 7 of the Authorized Persons Regulations of 2005 concerning their assets and money.⁴⁶⁶ Both the 2008 Circular and the 2010 Circular have stated that the CMA could, at its discretion, impose the discontinuation of any swap agreement or “*any qualitative or quantitative limitations or any requirements on [the swap]*”

⁴⁶⁴ CMA Circular No. 2-28-2008 dated 18 August 2008. See also Khalil Hanware, ‘Saudi Stocks Jump 5.18% on CMA Announcement’ *Arab News* (24 August 2008). Reuters, ‘Credit Suisse Hails CMA’s Approval For Foreigners’ *Arab News* (22 August 2008). Souhail Karam, ‘CMA Sets No Limits On Foreign Stock Ownership’ *Arab News* (27 August 2008).

⁴⁶⁵ CMA Resolution No. 3/10/2010 dated 16 March 2010.

⁴⁶⁶ Al Jadaan & Partners Law Firm, ‘Accessing Saudi Securities - the New Circular Gives Greater Clarity’ (April 2010) <<http://www.aljadaan.com/files/file/Accessing%20Saudi%20Securities%20-%20The%20New%20Circular%20Gives%20Greater%20Clarity.pdf>> accessed 3 May 2013.

agreements or on the ultimate beneficial investors". Also, both the 2008 Circular and the 2010 Circular require authorized persons to prepare standard forms for the swap agreement and to inform the CMA, prior to the conclusion of any transaction, of the form which they intend to utilize. Authorized persons need to report to the CMA the details of all executed transactions.

In 2011, the volume of swap agreements involving foreign investors stood at 31.7 billion Saudi Riyals, which is an insignificant part of the SR 1,271 billion Saudi Riyal total market capitalization of issued shares.⁴⁶⁷ It is not clear why the CMA has limited foreign investment so extensively. Regulators of emerging markets usually tend to eliminate barriers to attract additional capital to the markets.⁴⁶⁸ Allowing unrestricted foreign investment in Saudi Arabian listed stock could increase the liquidity of the stock exchange and could incentivize the floating of new securities by issuers trying to access available liquidity. Such liquidity and new listings could help to expeditiously achieve socio-economic targets, including the construction of infrastructure projects and the training of local labor.⁴⁶⁹

Foreign investment could also help mitigate the negative impact of the 'herding' type investors, since foreign investors are likely to have experience and institutional capabilities.

⁴⁶⁷ CMA, *supra* note 154, 40 and 45- 46.

⁴⁶⁸ Kabir Hassan and others, 'Stock Market Efficiency in the Gulf Cooperation Council Countries (GCC): The Case of Kuwait Stock Exchange' (2003) 1(1) *Scientific Journal of Administrative Development* 1, 3.

⁴⁶⁹ Ramady, *supra* note 106, 161. See also Ali Jamhour, 'The Role of the State in Economic Development: A Case Study of the GCC Countries' (DPhil thesis, University of Birmingham 2011) 164-166.

*“Foreign investors are an important source of demand for local securities, and several developing countries have opened their local markets to foreign investors in an attempt to widen and diversify the investor base [...] Although different types of foreign investors may have different investment strategies, market participations perceive foreign investors as playing a supportive role in local markets.”*⁴⁷⁰

It is surprising that the CMA has limited the duration of swap arrangements. Indeed, allowing the long-term commitment of 'patient' foreign funding should logically generate greater stability and socio-economic returns.⁴⁷¹ Since foreign investors are naturally more sensitive to market information, political and economic risks, it could be assumed that their investment would in any case have tended to be shorter in time than domestic investments, without need for the CMA's intervention in that regard.⁴⁷²

Perhaps the CMA's rationale for limiting the duration of swap arrangements is to prioritize domestic investments and the repatriation of Saudi Arabian capital kept offshore. The full liberalization of foreign investment could affect the levels of domestic investment, since competing demand from both the local and foreign investors would likely inflate stock prices and transaction costs. It may also be possible that the CMA wishes to prioritize foreign investment in sukuk and bonds rather than equity stock, since the former have a shorter term and since their market is less developed. Perhaps also, the CMA is of the opinion that the local market is still in its early phases of growth

⁴⁷⁰ Gerd Hausler, et al., 'Trends in Developing-Country Capital Markets Around the World', in Litan, et al., *supra* note 247, 40.

⁴⁷¹ See Joseph Stiglitz, 'Capital Market Liberalization, Economic Growth, and Instability' (2000) 28(6) *World Development* 1075. Stiglitz argues that foreign direct investment represent more stable source of foreign investment, and that it avoids the negative externalities associated with capital market liberalization.

⁴⁷² Hausler, et al., *supra* note 470, 40.

and would be vulnerable to overreaction and abrupt exits by foreign investors, which could unjustifiably affect the confidence of local investors.⁴⁷³ The CMA may be concerned that the sensitivity of foreign investors could be contagious to domestic investors, which would push volatility swings at the expense of pricing predictability.⁴⁷⁴ It could also be the case that the CMA is trying to avoid being blamed that strict Saudi Arabian visa requirements are affecting the ability of foreign investors to attend shareholder meetings and meetings with authorized persons.

In any event, it is obvious that the complexity of the swap structure may deter some foreigners from investing in listed Saudi Arabian shares.⁴⁷⁵ Foreign investors need trading flexibility and generally would not accept delays in the execution of their trading instructions since price movements cause intolerable harm. Also, the interpretation and enforcement issues raised by such complexity are likely to set off litigation.⁴⁷⁶ It is recognized that foreign investors need more assurances than local counterparts concerning the existence and application of basic legal protections by the local regulator.⁴⁷⁷ It is unclear whether the CRSD will constitute the exclusive forum for the settlement of disputes relating to swap agreements or whether the jurisdiction of the CRSD can be waived by the parties to a swap agreement.

⁴⁷³ Clemente Del Valle, and Piero Ugolini, 'The Development of Domestic Markets for Government Bonds', in Litan et al., *supra* note 247, 51. See Dania Saadi, 'Saudi Market Opens Up, but Gradually' *The New York Times* (21 March 2012) <<http://www.nytimes.com/2012/03/22/world/middleeast/22iht-m22-saudi-bourse.html?pagewanted=all& r=0>> accessed 20 October 2012.

⁴⁷⁴ Hassan, *supra* note 468, 2. See also Khaled Ahmad Othman, 'Direct Foreign Investment in the Saudi Stock Exchange' *Al Eqtisadiyah* (21 April 2012) <http://www.aleqt.com/2012/04/21/article_649198.html> accessed 15 October 2012.

⁴⁷⁵ Al Jazira Capital, *supra* note 14, 19-20.

⁴⁷⁶ Aljazeera Capital, *supra* note 14, 20.

⁴⁷⁷ Friedman and Grose, *supra* note 1, 8.

It is surprising that both the foreign investor and the authorized person were deprived from the exercise of voting rights attached to the underlying shares. Active participation by foreign investors could help improve Saudi Arabian models of corporate governance, since the foreign investors can be expected to question unreasonable local customs and traditions and introduce new concepts.

4. THE REGULATION OF SECURITIES FIRMS

Sound market decisions, either on the part of proposed issuers or investors, and smooth processing of such decisions, is in great part dependent on qualified securities firms, be them advisers, arrangers, brokers, underwriters or custodians.⁴⁷⁸ Empirical evidence suggests that well-developed securities firms assist economic development.⁴⁷⁹ Four of the 38 IOSCO Principles pertain to securities firms, which highlights the importance of their role. IOSCO has recommended that: (a) minimum entry standards be fixed by the regulator in relation to intermediaries, (b) initial and ongoing capital and other prudential requirements be imposed proportionately to the risks taken, (c) standards for internal organization and operational conduct be adopted to protect the clients, and that (d) procedures be adopted for dealing with the failure of a securities firm to contain systemic risk and damage to clients.⁴⁸⁰

4.1. Intermediation Firms: The Authorized Persons

⁴⁷⁸ Zhu Huayou, *supra* note 407, 28; See also Demirgüç-Kunt and Levine, *supra* note 2, 228.

⁴⁷⁹ Demirgüç-Kunt and Levine, *supra* note 2, 229.

⁴⁸⁰ IOSCO, *supra* note 155, 11.

In order to stimulate capital market transactions and in order to assist both issuers and investors in protecting their respective rights, the CMA has been encouraging the creation of securities firms.⁴⁸¹ Of course, precautions need to be taken in order to ensure that securities firms avoid systemically harmful exposure or practices.⁴⁸² In Saudi Arabia, preventive mechanisms at the intermediation level take the form described in the following Sub-Sections.

4.1.1. Requirements for Authorization

As per IOSCO's recommendation, the Authorized Persons Regulations of 2005 impose on securities firms a number of conditions and requirements for establishment.⁴⁸³ Pursuant to Article 6(e) of the Authorized Persons Regulations of 2005, a proposed securities firm must demonstrate to the CMA that:

- (a) It is fit and proper to carry on securities business of the kind and scale for which it is seeking authorization;
- (b) It has adequate expertise and resources for the kind of securities business that it proposes to carry on;
- (c) It has managerial expertise, financial systems, risk management policies and systems, technological resources, and operational procedures and systems that are sufficient to fulfill its business and regulatory obligations and to conduct the kind of securities business that it is proposing to carry on;

⁴⁸¹ As of 2011, there were 84 authorized intermediaries (three of which had not yet obtained a final authorization to commence business). See CMA, *supra* note 154, 118.

⁴⁸² Eilis Ferran and Charles Goodhart, 'Regulating Financial Services and Markets and Markets in the Twenty First Century: An Overview', in Ferran and Goodhart, *supra* note 175, 8.

⁴⁸³ IOSCO, *supra* note 155, ii.

- (d) Its directors, officers, employees and agents who will be involved in the proposed firm's securities business have the necessary qualifications, skills, experience, and integrity to carry on the kind of securities business that it is proposing to carry on.

Furthermore, pursuant to Article 6(g) of the Authorized Persons Regulations of 2005, it is required that the paid-up capital of proposed securities firms be no less than:

- (a) SR 50 million for securities firms specialized in dealing, custody, and/or managing activities;
- (b) SR 2 million for securities firms specialized in arranging;
- (c) SR 400,000 for securities firms specialized in advising.

Applications for authorization are quite voluminous and demanding, since applicants for registration must enclose to their application evidence that they are fit and proper. Applicants must, amongst other things, submit a detailed business profile and plan, a compliance manual, a code of conduct, a set of risk management policies, an operations manual, terms of business to be applied to transactions with the clientele, and a copy of the standard form of contracts to be routinely executed by or with clients and suppliers, an organizational chart, a business continuity plan, a list of proposed fees and commissions to be charged, a list of its controllers, a list of all persons with whom the applicant has close links.⁴⁸⁴

⁴⁸⁴ Annex 3.1 of the Authorized Persons Regulations of 2005.

The above-described verifications contribute to the preservation of systemic efficiency and in fulfilling systemic goals.

4.1.2. Organizational and Transactional Requirements

It has been argued that we cannot rely on the *caveat emptor* (buyer beware) principle and have clients be responsible for assessing the proper performance of securities firms. After all, investors do not have access to the information necessary to make such an assessment.⁴⁸⁵ Regulators must therefore intervene to set standards of performance onto securities firms. Such standards must not appear as being “aspirational” and must rather consist of clear-cut benchmarks that can effectively dissuade dishonest securities firms from prejudicing their clients.⁴⁸⁶

The CMA has imposed on securities firms, in the Authorized Persons Regulations of 2005, a number of requirements on the conduct of business (Part 5 of the Authorized Persons Regulations of 2005), internal systems and controls (Part 6 of the Authorized Persons Regulations of 2005), and on the utilization of client money and assets (Part 7 of the Authorized Persons Regulations of 2005). Examples of such requirements include the following:

- a) Securities firms may not induce clients to engage into a transaction (Art. 27);

⁴⁸⁵ McCleskey, *supra* note 146, 8-12.

⁴⁸⁶ *Ibid*, 33.

- b) Special commissions in excess of trade execution services are only acceptable in the circumstances described in the Authorized Persons Regulations of 2005 and must be disclosed in advance in the terms and regulations;⁴⁸⁷
- c) Information received from clients is to be considered confidential;⁴⁸⁸
- d) Securities firms must comply with certain requirements in relation to advertisements;⁴⁸⁹
- e) Clients must be provided with an agreement setting out the terms of business;⁴⁹⁰
- f) Situations of conflict between the interests of the securities firms and those of their clients must be avoided;⁴⁹¹
- g) Clients must understand the risks involved and securities firms must verify the suitability of the transaction vis-à-vis the client, prior to processing orders;⁴⁹²
- h) Certain restrictions apply in relation to customer borrowings and margined transactions;⁴⁹³
- i) Fees and commissions must be disclosed in advance;
- j) Reports must be delivered to clients periodically; and
- k) Establish and maintain systems and controls.

The Market Conduct Regulations of 2005 also contain a number of obligations directed at securities firms, such as the need to prioritize and timely execute client orders avoid

⁴⁸⁷ Article 28 of the Authorized Persons Regulations of 2005.

⁴⁸⁸ Article 29 of the Authorized Persons Regulations of 2005.

⁴⁸⁹ Articles 32-35 of the Authorized Persons Regulations of 2005.

⁴⁹⁰ Article 38 of the Authorized Persons Regulations of 2005.

⁴⁹¹ Article 41 of the Authorized Persons Regulations of 2005.

⁴⁹² Articles 42 and 43 of the Authorized Persons Regulations of 2005.

⁴⁹³ Articles 44 and 45 of the Authorized Persons Regulations of 2005.

churning, avoid the execution of orders that contradict recommendations or that are not sufficiently researched.⁴⁹⁴

4.1.3. Requirements for Staff Proficiency

Analysts have expressed concerns regarding the difficulties securities firms are facing to hire and retain proficient employees.⁴⁹⁵ Part 4 of the Authorized Persons Regulations of 2005 makes it a requirement that employees performing certain functions within securities firms be registered with the CMA, which requires the evidencing of proficiency and aptitudes and requires the passing of qualification examinations. Article 19 of the Authorized Persons Regulations of 2005 specifically subjects the following positions to proficiency requirements:

- 1) Chief Executive Officer or Managing Director;
- 2) Finance Manager;
- 3) Director or Partners;
- 4) Senior Officers or Managers;
- 5) Compliance Officers;
- 6) Money Laundering and Terrorism Financing Reporting Officer;
- 7) Staff performing client functions, including Sales Representatives, Investment Advisors, Portfolio Managers and Corporate Finance Professionals.

⁴⁹⁴ See Articles 12, 13, 15, 16, 18, and 19 of the Authorized Persons Regulations of 2005.

⁴⁹⁵ Abdallah Al Maafa, 'Saudi Investment Companies Suffer a Shortage in Proficient Labour and Will Not Be Dismissing' *Al Eqtisadiyah* (Riyadh, 14 December 2008) 11.

It is obvious that qualification examinations will help enhance the quality level of rendered services and should also help in harmonizing the different terms and processes utilized in the entire industry.

4.1.4. *Reporting of Complaints*

Article 63 of the Authorized Persons Regulations of 2005 should require from the securities firms to report to the CMA, all complaints that they receive with update as to how these have been resolved. For comparative purposes, Disposition 1.10.1 of the FSA Handbook requires firms to report to the FSA the complaints that they receive every six months. The FSA then publishes statistics regarding the number of complaints reported and closed (as defined in Disposition 1.10.7). The FSA has categorized complaints in the following manner:⁴⁹⁶

- a) Arrears Handling
- b) Breach of Contract
- c) Delays
- d) Dispute over sums/ amounts
- e) Failure to carry out instructions
- f) Misleading Advertising
- g) Misleading Advice
- h) Other Admin
- i) Overcharging
- j) Poor Customer Service

⁴⁹⁶ See FSA

<http://www.fsa.gov.uk/pages/Library/Other_publications/commentary/complaints_data/index.shtml>
accessed 20 November 2009.

- k) Switching/ Churning
- l) Other (category does not match complaint description)

The CMA should take a similar initiative in order to monitor the performance of securities firms. Another initiative which the CMA can replicate is the creation of an ombudsman office to receive and deal with certain types of complaints. The ombudsman service can be made available on a voluntary basis, but can also be imposed in certain circumstances.⁴⁹⁷ The CRSD could be utilized as a forum of last resort for disputes of a certain complexity.

4.1.5. *Inspections*

Pursuant to its powers stated in Article 5(c) of the Capital Market Law of 2003, the CMA conducts regular inspections of securities firms to ensure their legal compliance. The CMA has three different inspection programs:

- a) initial inspections, conducted immediately after the establishment of the firm, which serves to ensure that the firm understands the obligations that it needs to comply with and that it understands the processes that it needs to adopt for such purpose;
- b) cause inspections, conducted in case, for whatsoever reason, the CMA suspects that the firm is in violation of any its duties; and
- c) routine inspections, conducted at regular intervals, but with greater frequency for those firms determined to have more significant risk profiles. The CMA has announced that its evaluation of risk profiles takes into account financial, operational, compliance and legal, technological, and clearing and settlement

⁴⁹⁷ Iain MacNeil, *An Introduction to the Law on Financial Investment* (Hart Publishing 2005) 192-199.

risks.⁴⁹⁸ Such a broad evaluation should yield greater profiling accuracy and should, in turn, increase the value of CMA interventions.

In 2011, the CMA reports having carried out twelve initial inspections, 82 cause inspections, and twenty routine inspections.⁴⁹⁹ These numbers seem proportionate to the number of securities firms, which stood at 84 in that year.⁵⁰⁰

At first sight, these efforts show good diligence from the CMA. Nevertheless, it is important to emphasize the importance of disclosing and periodically reevaluating the conditions and parameters utilized for risk profiling.

5. **THE REGULATION OF FACILITATORS**

5.1. **Auditors**

Three of the 38 IOSCO Principles pertain to auditors.⁵⁰¹ Firstly, IOSCO has recommended that audit standards should be of high and internationally acceptable quality. Saudi Arabia applies its own standards, as established by the Saudi Organization for Certified Public Accountants ("**SOCPA**").⁵⁰²

Pursuant to the second IOSCO principle, auditors must be subject to adequate levels of oversight.⁵⁰³ This second IOSCO principle appears to be met, since even where no

⁴⁹⁸ CMA, *supra* note 154, 127-129.

⁴⁹⁹ *Ibid*, 128.

⁵⁰⁰ *Ibid*, 121.

⁵⁰¹ IOSCO principles 19-21. See IOSCO, *supra* note 155, 9.

⁵⁰² IMF, *supra* note 154, 13-14.

⁵⁰³ IOSCO principle 19. See IOSCO, *supra* note 155, 9.

SOCPA standard exists for a particular topic, recognized International Financial Reporting Standards ("IFRS") are typically used as a guide.⁵⁰⁴

Pursuant to the third IOSCO principle, auditing firms should be independent.⁵⁰⁵ This condition also appears to be met, although the appointment of the auditors, by the very businesses that they audit, does raise concerns of an inherent conflict between the interests of the beneficiaries of the audit reports (e.g. the investors, the minority shareholders, the regulator, etc.) and the interests of the auditing firm itself.⁵⁰⁶ Indeed, the auditing firm might be worried of losing its fees or future mandates if it gets vocal about issues which the audited businesses does not want exposed. This same situation also exists in the case of rating agencies and is discussed more elaborately in Section 5.2 of this Part. As recommended by the IMF, Saudi Arabian auditors should be required to report any "*breaches and all information of potential supervisory interest*".⁵⁰⁷

The MoCI issued a directive on the 31st of August 2008 obliging Saudi Arabian joint stock companies to replace their auditors every five years and not to reappoint an auditing firm before the lapse of two years from the end of their last mandate.⁵⁰⁸ The MoCI has clearly associated this directive with its efforts to increase corporate

⁵⁰⁴ *Ibid.*

⁵⁰⁵ IOSCO principle 20. See IOSCO, *supra* note 155, 9.

⁵⁰⁶ *Ibid.*, 228.

⁵⁰⁷ IMF, *supra* note 192, 36.

⁵⁰⁸ 'The Ministry of Commerce Requires Joint Stock Companies to Rotate the Auditor After Five Years' *Al Eqtisadiyah* (1 September 2008) <http://www.aleqt.com/2008/09/01/article_153085.html> accessed 21 October 2012. Stricter Requirements are applicable in the case of banks. See IMF, *supra* note 192, 32.

transparency.⁵⁰⁹ This measure is very tactful and should help in curbing frauds, and in uncovering inconsistencies and instances of incompliance. This point touches on another point of relevance which is to ensure that there constantly be a sufficient number of qualified accountants and auditors to cater the increasing demand for their services. The OECD has also recommended encouraging the setup of new accounting firms to compete with the existing oligopoly serving multinational corporations. The OECD has warned that the failure of major accounting firms could compound the severity of crises.⁵¹⁰ The role of auditors is invaluable for systemic stability and this role is discussed to some extent in Part VII.⁵¹¹

5.2. Credit Rating Agencies

Credit rating agencies offer investors valuable information regarding the creditworthiness of businesses entities and securities.⁵¹² They help facilitate the adoption of investment decisions through the use of standards for comparison and rating scales.⁵¹³ They also help reduce information asymmetry in capital markets between investors and issuers.⁵¹⁴

Article 6(a)(18) of the Capital Market Law of 2003 gives express authority to the CMA to issue conditions relating to the licensing of rating agencies. Only recently, on 10

⁵⁰⁹ *Ibid.*

⁵¹⁰ OECD, *supra* note 198, 37.

⁵¹¹ Black, *supra* note 210, 792-793.

⁵¹² Suzana Baresa et al., 'Role, Interests and Critics of Credit Rating Agencies' (2012) 3(1) *University of Tourism and Management Skopje (UTMS) Journal of Economics*, 71.

⁵¹³ *Ibid.*

⁵¹⁴ Alen Host et al., 'Credit Rating Agencies and their Impact on Spreading the Financial Crisis on the Eurozone' *XXL(2)* (2012) *Ekonomiska Misao Praksa Dbk.* 639, 641.

December 2012, the CMA has published the first draft of the Credit Rating Agencies Regulations, for the purposes of public consultation.⁵¹⁵

The draft of the Credit Rating Agencies Regulations makes licensing a prerequisite for all rating activities conducted in Saudi Arabia and stipulates minimum authorization requirements related to, amongst other things, the adequacy of resources, the soundness of risk management and operational policies, and the proficiency of the management and rating analysts.⁵¹⁶ The draft of the Credit Rating Agencies Regulations authorizes the establishment of branches of foreign credit rating agencies registered in foreign jurisdictions.⁵¹⁷ It is estimated that there are only about 130 to 150 rating agencies around the world.⁵¹⁸ It can therefore be expected that many of the new entrants in the Saudi Arabian market would already have an existence elsewhere.

Needless to say, the reliance on a weak ratings report could have devastating effects, at both macro and micro levels.⁵¹⁹ Credit rating agencies were blamed for having contributed to the 2007 financial crisis. This is because many of the securities that triggered the crisis had been highly ranked by credit rating agencies and were not

⁵¹⁵ CMA, *supra* note 182.

⁵¹⁶ Articles 4 and 8(c) of the draft Credit Rating Agencies Regulations.

⁵¹⁷ Article 8(b) of the draft Credit Rating Agencies Regulations.

⁵¹⁸ The three best known agencies (Standard and Poor's, Moody's and Fitch Ratings) cover more than 80% of the market. See UNCTAD, 'Credit Rating Agencies and their Potential Impact in Developing Countries' (Discussion Paper 186, 2008) 13 <http://unctad.org/en/Docs/osgdp20081_en.pdf> accessed 17 May 2013.

⁵¹⁹ Steven Scalet and Thomas Kelly, 'The Ethics of Credit Rating Agencies: What Happened and the Way Forward' (2012) 111 *Journal of Business Ethics* 477, 477.

promptly downgraded.⁵²⁰ One author described as follows the reasons behind the contributory role of credit rating agencies to the financial crisis:

*"A combination of their fee structure, the complexity of the bonds that they were rating, insufficient historical data, some carelessness, and market pressures proved to be a potent brew. This combination was enabled, however, by seven decades of financial regulation that, beginning in the 1930s, had conferred the force of law upon these agencies' judgments about the creditworthiness of bonds and that, since 1975, had protected the three agencies from competition."*⁵²¹

According to IOSCO, regulatory frameworks relating to ratings agencies must address the four following principles:⁵²²

- (a) quality and integrity in the rating process;
- (b) independence and prevention of conflicts of interests,
- (c) transparency and timeliness of ratings disclosure, and
- (d) confidential information.⁵²³

In June 2012, the Kingdom of Saudi Arabia had informed the FSB that:

"the proposed Credit Rating Agencies Regulations shall be in line with the IOSCO's Code of Conduct Fundamentals for Credit Rating Agencies. Also, the proposed Regulations will take into

⁵²⁰ *Ibid.*, 477. See also Host et al., *supra* note 514, 640.

⁵²¹ Lawrence White, 'The Credit-Rating Agencies and the Subprime Debacle' (2009) 21(2-3) *Critical Review* 389, 389.

⁵²² IOSCO, 'Regulatory Implementation of the Statement of Principles Regarding the Activities of Credit Rating Agencies: Final Report', Document FR04/11 (February 2011) <<http://iosco.org/library/pubdocs/pdf/IOSCOPD346.pdf>> accessed 1 September 2011; See also IOSCO, 'IOSCO Statement of Principles Regarding the Activities of Credit Rating Agencies' (25 September 2003) 3 <<http://www.fsa.go.jp/inter/ios/20030930/02.pdf>> accessed 5 May 2013.

⁵²³ *Ibid.*

account the regional and international best practices and the recent and ongoing developments in this area".⁵²⁴

As described in the section below, the Credit Rating Agencies Regulations appear to incorporate the principles recommended by IOSCO.

5.2.1. Quality and Integrity in the Rating Process

The draft regulations impose a general professional duty of care on agencies, including their analysts and employees as well as an obligation to avoid misrepresentations or misleading statements.⁵²⁵ The draft regulations impose on agencies a general obligation to maintain sufficient resources.⁵²⁶

The formulation of credit ratings is not an exact science.⁵²⁷ Credit analysts may adopt a different methodology and attribute different weight to different elements of information.⁵²⁸ Credit rating agencies must use rating categories and methodologies that are rigorous, systematic, and that can, where possible, be subjected to objective validation⁵²⁹

⁵²⁴ FSB, 'Progress in the Implementation of G20/FSB Recommendations' (June 2012) 28 <http://www.financialstabilityboard.org/publications/r_120619pp.pdf> accessed 15 April 2013.

⁵²⁵ Articles 15 f) and 15(g) of the draft Credit Rating Agencies Regulations.

⁵²⁶ Article 15(c)(2) and 15(g) of the draft Credit Rating Agencies Regulations.

⁵²⁷ Baresa et al., *supra* note 512, 73-74.

⁵²⁸ *Ibid.*

⁵²⁹ Article 17(b) of the draft Credit Rating Agencies Regulations.

The draft regulations requires credit rating agencies to use "*established and defined ranking system of rating categories*".⁵³⁰ It was advised by some academics to standardize the definitions and nomenclature used in ratings and to subject them to a common benchmark.⁵³¹ The term "established" may be interpreted to mean that rating agencies are not absolutely free to choose any ranking systems and that there is a specific set of recognized systems to choose from.

The compensation of independent members of the administrative or supervisory board must not be linked to the business performance of the credit rating agency and must be arranged so as to ensure their independence.⁵³²

5.2.2. Independence and Prevention of Conflicts of Interests,

A general duty of independency is also imposed on credit rating agencies.⁵³³ The draft regulations also contain a general obligation to avoid conflicts of interest and to adopt internal procedures to identify, disclose, and eliminate actual or potential conflicts.⁵³⁴ Credit rating agencies are required to segregate between their rating activities and their rating analysts from any other businesses.⁵³⁵ The independence of analysts is important since the investigation of the financial crisis has revealed that, at times, analysts were

⁵³⁰ IOSCO, *supra* note 522, 3 and 34-37.

⁵³¹ Avinash Persaud, 'The Right and Wrong Way to Regulate Credit Rating Agencies' (2007) 42(42) Economic and Political Weekly 4212, 4213.

⁵³² Article 26(d) of the draft Credit Rating Agencies Regulations.

⁵³³ Article 22(5) of the draft Credit Rating Agencies Regulations.

⁵³⁴ Articles 16(a) and 16(e) of the draft Credit Rating Agencies Regulations.

⁵³⁵ Article 16(b) of the draft Credit Rating Agencies Regulations.

reluctant to rate securities issuances when they felt that this could create problems with their management teams.⁵³⁶

In addition to the broad requirements, the draft Credit Rating Agencies Regulations also stipulate particular examples of conflict of interest circumstances that agencies must avoid. For instance, an agency cannot conduct any rating activity if any of its credit analysts (or any employee involved in the rating activities) is related to any manager within the rated entity.⁵³⁷ Also, an agency cannot conduct any rating activity where the credit rating would be affected by the existence, potential existence, or the non-existence of a business relationship between the agency and the rated entity.⁵³⁸ This obligation should help resolve the criticism that certain credit agencies had, at times, rated instruments or structures that they had themselves designed.⁵³⁹ Critics of such an environment have claimed that ratings agencies are likely to purposely distort information or present it simplistically in order to retain the issuers as clients and to facilitate their marketing of rated securities to uninformed investors.⁵⁴⁰

⁵³⁶ Maurice Mullard, 'The Credit Rating Agencies and their Contribution to the Financial Crisis' (2012) 83(1) *The Political Quarterly* 77, 77.

⁵³⁷ Article 16(g)(6) of the draft Credit Rating Agencies Regulations.

⁵³⁸ Article 16(g)(2) of the draft Credit Rating Agencies Regulations.

⁵³⁹ Abbas Mirakhor, 'The Recent Crisis: Lessons from Islamic Finance' (IFSB Conference on Financial Policy and Stability, Kuala Lumpur 2009) 26.

⁵⁴⁰ Marco Pagano and Paolo Volpin, 'Credit Failures and Policy Options' 25(62) *Economic Policy* (April 2010) 401, 406 and 413; See also The High-Level Group on Financial Supervision in the EU, 'Report' (Brussels 25 February 2009)

<http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf> accessed 19 October 2012, 19-20.

The CMA should consider imposing greater safeguards to avoid conflicts of interests and biasness resulting from the 'issuer pays' model.⁵⁴¹ Amongst other things, the CMA could for instance impose mandatory rotation policies (e.g. the appointment of a different credit rating agency every three years).⁵⁴²

5.2.3. Transparency and Timeliness of Ratings Disclosure

Credit rating agencies must disclose, amongst other things:

- a) the nature of the compensation arrangements made with rated entities, as well as any arrangements that provide more than 10% of their annual revenue;⁵⁴³
- b) a description of actual or potential conflicts;⁵⁴⁴
- c) their methodologies and the assumptions used in their rating activities;⁵⁴⁵
- d) any material modifications to their assumptions;⁵⁴⁶
- e) information regarding their legal structure and ownership;⁵⁴⁷
- f) a list of their largest 20 clients, based on the revenues generated from each of them;⁵⁴⁸
- g) statistics on the allocation of their staffing resources.⁵⁴⁹

⁵⁴¹ Scott Boylan, 'Credit Rating Agency Reform: Insight from the Accounting Profession' (2011) *The Certified Public Accounting Journal* 40, 40; See also Host et al., *supra* note 514, 650.

⁵⁴² *Ibid.*

⁵⁴³ Article 21(c)(3) of the draft Credit Rating Agencies Regulations. A number of academics had emphasized the importance of the transparency of the fees charged by credit rating agencies to indicate probabilities of biasness. See Host et al., *supra* note 514, 642.

⁵⁴⁴ Article 22(2) of the draft Credit Rating Agencies Regulations.

⁵⁴⁵ Article 21(f)(1) of the draft Credit Rating Agencies Regulations; The non-transparency of credit rating agencies regarding the rationales for their rating decisions and the risk models used was considered as one of the reasons that culminated in the financial crisis. See Mullard. *supra* 536, 78.

⁵⁴⁶ Article 21(c)(6) of the draft Credit Rating Agencies Regulations.

⁵⁴⁷ Article 22(2) of the draft Credit Rating Agencies Regulations.

⁵⁴⁸ Article 21(f)(1) of the draft Credit Rating Agencies Regulations.

⁵⁴⁹ Article 22(4) of the draft Credit Rating Agencies Regulations.

Each credit assessment must be accompanied by a disclosure statement containing a number of the elements of information listed in the preceding paragraph.⁵⁵⁰

Interestingly, the form of the statement, as contained in the draft Credit Rating Agencies Regulations does warn that: "*A person should not rely on credit ratings for the purposes of making an investment decision. A person (other than an authorized person or a bank) should consult an investment adviser*".⁵⁵¹ Taking from the American experience during the crisis, investors tend to rely on ratings despite disclaimers.⁵⁵²

5.2.4. Confidential Information

Credit rating agencies and their employees must only use confidential information for their rating activities or in accordance with any confidentiality agreements with the rated entities.⁵⁵³ This obligations adequately satisfy IOSCO's fourth principle in relation to ratings agencies.

5.2.5. Forced Use of Credit Ratings

In the United States, banks were prohibited from investing in 'speculative' securities, below 'investment grade'. US Banks therefore had to defer to the opinion of credit rating agencies.⁵⁵⁴ Both US insurance companies and pension funds were incentivized to invest in rated products since their minimum capital requirements varied according to the level of their investment risks.⁵⁵⁵ It will be interesting to see if Saudi Arabian

⁵⁵⁰ Section 2 of Annex 2 of the draft Credit Rating Agencies Regulations.

⁵⁵¹ Section 1 of Annex 2 of the draft Credit Rating Agencies Regulations.

⁵⁵² Mullard, *supra* 536, 79.

⁵⁵³ Article 15(f) of the draft Credit Rating Agencies Regulations; See also Article 28(4) of the draft Credit Rating Agencies Regulations which repeats in great part Article 15(f).

⁵⁵⁴ White, *supra* note 521, 391.

⁵⁵⁵ *Ibid.*

legislative and regulatory governmental institutions will give credit rating agencies similar support. The CMA did give support to credit rating agencies. Article 30 of the Prudential Rules of 2012 stipulates that:

"When determining the risk weight of an exposure, credit ratings shall be used consistently and continuously".

Although credit ratings can be utilized to improve the sustainability in Saudi Arabian capital markets, more research needs to be carried out to determine how this is best accomplished.

6. CONCLUSION

The systemic success of capital markets requires the establishment of a regulatory framework that expressly prohibits abuse by market participants and encourages the adoption of best commercial practices. Saudi Arabia still suffers from an inadequate corporate governance culture, which exposes minority shareholders and possibly also the public to abuse by majority shareholders or directors. The issuance of the Corporate Governance Regulations of 2006 in respect of listed companies constituted a step in the right direction. The next priority would be to clearly spell out the fiduciary duties of managers in the case of closed companies, especially limited liability companies. Furthermore, attempts must be made to consolidate the leverage of minority shareholders, so that they are able to prevent or redress abuse more effectively.

The CMA must be proactive in demanding from issuers the disclosure any information that can affect the trading value of shares. Such disclosure should help achieve greater

price discovery and should help in curbing insider trading and false rumors. Investors need education and guidance in refining their investment skills and learning to avoid undesirable behavior. The CMA's limitation on commissions payable to brokers and limitation of trading hours are tactful ways to promote liquidity and yet prompt individual investors to maintain their portfolio or delegate the management of such portfolio to professionals. Even so, the Saudi Arabian population should be encouraged to acquire shares for their long-term expected dividend yield rather than the ability to make a short-term gain from fluctuations in trading price.

This Part attempted to deduce the rationale for the prohibition of foreign investment in listed stock. Arguably, the foremost intent would be the prioritization of investment flows originating from within Saudi Arabia and avoiding any abrupt volatility that could result from sudden withdrawals. Abrupt volatility may in turn result in loss of confidence by market participants in the systemic resistance of the market. Swap arrangements, through which foreign investors are permitted to indirectly invest in Saudi stocks, are unattractive in many ways and pose a number of implementation and enforcement issues. The CMA should conduct consultations with the industry to identify any practical difficulties encountered by the parties to swap arrangements.

In respect of the regulation of securities or securities firms, this Part concluded that the CMA's licensing system is strong in screening the suitability and appropriateness of applicants. The CMA has taken positive steps in ensuring the proficiency of the staff of securities firms, by subjecting these to qualification exams. Also, CMA inspections carried out at the level of securities firms should help identify compliance gaps. The

CMA should however reveal the criteria and parameters that it utilizes for the determination of risk profiles.

In respect of the regulation of professionals, who assist in the facilitation of capital market transactions, this Part described the invaluable role played by lawyers and financial consultants in conducting due diligence assessments of issuers, in preparing offering memoranda, and in alerting potential investors to issues and risks that they have identified.

Saudi Arabian law seems broadly in compliance with IOSCO's recommendations relating to auditors, namely that they be subjected to oversight and that they be independent. The CMA should be praised for having restricted the appointment of auditing firms to only five years. This should help bring to light to any inconsistency, incompliance or fraud resulting from poor auditing or loss of independence (or perhaps even complicity).

In relation to rating agencies, the CMA has issued the draft of the Credit Rating Agencies Regulations, which have taken into account IOSCO's recommendations on the subject. Once enacted, these regulations should play a significant role in guiding investment decisions and deepening the investment culture.

PART VI - THE PREVENTION AND CONTAINMENT OF CRISES

1. INTRODUCTION

The 2007 financial crisis has revealed to the world that crises are 'virulent' and that no country is an island. It has been estimated that not more than 18 months following the onset of the crisis, listed stock had lost value across the world by more than €16 trillion.⁵⁵⁶ The recent "Occupy Wall Street" protests have conveyed a growing and strong sentiment of public distrust of banks and securities firms.⁵⁵⁷ Bankers and brokers are now viewed by many as greedy profiteers whose recklessness was a root cause of the recent crisis, and what followed in terms of job losses, foreclosures and corporate and personal bankruptcies.

Even when the Gulf economies had minimal exposure to the assets at the epicenter of the 2007 financial crisis, there were nevertheless shock waves that reached the Middle East, as a result of cross-border investments.⁵⁵⁸ According to the World Bank, stock indices have fallen in the last quarter of 2008 by about between 30 to 60% in the GCC

⁵⁵⁶ The High-Level Group on Financial Supervision in the EU, *supra* note 540, 6.

⁵⁵⁷ Colin Moynihan, 'Protesters Arrested in Sleep-Out and Demonstration Near Stock Exchange' *The New York Times* (16 April 2012) <<http://cityroom.blogs.nytimes.com/2012/04/16/four-protesters-arrested-in-sleep-out-near-stock-exchange/?ref=occupywallstreet>> accessed 7 September 2012. See also Peter Walker and Shiv Malik, 'Protesters Plan to Occupy London Stock Exchange' *The Guardian* (14 October 2011) <<http://www.guardian.co.uk/world/2011/oct/14/protesters-london-stock-exchange>> accessed 7 September 2012.

⁵⁵⁸ Abdulrahman Al Hamidy, 'The Global Financial Crisis: Impact on Saudi Arabia', 1 <<http://www.bis.org/publ/bppdf/bispap54u.pdf>> accessed 14 April 2012.

region and by an average of 50% in the MENA region.⁵⁵⁹ The World Bank also reports that MENA sovereign funds with high allocation into equity have lost approximately 40% of their portfolio value between December 2007 and December 2008. The World Bank expects such devaluation to severely impact on poverty levels in the MENA.⁵⁶⁰

In the most isolated Middle East economies, the spillover effects took the form of unwanted variation in the price of imported or exported commodities, a reduction in worker remittances, or a reduction in international aid.⁵⁶¹ In rich oil and gas producing Middle East economies, the spillover effects took the form of a fall in oil and gas prices and revenues, shortage of liquidity and increase in risk aversion at the banking level, losses by outward-focused sovereign wealth funds, and devaluation of currency as a result of pegging to the American Dollar.⁵⁶²

In today's delicate times of financial instability, recession, implosion, crunches, crises, meltdowns, and corresponding reform, regulators must do more than structural or framework facilitation. Capital market regulators must provide close supervision and preparedness to tactically intervene and even interfere for the protection of investors. This interference right and duty is similar to that of banking regulators when it comes to

⁵⁵⁹ The World Bank, 'Q&A on the Global Financial Crisis: Interview with the Acting Chief Economist for the MENA Region' (23 April 2009)

<<http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/MENAEXT/0,,contentMDK:22153569~pagePK:146736~piPK:146830~theSitePK:256299,00.html>> accessed 21 October 2012.

⁵⁶⁰ *Ibid.*

⁵⁶¹ Shalendra Sharma, 'The Arab World Amidst the Global Crisis of 2008-2009' (2010) 3 Contemporary Arab Affairs 1, 43 and 45.

⁵⁶² *Ibid.*, 48-49. See also Shereef Ellaboudy, 'The Global Financial Crisis: Economic Impact on Countries and Policy Implications' (2010) 41 International Research Journal of Finance and Economics 177, 178-179.

the protection of depositor funds. A laissez-faire approach would pose a great systemic risk with the endless possibilities of market abuse and manipulation.

The containment of systemic risk is one of the three core IOSCO Objectives along with the protection of investors, and market fairness, efficiency, and transparency. IOSCO acknowledges that the core objectives are interrelated.⁵⁶³

IOSCO has defined systemic risk as follows:

"Systemic risk refers to the potential that an event, action, or series of events or actions will have a widespread adverse effect on the financial system and, in consequence, on the economy. Securities regulators are concerned about systemic risk because it not only has the potential to harm a large number of investors and market participants, but because it also can have a widespread negative effect on financial markets and the economy."⁵⁶⁴

Systemic failure may either occur abruptly, in case, for instance, a number of securities firms go insolvent. In such case, the regulatory prudential safeguards would be put to the test. On the other hand, systemic failure may occur gradually, in case, for instance, of transactional deterrence resulting from the loss of investor confidence.⁵⁶⁵ Such scenario has greater likelihood when the regulatory framework is poorly built or enforced.

⁵⁶³ IOSCO, 'Methodology for Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation' (September 2011) 11, <<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD359.pdf>> accessed 25 November 2011.

⁵⁶⁴ *Ibid.*, 40.

⁵⁶⁵ *Ibid.*

In response to the financial crisis, IOSCO has recommended that the regulator “*have or contribute to a process to monitor, mitigate and manage systemic risk*”.⁵⁶⁶ This Part will examine the current processes and safeguards applied in Saudi Arabia and will formulate some suggestions to reinforce them.

2. STRENGTHENING THE REGULATORY APPARATUS

It is now well agreed upon that there are measures that, while avoiding over-regulation, could and should be put into place in order to prevent the recurrence and/or the frequency of crises.⁵⁶⁷ It has also become clear that closer supervision will be required to ensure that these preventative measures are properly adopted.

With the expansion of the private sector through privatization, the government is no longer controlling certain industries through ownership and needs to now, in the first instance, require and rely on private-sector disclosures. Disclosures will mainly take the form of document submissions, either through electronic or printed form. Obviously, the volume of these submissions might be overwhelming to the regulator and the information therein-contained might be complex and confusing. The regulator will therefore need to have in place the resources necessary to go through, verify, and understand such submissions. The regulator will also need to carry out field visits and interviews, with the regulated and with affected persons.

⁵⁶⁶ IOSCO, 'Mitigating Systemic Risk: A Role for Securities Regulators' (13 February 2011) 13-14 <<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD347.pdf>> accessed 28 September 2012.

⁵⁶⁷ The High-Level Group on Financial Supervision in the EU, *supra* note 540, 13.

According to the conclusions of a recent investigation on the optimum SEC organizational structure, significant new investments is needed in the SEC's key enabling infrastructure, such as technology and human resources.⁵⁶⁸ The CMA should borrow from the SEC model any transposable measures that could lighten and enhance the CMA's internal structure. The CMA should also inquire about any available technology or strategic policies that can be adopted for the improvement of processes.

The CMA's enforcement units should receive special training for the detection of Ponzi and pyramid schemes, where investments are called for a non-existent opportunity, with the intent of ultimately retaining the majority of funds collected. Under Ponzi and pyramid schemes, the trust of investors is sustained until the point of collapse through the payment of short-term returns originating from the pool of funds collected.⁵⁶⁹

As per the OECD's Principles for a Policy Framework for Effective and Efficient Financial Regulation:

*"Governmental authorities should have the requisite expertise and resources to conduct appropriate surveillance and analysis on a timely basis and formulate sound policy and regulation".*⁵⁷⁰

According to a report of the SEC Office of Inspector General, Bernard Madoff's Ponzi scheme was never fully investigated despite the fact that six substantive complaints

⁵⁶⁸ SEC, 'Report on the Implementation of SEC Organization Reform Recommendations' (9 September 2011) 6 <<http://www.sec.gov/news/studies/2011/secorgreformreport-df967.pdf>> accessed 21 October 2012.

⁵⁶⁹ On the example of Al Rayan, an Egyptian private Islamic investment company which collapsed in 1988 as a result of such type of fraud, see Wilson, *supra* note 94, 7-8.

⁵⁷⁰ *Ibid*, 15.

were filed against Madoff between June 1992 and December 2008.⁵⁷¹ Said complaints were described as having raised significant red flags against the operations of Madoff. The report clearly describes the SEC's enforcement staff as "*fairly inexperienced*".⁵⁷² The report also describes how, in 1992, by having failed to act on certain red flags uncovered by an accounting firm, the SEC's enforcement staff had "*missed [an] opportunity to uncover Madoff's Ponzi scheme 16 years before Madoff confessed*".⁵⁷³ The CMA should learn from the experiences acquired by foreign regulators and should assess the replication of any tested safeguards.

3. ENCOURAGING COMPLIANCE AND SELF-REGULATION

Stricter regulation will inevitably require greater regulatory deployments and audits and will therefore imply a greater public cost.⁵⁷⁴ At the level of regulated financial institutions, the cost of complying with a stricter regulatory framework will imply greater operational costs, which would surely be passed on to the clients, affecting therefore transactional costs. Such resulting inflation may seem justifiable when measured against the cost of possible bailout plans. It may also seem justifiable when measured against the greater public confidence and greater transactional activity that could be achieved in markets that 'race to the top'.⁵⁷⁵

⁵⁷¹ SEC, 'Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme' (Case No. OIG-509, 31 August 2009) <<http://www.sec.gov/news/studies/2009/oig-509.pdf>> accessed 11 November 2011.

⁵⁷² *Ibid*, 21.

⁵⁷³ *Ibid*, 26.

⁵⁷⁴ Pritchard, *supra* note 343, 32.

⁵⁷⁵ Although Benston recognizes that other scholars have linked regulation with enhanced public confidence, he himself, argues that there is no such correlation. See George Benston, *Regulating Financial Markets: A Critique and Some Proposals*, (The AEI Press 1999) 61-62.

Nonetheless, the CMA should attempt to develop in the system and in market participants an intrinsic ability to shun and deter undesirable transactions and practices. For example, investor-awareness will help investors place quality criteria and steer away from low-quality products. Well-functioning ratings-agencies could also assist investors in formulating, accelerating, or improving their investment decisions.⁵⁷⁶ In turn, issuers will adapt to consumer demand and raise the quality of the securities that they issue, without need for any regulatory intervention. Similarly, the proper application of rules of corporate governance and disclosure could help raise the quality of corporate decisions and safeguard the communal interest.⁵⁷⁷

In order to train investors and other market participants in the recognition of unacceptable risks, the CMA should consider disclosing recurring issues that have caused the rejection of offering applications. This would not only help avoid offering applicants from incurring unnecessary expenditures but would also help in creating greater transparency, accountability, and review by professionals and academics.

4. PRODUCT INNOVATION AND COMPLEXITY

According to the Turner Review, “*financial innovations can sometimes achieve economic rent extraction, rather than delivering valuable customer and economic benefits*”.⁵⁷⁸ The complexity and opacity of new transactional structures was blamed as

⁵⁷⁶ The High-Level Group on Financial Supervision in the EU, *supra* note 540, 16.

⁵⁷⁷ Stiglitz and Bhattacharya, *supra* note 4, 7.

⁵⁷⁸ FSA, ‘The Turner Review: A Global Response to the Global Banking Crisis’ (March 2009) 51 <http://www.fsa.gov.uk/pubs/other/turner_review.pdf> accessed 18 October 2012; See also IOSCO, ‘Suitability Requirements with Respect to the Distribution of Complex Financial Products: Consultation

one of the primary reasons for the occurrence or at least the severity of the financial crisis.⁵⁷⁹ Product complexity makes consumer choices more difficult and reduces market dynamicity. Innovative securities were made available to certain retail investors, although they were unsuitable to them due to complexity.⁵⁸⁰ Apparently, even certain professional investors and market specialists lacked an understanding of the core features and risks of some of the complex securities being transacted.⁵⁸¹ It was observed that the regulator also is often unable to keep pace with financial innovation.⁵⁸²

Since self-correcting market forces alone have not succeeded in driving out unreasonable or value destructive innovation, it has become clear that corrective regulatory interference would not be disruptive or intrusive, but actually desirable and necessary.⁵⁸³ Without hindering healthy innovation, regulatory measures must be introduced to regulating products and, where possible, standardizing their underlying transactional structure.⁵⁸⁴ This would develop familiarity and would reduce transactional

Report', (February 2012) <<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD373.pdf>> accessed 17 October 2012.

⁵⁷⁹ IOSCO, *supra* note 563, 40; See also Panagiotis Delimatsis, 'Transparent Financial Innovation in a Post-Crisis Environment' (2013) 16(1) *Journal of International Economic Law* 159, 169.

⁵⁸⁰ Delimatsis, *supra* note 579, 170-171; IOSCO, *supra* note 578, 7.

⁵⁸¹ IOSCO, *supra* note 566, 9; See also Ibrahim Warde, *Islamic Finance in the Global Economy* (Edinburgh 2000) 140; Delimatsis, *supra* note 579, 172; The High-Level Group on Financial Supervision in the EU, *supra* note 540, 10.

⁵⁸² Delimatsis, *supra* note 579, 173.

⁵⁸³ Delimatsis, *supra* note 579, 172 and 180; IOSCO, *supra* note 578, 24 and 51-58; See also FSB, 'Improving Financial Regulation: Report of the Financial Stability Board to G20 Leaders' (25 September 2009) 9-10 <http://www.financialstabilityboard.org/publications/r_090925b.pdf> accessed 2 May 2013; See also Domenica Tropeano, 'Financial Regulation After the Crisis: Where Do We Stand?' (2011) 40(2) *International Journal of Political Economy* 45, 56.

⁵⁸⁴ IMF, 'Global Financial Stability Report: Containing Systemic Risks and Restoring Financial Soundness' (April 2008) 2 and 54 <<http://www.imf.org/external/pubs/ft/gfsr/2008/01/pdf/text.pdf>> accessed 2 May 2013.

risks, costs, and processing time.⁵⁸⁵ Standards and uniform rules should be imposed by the regulator, based on the experience and input of market participants. Interestingly, it is observed that the takeover of failed institutions can represent lesser disruptions to customers and employees if they were dealing with standard products.⁵⁸⁶ If sufficiently simplified and standardized, products could be traded through formal exchanges.⁵⁸⁷ This would lead to greater transparency regarding the nature of the product and the identity of the owner.⁵⁸⁸

5. DIVERSIFICATION

Diversification and basket investments will act as a good initial buffer in the event of the failure of a particular issuer, industry, or economy. Regulators should therefore verify that financial institutions are not over-exposed to particular products or markets.⁵⁸⁹ The petrochemical and the banking sector are by far the most important sectors on the Saudi Arabian Stock Exchange, with SR 4.9 billion (28.7%) and SR 3.6 billion (21.2%) respectively.⁵⁹⁰ The predominance of the petrochemical sector is not surprising since the oil sector is the prevailing sector of the Saudi Arabian economy as a whole. On the other hand, the banking industry is undoubtedly extremely valuable since it channels liquidity from areas of surplus to areas of deficit. However, since banks borrow short and lend long, they are vulnerable to abrupt collective deposit withdrawals or loan irrecoverableness. Capital market investors are usually inevitable victims of

⁵⁸⁵ *Ibid.*

⁵⁸⁶ Benston, *supra* note 575, 23.

⁵⁸⁷ OECD, *supra* note 198, 39; IMF, *supra* note 584, 54 and 67.

⁵⁸⁸ OECD, *supra* note 198, 39.

⁵⁸⁹ Steven L. Schwarcz, 'Systemic Risk', (2008) 97 Georgetown Law Journal 193, 200.

⁵⁹⁰ CMA, *supra* note 154, 53.

banking sector crises, even where banking sector receivables have not been recycled, repackaged and resold as capital market products. This is because banks usually list their own equity and because, in times of crisis, such equity is likely to severely devalue at the expense of investors.⁵⁹¹ The exposure of capital markets to the banking sector equity and products is therefore significant.⁵⁹² The exposure of non-banking sectors to the banking sector is also significant, since these are dependent on the banking sector as depositors and borrowers.

The mitigation of the risks of over-exposure of capital markets and non-banking sectors to the banking sector could be achieved through the sectoral diversification and balancing of capital market products. Instead of having the capital market channel funds to the banking sector which would then be relayed to other sectors by way of banking loans, the capital market could itself directly help in funding the ultimate sectors that suffer from liquidity shortages. Diversifying the funding sources for companies operating infrastructure projects and reducing their reliance on banking finance should reduce any liquidity shocks that they could experience during recession time and reduce the probabilities of disruption in the provision of basic services. Such diversification could help channel liquidity to sectors that may have been redlined by banks and would help fulfill the MEP's goal to diversify the economy.⁵⁹³

⁵⁹¹ IOSCO had observed growing interconnectedness and interaction between banks and capital markets. IOSCO, *supra* note 566, 9.

⁵⁹² Sophia Antonopoulou, 'The Global Financial Crisis', (2010) 6(1) The International Journal of Inclusive Democracy 4.

⁵⁹³ See IMF, 'Statement at the Conclusion of the 2011 Article IV Consultation Mission to Saudi Arabia' (Press Release No. 11/205, 31 May 2011) <<http://www.imf.org/external/np/sec/pr/2011/pr11205.htm>> accessed 1 September 2011.

The improvement of banking practices would not only contribute to their own stability and durable growth, but also to that of capital markets. Numerous calls have been made worldwide for the adoption of stricter banking rules. As stated in the speech of the Governor of the SAMA, at the Euromoney Saudi Arabia Conference – 17th May 2011

Diversifying Sources of Finance:

*“In my view, international banks need to accept tighter regulation, which will mean lower returns on capital in good years due to lower leverage. In return, this approach should help them avoid the frequent crises and losses of bank capital which have been seen in the last two decades or so.”*⁵⁹⁴

The CMA will not be able to fully regulate capital markets without coordination with other regulators in Saudi Arabia, and without coordination with other capital market regulators in other countries. The IMF has observed that it is important for SAMA to "refine already good coordination" with the MoF and the CMA and has recommended the publication of financial stability reports.⁵⁹⁵ By comparison, the PRA and the FCA are also expected to engage in a similar cooperation effort with other domestic regulators, such as the regulatory authority responsible for work-based pension schemes.⁵⁹⁶

6. DISCLOSURE AND TRANSPARENCY

⁵⁹⁴ Muhammad Al-Jasser, Speech, (Euromoney conference titled 'Diversifying Sources of Finance 17 May 2011) <<http://www.sama.gov.sa/sites/samaen/News/Pages/DiversifyingSourcesofFinance.aspx>> accessed 3 May 2013.

⁵⁹⁵ IMF, *supra* note 156, 31.

⁵⁹⁶ HM Treasury, *supra* note 200, 110-111.

Disclosure and transparency could help investors discern the financial position of issuers and to act on strategies rather than impressions or rumors.⁵⁹⁷ It was discovered that certain EU financial institutions had not reported on their balance sheets some of the problematic financial assets that triggered the crisis. It was also discovered that certain companies engaged in highly-risky business had financed their activities through loans obtained by affiliates.⁵⁹⁸ Likewise, under prevailing accounting practice, financing structured on Islamic models allowed certain obligors to categorize debt as operating expenses and have it omitted from its balance sheet. By resorting to such disguise, they showed lower debt ratios and higher returns on assets.⁵⁹⁹

It has been strongly proposed to tighten the accounting rules by requiring balance sheet comprehensiveness.⁶⁰⁰ As recommended by the OECD, information relating to private and off-balance sheet vehicles should be reported to relevant stakeholders.⁶⁰¹ The US Sarbanes-Oxley Act of 2002 serves as a good example of a recent legislative attempt to improve auditing practices.⁶⁰² The Sarbanes-Oxley Act of 2002 created the Public Company Accounting Oversight Board, to oversee the audit of companies that are subject to the securities laws, and ensure the accuracy, thoroughness and independence

⁵⁹⁷ *Ibid*, 9.

⁵⁹⁸ FSA, *supra* note 578, 72.

⁵⁹⁹ Mahmoud El-Gamal, *Islamic Finance: Law, Economics, and Practice* (Cambridge University Press 2006) 102-103.

⁶⁰⁰ FSA, *supra* note 578, 72.

⁶⁰¹ OECD, 'Policy Framework for Effective and Efficient Financial Regulation: OECD Recommendation and Principles' (3 December 2009) 4

<<http://www.oecd.org/dataoecd/18/53/44187223.pdf>> accessed 12 November 2011.

⁶⁰² Sarbanes-Oxley Act of 2002 (107th Congress Public Law 204, 116 Stat. 745, enacted on 29 July 2002) <<http://www.gpo.gov/fdsys/pkg/PLAW-107publ204/html/PLAW-107publ204.htm>> accessed 23 October 2012.

of audit reports.⁶⁰³ Pursuant to the Sarbanes-Oxley Act of 2002, auditors have been required to attest the effectiveness of an issuer's internal controls.⁶⁰⁴ A similar requirement should be formulated in Saudi Arabia.

7. REMUNERATION PRACTICES

Directors and executives of large corporations were blamed of having contributed to the 2007 financial crisis, by having, for the sake of receiving annual performance bonuses, allowed their companies to incur excessive risks and liabilities.⁶⁰⁵ These liabilities created, in the short term, an appearance of profitability and expansion, but, in the long term, exposed firms to loss and possibly failure.⁶⁰⁶ Throughout various jurisdictions, there have been efforts to limit remuneration policies that create excessive risk exposures. For instance, the FCA issued the Remuneration Code, which contains high-level standards on the topic.⁶⁰⁷

Pursuant to the FCA's Remuneration Code, variable remuneration should not limit a firm's ability to strengthen its capital base.⁶⁰⁸ Performance measurements used in the calculation of variable remuneration must be adjusted for future risks and must take into

⁶⁰³ Sections 101 to 109 of the Sarbanes-Oxley Act of 2002.

⁶⁰⁴ Section 302(a)(4)(B) of Sections 101 to 109 of the Sarbanes-Oxley Act of 2002. See also Roel C. Campos, 'SEC Regulation Outside the United States' (Speech made in London, England, 8 March 2007) <<http://www.sec.gov/news/speech/2007/spch030807rcc.htm>> accessed 18 October 2012.

⁶⁰⁵ FSA, 'Reforming Remuneration Practices in Financial Services' (March 2009) 3-4 and 9 <http://www.fsa.gov.uk/pubs/cp/cp09_10.pdf> accessed 2 May 2013.

⁶⁰⁶ HM Treasury, *supra* note 185, 36; FSA, *supra* note 605, 22.

⁶⁰⁷ FCA, 'Remuneration Code (SYSC 19A)' <<http://fshandbook.info/FS/html/FCA/SYSC/19A>> accessed 18 June 2013.

⁶⁰⁸ Article 19A.3.19 and Remuneration Principle 6 of the Remuneration Code.

account the cost and quantity of capital and liquidity required.⁶⁰⁹ Performance-based remuneration must take into account not only the performance of the individual, but also that of the business unit concerned and the overall results of the firm.⁶¹⁰ Performance assessments must incorporate non-financial metrics and must be set in multi-year frameworks.⁶¹¹

The Saudi legal and regulatory framework should require greater deterrence of remuneration arrangements that encourage excessive risk-taking by employees. The CMA should assess the transposition into Saudi Arabian law of any provisions in the Remuneration Code deemed relevant in the Saudi Arabian context. Legal and empirical research should be conducted to guide and assist such transposition process.

8. CAPITAL REQUIREMENTS

8.1. Purpose

Financial institutions are usually required to retain capital in order to absorb operating losses and safeguard their ability to honor their obligations. Capital requirements are therefore intended to act as a counter-cyclical buffer in case of a crisis or stress of any kind on an institution or national economy.⁶¹² That said, if capital requirements are imposed following the onset of a crisis, they could rather constitute a source of pro-cyclicality and could lead financial institutions to depart from valuable assets for the

⁶⁰⁹ Article 19A.3.22 and Remuneration Principle 8 of the Remuneration Code; Grant Kirkpatrick, 'The Corporate Governance Lessons from the Financial Crisis', (2009) 2009 OECD Financial Market Trends 1, 15 <<http://www.oecd.org/finance/financialmarkets/42229620.pdf>> accessed 21 October 2012.

⁶¹⁰ Article 19A.3.26 and Remuneration Principle 12(b) of the Remuneration Code.

⁶¹¹ Article 19A.3.37 and Article 19A.3.38 of the Remuneration Code.

⁶¹² The High-Level Group on Financial Supervision in the EU, *supra* note 540, 15 and 17; See also FSA, *supra* note 578, 61.

sake of increasing their liquidity.⁶¹³ Capital requirements should therefore be imposed early, in times of good financial performance when liquidity is available to build-up capital buffers.⁶¹⁴

8.2. Capital Requirements in the Context of Securities Firms

Securities firms convert the funds of their clients into securities, which to the extent possible and most often, are registered in the name of such clients.⁶¹⁵ In case of the insolvency of a securities firm, the assets under its custody should, to a large extent, be traceable to, and recuperated by, their owners.⁶¹⁶ It was estimated that the unsecured credit exposure of securities firms, as typically reflected on their balance sheets, constituted roughly ten percent of assets. As for liabilities, these usually consist of obligations arising from the finance of short sale of securities and the finance of operating expenses.⁶¹⁷

The Companies Law of 1965 does generally require from all Saudi Arabian companies the build-up of capital reserves. Pursuant to Article 125 and 176 of the Companies Law of 1965, joint stock and limited liability companies, respectively, must set aside ten percent of their net profits, each year, towards the build-up of a statutory reserve. This obligation ceases when the reserve reaches one half of the declared capital. That said,

⁶¹³ The High-Level Group on Financial Supervision in the EU, *supra* note 540, 11; See also FSA, *supra* note 578, 59.

⁶¹⁴ The High-Level Group on Financial Supervision in the EU, *supra* note 540, 17 and 19.

⁶¹⁵ Articles 69(b) and 70 of the Authorized Persons Regulations of 2005.

⁶¹⁶ *Ibid.*

⁶¹⁷ Bank for International Settlements, 'Risk Management Practices and Regulatory Capital: Cross-Sectoral Comparison' (November 2001) 11 <<http://www.bis.org/publ/joint04.pdf>> accessed 21 October 2012.

until the recent enactment of the Prudential Rules in December of 2012, the CMA had not imposed on securities firms, even those licensed for dealing, any fixed capital adequacy requirements. The CMA only required the segregation of the assets of clients from those of the securities firms. Article 66(a) of the Authorized Persons Regulations of 2005 contained the only requirement regarding the adoption of business continuity safeguards. Said Article left it for securities firms to assess their own risks and establish whatever prudential safeguards that they deemed appropriate. Pursuant to Article 66(a) of the Authorized Persons Regulations of 2005:

"An authorized person should have in place appropriate arrangements, having regard to the nature, scale and complexity of its business, to ensure that it can continue to operate and meet its regulatory obligations in the event of an unforeseen interruption to its activities. These arrangements should be documented and regularly updated and tested to ensure their effectiveness."

Although the Authorized Persons Regulations of 2005 do not contain any express requirements for securities firm to create capital adequacy buffers, Article V(2) of Annex 3.2 of the Authorized Persons Regulations of 2005 does require securities firms to report on events affecting their capital adequacy.⁶¹⁸

The Prudential Rules issued by the CMA in December 2012 are quite technical. They are 163 pages long and are composed of 9 parts and 27 chapters. The Prudential Rules

⁶¹⁸ The Authorized Persons Regulations of 2005 only impose on securities firms the establishment of systems and controls, which must cover, amongst other things risk management policies and business continuity plans. (See Article 55(b)). See also CMA, *supra* note 154, 130-131.

of 2012 were described as having taken into account the best international practices and standards and to have incorporated the requirements of Basel II and Basel III.⁶¹⁹

The Prudential Rules of 2012 do seem to be fixed in proportion to the aggregate risk exposure, as recommended by IOSCO.⁶²⁰ Indeed, on the one hand, the Prudential Rules of 2012 require securities firms licensed for arranging and advising to only maintain at all times owners' equity of not less than SR 200,000 and working capital for three months.⁶²¹ On the other hand, the Prudential Rules of 2012 require securities firms licensed for dealing, management, or custody, to continuously maintain a minimum capital base of not less than the "*total of the minimum capital requirements*" calculated for each of the following category of risks:⁶²²

- a) trading book exposures;⁶²³
- b) non-trading exposures (capital requirements for non-trading exposures must correspond to not less than 14% of the securities firm's risk-weighted exposure amounts);⁶²⁴

⁶¹⁹ 'CMA-Authorized Firms Set to Apply Basel III' (10 March 2012) *Arab News* <<http://www.arabnews.com/node/408351>> accessed 15 April 2013.

⁶²⁰ IOSCO, 'Capital Adequacy Standards for Securities Firms' (October 1989) 4 and 24-25 <<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD1.pdf>> accessed 14 November 2011.

⁶²¹ Article 1(c) of the Prudential Rules of 2012. For the purposes of comparison, this is similar to the requirement under the European Union Capital Adequacy Directive of 2006 for securities firm minimum capital to maintain reserves that vary depending on the type of activities that they conduct. Securities firms that hold clientele money or assets must have a minimum capital of EUR 125,000 if they: (a) receive, transmit, or execute orders, or (b) manage portfolios of investments or financial instruments.⁶²¹ Firms are also required to hold one quarter of the previous year's overhead expenses, as a cover for operational risks. Articles 5(1) and 21 of Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions of 21 April 2004 <<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2006:177:0201:0201:EN:PDF>> accessed 23 October 2012.

⁶²² Article 2 of the Prudential Rules of 2012.

⁶²³ This comprises counterparty risks for trading book exposures, settlement risks for trading book exposures, market risk for trading book operations, foreign exchange risks and commodity risks in the entire operations. See Articles 15 to 20 39 of the Prudential Rules of 2012.

- c) operational risks (capital requirements for operational risks ranges between either 15% or 25%, depending on the calculation method utilized);⁶²⁵
- d) foreign exchange rate risk;⁶²⁶ and
- e) commodities risk.⁶²⁷

At least 50% of the capital base must be maintained in the form of paid-up capital, audited retained earnings, share premium, or reserves, which are considered as a more loss-absorbing form of capital.⁶²⁸ The CMA, if it deems necessary, may impose additional requirements in particular instances, if it considers it appropriate.⁶²⁹

The value of a securities firm's exposures to a single counterparty, or group of connected counterparties, may not exceed 25% of its capital base.⁶³⁰ Also, the total value of a securities firm's large exposures may not exceed 800% of its capital base.⁶³¹

Securities firms must have a written liquidity risk policy that is tailored to its business objectives, strategic direction, and general risk preference.⁶³² This policy must ensure that the securities person can meet its day-to-day needs for liquidity, as well as any temporary emergencies.⁶³³ Securities must establish an independent central function for

⁶²⁴ See Article 21 of the Prudential Rules of 2012.

⁶²⁵ Articles 39 to 44 of the Prudential Rules of 2012.

⁶²⁶ Article 45 of the Prudential Rules of 2012

⁶²⁷ Article 50 of the Prudential Rules of 2012

⁶²⁸ Article 2 of the Prudential Rules of 2012.

⁶²⁹ Article 1(e) of the Prudential Rules of 2012.

⁶³⁰ Article 52 of the Prudential Rules of 2012.

⁶³¹ Article 53 of the Prudential Rules of 2012.

⁶³² Article 58 of the Prudential Rules of 2012.

⁶³³ Article 62(a) of the Prudential Rules of 2012.

the oversight of liquidity risk.⁶³⁴ Securities firms must also have in place an internal capital adequacy assessment process ("ICAAP") consisting of the following features: (a) Governing body oversight; (b) Sound capital assessment; (c) Comprehensive assessment of risks; (d) Monitoring and reporting; and (e) Internal control review.⁶³⁵ The process must be reviewed and revised annually and must be proportionate to the nature, scale, and complexity of the activities of the securities firm.⁶³⁶ The process should capture all the material risks to which the securities firm is exposed.⁶³⁷ It should also take into account the securities firm's strategic plans and how they relate to macroeconomic factors.⁶³⁸

There appears to be no secondary sources of materials as of now regarding the Prudential Rules of 2012. It would have been interesting to learn how the Prudential Rules of 2012 were received by the industry and the academic community.⁶³⁹ The Prudential Rules of 2012 should offer adequate protection to investors and should boost their confidence.

8.3. Capital Requirements in the Context of Listed Companies

The CMA should verify the appropriateness of capital buffers applied by issuers that have excessive risk exposures, such as banks and insurance companies. The imposition

⁶³⁴ Article 64(a) of the Prudential Rules of 2012.

⁶³⁵ Article 66(a) of the Prudential Rules of 2012.

⁶³⁶ Articles 66(b) and 66(c) of the Prudential Rules of 2012.

⁶³⁷ Section 7(a) of Annex 9 of the Prudential Rules of 2012.

⁶³⁸ Section 8(a) of Annex 9 of the Prudential Rules of 2012.

⁶³⁹ The CMA should have published the comments that it had received from the industry when the regulations were published in draft form for the purposes of consultation. As discussed in Section 3.4.3 of Part III, this could have helped elucidate some of the complex concepts in the Prudential Rules of 2012.

of capital requirements onto banks and insurance companies falls within the primary jurisdiction of the SAMA pursuant to, respectively, the Banking Control Law of 1966 and the Cooperative Insurance Companies Law of 2007. Nevertheless, nothing theoretically prevents the CMA from lobbying for or even from adopting stricter requirements if it feels that these are necessary for the protection of capital markets. As discussed in Section 5 of Part VI, the CMA and the SAMA should definitely collaborate in the assessment of risks and safeguards in respect of banks and insurance companies.

On the topic of capital requirements in the context of banks, numerous studies and reports have suggested the adoption of dynamic provisioning. Dynamic provisioning is a counter-cyclical measure that consists of increasing the capital reserve formation requirements during periods of expansion so to offset portfolio and clientele losses during times of recession. The ideal aim would be to segregate reserves into, on the one hand, cyclically depletable and replenishable reserves and, on the other hand, reserves that are meant to remain intact and available solely in emergency situations, such as severe insolvency. Dynamic provisioning has been implemented in Spain since 2000 and did help Spanish banks surmount the 2007 financial crisis.⁶⁴⁰ Studies should be conducted on the transposability of dynamic provisioning into the context of both Saudi Arabian banks and securities firms.

9. CONTAINMENT MEASURES

⁶⁴⁰ FSA, *Ibid*, 59, 63.

The IMF has recommended that the CMA prepares a plan to deal with the insolvency of a securities firm and to fix with the SAMA and the MoCI a procedure to apply in such an event.⁶⁴¹ Governments have a number of containment measures at their disposal following the onset of a crisis. Containment measures can be drastic and could take the form of the provision of liquidity by acting as a lender of last resort, the nationalization of defaulting entities, and the imposition of controls on capital outflows.⁶⁴² These measures will not be discussed in this Section since they have generally only been applied in the context of banks and since they exceed the immediate purposes of this thesis.

As recommended by the OECD, the CMA does enjoy early and general intervention powers in case of the insolvency of a securities firm. Securities firms must notify the CMA in advance prior to the institution of settlement or liquidation proceedings.⁶⁴³ The appointment by a securities firm of a liquidator requires the approval of the CMA.⁶⁴⁴ The CMA made clear that it shall have the right to attend and be heard at any meeting with the creditors.⁶⁴⁵ As from the initiation of settlement or liquidation proceedings, the consent of the CMA is needed for any acceptance of further client money or assets, the disposition of client money or client assets, or the encumbrance or disposition of any of the proprietary assets of the securities firm.⁶⁴⁶ Further, the CMA clarified that it shall

⁶⁴¹ IMF *supra* note 154, 20.

⁶⁴² Regarding the containment of banking crises, see Ash Demirgüç-Kunt and Luis Servén, 'Are all the Sacred Cows Dead? Implications of the Financial Crisis for Macro and Financial Policies' (2010) The World Bank Research Observer.

⁶⁴³ Articles 97(a) and 98(a) of the Authorized Persons Regulations of 2005.

⁶⁴⁴ Article 98(b) of the Authorized Persons Regulations of 2005.

⁶⁴⁵ 97(b) and 98(c) of the Authorized Persons Regulations of 2005.

⁶⁴⁶ Articles 97(d) and 98(d) of the Authorized Persons Regulations of 2005.

have the right to direct the liquidator to take such steps as it considers fit to establish the entitlements of the clients of the securities firm.⁶⁴⁷

The above provisions, although helpful, are complementary to a bankruptcy regime that is contained in a law that dates as far back as 1931.⁶⁴⁸ The Saudi Arabian government should reform its bankruptcy law, at least to refer to the jurisdiction and procedure of the new judicial structures. The Saudi legislator should also consider the creation of an equivalent of the Orderly Liquidation Authority, created pursuant to the Dodd-Frank Act of 2010.⁶⁴⁹

Scholars noted that, in order to compensate for the devaluation of failed products, to meet the withdrawal requests of clientele, and to continue meeting mandatory capital requirements, some financial institutions have abruptly resorted to the fire sale of bad and good products alike.⁶⁵⁰ These fire sales have in turn devalued the price of good-quality products and have further plunged the markets. In times of crisis, since good quality products get devaluated, it becomes difficult for the regulator to differentiate between good and bad quality products and time is lost in the process of investigation.⁶⁵¹

⁶⁴⁷ Article 98(e) of the Authorized Persons Regulations of 2005.

⁶⁴⁸ The Commercial Court Law, issued pursuant to Royal Decree No. 32, dated 1 June 1931.

⁶⁴⁹ Sections 201-217 of the Dodd-Frank Act of 2010. Sebastian Schich and Byoung-Hwan Kim, 'Systemic Financial Crises: How to Fund Resolution' (December 2010) 2 OECD Journal: Financial Market Trends, 7

<<http://www.oecd.org/dataoecd/16/16/46681329.pdf>> accessed 21 October 2012.

⁶⁵⁰ Joshua Coval and Eric Stafford, 'Asset Fire Sales (and Purchases) in Equity Markets' (2007) 86 Journal of Financial Economics 479, 480-481.

⁶⁵¹ *Ibid.*, 510-511.

Supposedly, the CMA could, in accordance with Part 8 of the Authorized Persons Regulations of 2005 and Articles 4(d), 4(e), and 4(f) of the Bankruptcy Prevention Settlement Regulations of 1996, negotiate with the creditors of an insolvent securities firm, the deferral of the payment of the debts of that firm and/or the assignment of management to an independent administrator.⁶⁵² Such an intervention could help the creditors of the insolvent securities firm maximize their recoveries and could also help the securities firm regain solvency.

10. CONCLUSION

Crises can destroy any socio-economic benefits realized and could plunge the welfare of generations to come. This Part explained that the regulatory apparatus must be adequately equipped and efficiently structured to timely recognize and react to systemic risks. Investment by the CMA in this regard is necessary and the CMA could benefit immensely from the models and staff training materials utilized by Western regulators. As was shown in this Part, the CMA must encourage self-regulation by raising the ability for capital market participants to recognize, by themselves, risks that affect their own interests as well as overall systemic interests. The CMA should also classify issuers and securities firms in terms of the systemic risks that they represent. Regulatory focus should obviously be targeted towards riskier entities.

Moreover, as was discussed in this Part, experts have found that a number of current market practices have been exposing the system to greater vulnerability. This Part

⁶⁵² The Bankruptcy Prevention Settlement Regulations, issued pursuant to Royal Decree No. M/16, dated 24 January 1996.

explained how products are growing increasingly complex and must be simplified for the sake of transactional fluidity and the reduction of inherent risks. The regulator should ensure that there is diversification in the issuer-base so to limit excessive sectoral exposures. Other preventative measures suggested in this Part include the avoidance of managerial bonus schemes that encourage inappropriate risk-taking. They also include the placing of restrictions on the distancing of the end-obligor and the end-beneficiary to minimize damages and long chain reactions resulting from the failure of the end-obligor.

This Part also explained that the main tool to assist in recovery from insolvency is the availability of sufficient built-up capital reserves. Minimum capital requirements are different in the case of general corporations, securities firms, and banks. This Part argued that the CMA should impose greater capital requirements on securities firms and should verify the adequacy of the capital buffers adopted by listed companies.

PART VII - THE INTEGRATION OF CAPITAL

MARKETS

1. INTRODUCTION

Capital markets are already international in many ways and cross-border investments are taking place without need for any formal efforts towards integration.⁶⁵³ Nevertheless, formal and coordinated integration could help in pooling capital scattered over many jurisdictions and in allocating the pooled capital, optimally, towards its most productive use. Integration could lower transactional and administrative costs and raise investment returns.⁶⁵⁴ Indeed, it was estimated that the creation of a fully-integrated pan-European financial market had reduced the cost of equity-capital by about 40 basis points on average and had increased the level of overall European GDP by 1.1% and employment by 0.5%.⁶⁵⁵ Integration is said to encourage venture capital financing and, in the process, benefit small and medium sized companies.⁶⁵⁶ Integration could foster healthy competition between securities firms and could consequently catalyze innovation. In a nutshell, an integrated capital market should:

“improve the overall macroeconomic performance of the economy, producing higher economic growth with positive impacts on employment creation and productivity.”⁶⁵⁷

⁶⁵³ Grote and Marauhn, *supra* note 456, 8.

⁶⁵⁴ The Committee of Wise Men, 'Final Report of the Committee of Wise Men on the Regulation of European Securities Markets' (Brussels, 15 February 2001) 5 <http://ec.europa.eu/internal_market/securities/docs/lamfalussy/wisemen/final-report-wise-men_en.pdf> accessed 21 October 2012.

⁶⁵⁵ Ferran and Goodhart, *supra* note 482, 12-13. For a summary of benefits that can be expected from integration, see The Committee of Wise Men, *ibid*, 4.

⁶⁵⁶ *Ibid*, 6.

⁶⁵⁷ *Ibid*, 5.

Capital markets may be integrated in many different ways and to varying extents. Capital market integration could take the form of a permission for investors to invest in securities cross-border, for securities firms to deliver cross-border services, or for issuers to offer securities cross-border. Integration could also involve a consolidation of systems, such as stock exchanges, clearing and settlement platforms, or even regulatory bodies.⁶⁵⁸

Legally speaking, integration could also be achieved by setting the minimum content to be included in the different instruments enacted by each participating jurisdiction. This is referred to as harmonization. A higher harmonization model would be to adopt a single instrument applicable across all such jurisdictions. As an example of this latter option, GCC members have all ratified the 1999 Common Customs Law of the GCC States to unify and facilitate customs procedures and "*enhance cooperation among member states*".⁶⁵⁹ An even deeper integration model would be to harmonize completely the operative environment of users, in an integral way. For instance, securities firms allowed to operate across a region are not only made subject to the same capital market rules, but also to the same labour law and taxation requirements. Such an equal footing would eradicate undue competitive advantages by securities firms located in one jurisdiction over those located in other jurisdictions.⁶⁶⁰ Such an equal footing would also eradicate the loss of systemic efficiency, at regional level, resulting from arbitrage.

⁶⁵⁸ Heiko Schmiedel and Andreas Schonenberg, 'Integration of Securities Market Infrastructures in the Euro Area' (July 2005) 5 Occasional Paper Series - European Central Bank, July 2005) 7 <http://ssrn.com/abstract_id=752093> accessed 28 June 2012.

⁶⁵⁹ Adopted in the 20th session of the Supreme GCC Council held in Riyadh on 27-29 November 1999.

⁶⁶⁰ Tzung-Bor Wei, 'The Equivalence Approach to Securities Regulations' (2006) The Berkeley Electronic Press - Bepress, Working Paper 1482, 53-54 <<http://law.bepress.com/expresso/eps/1482>>

Section 2 of this Part will examine the typical competition between capital markets. As will be shown in this Section, integration could accentuate competition and therefore form a threat to market participants.

Section 3 will present the current integration initiative by GCC member states and will look into the European experience for insights regarding the integration model and strategy that could be applied in the GCC. The European Union provides certainly the most illustrious example of financial and capital market integration amongst independent sovereign states.

2. **BETWEEN COMPETITION AND COOPERATION**

2.1. **Competition**

Capital has grown mobile and borderless and there has been consequently an evident competition between capital markets to attract investments. Depending on the desires and priorities of investors, jurisdictional competition may take the form of either a "race to the bottom" or a "race to the top".⁶⁶¹

"Races to the bottom" or "race of laxity" aim at retaining local capital and attracting foreign investments.⁶⁶² It takes the form of a reduction in the regulatory barriers and

accessed 2 May 2013; See also Manning Gilbert Warren III, 'Global Harmonization of Securities Laws: The Achievements of the European Communities', (1990) 31 Harvard International Law Journal 185, 190.

⁶⁶¹ Nancy Worth, 'Harmonizing Capital Adequacy Rules for International Banks and Securities Firms' (1992) 18 North Carolina Journal of International Law and Commercial Regulation 133.

⁶⁶² Joel P. Trachtman, 'International Regulatory Competition, Externalization, and Jurisdiction' (1993) 34 Harvard International Law Journal 47, 52.

burdens that usually prevent investment offerings or restrict their potential profitability.⁶⁶³ Typically, licensing and conduct of business requirements may be eased, lower-grade products may be permitted, and more lenient penalties may be applied. Some academics have compared such type of deregulation as a subsidy aimed at supporting particular firms at the expense of society at large.⁶⁶⁴ Investors attracted by greater profit margins may be attracted by offers originating from poorly regulated environments, even if these offers consist of riskier products and imply weaker investor protections. If races to the bottom are allowed, investment losses may occur, accompanied by transactional deterrence and loss of confidence in both the market and its regulator. Despite vigilance, states with stricter quality standards may find themselves unable to protect their markets from influxes of deficient products and services. Ultimately, capital market transactions are characterized by intangible products that can be offered by a variety of means (e.g. telephone or internet) without the knowledge and beyond the control of the regulatory authority.

"Race to the top" or "flight to quality" approaches aim at catering for risk-averse investors, who place more importance on the security of their investment rather than the potential returns that it could yield.⁶⁶⁵ Certain scholars have noted that, when issuers choose jurisdictions with lesser disclosure requirements, risk-averse investors suspect an intent to hide information and discount the trading value of the equity of such issuers.⁶⁶⁶

⁶⁶³ Georges de Ménéil, 'Real Capital Market Integration in the EU: How Far Has it Gone? What will the Effect of the Euro Be?' (1999) 14(28) *Economic Policy* 165, 166-201. See also, Wilson, *supra* note 94, 3. See also Trachtman, *supra* note 662, 4.

⁶⁶⁴ *Ibid.*, 82.

⁶⁶⁵ *Ibid.*, 62.

⁶⁶⁶ Black, *supra* note 210, 844.

Inter-jurisdictional competition to attract risk-averse investors would take the form of stricter regulation and investment protections.⁶⁶⁷

2.2. Cooperation

As a result of disparity between the capital market rules of different jurisdictions, as may be compounded by inter-jurisdictional competition, distortions and regulatory arbitrage could occur. In order to avoid loss of control over national regulatory strategies and to reduce negative externalities and sources of systemic risk, jurisdictions should cooperate towards the creation of a regional level-playing field, through the harmonization of the regulatory framework applicable to their market players.⁶⁶⁸ Even-level playing fields should enhance the dynamics of competition and the quality of marketed products and services (e.g. through improved corporate governance systems).⁶⁶⁹ Economies of scale should also be achieved and transaction costs should consequently be reduced.⁶⁷⁰ Indeed, investors can better monitor issuers and can better process disclosures when they are based on uniform delivery triggers and presentation protocols. This, in turn, reduces the discount rate applied by investors and, in the same token, facilitates access to and lowers the cost of capital of issuers.

⁶⁶⁷ Campos, *supra* note 604.

⁶⁶⁸ Alan D. Morrison and Lucy White, 'Level Playing Fields in International Financial Regulation' (June 2009) 64(3) *The Journal of Finance* 1099, 1136.

⁶⁶⁹ Stulz, *supra* note 349, 16; See also John Coffee, 'The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications' (1999) 93 *Northwestern University Law Review* 641, 641 and 643.

⁶⁷⁰ Trachtman, *supra* note 662, 66-67.

Scholars have identified four different integration models which vary in the degree of tightness.⁶⁷¹

- (a) commonality, which consists of setting universal minimum standards, as is done for instance by IOSCO;
- (b) comparability, which consists of the recognition by the cooperating jurisdictions of any substantially equivalent rules developed by other cooperating jurisdictions, even if these are not identical;
- (c) national treatment, which allows foreign firms to operate within a jurisdiction, under the rules of the host jurisdiction; and
- (d) mutual recognition, which allows foreign firms to operate within a jurisdiction, under the rules of its home jurisdiction.

Usually, cooperating jurisdictions will start by identifying and reaffirming the core standards that they have in common. This lowest common denominator is easily achieved by jurisdictions with stringent regulations. According to some scholars, jurisdictions with marked disparity between the severity of their laws would not be compatible for high-level cooperation or integration.⁶⁷²

Even if we assume that all member states apply the same minimum standards, it would be unconceivable that they would each derive the same benefits from cooperation. Indeed, jurisdictions with the most mature and sophisticated financial firms can expect

⁶⁷¹ Worth, *supra* note 661, 144.

⁶⁷² According to Campos: “Of course, the idea is that the U.S. would embrace [convergence] approaches only with jurisdictions that have a regulatory regime largely comparable to that of the U.S.”. See Campos, *supra* note 604.

to grab a greater market share, gather more detailed market intelligence, design superior marketing strategies, and attract greater consumer trust. Capital market integration should therefore seldom be instantaneous and should logically be coordinated and gradual. Depending on the realities of the jurisdictions involved, the framework involved must attempt to place all players across jurisdictions on a common pedestal and find modalities for the implementation of the integration and the channelization of wealth to all collaborating jurisdictions. A comprehensive design must be placed so to prompt the desired attitudinal, behavioral, and transactional response and so to facilitate adjustment.

Member states in an integrated market must all be ready to deploy the same level of dedication and resources to monitoring activities in their respective jurisdiction.⁶⁷³ Capital market integration requires close collaboration to halt unauthorized offers or to monitor funds raised by issuers or placed with intermediaries. Rules enacted by the collectivity must be simultaneously and carefully transposed so not to create any patching or distortions.

Non-autonomous and non-independent centralization may cause rigidity if it would imply that the central regulator has to revert to the regulator of each jurisdiction to enact central regulations. Jurisdictional regulators must be willing to forego some of their sovereignty in rule-making in favor of any joint bodies created.⁶⁷⁴

⁶⁷³ The High-Level Group on Financial Supervision in the EU, *supra* note 540, 23.

⁶⁷⁴ Fawcett, *supra* note 175, 52-53.

Where integration results in unanticipated complications and disruptions, reversal therefrom may represent a greater failure than that which the integration was trying to prevent.⁶⁷⁵ Reversal may leave certain collaborating jurisdictions unable to compete for international capital flows and may also leave them with a damaged socio-economy. Capital market liberalization should follow trade and corporate liberalization as these are not only precursory but also conditional to the stimulation and maintenance of synergies.⁶⁷⁶

3. THE GCC INTEGRATION INITIATIVE

3.1. Broad Description of the Initiative

On 25 May 1981, Saudi Arabia, Oman, the United Arab Emirates, Bahrain, and Qatar, formed the Gulf Cooperation Council, with amongst other aims the encouragement of cross-border private sector corporate trade, investments, and joint ventures.⁶⁷⁷ One of the catalysts for the achievements of the GCC is the homogeneity of the region in terms of language, cultural traditions and values, and abundance of oil resources.⁶⁷⁸

The idea of an integrated capital market across the Arabian Gulf has been under discussion for more than a decade. This idea is a natural extension of the trade integration efforts that are currently taking place. Pursuant to Article 5 of the Economic

⁶⁷⁵ Bacharuddin Jusuf Habibie, *Economic Cooperation for Regional Stability* (IRTI 1996) 11-13.

⁶⁷⁶ Schmiedel and Schonenberg, *supra* note 658, 10.

⁶⁷⁷ See The Cooperation Council Charter of 25 May 1981, The Cooperation Council for the Arab States of the Gulf, <<http://www.gcc-sg.org/eng/indexfc7a.html?action=Sec-Show&ID=1>> accessed 21 October 2012.

⁶⁷⁸ *Ibid*; See also Bernard Savage, 'Monitoring Regional Integration and Cooperation in the Gulf Region', in Philippe De Lombaerde, et al., *Governing Regional Integration or Development: Monitoring Experiences, Methods and Prospects* (Ashgate Book 2008) 163.

Agreement made between the GCC member states on 31 December 2001, it was agreed to “*integrate financial markets in member states and unify all related legislation and policies*”.⁶⁷⁹

3.2. *Lessons from the European Experience*

3.2.1. *Relevance and Value of the Model*

The European experience comes to mind as the classical and best current example of financial integration and capital mobility, amongst other types of integration. Numerous efforts were made over time to deepen the compatibility and consolidation of the securities regulatory frameworks of European member states. The product of these efforts provides valuable practical lessons to the GCC. The GCC has already realized the benefit of close collaboration with the European Union and, to this end, has entered into a Cooperation Agreement therewith in 1988.⁶⁸⁰ The collaboration aims at, amongst other things, “*strengthen[ing] the process of economic development and diversification of the GCC countries*”.⁶⁸¹

3.2.2. *Highlights of the European Experience*

The mainstream has maintained that a single European capital markets regulator, at this stage, would be unnecessary and ineffective and would raise new concerns regarding

⁶⁷⁹ For a description of the historic evolution of the GCC integration process, see Michael Sturm and Nikolaus Siegfried, 'Regional Monetary Integration in the Member States of the Gulf Cooperation Council' (June 2005) 31 Occasional Paper Series - European Central Bank, 26-31 <<http://www.ecb.int/pub/pdf/scpops/ecbocp31.pdf>> accessed 9 June 2013.

⁶⁸⁰ Jorg Bley and Kim Heng Chen, 'Gulf Cooperation Council (GCC) Stock Markets: The Dawn of a New Era' (2006) Global Finance Journal 75, 77.

⁶⁸¹ EurLex, 'Cooperation Agreement between the European Economic Community and the Countries Parties to the Charter of the Cooperation Council for the Arab States of the Gulf' <[http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:21989A0225\(01\):EN:HTML](http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:21989A0225(01):EN:HTML)> accessed 25 October 2012.

transparency and accountability.⁶⁸² Based on such predominant belief, pan-European institutions were consistently limited to a direction, coordination and standard-setting role.⁶⁸³

As early as 1979, the European Council adopted a directive for the coordination of the conditions for admission to listing.⁶⁸⁴ Likewise, as early as 1989, the Council adopted a directive on the coordination of the requirements for the preparation, scrutiny and distribution of prospectuses relating to transferable securities offered to the public.⁶⁸⁵

In 1993, the EU Council issued the European Investment Services Directive (“ISD”), which primarily aimed to regulate the passport concept whereby investment firms, licensed in one member state become authorized to operate across the European territory.⁶⁸⁶ The ISD had broadly stipulated the minimal prudential requirements and rules of conduct to be drawn-up by member states and observed by investment firms. Academics observed that the objectives of the ISD were not satisfactorily fulfilled, and

⁶⁸² McCleskey, *supra* note 146, 135-136. See also Ferran and Goodhart, *supra* note 482, 2.

⁶⁸³ McCleskey, *supra* note 146, 138. See also Ferran and Goodhart, *supra* note 482, 1.

⁶⁸⁴ Directive 79/279/EEC of the European Council of 5 March 1979 coordinating the conditions for the admission of securities to official stock exchange listing <<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31979L0279:EN:HTML>> accessed 23 October 2012. See also Alfred Steinherr, 'EU Securities Market Regulation: Adapting to the Needs of the Single Capital Market' (Report of a Centre for European Policy Studies Task Force, March 2001) 19 <<http://aei.pitt.edu/9558/2/9558.pdf>> accessed 23 October 2012.

⁶⁸⁵ Article 3(1) of the Directive 89/298/EEC of the European Council of 17 April 1989 coordinating the requirements for the drawing-up, scrutiny and distribution for the prospectus to be published when securities are offered to the public <<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31989L0298:EN:HTML>> accessed 23 October 2012.

⁶⁸⁶ Directive 93/22/EEC of the European Council of 10 May 1993 (European Investment Services Directive), superseded by Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments <<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:1993L0022:19980926:EN:PDF>> accessed 23 October 2012.

only few investment firms made use of the passport concept. This failure was attributed to the adoption by some EU member states of measures that were unnecessarily burdensome and protectionist in effect. These measures took the form, for instance, of obligations to make additional disclosures, translate prospectuses into certain languages, or comply with certain business conduct obligations. It became hence clear that further harmonization was necessary.⁶⁸⁷

According to a study conducted by Mr. Jacques de Larosière at the request of the EU Commission, the competition of financial centers for investments had negatively affected the performance of regulators.⁶⁸⁸ The de Larosière study concluded that the EU's regulatory framework was "*seriously fragmented*" and suffered from divergence in the rules and supervisory practices adopted by different member state.⁶⁸⁹ The de Larosière study recommended stronger coordination and a new regulatory agenda.⁶⁹⁰ According to the findings of the de Larosière study, an efficient integrated community should have a harmonised set of core rules.⁶⁹¹ Member states are permitted to adopt measures that are more stringent, provided that these do not contradict the spirit of the integrated market.⁶⁹²

The de Larosière study confirmed the findings of an earlier study conducted by Mr. Alexandre Lamfalussy, also commissioned by the EU. The Lamfalussy study also noted

⁶⁸⁷ The Committee of Wise Men, *supra* note 654, 16.

⁶⁸⁸ The High-Level Group on Financial Supervision in the EU, *supra* note 540, 11 (par. 29).

⁶⁸⁹ *Ibid.*, 3-4.

⁶⁹⁰ *Ibid.*

⁶⁹¹ *Ibid.*, 27.

⁶⁹² *Ibid.*, 29.

excessive fragmentation in national regulatory systems and emphasized that convergence was an essential reform measure.⁶⁹³ The Lamfalussy study criticized the rule-making process as being excessively rigid and slow, as integrating insufficient consultation, and as being inconsistently transposed.⁶⁹⁴

In order to increase the efficiency of the EU rule-making and rule enforcement process, the Lamfalussy put in place a four-level system for the issuance, implementation and enforcement of legislation.⁶⁹⁵ Most worthy of note for our purposes is that, at the first level, the European Parliament and the Council of Ministers Union articulate the core values and objectives of the law. At the second level, technocrat committees, composed of experts from national regulatory agencies, were put in place to advise the Commission on the technical implementing measures required to achieve the objectives and values articulated at level 1.⁶⁹⁶ These committees are namely the European Securities Committee and the Committee of European Securities Regulators (“CESR”). At the third level, national regulators work to coordinate the proper transposition of the enacted community laws in the Member States. The CESR is responsible to assist in the transposition process and prepares any necessary interpretations and recommendations. Finally, at the fourth level, the Commission verifies the compliance of individual member states with EU legislation and takes action in case of breach.⁶⁹⁷

⁶⁹³ *Ibid*, 27. The Committee of Wise Men, *supra* note 654, 15-16.

⁶⁹⁴ The Committee of Wise Men, *supra* note 654, 7 and 102.

⁶⁹⁵ Commission of the European Communities, 'The Application of the Lamfalussy Process to EU Securities Markets Legislation' (Brussels, 15 November 2004), 16
<http://ec.europa.eu/internal_market/securities/docs/lamfalussy/sec-2004-1459_en.pdf#page=16>
accessed 25 October 2012.

⁶⁹⁶ *Ibid*.

⁶⁹⁷ *Ibid*.

3.2.3. *Transposition of the EU Experience into the GCC*

In the case of the GCC, it seems premature to replace national regulators with a single regional regulator.⁶⁹⁸ There is still significant disparity between the capital market sophistication and investment cultures of various GCC member states.⁶⁹⁹ Also, GCC member states still do not have reliable experience in centralized law-making.⁷⁰⁰ The GCC is slowly following the footpath of the EU and is currently concentrating efforts towards the building of a common benchmark between GCC member states. In its 32nd session held in December 2011, the Council enacted unified rules for the listing of shares, investment fund units and bonds and certificates onto the stock exchanges (the “**Unified Rules**”).⁷⁰¹ These rules are only indicative in nature and are scheduled to be reviewed two years following their issuance. The GCC may then decide to make these rules compulsory.⁷⁰² The Unified Rules do not seem to conflict with the CMA Regulations. They also do not seem to add any content that was not already put in place by the Saudi legislator and the CMA. For instance, the criteria for listing are almost identical to those of the Listing Rules of 2004. As observed by some analysts, common rules and standards should promote investor confidence and capital formation and should help in building a database for use by securities analysts.⁷⁰³

⁶⁹⁸ Savage, *supra* note 678, 176.

⁶⁹⁹ *Ibid.*

⁷⁰⁰ *Ibid.*

⁷⁰¹ GCC, 'Integration of Capital Markets' <<http://62.3.35.34/index8df9.html?action=Sec-Show&ID=542>> accessed 25 October 2012.

⁷⁰² *Ibid.*

⁷⁰³ Warren III, *supra* note 660, 191.

The gradual harmonization of capital market regulations should pave the ground for the implementation of a detailed mutual recognition or “passport” system, where an issuer or intermediary that meets the requirements in one jurisdiction is able to transact in another.⁷⁰⁴

4. CONCLUSION

Capital market integration could draw countless benefits to participating members. It is important to gradually deepen the level of harmonization of the capital market laws and regulations of the GCC member states. This would help create even-level playing fields for market participants.

Currently, harmonization at the level of the GCC is limited to the determination of universally-acceptable core principles. Harmonization may possibly progress to the establishment of common implementation rules and maybe even common instruments, as currently done in the European Union. Valuable lessons can be extracted by GCC member states from the experience of the European Union, both in terms of legislative structural processes, legal formulations, and enforcement strategies. Further legal and empirical research should be performed to determine the best way forward for GCC integration efforts.

⁷⁰⁴ Lederer, *supra* note 196, 177-180.

PART VIII - SOCIO-ECONOMIC POLICY

CONSIDERATIONS IN THE

PRIORITIZATION OF OFFERINGS

1. INTRODUCTION

The success of capital markets is dependent on the quality of the investment opportunities which they draw. There are numerous reasons which drive potential issuers to opt for or against the idea of conducting capital market offers. There are likewise numerous reasons which motivate a regulator to encourage or deny certain proposed issuers from being able to engage in certain types of capital market transactions.

Section 2 will commence with a brief comparison between market-based and bank-based finance and will then present in some detail the persuasive and dissuasive factors which influence the decision of whether or not to resort to capital markets for funding. As will be shown in this Section, the offering of equity-based securities avoids certain obstructions which can handicap debt-based securities and bank-based finance. While bank-based finance and debt-based securities most often need to be securitized, equity-based transactions turn the issuer and the investor into partners instead of a lender/borrower or a creditor/debtor. The latter types of relationships imply a continuous fear of borrower or debtor default and a consequent need for the lender or the creditor to feel adequately securitized.

Section 3 will briefly explain that large family companies are prone to failure due to succession disputes. Section 3 will explain that the listing of large family companies helps avoid such a fate and, at the same time, presents a great opportunity for market investors. Non-related shareholders should improve the quality of internal decision-making processes of family companies and should enhance the pursuit of financial performance.

Section 4 will explain the socio-economic role of small and medium companies (“SMEs”) and will discuss the possibility and advisability of letting them access capital market finance. As will be explained in Section 4, capital market access could widen the ownership base of SMEs, and could safeguard their continuation. Capital market access could also help SMEs in achieving higher levels of governance, and ultimately improve the country’s socio-economic environment.

Section 5 will explain the capital market opportunities offered by privatization. While privatization transfers the benefit of privatized infrastructure to a limited group of private sector individuals, it is possible, through listing, to retain part of that benefit in the public hand.

2. THE DECISION TO SEEK MARKET-BASED FINANCE

2.1. Market-Based versus Bank-Based Finance

The main competitor for (capital) market-based finance is bank-based finance. Whilst it would be relevant to perform separately a detailed comparative study between market-based and capital-based finance, the question is simply touched upon to the extent

necessary to understand and place into perspective the role, position, and value of capital markets.

It is estimated that forty percent and possibly even fifty percent of banking deposits in Saudi Arabia are non-interest bearing, mainly for the religious reasons previously explained in Part II.⁷⁰⁵ Moreover, Saudi Arabian banks have been found to be the least efficient in the Gulf.⁷⁰⁶ Consequently, general bank deposits in Saudi Arabia would generally not qualify as a form of investment. Investors would therefore find that the stock exchange, the real estate market, or commercial trading provide a more obvious investment outlet.

As will be explained in Section 2.2., market-based transactions carry a number of disadvantages over bank-based finance, such as tighter access criteria and process. Market-based transactions are only accessible to a restricted tranche of finance seekers, while bank-based finance can, through the form of micro-finance, for instance, fund even the low-income working class. As will be discussed in more detail in Section 2.3, the most obvious advantage of market-based finance over bank-based finance is that, unlike borrowers in a debt-based transaction, issuers in market-based transactions can issue equity-based securities and dispense themselves from the need to repay the funds

⁷⁰⁵ IMF, *supra* note 192, 16. See also Beach, *supra* note 6, 310.

⁷⁰⁶ See Reza Chowdhury, 'Capital Market and Operating Efficiency of Firms in Emerging Gulf Countries' (13 September 2011) 6 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1926546> accessed 28 June 2012.

received.⁷⁰⁷ Moreover, market-based transactions, especially public offerings, usually imply a great level of publicity which should be beneficial to the business of the issuers.

Section 2.4 will explain the common difficulties which hinder the adequate securitization of bank-based finance and market-based finance utilizing debt-based securities.

2.2. *Factors Dissuading Market-Based Finance*

As was explained in Part 3, issuers must receive the CMA's approval for any type of capital market offerings which they intend to undertake. Such approval requires the fulfillment of criteria which, given their difficulty, are at the disposal of only a limited number of corporate entities.

It was estimated that up to 80% of Saudi Arabian businesses are either family-owned or controlled.⁷⁰⁸ The dilution of ownership resulting from equity-based securities may lead to loss of control over part or all of the affairs of the company, depending on the terms and conditions of the offered equity. Even at the thirty percent minimum flotation level in public offers, the initial shareholders of Saudi Arabian listed companies lose absolute control and may be unable to realize their plans for the company should they fail to

⁷⁰⁷ McLindon, *supra* note 413, 56.

⁷⁰⁸ 'Family Businesses Can Flourish More with Strong Governance' (1 April 2013) *Arab News* <<http://www.arabnews.com/news/446687>> accessed 15 April 2013; In 2011, there were only 5,076 joint stock companies, 54,294 limited liability companies and 1,020,281 individual establishments. See SAMA, 'Annual Report 2012', 130 <http://www.sama.gov.sa/sites/samaen/ReportsStatistics/ReportsStatisticsLib/5600_R_Annual_En_48_2013_02_19.pdf> accessed 15 April 2013.

obtain the level of public support necessary to meet the minimum voting thresholds applicable.⁷⁰⁹

The level of disclosure associated with the offering process is generally difficult for closed companies since it would expose any contractual or legal breaches that they have committed. Some companies are simply disorganized and may not have been diligent in preparing and documenting corporate resolutions and may not even hold a Minutes' Book.

The pecuniary cost for the structuring of an offer can be quite significant. Most proposed issuers may for instance need to adapt years in advance to the criteria for offering. They may for instance need to convert into a closed joint stock company and accumulate a three-year track record. They may need to settle litigation at a loss so not to lose possible investors. They may need to replace directors for more qualified individuals. They may need to retract from certain markets or projects and may need to rethink their business strategy and modify their course. Also, they will inevitably need to disburse the fees of financial and legal consultants. The aforementioned costs and implications are far less significant for bank-based finance.

2.3. *Persuasive Factors*

⁷⁰⁹ Article 92 of the Companies Law of 1965.

In many respects, securities markets enjoy inherent advantages over banks. Michael Mann, the former head of international relations for the US Securities and Exchange Commission was quoted as saying:

*"[s]ecurities markets are the capital-raising vehicle of choice today for companies in both developed and developing countries. New markets are springing up around the globe as countries move towards market economies. Indeed, both as vehicles for government-sponsored privatisation or simply as means for capital raising, the role of bank financing has been vastly overshadowed by the direct use of the securities markets".*⁷¹⁰

While the banking system is based on oligopolistic setups, issuers in a capital market environment are quite diversified. It was advanced that the range of sectors is wider in market-based economies than in bank-based economies.⁷¹¹ While, banking products ultimately underlie a loan transaction, capital market products permit greater transactional diversification and innovation, at a structural level. Some scholars have praised capital markets for facilitating the ability to trade the ownership of companies without disrupting the business processes of such companies.⁷¹² The stock market offers a simple and immediate exit mode for shareholders of listed companies.⁷¹³ This facilitated exit ensures the continuation of companies as, at times, shareholders seeking

⁷¹⁰ Alan Cameron, *supra* note 414, 153.

⁷¹¹ Julien Allard and Rodolph Blavy, 'Market Phoenixes and Banking Ducks: Are Recoveries Faster in Market-Based Financial Systems?' (September 2011) IMF Working Paper WP/11/213, 6 <<http://www.politiquestociales.net/IMG/pdf/wp11213.pdf> accessed 28 June 2012> accessed 28 June 2012.

⁷¹² See Ross Levine, 'Stock Markets, Growth, and Tax Policy' (1991) 46(4) *The Journal of Finance* 1445, 1458.

⁷¹³ Subject to Article 31(a) of the Listing Rules of 2004 which imposes a six-month restriction period, from the commencement of trading, on the disposition of shares held by shareholders owning five percent or more of an issuer's voting share. Subject also to Article 100 of the Companies' Law of 1965, which imposes a prohibition on the trading of founders' shares, until the publication of the company's balance sheet and the profit and loss statement for two complete financial years, each consisting of at least twelve months as from the date of the company's incorporation.

exit are unable to solicit a purchaser and may ultimately demand the liquidation of the company for the retrieval of their shares' worth.

Capital market offerings can play an effective role in reinforcing an issuer's name, considering that they usually attract significant attention by the media. Moreover, capital market offerings are generally viewed as a sign of good business given the continuous oversight by the CMA, the intermediaries, investors, and media over the affairs of such issuers.

2.4. Difficulties in the Securitization of Debt-Based Finance

In Saudi Arabia, bank-based finance and capital-market finance through debt-securities are prohibited or obstructed by a number of factors. These factors are as follows:

Prohibition of Interest. As explained in Part II, interest on loans is prohibited under Islamic law and would not generally be judicially enforced. As such, financing options mainly consist of Sharia-compliant mechanisms, which usually involve some sort of venture by the lender, either in the form of ownership in the financed asset or in the form of participation in the risks of the project financed.

Lack of Clear Mortgaging Legislation. For long, Saudi Arabia lacked clear mortgaging rules over immovables. This legal vacuum had dissuaded Saudi Arabia's Public Notaries from recording mortgages over immoveable property and had dissuaded

financiers from advancing loans that could not be adequately secured by collateral.⁷¹⁴ It was found that the Saudi Arabian mortgage market was the least developed in the GCC and that only two percent of home finances were financed through mortgages as compared with 17% in the United Arab Emirates and 70% in the U.K.⁷¹⁵ Only recently, in 2012, and as a result of intense pressures to resolve the housing crisis and to promote the growth of the private sector, has Saudi Arabia's legislator taken concrete measures to codify and clarify mortgaging rules for immovables.⁷¹⁶

In comparison, the legal framework for the pledge of movable property has existed for some time now, although it is only applicable in the context of commercial transactions.⁷¹⁷ The MoCI, which is the body vested with the regulation of commercial mortgages, has recently created a Unified Registration Center to inform the public of existing commercial pledges on any movable assets of a proposed or existing debtor. The Unified Registration Center has just become operational. It is still unclear to what extent those reforms will help to stimulate business dealings.

Unreliable Title Deeds. Title security is not sufficiently secure in Saudi Arabia. Indeed, it has happened that different deeds have been issued to different persons for the same

⁷¹⁴ See OECD, *The SME Financing Gap: Volume I – Theory and Evidence* (OECD 2006) 38. See also Salah Dewdar, 'Real Estate Mortgage and Its Importance in Saudi Arabia' (June 2007) 6 *The Law*, 26.

⁷¹⁵ Zainab Fattah, 'Saudi Arabia's Cabinet Approves First Mortgage Law' *Bloomberg* (2 July 2012) <<http://www.bloomberg.com/news/2012-07-02/saudi-arabia-s-cabinet-approves-first-mortgage-law.html>> accessed 5 October 2012.

⁷¹⁶ The Real Estate Registered Mortgage Law, issued by way of Royal Decree No. M/49, dated 3 July 2012.

⁷¹⁷ The Commercial Pledge Law, issued pursuant to Royal Decree No. M/75, dated 14/1/2004. See also the Commercial Pledge Regulations, issued pursuant to Council of Ministers/ Resolution No. 6320, dated 3/2/2010.

property, as a result of weaknesses in centralization and gaps in historical records.⁷¹⁸ An electronic system is under implementation to prevent the occurrence of deed duplicity, but its effectiveness is still to be assessed.⁷¹⁹

Reluctance to Seek Insurance Contracts. Lack of coverage against common business and proprietary risks unquestionably jeopardizes the lenders' rights over mortgaged objects. There had been a long reluctance on the part of Saudis in general to enter into insurance contracts due to a long controversy amongst Islamic scholars as to whether insurance transactions are permissible given the implied element of uncertainty and gambling.⁷²⁰ For a long period, the insurance sector was monopolized by the government-owned National Company for Cooperative Insurance ("NCCI"), established by Royal Decree in 1986. NCCI's structure intended for policy-holders to own operations and to participate in the company's profit and losses.⁷²¹ This was tailored to meet principles of Islamic law and was deemed by the Council of Senior Ulama (Islamic scholars) as an acceptable alternative to conventional insurance.⁷²² The Cooperative Insurance Companies Control Law of 2007 has since then allowed insurance based on such model.

⁷¹⁸ 'Duplication of Deeds and Multiplicity in Ownership Cited as the Main Cause for the Inflation of Real Estate Prices in Saudi Arabia' *Al Eqtisadiyah* (13 October 2012) <http://www.aleqt.com/2012/10/13/article_700973.html> accessed 21 October 2012. Robert Looney, 'Development Strategies for Saudi Arabia: Escaping the Rentier State Syndrome' (March 2004) 3(3) *Strategic Insights* <<http://www.nps.edu/Academics/centers/ccp/publications/OnlineJournal/2004/mar/looneyMar04.pdf>> accessed 28 September 2012.

⁷¹⁹ Abdulaziz Al Shilaji 'New System to Expedite Real Estate Conveyances and Prevent Deed Duplicity' *Al Madina* (Riyadh, 3 June 2012) <<http://www.al-madina.com/node/381969>> accessed 21 October 2012.

⁷²⁰ Nabil Saleh, *Unlawful Gain and Legitimate Profit in Islamic Law; Riba, Gharar and Islamic Banking*, (Cambridge University Press 1986) 4-5 and 100.

⁷²¹ Ramady, *supra* note 106, 142.

⁷²² Saleh, *supra* note 720, 5-6.

Unreported Judicial Decisions. In Saudi Arabia, judicial decisions are neither compiled nor reported and the doctrine of binding precedent is only applied in a limited range of cases.⁷²³ This creates uncertainty as to the enforceability of legal transactions, which poses a dissuasive risk for some lenders.

3. RELEVANCE OF FAMILY COMPANIES

A significant proportion of family businesses develop into relatively large-sized companies, without manifest interest in seeking market-based finance or in soliciting investors or new partners.⁷²⁴ These companies remain owned and controlled by a small number of individuals, who are unwilling to cede control or dilute their profit share.⁷²⁵ Their capitalization is sufficient and their finance venues available.⁷²⁶ These businesses engage in different types of activities and gain significant market share in more than one area. A family business may leverage a particular arm for the advancement of another, thus creating inter-dependency between otherwise independent units and markets. That said, the failure of a particular business arm of a family business could affect its other business arms and may possibly trigger a devastating chain reaction throughout many sectors of the economy.

⁷²³ Zegers, *supra* note 54, 94-96. See also Michael McMillen, 'Contractual Enforceability Issues: Sukuk and Capital Market Development' (2006-2007) 7 *Chicago Journal of International Law* 427, 432.

⁷²⁴ According to The World Bank: "*Some of the largest 20 companies in Saudi Arabia are not listed and do not plan to do so in the near future.*" The World Bank, *supra* note 352, 2; For a list of some of the leading Saudi Arabian merchant families see Malik, *supra* note 126, 118-122.

⁷²⁵ See OECD, *supra* note 714, 34. See also Donald Hay and Derek Norris, *Unquoted Companies* (Palgrave MacMillan 1984) 8 and 14.

⁷²⁶ *Ibid.*, 24.

The concentration of shareholding into the hands of a few family members poses immense risks especially upon succession and inter-generational transfer of shareholding and decisional control. This phase in the life of a family business may result in disputes between the successors and may result in the liquidation of the company, even when successful. It was reported that three different corporate family disputes have, alone, resulted in losses of approximately ten billion Saudi Riyals.⁷²⁷ One scholar noted that:

“much of the economic power in Saudi Arabia is still concentrated in the hands of a few dozen families [...] The financial collapse of any of these behemoths could do damage to the stability of the Saudi Economy”.⁷²⁸

Various recommendations were advanced to help avoid such fate, including training programs to the generation of shareholders that would be succeeding, separation between ownership and management, and assignment of executive positions on the basis of qualification, as opposed to other factors such as age or degree of family tie.⁷²⁹ More importantly, it was recommended to diversify their ownership through the intake of non-family shareholders and, ideally, to list them.⁷³⁰ It is thought that a diversified body of shareholders would play an oversight and mediation role and would

⁷²⁷ See Mohamed Al Sharif, and Issam Al Zohairi, ‘Billions of Riyals in Losses Because of Disputes in Three Companies Alone; The Family Business Symposium Calls for the Improvement of the Judicial System and the Amendment of Company Laws’ *Al Watan* (Jeddah, 27 April 2004) 1306.

⁷²⁸ Pampanini, *supra* note 105, 19.

⁷²⁹ MEP, *supra* note 11, 116.

⁷³⁰ Faisal Al Zahrani, ‘Al Tuwajiri: The Conversion of Family Companies into Joint Stock Companies Supports Their Continuation’ *Al Eqtisadiyah* (Dammam, 11 May 2011) <http://www.aleqt.com/2011/05/11/article_536777.html> accessed 16 October 2012; See also Malik, *supra* note 126, 216-221.

consequently help appease any tension between the family-related shareholders, even if these hold a majority share.⁷³¹

As of June 2005, over 56 family-owned companies had initiated conversion proceedings into the closed joint stock form, in view of later listing.⁷³² Moreover, in 2006, it was estimated that over 1,500 Saudi family-owned companies, with an overall capitalization of close to USD 100 billion, met the MoCI's stringent criteria for conversion into the joint stock form (now repealed).⁷³³

The CMA organized a number of meetings with owners of large businesses to promote listing.⁷³⁴ These efforts appear as useful since it is estimated that there are currently 16 listed family businesses and that most of them were listed by the second generation of owners, following the establishment of the CMA.⁷³⁵

4. RELEVANCE OF SMALL AND MEDIUM ENTERPRISES

4.1. Role of SMEs in Economic Development

⁷³¹ McCall, *supra* note 348, 4.

⁷³² Badi Al Badrani, '56 Saudi Family Companies Prepare for Conversion into the Joint Stock Form' *Al-Riyadh* (Riyadh, 27 June 2005) 13517. See also Ali Al Zikri, A., 'Family Businesses are Vulnerable to Failure and Conversion into the Public or Closed Joint Stock Form is a Successful Solution' *Al Yaoum* (Dubai, 8 June 2006).

⁷³³ Moeed Al Husaini, '1,500 Saudi Family-Owned Companies Are Capable of Conversion Into the Joint Stock Form; Their Assets are Evaluated at USD 100 Billion' *Al Watan* (Jeddah, 5 March 2006). See PART IV - 4.1.1.

⁷³⁴ 'Meeting for Raising the Awareness of Companies regarding the Challenges and Benefits of Stock Exchange Listing' *Al Eqtisadiyah* (Riyadh, 4 April 2012)

<http://www.aleqt.com/2012/04/04/article_643397.html> accessed 15 October 2012.

⁷³⁵ Abdul Wahab Abu Dahash, 'Family Businesses in the Saudi Stock Exchange' *Al Eqtisadiyah* (22 April 2012) <http://www.aleqt.com/2012/04/22/article_649518.html> accessed 15 October 2012.

In 2004, SMEs in Saudi Arabia represented 93 percent of 693,000 licensed establishments and eighty to ninety percent of total membership in chambers of commerce across Saudi Arabia.⁷³⁶ The contribution of SMEs to productivity and economic growth is generally well acknowledged amongst researchers, governments, and NGOs.⁷³⁷ By diversifying economic activities, by providing most job opportunities, by limiting rural-urban migration, and by widely dispersing profit, even to the lowest of social classes, SMEs have displayed a key role in poverty reduction and the empowerment of disadvantaged groups.⁷³⁸

Practically all development plans prepared by the MEP have recognized the importance of SMEs in achieving macroeconomic and social objectives and have emphasized the necessity to devise the proper support schemes for SME creation and viability.⁷³⁹ The importance of support provision is accentuated by the fact SMEs in Saudi Arabia have been significantly less vibrant than elsewhere. Indeed, the contribution of Saudi Arabian

⁷³⁶There is generally no single definition in Saudi Arabia regarding what constitutes an SME. The Saudi Chambers of Commerce defines micro-companies as those companies employing fewer than 10 employees and holding less than SR 200,000 in assets, small companies as those companies employing between 10-25 employees and holding less than SR 1 million in assets and medium enterprises as those companies employing between 25-100 workers and holding less than SR 5 million in assets. See Ramady, *supra* note 106, 197.

⁷³⁷ OECD, *supra* note 714, 9; See also Saleh Shoaib, 'Kingdom of Saudi Arabia Small and Medium Sized Enterprises: Development Strategies in the Context of the World Trade Organization' (DPhil thesis, University of Aberdeen 2011) 46.

⁷³⁸ OECD, 'Facilitating SMEs Access to International Markets' (Second OECD Ministerial Conference on SMEs, Istanbul, 3-5 June 2004) 9 <<http://www.oecd.org/cfe/smesandentrepreneurship/31919590.pdf>> accessed 21 October 2012. See also Tilman Altenburg, and Ute Eckhardt, 'Productivity Enhancement and Equitable Development: Challenges for SME Development' (UNIDO 2006) 6 <[http://www.die-gdi.de/CMS-Homepage/openwebcms3.nsf/\(ynDK_contentByKey\)/ADMR-7CAFBA/\\$FILE/Unido%20Ebook%20Altenburg.Eckardt.pdf](http://www.die-gdi.de/CMS-Homepage/openwebcms3.nsf/(ynDK_contentByKey)/ADMR-7CAFBA/$FILE/Unido%20Ebook%20Altenburg.Eckardt.pdf)> accessed 21 October 2012. See also OECD, 'Promoting Entrepreneurship and Innovative SMEs in a Global Economy' (Second OECD Ministerial Conference on SMEs, Istanbul, 3-5 June 2004) 5 <<http://www.oecd.org/cfe/smesandentrepreneurship/31919590.pdf>> accessed 21 October 2012.

⁷³⁹ Section 6.3 of the MEP's 'Eighth Development Plan: 2005-2009' <<http://www.mep.gov.sa/inetforms/article/Download.jsp;jsessionid=A55B29213761DCD3865F17A35C7A1282.alfa?Download.ObjectID=85>> accessed 21 October 2012.

SMEs to total employment and to the GDP, although considerable, has been weaker than that of SMEs in other countries.⁷⁴⁰ Differences in the overall level of SME contribution may be signaling market concentration by the larger enterprises and may also be reflecting excessive reliance by the Saudi Arabian economy on the primary sector rather than the secondary or tertiary sectors.⁷⁴¹ It may also be signaling concentrated employment in the public sector.⁷⁴²

4.2. Limited Financial Access

As it is generally the case in Saudi Arabia and elsewhere, SMEs do not have the resources necessary to implement efficient production processes, meet elevated quality standards, achieve economies of scale, develop new markets, or offer competitive prices.⁷⁴³ SMEs are usually funded either by the savings of their proprietors, in the case of sole proprietorships and partnerships, or those of their shareholders, in the case of limited liability companies. Typically, SMEs have limited access to loans considering they often cannot provide sufficient repayment guarantees and exhibit inherent credit risks.⁷⁴⁴ Moreover, 94.8 per cent of SMEs operate as sole proprietorships, the simplest form of business, with least requisites. Considering sole proprietorships do not have a

⁷⁴⁰ See Fahd Al Bokmi, 'Moves Towards the Creation of an Independent Body for the Support of Small and Medium Enterprises' *Al Eqtisadiyah* (Jeddah, 16 February 2005).

⁷⁴¹ Diversification of national income sources beyond oil export was cited as one of the objectives of the MEP objectives, as approved by the Council of Ministers' Resolution No. 58, dated 12 July 1999. See Sections 4.3.1 and 4.4.6 of the MEP's 'Seventh Development Plan: 2000-2004' <<http://www.mep.gov.sa/inetforms/article/Download.jsp;jsessionid=A55B29213761DCD3865F17A35C7A1282.alfa?Download.ObjectID=81>> accessed 21 October 2012.

⁷⁴² This statement is supported by the assertion made in the Seventh Development Plan that SMEs absorb 75% of the foreign (expatriate labor force). See Section 7.1.2 of the Seventh Development Plan, *ibid*.

⁷⁴³ Looney, *supra* note 718, 3. See also, OECD, *supra* note 738, 9. Also see Jacob Levitsky, 'Support Systems for SMEs in Developing Countries' UNIDO (March 1996) 1 <http://www.unido.org/fileadmin/user_media/Publications/Pub_free/Support_systems_for_SMEs_in_developing_countries.pdf> accessed 21 October 2012.

⁷⁴⁴ OECD, *supra* note 737, 46.

distinct legal existence from their owners, it is often the case that, from an accounting point of view, no clear delineation is drawn between the assets and obligations of the businesses and those of their proprietors.⁷⁴⁵ As a result, it is more difficult for banks to appraise the creditworthiness of SMEs generally. It is also more difficult to reassure lenders that the borrowings will not ultimately serve endeavors that are unrelated to the business.

4.3. Currently Implemented SME Support Mechanisms

Reports by the United Nations Industrial Development Organization ("UNIDO") have concluded that SME support schemes were more efficient when decentralized and when offered by a plurality of institutions, such as the chambers of commerce, banks, and even universities and the media.⁷⁴⁶ In Saudi Arabia, support for SMEs has drawn the efforts of numerous institutions such as the Chamber of Commerce, the MoCI, the MEP, the Ministry of Municipal and Rural Affairs, and the Labor Office.⁷⁴⁷ In turn, the Council for Saudi commercial chambers has been calling for the establishment of a governmental authority that would oversee Saudi Arabia's response to SME needs.⁷⁴⁸ Keeping aside the differences regarding the form of assistance to be delivered, it does seem clear that such assistance should be formal and coordinated.

4.3.1. Assistance with Feasibility Studies

⁷⁴⁵ *Ibid*, 18 and 41 and 44 and 55.

⁷⁴⁶ Levitsky, *supra* note 743, 1-9.

⁷⁴⁷ 'Study of the Norms for the Incorporation and Operation of New Small and Medium Businesses' *Al Yaoum* (Riyadh, 12 November 2006).

⁷⁴⁸ Mohamed Al Shomari 'Saudi experts Read the Need of Small Enterprises for a Support Body' *Al Eqtisadiyah* (Jeddah, 16 January 2005). See also Fahd Al Bokmi, *supra* note 740.

It is estimated 61 percent of SMEs were founded without feasibility studies and where a study was done, it revealed to be unprofessionally prepared two thirds of the time. Not surprisingly therefore, a total of almost 10,000 SMEs go out of business each year.⁷⁴⁹ To help SMEs formulate sharper business strategies, and reduce their risk exposure to failure, the MEP has therefore encouraged the Council of Saudi Chambers of Commerce and Industry to assist SMEs in carrying out feasibility studies before committing to their specific business endeavors, so to minimize the risk of failure.⁷⁵⁰

4.3.2. Clustering and Mergers

Linkages between SMEs and their suppliers (backward linkages), their customers (forward linkages), or even their competitors, catalyze mutual growth and integration. Obviously, mergers as well are creators of mutual gain.⁷⁵¹ In a pioneering move, for instance, on 27 June 2008, 37 Saudi Arabian contracting firms have agreed to merge and form a giant national company, with a capital of approximately SR 5 billion. The move was aimed at “*empower[ing] the company to grab a major share of SR 1.9 trillion projects to be implemented in Saudi Arabia and other Gulf countries during the next 10 years.*”⁷⁵² Clustering and mergers have the capacity to maximize the bargaining strength, profitability, and reach of relatively small players. Clustering and mergers also

⁷⁴⁹ Habib Shaikh, 'Saudi SMEs Vulnerable to Disaster' *Business Times* (Jeddah, 25 May 2007) <http://www.khaleejtimes.com/DisplayArticleNew.asp?xfile=data/business/2007/May/business_May803.xml§ion=business&col=> accessed 19 October 2012.

⁷⁵⁰ MEP, *supra* note 741, Section 7.2.4.

⁷⁵¹ Levitsky, *supra* note 743, 10-11.

⁷⁵² P.K. Abdul Ghafour, '37 Contracting Firms to Merge' *Arab News* (27 June 2008).

allow the clustered or merged pool to benefit from economies of scale and elevated competitive standing so to access otherwise unattainable projects.⁷⁵³

It could be productive to encourage the listing of investment companies, whose core activity is the participation, takeover, and merger with unquoted companies in the like of SMEs. It was observed that acquisitions can contribute to corporate growth more than investments in research and development or capital expenditures.⁷⁵⁴ In theory, takeovers or acquisitions by listed companies should create value for stock market investors when anticipated synergistic and product market gains have actually been achieved.⁷⁵⁵ It was observed indeed that “[m]ergers seem to create value for shareholders overall”.⁷⁵⁶

4.4. SME Offering Feasibility

Most SMEs are structured as sole proprietorships and do not enjoy any limited liability shield. Most entrepreneurs are unfamiliar with the corporate sophistication of limited liability or joint-stock companies.⁷⁵⁷ A first hurdle facing the engagement by SMEs in capital market offerings lies in the settlement of the cost and the fulfillment of the

⁷⁵³ Paul Pautler and Robert O’Quinn, ‘Recent Empirical Evidence on Mergers and Acquisitions’ (1993) *The Antitrust Bulletin* 741, 742-743; See also Stephen Gong and Michael Firth, ‘The Competitive Effects of Airline Mergers and Acquisitions: More Capital Market Evidence’ (2006) 11(1) *Journal of Air Transportation* 88, 90.

⁷⁵⁴ Armen Hovakimian and Irena Hutton, ‘Merger-Motivated IPOs’ (2010) *Financial Management* 1547, 1547.

⁷⁵⁵ George Alexandridis et al., ‘Gains from Mergers and Acquisitions Around the World: New Evidence’ (2010) *Financial Management* 1671, 1671 and 1693; See also Ninon Kohers, ‘Acquisitions of Private Targets: The Unique Shareholder Wealth Implications’ (2004) 14 *Applied Financial Economics* 1151, 1151.

⁷⁵⁶ Gregor Andrade et al., ‘New Evidence and Perspectives on Mergers’ (2001) 15(2) *Journal of Economic Perspectives* 103, 111 and 115 and 118.

⁷⁵⁷ ‘Tapping Human Capital Remains a Huge Challenge for Gulf SMEs’ *Arab News* (15 October 2011) <<http://www.arabnews.com/node/394877>> accessed 28 October 2012.

criteria for the establishment of a corporation. The cost of the structuring of an offering would also be exorbitant for an SME (e.g. the fees of the financial and legal consultants, etc.). In comparison with large enterprises, SMEs pose greater concerns as to the profitability and security of the investment opportunities presented. The regulator will hence require that a more explicit due diligence assessment be conducted in relation to the business of SME offering applicants. Such higher level of details and such response to added scrutiny entails higher application costs for SMEs.

In their present state, the listing requirements are unfeasible for a majority of SMEs. SMEs usually cannot float shares for an aggregate market value of 100 million Saudi Riyals, as required by Article 13(e) of the Listing Rules of 2004. Other fundamental obstacles to listing by SMEs include the difficulty in soliciting underwriting.

Some jurisdictions have created specialized trading forums tailored specifically for SMEs.⁷⁵⁸ Lowering listing criteria and offering criteria generally, to provide eligibility to SMEs would be a premature policy at this stage in Saudi Arabia, given that the Stock Exchange is yet to be adequately populated with large issuers. With the still narrow but widening investment choices, and with the still modest investor awareness and diligence, it is not advisable to allow the entry of smaller and more risky issuers. In the long term, however, once investment decisions become more sophisticated and

⁷⁵⁸ Examples of these include: (i) NASDAQ Small Cap (USA), (ii) the Alternative Investment Market (UK), (iii) NSX National Stock Exchange SMEB Small and the Medium Enterprise Block of (Australia), (iv) the Euro NM Belgium (Belgium), (v) the Shenzhen Stock Exchange (China), (vi) the Nouveau Marché (France), (vii) the GEM Growth Enterprise Market (Hong Kong), and (viii) the MESDAQ Bursa Malaysia (Malaysia). See Solomon Karmel and Justin Bryon, *A Comparison of Small and Medium Sized Enterprises in Europe and the USA* (Routledge 2002) 107.

motivated and once issuers, securities firms, and investors gain maturity, it could be proposed that exemptions be made more accessible to companies which do not meet offering requirements but nevertheless can provide satisfactory assurances to the CMA of involvement in lucrative and secure business projects, with sound practices and managerial policies, and reliable growth expectations. Such assessment could be left to the discretion of the CMA, on a case-by-case basis depending on the profile of the proposed issuer. Eventually, it could also be suggested that a parallel stock exchange be created exclusively for more risky issuers, with express caveats to investors. Such a parallel exchange could be limited to institutional investors, if deemed too risky for retail investors.

5. RELEVANCE OF PRIVATIZATION AND PRIVATE PUBLIC PARTNERSHIPS

5.1. General Comments

Privatization is praised by some as a promoter of increased private-sector competition, which entails efficiency and moderation in the use of resources at production-level and a reduction in retail prices.⁷⁵⁹ It is however criticized by others who view privatization as having quite the opposite effect and argue that the advancement of corporate profit over public interest could cause unemployment, inflation, and widened socio-economic gaps.⁷⁶⁰

⁷⁵⁹ M. McLindon, *supra* note 413, 32-33.

⁷⁶⁰ David Macarov, *What the Market Does to People: Privatization, Globalization and Poverty* (Clarity Press 2003) 77.

In Saudi Arabia, particularly, privatization has rather widely been viewed as an excellent solution to stimulate the country's private-sector economy, and non-petroleum exports and to reduce unemployment rates. Indeed, the Council of Ministers' Decision No. 60, dated 6 August 1997, articulated the following eight objectives sought from Saudi Arabia's privatization scheme:

1. Improve the national economy's ability to compete regionally and internationally;
2. Encourage private sector investment and effective participation in the national economy (diversification of the economic base away from dependence on oil);
3. Enlarge the ownership of productive assets by Saudi citizens;
4. Encourage domestic and foreign capital to invest locally;
5. Increase employment opportunities and optimize the use of the national work force;
6. Provide services to citizens and investors in a timely and cost-efficient manner;
7. Rationalize public expenditure and reduce the burden on the government budget by giving the private sector opportunities to finance, operate, and maintain certain services; and
8. Increase government revenues from returns on participation in activities to be transferred to the private sector (i.e concessions).

The third and fourth objectives stated above support the contention that privatization presents important socio-economic opportunities, which if not seized could result in inequity and imbalance.

According to Mohamed Ramady, possible obstacles to Saudi Arabia's privatization efforts could include:⁷⁶¹

1. Discrepancy between the fair book value and the market price for public assets;
2. Adjustment of the pay structure of employees in privatized entities;
3. Social problems associated with the cancellation of any subsidy programs;
4. Lack of regulatory framework for the protection of customers and competition;
5. Possibly inadequate public sector accounting standards which hamper the evaluation of the true worth of those public corporations marked for privatization;
6. Need for additional depth in Saudi Arabia's capital market to absorb the listing of newly privatized entity; and
7. Potential unemployment.

In light of the desire to diversify the economy and raise the performance of the private sector, it does seem sensible to study ways to promote privatization and overcome associated obstacles. The following Sections will present how capital markets could contribute to privatization efforts.

5.2. Public Subscription in Privatized Entities

Privatization can be carried out through various techniques. A government may choose to sell the assets of the state-owned enterprise, in whole or in part, by way of auction, or direct sale. A government may also choose to list the state-owned enterprise onto the stock exchange or may privately offer shares in the privatized entity. Privatization is a

⁷⁶¹ Ramady, *supra* note 106, 334.

great opportunity to deepen a country's capital markets, especially its stock exchange. It was observed that the privatization initiative in France increased the number of households that own stocks from three percent in 1982 to eleven percent in 1997.⁷⁶²

According to Council of Ministers Decision No.60:

*“Privatization can be an effective mean to expand the participation of Saudi citizens in the ownership of productive assets in public enterprises and projects, by using the method of public subscription in the privatization, which is considered the most important privatization method to develop the domestic capital market.”*⁷⁶³

In some instances, share issue privatization policies went beyond the listing of the privatized entity and imposed the listing of all enterprises working in certain sectors. For example, and as mentioned earlier in PART IV - 4.1.1, the Communications Law of 2001 and the Cooperative Insurance Companies Control Law of 2007 have required that respectively all telecommunications and insurance companies be structured under the public joint stock form.⁷⁶⁴ This legislative requirement resulted in additional capitalization for the Stock Exchange and additional investment opportunities for the public. Indeed, in 2006 and 2007, thirteen insurance companies listed onto the Stock Exchange and, in 2007, accounted for 1.95 percent of its capitalization and 15.6 percent of value traded.⁷⁶⁵ These companies not only stimulate the stock market as offerors, but

⁷⁶² Lederer, *supra* note 196, 102.

⁷⁶³ McLindon, *supra* note 413, 13-21.

⁷⁶⁴ Article 5 of the Communications Law, issued pursuant to Royal Decree No. 12, dated 4 June 2001. See also the Cooperative Insurance Companies Control Law, issued pursuant to Royal Decree No. M/32, dated 31 July 2007. See also Council of Ministers' Resolution No. 219 dated 11 November 2002 which listed those facilities and activities to be privatized.

⁷⁶⁵ Tadawul, Monthly Statistical Report – November 2007.

also as institutional investors, which helps foster a healthy stock market growth.⁷⁶⁶ The requirement that insurance companies be listed means the participation of the public in an industry that is expected to grow by 23 percent between September 2008 to 2015 to approximately USD 5.7 billion, as forecasted by experts in the field.⁷⁶⁷

As observed by two members of the Capital and Risk Markets Group in the World Bank's Financial Sector Vice Presidency, Felice Friedman and Claire Grose:

“Through listing on the exchange, a privatized state-owned enterprise is exposed to greater competition and public scrutiny and can also boost private sector development by providing smaller exchanges with quality blue chip shares for secondary trading, thereby increasing total market capitalization of the exchange, and furnishing pension fund, collective investment schemes and individual investors with a broader array of investment choices.”⁷⁶⁸

Asset-rich and profitable privatized entities comprise Saudi Basic Industries Corporation (the Middle East's largest non-oil hydrocarbon-based industrial company), the Saudi Electricity Company, the Saudi Telecommunication Company. Current privatization targets include the Saudi Arabian Airlines.⁷⁶⁹

The issue of disclosure is also worthy of note, as government entities marked for privatization need to achieve satisfactory disclosure levels for private investors. The position of the government entity will need to be well monitored and clearly described

⁷⁶⁶ McLindon, *supra* note 413, 54.

⁷⁶⁷ ‘5.7 Billion Dollars the Size of Cooperative Insurance In the Year 2015’ *Al Eqtisadiyah* (8 September 2008) 17.

⁷⁶⁸ Friedman and Grose, *supra* note 1, 13.

⁷⁶⁹ CMA, *supra* note 154, 144.

in a verifiable prospectus. Stock exchange investors in privatized entities must realize that their investment is subject to greater risk until such entities' internal structure stabilizes. Internal issues that need to be addressed quickly post-privatization include staff roles and remuneration, supply and production processes, charge mechanism and margins, etc. Until the directors and executives of each individual privatized entity familiarize themselves (possibly through trial and error) with their entity's own internal and external dynamics, corporate turbulence may be expected including share price volatility. The CMA should ensure that this risk is notified to potential investors in the offering prospectus.

5.3. *Public Subscription in Public Private Partnership Arrangements*

The MEP's Ninth Development Plan describes the socio-economic need to develop the agricultural, water, electricity, industrial, and tourism sectors. It is estimated that an expenditure of SR 227.6 Billion in that regard will be required over the next five years.⁷⁷⁰ Such expenditure is, of course, expected to generate a much greater yield, given the important demand for the products and/or services of those sectors.

Mechanisms suggested by the Ninth Development Plan towards the achievement of the above sectoral priorities include the setup of public private partnerships, possibly involving foreign investors. Typically, projects on which private sector involvement is required are tendered out pursuant to the Government Procurement and Tendering Law

⁷⁷⁰ MEP, *supra* note 11, 79.

of 2006.⁷⁷¹ Tender documents are usually issued under the header “*Request for Proposals*” and include what resembles a prospectus describing the project and the bidding and contract formation terms and process.

Tenders usually solicit hired technical abilities, but at times also imply no disbursement of funds by the tendering office. For instance, under the Build-Operate-Transfer (“**BOT**”) structure, the investor will be allowed to construct the project, exploit it for a specified period of time and retain earnings during such period, possibly against a rent or a fee, and finally transfer back the land and built structures to the government. As discussed in more detail below, it is worthwhile considering the imposition of a requirement to finance BOT structures through public subscription into the equity of the company that will build, exploit and operate the project during the term of the BOT arrangements.

Where any part of the population is striving to secure certain essential needs, the specific sectors where shortages are faced may be ‘subsidized’ indirectly through more facilitated access to capital markets. For instance, a dramatic water shortage is recurrently experienced in Saudi Arabia, with people often having to wait for hours at the water distribution centers for the order of a delivery truck.⁷⁷² Sixty percent of the

⁷⁷¹ The Government Procurement and Tendering Law, issued pursuant to Royal Decree No. M/58, dated 27 September 2006.

⁷⁷² Sarah Abdullah, 'Jeddah Water Shortage Returns' *Arab News* (11 August 2012) <<http://www.arabnews.com/jeddah-water-shortage-returns>> accessed 21 October 2012.

water consumed in Saudi Arabia's cities is produced through desalination.⁷⁷³ Shoura Council members and the King himself have exerted pressure for the rectification of the problem.⁷⁷⁴ In one day alone, on 9 May 2009, projects of a value of over SR 9 billion were sponsored and assigned by the Saudi government for the increase of the water supply in Saudi Arabia's central region (which includes Riyadh).⁷⁷⁵ The government of Saudi Arabia should explore more closely the possibility of requiring the listing of desalination companies in the same way required for insurance companies. On the one hand, the funding sources of desalination companies would have been diversified, which could accelerate their growth and reinforce their stability, and which could even reduce the frequency or severity of water shortages. On the other hand, the public investors would have been given the opportunity to participate in the investment's strong profitability prospects (in light of the obvious demand for water) and would have been recognized and rewarded for their role as consumers and the source of that profitability. As another option, desalination companies could have been encouraged to issue sukuk that provide holders with ownership rights in part or all of the plants and with rights to rental payments from the sukuk issuer, acting as the lessee and operation company. The sukuk could even entitle investors to services alongside or instead of pecuniary returns.

⁷⁷³ Adnan Jaber, 'Desalination Research Center at KAUST is the Need of the Hour' *Arab News* (16 July 2009) <<http://arabnews.com/?page=6§ion=0&article=124597&d=16&m=7&y=2009>> accessed 12 November 2009.

⁷⁷⁴ 'Shoura Demands Explanation for Ongoing Water Crisis' *Arab News* (26 June 2008) <<http://arabnews.com/?page=1§ion=0&article=111259&d=26&m=6&y=2008>> accessed 12 November 2009. See also: 'King Urges Solution for Water Crisis' *Arab News* (26 August 2008) <<http://arabnews.com/?page=1§ion=0&article=113371&d=26&m=8&y=2008>> accessed 26 August 2008.

⁷⁷⁵ Ghazanfar Ali Khan, 'Water Deals Worth SR 9 Billion Signed', *Arab News* 10 May 2009, <<http://arabnews.com/?page=6§ion=0&article=122379&d=10&m=5&y=2009>> accessed 12 November 2009.

6. CONCLUSION

The inward migration of funds into a jurisdiction stimulates its socio-economic development. As Scott McCleskey writes: “[l]iquidity begets liquidity [...] A lack of liquidity [on a stock exchange] becomes a major obstacle to attracting liquidity”⁷⁷⁶. As a practical example, the post 9-11 repatriation of Saudi Arabian investments has resulted in the invigoration of the local economy.⁷⁷⁷ The Saudi Arabian socio-economy is thirsty for additional capital market liquidity.

The institutions created by the Capital Market Law of 2003 will have no value if they cannot attract and convince proposed issuers to utilize them. It is actually in the socio-economic interest of Saudi Arabia to diversify the ownership base of certain companies such as family businesses and SMEs not only to benefit investors, but also to preserve the continued existence of the issuing entities.

The ongoing foreign investment and privatization efforts present great opportunities for Saudi Arabian capital markets. To this end, the legislator has, for instance, stipulated that certain public infrastructure (e.g. telecommunications) can only be exploited through a listed company. Clever rules of such type should maximize societal gains. Also, they should not only act as a great engine for the growth of the private sector, but should also maximize returns for share-owners.

⁷⁷⁶ McCleskey, *supra* note 146, 100.

⁷⁷⁷ Rodney Wilson, 'Capital Flight Through Islamic Managed Funds' in Clement Henry and Rodney Wilson, *The Politics of Islamic Finance* (Edinburgh University Press 2004) 139-140.

PART IX - CAPITAL MARKETS AMONGST OTHER

POLICY TOOLS FOR SOCIO-ECONOMIC

DEVELOPMENT

1. INTRODUCTION

As stated in the eighth development plan of the MEP, capital markets play a significant role in promoting socio-economic growth.⁷⁷⁸ Nonetheless, the government of Saudi Arabia has at its disposal other valuable tools that contribute to the same objective and that contribute to the creation of an optimal socio-economic environment. This Part does not aim to make a complete inventory of the ways available to reap socio-economic rewards. This Part will only present certain types of policies which could complement capital market regulations, which share common objectives, or which can be characterized as being interdependent. This will help the reader appreciate the wider context in which capital markets exist and appreciate the relevance of other factors which affect the comprehensive socio-economic design.

Section 2 will describe how Saudi Arabia has been making serious attempts to attract foreign direct investment. Section 2 will explain the role of foreign direct investment and will present the governing legal framework. Section 2 will describe the current levels of liberalization and will explain the rationale underlying Saudi Arabia's liberalization strategy.

⁷⁷⁸ MEP, *supra* note 739, Section 6.2.2, Chapter 6.

Section 3 will describe the importance of corporate social responsibility as a tool for income redistribution. Section 3 will explain how corporate social responsibility is not mandatory but can be encouraged through various ways.

Section 4 will discuss cooperatives and will explain the features and circumstances that render them more attractive than regular corporations. Section 4 will explain how cooperatives can help achieve great rewards to their members, including economies of scale, and can help stimulate and safeguard certain interests.

Section 5 will discuss taxation and its usefulness as a tool for behavioral inducement and income redistribution. Section 5 will explain that taxation policies could help in invigorating capital markets and could help in steering the decisions of market participants.

Section 6 will present the Competition Law of 2004 and will describe how markets are healthier when competitive. This Section will offer original proposals to diffuse the negative effects of hegemonistic companies and, at the same time, invigorate capital markets.

Section 7 will describe the manner by which Saudi Arabia has utilized the Government Procurement and Tendering Law of 2006 to support local business. This Section will describe how, even though such law is protectionist in nature, it nevertheless does not breach Saudi Arabia's commitments under the WTO.

Finally, Section 8 will describe the dangers of corruption and will describe the efforts made by the Saudi Arabian government towards its eradication.

2. FOREIGN DIRECT INVESTMENT

2.1. Role of Foreign Direct Investment

In 2009, Saudi Arabia hosted SR 552 Billion in foreign investments, which created 375,000 jobs, and unlocked SR 29 Billion in yearly salaries.⁷⁷⁹ The entry of foreign investors and particularly multinationals in Saudi Arabia is of fundamental importance to socio-economy, especially that, as some scholars describe:

*“[they] are among the most powerful transnational actors and serve as important agents of globalization. Given their resources and operational efficiencies, they have the power to significantly improve the lot of the poor by stimulating commerce and development in the world’s poorest countries.”*⁷⁸⁰

Foreign investors, especially those with a diversified international investment portfolio, possess multi-jurisdictional experience, which translates into greater managerial and technical support abilities, more intuitive strategies and policies, and superior product or service quality. Moreover, when foreign investors enter into a company, the resulting diversification and heterogeneity are likely to raise the level of transparency, provide

⁷⁷⁹ Ali Al Jibril, 'The Second Deputy: The Kingdom Gives Primordial Importance for the Raising of the Economy's Competitiveness and Investments are a Partner for Growth' *Al Eqtisadiyah* (Riyadh, 23 January 2011) <http://www.aleqt.com/2011/01/23/article_494969.html> accessed 16 October 2012.

⁷⁸⁰ Subhash Jain and Sushil Vachani, (eds), *Multinational Corporations and Global Poverty Reduction* (Edward Elgar Publishing Ltd. 2006) 6.

monitoring for the company's internal governance, maximize efforts towards the pursuit of corporate objectives, and ultimately improve performance.⁷⁸¹

Certain researchers have observed that the contribution expected from foreign direct investment would be more significant, and may in certain circumstances only be possible, if the host jurisdiction builds sufficient capacity to absorb transfers of technology and know-how.⁷⁸² On the technology front, the building of absorptive capacity requires access to financial resources that can fund technological upgrading. Second, the domestic work force needs to be sufficiently educated to comprehend and learn foreign skills and know-how. It is argued that unless such absorptive capacity is existent, the cost of efforts in attracting foreign investors would be disproportionate to the value of benefits derived.⁷⁸³

The investment decision of foreign investors is obviously dependent on a myriad of factors such as the presence of legal protections, the reasonability of the fiscal burden, the depth of the legal market, the stability of the economy and consumer demand, etc.⁷⁸⁴

2.2. *Foreign Direct Investment in Saudi Arabia*

⁷⁸¹ Salim Chahine observes that the dedication of local shareholders to the success of the joint venture company may be affected by personal interests. See Salim Chahine, 'Activity-Based Diversification, Corporate Governance, and the Market Valuation of Commercial Banks in the Gulf Commercial Council' (2007) 11 *Journal of Management and Governance* 353, 355.

⁷⁸² Chung-Hua Shen et al., 'What Makes International Capital Flows Promote Economic Growth? An International Cross-Country Analysis' (2010) 57(5) *Scottish Journal of Political Economy* 515, 516.

⁷⁸³ Signe Krogstrup and Linda Matar, 'Foreign Direct Investment, Absorptive Capacity and Growth in the Arab World' (Working Paper No. 02/2005, Graduate Institute of International Studies, 5 May 2005) 11-15

⁷⁸⁴ MEP, *supra* note 11, 157-160. See also, IFC and the World Bank, 'Ease of Doing Business in Saudi Arabia' <<http://www.doingbusiness.org/ExploreEconomies/?economyid=163>> accessed 2 October 2012.

In 2006, Saudi Arabia was the largest recipient of foreign direct investment ("**FDI**") in the Arab world, attracting \$18 billion, an increase of 51 percent over 2005, according to a report of the United Nations Conference on Trade and Development ("**UNCTAD**").⁷⁸⁵ It was described by analysts as one of the most interesting markets for investors.⁷⁸⁶

As described in the previous paragraph, the decision by a foreign investor to establish itself in Saudi Arabia means not only a long-term inwards flow of funding, but also a transfer of technology and know-how and a deepening in market abilities. It is estimated that 80% of all industrial licenses awarded in 2004 were issued to companies with foreign participation.⁷⁸⁷ This level of foreign investment was primarily triggered by Saudi Arabia's increased oil liquidity, its bullish markets and reformed foreign investment policy. The Saudi Arabian legislator has deployed significant efforts in facilitating the entry of foreign investors and in simplifying the regulatory framework involved in such process. The 18 Articles of the Foreign Investment Law of 2000 and the 22 Articles of the Foreign Investment Regulations of 2002, represent the product of such efforts, and succinctly present to foreign investors a single contact point with the government of Saudi Arabia: the Saudi Arabian General Investment Authority

⁷⁸⁵ OECD, *supra* note 714, 80. Also, see P.K. Abdul Ghafour, 'Kingdom is Top FDI Recipient in the Arab World', *Arab News* (18 October 2007); see also R. Qudsi, 'Saudi Arabia World's Seventh Fastest Reformer', *Arab News* (Riyadh, 1 October 2007).

⁷⁸⁶ Kevin Connor, 'Building for the Future: An Overview of Infrastructure Development in the Kingdom of Saudi Arabia', (2010) Global Reference Guide <http://www.squiresanders.com/files/Publication/71d6db5d-abd3-4ea0-81e2-603bd3db2c01/Presentation/PublicationAttachment/e0539879-f503-41d7-8864-60555f985602/Building_for_the_Future_-_An_Overview_of_Infrastructure_Development_in_the_Kingdom_of_Saudi_Arabia.pdf> accessed 15 October 2012.

⁷⁸⁷ Anthony Shoult, 'Economic and Political Background', in Shoult, *supra* note 723, 37.

(“SAGIA”). SAGIA describes itself as a one-step-shop as it hosts three departments and nine ministries under one umbrella. As SAGIA, itself, describes:

*“The One Step Shop (“OSS”) ensures an environment that provides a comprehensive and hassle-free process for establishing a company in Saudi Arabia. The OSS shall provide parties interested in investment with all necessary information, licensing, statistics, and even facilities and support services needed to complete all matters to your investment startup.”*⁷⁸⁸

SAGIA makes the experience for interested investors somewhat friendly as the organism is not only responsible for licensing foreign investment in Saudi Arabia, but also for promoting such investment.⁷⁸⁹

The Foreign Investment Law of 2000 expressly guarantees to foreign investors certain rights and assurances. For instance, foreign investors can repatriate their share of the profit or the proceeds of any sale of shares or liquidation.⁷⁹⁰ Saudi companies with foreign owners can own the property needed for the carrying out of their activities or for the housing of their workers.⁷⁹¹ Also for instance, the property of Saudi-companies with foreign owners cannot be confiscated, except with a court order, and cannot be expropriated, except in the public interest and against the payment of compensation.⁷⁹²

2.3. Reforms and Liberalization

⁷⁸⁸ This partly is taken from the text of Article 10 of the Foreign Investment Law of 2000.

⁷⁸⁹ See Article 6 of the Foreign Investment Regulations, issued pursuant to Resolution of SAGIA Governor No. 20/1, dated 24 June 2002, which stipulates that SAGIA is to promote investment opportunities in Saudi Arabia through conferences, lectures, advertisements, etc.

⁷⁹⁰ Article 5(5) of the Foreign Investment Law of 2000.

⁷⁹¹ Articles 6, 7, and 8 of the Foreign Investment Law of 2000.

⁷⁹² Article 11 of the Foreign Investment Law of 2000.

Shortly following its accession to the WTO in 2005, Saudi Arabia was ranked as the second fastest reformer regionally and the seventh fastest globally.⁷⁹³ Saudi Arabia's legislative overhaul included, amongst other things, the issuance of the following instruments:

- a) The Competition Law of 2004;⁷⁹⁴
- b) The Labor Law of 2005;⁷⁹⁵
- c) The Commercial Pledge Law of 2004;⁷⁹⁶
- d) The Real Estate Registered Mortgage Law of 2012;⁷⁹⁷
- e) The Commercial Fraud Law of 2008;⁷⁹⁸
- f) The Patents, Industrial Designs, Plant Varieties, and Integrated Circuits Unified Law of 2004;⁷⁹⁹
- g) The Copyright Law of 2003;⁸⁰⁰
- h) The Cooperative Insurance Companies Law of 2007;⁸⁰¹
- i) The 2006 Anti-Dumping, Countervailing, and Safeguard Measures Law;⁸⁰²
- j) The Trade Information Law of 2002;⁸⁰³

⁷⁹³ IFC and the World Bank, *supra* note 784. In January 2007, Saudi Arabia has made a call for foreign investment in the amount of USD 50 billion in sectors such as infrastructure and oil and gas. See: Asia Pulse Pty Ltd., 'Saudi Arabia Seeks USD 50 billion Foreign Capital Investments' *The Press Trust of India Ltd.* (19 January 2007).

⁷⁹⁴ The Competition Law, issued pursuant to Royal Decree No. 25, 22 June 2004.

⁷⁹⁵ The Labor Law, issued pursuant to Royal Decree No. M/51, dated 27 September 2005.

⁷⁹⁶ The Commercial Pledge Law, issued pursuant to Royal Decree No. M/75, dated 14 January 2004. The Commercial Pledge Law of 2004 only applies for the pledging of movables.

⁷⁹⁷ The Real Estate Registered Mortgage Law, issued by way of Royal Decree No. M/49, dated 3 July 2012

⁷⁹⁸ The Commercial Fraud Law, issued pursuant to Royal Decree No. M/19, dated 30 April 2008.

⁷⁹⁹ The Patents, Industrial Designs, Plant Varieties, and Integrated Circuits Unified Law, issued pursuant to Royal Decree M/27 dated 17 July 2004.

⁸⁰⁰ The Copyright Law, issued pursuant to Royal Decree No. M/41, dated 30 August 2003.

⁸⁰¹ The Cooperative Insurance Companies Control Law, issued pursuant to Royal Decree No. M/32, dated 31 July 2007.

⁸⁰² The Anti-Dumping, Countervailing, and Safeguard Measures Law, issued pursuant to Royal Decree No. M/30, dated 14 June 2006.

- k) The Electronic Transactions Law of 2008;⁸⁰⁴ and
- l) The Trademarks Law of 2002.⁸⁰⁵

Many reforms were also made to existing laws, regulations, and guidelines. For instance, the incorporation process was alleviated, resulting in an upscale in Saudi Arabia's ranking in the World Bank's 2009 and 2010 Ease of Doing Business Reports.⁸⁰⁶ Also, SAGIA and the Supreme Economic Council have eased foreign investment requirements and have liberalized various sectors which were completely excluded from foreign investment.⁸⁰⁷ These include air transport services, inter-city passenger transport by train, space transport services, wholesale and retail trade, and insurance.⁸⁰⁸ Foreign investors were also for the first time permitted to engage in certain sectors without needing to have a minimum Saudi participation (e.g. contracting).⁸⁰⁹

The above-described liberalization is a creator of both challenges and opportunities. Inevitably, foreign entrants will reap a share of the market's potential and Saudi Arabian companies generally would then have the choice to either compete or associate with such new entrants. For those favoring association, a second level competition is created amongst them for association opportunities and for the implied foreign

⁸⁰³ The Trade Information Law, issued pursuant to Royal Decree No. M/15, dated 25 June 2002.

⁸⁰⁴ The Electronic Transactions Law, issued pursuant to Royal Decree No. M/8, dated 26 July 2008.

⁸⁰⁵ The Trademarks Law, issued pursuant to Royal Decree No. M/21, dated 8 August 2002.

⁸⁰⁶ See IFC and the World Bank, *supra* note 784.

⁸⁰⁷ Pursuant to Article 3 of the Foreign Investment Law of 2000: "*the [Supreme Economic] Council shall have the authority to issue a list of activities of excluded from foreign investment*". See <<http://www.sagia.gov.sa/en/buisness-environment/investment-laws/negative-list.html>>.

⁸⁰⁸ See Saudi Arabia's Schedule of Specific Commitments to the World Trade Organization (Document GATS/SC/141), dated 29 March 2006.

⁸⁰⁹ *Ibid.*

contributions in both funding and skills. Such competition is not new in Saudi Arabia or the Middle East in general, as competition has already long existed over agency rights to branded products or services.⁸¹⁰

Some scholars however have warned that:

*“foreign investment can [...] lead to detrimental dependence in the long run if transnational corporations control a disproportionately large share of the domestic economy. Capital dependence theory claims that this dependence “disarticulates” the host economy, separating foreign and domestic sectors with poor linkages between them. In this situation, state policies are uncoordinated at best and are often held hostage to foreign interests. Over the long-term therefore, dependence stemming from extensive foreign penetration yields lower growth rates than in less dependent [less-developed-countries].”*⁸¹¹

Fears such as those described above can also be mitigated through the diversification of the origin and sectors of foreign investment. It is probably out of such fear of capital dependence or subordination to foreign interests that Saudi Arabian law has long required and still requires a minimum Saudi Arabian participation in companies practicing certain types of activities. For instance, in the context of companies established amongst professionals (e.g. architects, legal consultants, tax specialists, doctors, dentists, and veterinaries), the Professional Companies Law of 1991 requires the detention by a Saudi Arabian partner of at least 25 percent of the equity.⁸¹² Also for

⁸¹⁰ Wilson, *supra* note 777, 130.

⁸¹¹ Jeffrey Kentor and Terry Boswell, 'Foreign Capital Dependency and Development: A New Direction' (April 2003) 68(2) *American Sociological Review* 301, 301-302.

⁸¹² Article 2(6) of the Professional Companies Law, issued pursuant to Royal Decree No. M/4 dated 29 August 1991. See also Saudi Arabia's Schedule of Specific Commitments to the World Trade Organization (Document GATS/SC/141, 29 March 2006) 11.

instance, SAGIA requires a minimum Saudi Arabian participation of 25% in companies engaged in retail and wholesale trading.⁸¹³ By maintaining restrictions on the requirements for wholesale and retail trade, Saudi Arabia has maintained incentives for foreign investors to set up manufacturing and processing plants in Saudi Arabia to cater for local demand for products. This is because a foreign-owned manufacturing plant established in Saudi Arabia can sell its finished products in the local markets (on a wholesale basis), without needing to abide by the general restrictions imposed on wholesale and retail trade.

The requirement for minimum Saudi participation, although a burden for the foreign investor, is obviously a privilege to Saudi Arabian nationals and entities. It was affirmed that Saudis have relied on such legal privilege without any efforts to acquire or develop skills. As Tim Niblock describes:

“Living off ‘unearned income’, the population orients itself towards easy gain rather than productive labour. Legal processes, requiring foreign businesses to find local partners, buttress such attitudes. Substantial gains accrue to citizens through serving as the necessary kafils (sponsors) of foreign companies, performing no serious work but earning a share of the income.”⁸¹⁴

Instead of establishing a direct presence in Saudi Arabia, foreign companies in the manufacturing or the service sectors (e.g. restaurant, store, or hospital operators) may decide to appoint a commercial agent, distributor, or franchisee in Saudi Arabia to

⁸¹³ SAGIA, *License Guide*, (October 2010) 26 and 29

<http://www.sagia.gov.sa/Documents/Wizard/License_guide_Oct10.pdf> accessed 18 October 2012.

⁸¹⁴ Niblock, *supra* note 8, 17. Niblock refers on this particular point to Beblawi, H., 'The Rentier State in the Arab World', in Hazem Beblawi and Giacomo Luciani (eds), *The Rentier State* (Croom Helm 1987) 52-53 and 56.

market their products or services. Commercial agents, distributors, and franchisees in Saudi Arabia must be 100 percent Saudi-owned.⁸¹⁵

There is certainly a subjective dimension as to whether a multinational should establish a presence in Saudi Arabia, if this would imply a litigation risk with the Saudi partner and a possible loss of control and investment.⁸¹⁶ Mitigating this risk could rationally justify the distancing of valuable processes beyond the reach of the Saudi partner(s), which processes are in essence, the bulk and heart of the operations and the more valuable facet thereof.⁸¹⁷ Such a provoked reaction would constitute a definite loss to Saudi Arabia. Presumably, it is to avoid such a potential loss that the Saudi Arabian government has allowed foreign investors to engage in technical areas such as manufacturing and contracting, without need for a Saudi Arabian partner and without specific minimum capital requirements.⁸¹⁸

On the other hand, rules for minimum Saudi participation when coupled with rules for minimum paid-in capital could actually contribute to the protection and encouragement of Saudi Arabian entrepreneurs, and especially national SMEs, in areas where foreign know-how is not very valuable. It is probably for that reason that the Saudi Arabian

⁸¹⁵ Article 1 of the Commercial Agencies Law, issued pursuant to Royal Decree No. 11, dated 22 July 1962; See also Mohammed Al-Qahtany, 'Doing Business in Saudi Arabia: Implication for International Investors' (2003) 8(1-2) *Journal of Transnational Management Development* 3, 5.

⁸¹⁶ Shoult A., 'Joint Venture Formation', in Shoult, *supra* note 723, 169-170; See also William Clatanoff, et al., 'Saudi Arabia's Accession to the WTO: Is a 'Revolution' Brewing?' (2006) *Journal Compilation, Middle East Policy Council* 1.

⁸¹⁷ For a discussion on the determinants of FDI, see Bala Ramasamy and Matthew Yeung, 'The Determinants of Foreign Direct Investment in Services' (2010) 33(4) *The World Economy* 573, 592.

⁸¹⁸ SAGIA, *supra* note 813, 25 and 28. See also Omar Al Jrifani, 'Before the Sight of the Respected Investment Authority' *Al Eqtisadiyah* (12 July 2012) <http://www.aleqt.com/2012/07/12/article_673737.html> accessed 15 October 2012.

government has imposed Saudi participation and high minimum capital requirements in fields such as trading and real estate development.⁸¹⁹

2.4. Prohibited Sectors

The Supreme Economic Council has prohibited from foreign investment catering to military sectors, poison centers, blood banks, health quarantines, and investigation and security services.⁸²⁰ The government of Saudi Arabia probably finds that foreign investment in these sectors could cause issues of national security. The American Dubai Port controversy became a famous example of national security concerns raised in the context of foreign direct investment. In this example, the American House Panel voted 62-2 to block Dubai Port, a company established in the United Arab Emirates, from managing through a subsidiary operations in a number of vital American ports. It was claimed that ports could serve as an entry for illegal weapons and terrorists and would place the United States in a position of vulnerability.⁸²¹ On a broader level, national security concerns could be raised in practically every sector.⁸²² For instance, dozens of

⁸¹⁹ SAGIA, *ibid*, 26 and 29.

⁸²⁰ Supreme Economic Council Resolution dated 24 March 2007, <<http://www.sec.gov.sa/getdoc/be8e7887-27b1-4bb7-9879-bd75f8ad9acf/list-of-types.aspx?lang=en-US>> accessed 27 September 2012.

⁸²¹ 'Dubai Company Gives Up On Ports Deal' *CBS News* (11 February 2009) <<http://www.cbsnews.com/stories/2006/03/09/politics/main1385030.shtml>> accessed 25 November 2011.

⁸²² Edwin M. Truman, 'Sovereign Wealth Funds: The Need for Greater Transparency and Accountability' (Peterson Institute for International Economics, Policy Brief, August 2007). See also Roland Beck and Michael Fidora, 'The Impact of Sovereign Wealth Funds on Global Financial Markets', (2008) 43(6) *Intereconomics* 349, 358.

dogs in the United States and Africa were killed as a result of Chinese-produced pet foods contaminated with Melamine.⁸²³

2.5. Commercial Covering-Up Law of 2004

Pursuant to the Companies Law of 1965, the Foreign Investment Law of 2000, and the Commercial Covering-Up Law of 2004, a non-Saudi may not invest or practice for his own personal account or in collaboration with others, any activity that the Foreign Investment Law of 2000 or other related laws and instructions do not allow him to practice.⁸²⁴ Moreover, any Saudi citizen, who enables a foreigner to illicitly invest or practice any activity, without a foreign investment license, shall be considered a covering-up (harboring) accomplice.

Violations may be reported to authorities by any person who has knowledge of the cover-up, and, pursuant to Article 9 of the Commercial Covering-Up Law of 2004, a financial reward not exceeding thirty percent of the fines collected may even be paid to such 'whistleblower'. Furthermore, pursuant to Article 3 of the Commercial Covering-Up Law of 2004, every authority issuing licenses to practice commercial and non-commercial activities must regularly inspect the facilities and commercial places they licensed to verify the legality of their situations and report to the MoCI any covering-up violations discovered.

⁸²³ 'Melamine - China Tainted Baby Formula Scandal' *New York Times* (4 March 2011) <<http://topics.nytimes.com/top/reference/timestopics/subjects/m/melamine/index.html>> accessed 6 September 2012.

⁸²⁴ Article 1 of the Anti Covering-Up Law, issued pursuant to Royal Decree No. M/22, dated 22 June 2004.

The consequences of a cover-up conviction include the following:⁸²⁵

- i) Cancellation of the commercial registration of the company used in the cover-up;
- ii) Cancellation of all licenses issued to the company used in the cover-up;
- iii) Liquidation of the company used in the cover-up;
- iv) The hidden partner and the covering-up accomplice shall be responsible to settle all taxes, fees, and other liabilities resulting from the covering-up arrangements;
- v) Expulsion of the foreign partner from Saudi Arabia (after payment of all owed dues) and permanent prohibition from returning to work or conduct business in the Kingdom of Saudi Arabia. On the other hand, the Saudi partner involved in the cover-up will be prohibited from performing the same or a similar activity for a period of five years from the date of conviction; and
- vi) All accomplices involved in the covering-up arrangements are punished with a maximum two-year imprisonment term and/or a fine not exceeding one million Saudi Riyals.⁸²⁶

The legislator therefore severely penalizes unlicensed foreign investments in Saudi Arabia. Such stance should perhaps be reevaluated. Ultimately, an unlicensed foreign investment can actually be very beneficial for the country, even though taxes were not collected to the supposed extent. The whistleblower reward should not be based on the value of fines collected. This attaches an aggressive attitude to the enforcement of the Commercial Covering-Up Law of 2004. Since it would not be fair to the whistleblower to reduce the reward by making concessions regarding the amount of fines payable by

⁸²⁵ Article 6 of the Anti Covering-Up Law of 2004 and Article 11 of the Implementation Regulations thereto issued by Ministerial Resolution No. 7/MW, dated 20 June 2005.

⁸²⁶ Article 4 of the Anti Covering-Up Law of 2004.

the violator, the system may actually be encouraging the prosecution of violators to the full extent of the law. The Saudi legislator should not risk the dissolution of a business that transfers valuable know-how and contributes to the country's social and economic agenda. The Saudi Arabian legislator should perhaps first grant violating entities an opportunity to remedy a violation before being exposed to liquidation.⁸²⁷ During such a remediation period, the unlicensed foreign investor could either apply for and obtain a license or could otherwise transfer its shares to a Saudi entity. In such a way, the continuation of the business would not be immediately placed at risk.

3. CORPORATE SOCIAL RESPONSIBILITY

3.1. Distinguishing Corporate Social Responsibility from Corporate Governance

The layman continues to use the terms corporate governance ("CG") and corporate social responsibility ("CSR") interchangeably, as literature still does not sufficiently distinguish between them. CSR and CG comparative studies usually acknowledge that the terms encapsulate different concepts but have blurred the demarcating lines by having excessively concentrated on the overlapping characteristics.⁸²⁸ A number of proposed definitions have unnecessarily broken down CSR into confusing components (e.g. ethical, altruistic, and strategic), before placing the term in context.⁸²⁹ It is beyond

⁸²⁷ Article 16 of the Omani Foreign Capital Investment Law, issued pursuant to Royal Decree No. 102/94 dated 16 October 1994 <<http://om.mofcom.gov.cn/table/wgtz.pdf>> accessed 25 October 2012. Article 15 of the Investment Law Regulating the Investment of Foreign Capital in Economic Activities, No. 13/2000 <http://www.mbt.gov.qa/English/ForeignInvestor/Documents/rule_13e.pdf> accessed 25 October 2012.

⁸²⁸ Some analysts have described the literature on the subject as lacking "coherence" and that there is "little about CSR which is not contestable - and contested". See Rob Gray, et al., 'Corporate Social and Environmental Reporting: A Review of the Literature and a Longitudinal Study of UK Disclosure' (1995) 8(2) Accounting, Auditing & Accountability Journal 47, 47.

⁸²⁹ See Dima Jamali and Myriam Rabbath, 'Corporate Governance and Corporate Social Responsibility: Synergies and Inter-Relationships', (Corporate Responsibility Research Conference, University of Leeds, United Kingdom, 15-17 July 2007)

the objects of this thesis to lay down and offer a critical analysis of the various definitions presented for the term CSR. Since models of CG vary from one jurisdiction to another, the definition of CSR will inevitably vary accordingly. It suffices to say that the term CSR cannot be properly defined without reference to CG since the meaning of the term CG should by now be well-understood, and has been defined not only in the literature but also in legislative enactments.

There seems to be three main demarcating lines between CG and CSR. Firstly, while CG frameworks are imposed by mandatory rules, CSR frameworks are voluntary initiatives.⁸³⁰ Secondly, while CG aims to safeguard the interests of “[a]ny person who has an interest in [a particular] company, such as shareholders, employees, creditors, customers, suppliers, community”, the term CSR includes parties with no interaction or dealings with the concerned company.⁸³¹ Thirdly, while CG places no system of prioritization between stakeholders, CSR should favor those who are in most need or those whom a donor company is able to most help.

<<http://www.crrconference.org/downloads/crrc2007jamalirabbath.pdf>> accessed 16 November 2011.

⁸³⁰ The World Bank described corporate social responsibility as a self-regulation measure. See The World Bank, 'CST Implementation Guide: Non-Legislative Options for the Polish Government' (November 2006)

<<http://siteresources.worldbank.org/EXTDEVCOMMENG/Resources/CSRImplementationGuideNovember2006.pdf>> accessed 16 November 2011. According to Dima Jamali: “[w]hile CG implies ‘being held accountable for’ CSR means ‘taking account of’”. See Dima Jamali and Myriam Rabbath, *supra* note 829. See also Minna Halme, and Juha Laurila, ‘Philanthropy, Integration or Innovation? Exploring the Financial and Societal Outcomes of Different Types of Corporate Responsibility’ (2009) 84(3) *Journal of Business Ethics* 325, 326-327.

⁸³¹ Jamali and Rabbath, *supra* note 829.

Based on such demarcation, it can be said that CSR consists of all contributions made to the community above and beyond the span of mandatory rules of CG.⁸³² A company may be in compliance with compulsory CG obligations and may, otherwise, be socially indifferent. CSR must not however be defined in contrast with a deficient definition for CG. If CG is solely limited to the resolution of agency problems at the managerial level or the prevention of abuse by majority shareholders, then any program aimed towards the support of "employees, creditors, customers, suppliers, community" would likely be considered a CSR program.

3.2. Importance of Social Responsibility Programs

With the current levels of population increase, population ageing, unemployment, pollution, and resource shortages, the ability of governments to respond to social needs is increasingly limited.⁸³³ It was recounted that:

*"HRH The Prince of Wales said that in his experience an actively engaged business sector could be more flexible and adaptable than governments, and better able to make a real difference to communities at a grassroots level."*⁸³⁴

As observed by some academics, companies that display strong CSR have a greater potential of sustaining earnings for their shareholders, employment for their workers, and products or services for their customers.⁸³⁵ Additionally, a number of studies have confirmed linkages between CSR and competitiveness. Such linkages can be stronger or

⁸³² Jamali and Myriam Rabbath, *ibid*, 7-8. The World Bank, *supra* note 830, 5.

⁸³³ Halme, and Laurila, *supra* note 830, 325. See also, Jamali and Rabbath, *supra* note 829.

⁸³⁴ International Business Leaders Forum, 'New Models of Engagement Needed to Combat Poverty' (8 February 2008) <http://www.iblf.org/media_room/general.jsp?id=123989> accessed 24 August 2008.

⁸³⁵ Klaus Leisinger, 'The Role of Corporations in Shaping Globalization with a Human Face', in Joseph Strauss, *The Role of Law and Ethics in the Globalized Economy* (Springer 2009) 30.

weaker depending on the sector concerned and depending on the type of CSR policy adopted.⁸³⁶

3.3. Adoption Levels

Managers would probably be reluctant to adopt CSR initiatives that would deviate the company from its lucrative objects or that would reduce net profitability without reward to the principals (i.e. the shareholders). In practice, CSR initiatives will most probably need to be approved by the shareholders themselves, since they are the owners and true donors of resources allocated to CSR programs. Such authorization might be difficult to obtain, especially in the case of companies with dispersed ownership such as listed companies. In the context of listed companies, the majority shareholders will probably prefer the satisfaction of the dividend aspirations of the public shareholders, rather than engaging them in acts of benevolence that could deter investors and reduce the trading value of the company's stocks. That said, scholars have nevertheless noted that:

“[...] the concept of corporate social responsibility is moving beyond the boundaries of legal compliance, public relations and ‘nice-to-do’ philanthropy, and becoming a central factor in determining corporate success and legitimacy. It has gained traction in many major companies as a new approach to: managing emergent business risks, impacts and opportunities; improving corporate engagement with key stakeholders; and ensuring greater public accountability of the private sector.”⁸³⁷

⁸³⁶ Andre Martinuzzi et al., ‘Does Corporate Responsibility Pay Off? Exploring the Links Between CSR and Competitiveness in Europe’s Industrial Sectors’ (Research Institute for Managing Sustainability, Vienna University of Economics and Business Administration, 2010), 77
<http://ec.europa.eu/enterprise/policies/sustainable-business/files/csr/documents/competitiveness/101124_csr_comp_final_report_long_version_final_en.pdf
> accessed 16 November 2011.

⁸³⁷ Jane Nelson, ‘Building Linkages for Competitive and Social Entrepreneurship’ (2007) UNIDO and the Fellows of Harvard College 55.

It is worth encouraging the inclusion of a broad commitment to CSR in the constitutional documents of start-up companies. Such a commitment is easier to enshrine at start-up, when the founders are few, and represent the company's highest-most level. If engagement towards CSR is enshrined in a company's constitutional documents, all subordinated corporate levels will become irrevocably bound thereby and will have greater initiative and flexibility, as well as the necessary enabling environment, to commit the company's resources towards CSR.

Certainly, the adequacy and efficiency of CSR initiatives may only be measured on a case-by-case basis, taking into account the financial status of each corporation. Parameters such as net corporate profit and return on investments, and net capital worth could be examined for such purpose. Greater CSR engagement could be expected from companies with greater worth or profitability levels.

3.4. Governmental Role in Strengthening CSR

Halina Ward of the World Bank listed four different types of government interventions that could be made in order to strengthen CSR: mandating, facilitating, partnering, endorsing.⁸³⁸ The UN Global Compact is a good example of governmental action taken towards the promotion of CSR. Companies that are prepared to adhere to the compact must comply with ten principles in the areas of human rights, labour standards,

<http://www.unido.org/fileadmin/user_media/Publications/Pub_free/Building_linkages_for_competitive_and_responsible_entrepreneurship.pdf> accessed 18 October 2012.

⁸³⁸ Halina Ward, 'Public Sector Roles in Strengthening Corporate Social Responsibility: Taking Stock' (January 2004), 5-6 <<http://pubs.iied.org/pdfs/16014IIED.pdf>> accessed 22 October 2012.

environmental care, and anti-corruption efforts.⁸³⁹ Similarly, the International Organization for Standardization ("ISO") issued guidance notes for the achievement of social responsibility. These notes are built around core subjects resembling those of the UN Global Compact: organizational governance, human rights, labour practices, the environment, fair operating practices, consumer issues, and community involvement and development.⁸⁴⁰

As noted by academics, "*Islamic teaching on business ethics is very much in line with the CSR agenda and Islamic laws require high standards from all stakeholders*".⁸⁴¹ Yet, the legislator may not wish to force companies to engage in CSR, otherwise this may be perceived akin taxation. In order to facilitate CSR and create an enabling environment for CSR initiatives within corporations, the legislator should consider imposing on companies just a broad duty to evaluate their ability to contribute to CSR. The legislator could also require companies that achieve a certain threshold of profitability to periodically report to the shareholders, the government, and/or the public on their CSR achievements.⁸⁴² Such a reporting duty may encourage internal support and dissuade internal objections to CSR initiatives. Such a duty could also promote social education, invite feedback by, and interaction between, concerned groups, and help develop more

⁸³⁹ See United Nations Global Compact <www.unglobalcompact.org> accessed 21 October 2012. See also, Leisinger, *supra* note 835, 31-32.

⁸⁴⁰ ISO, 'ISO 26000: Social Responsibility' <http://www.iso.org/iso/discovering_iso_26000.pdf> accessed 16 October 2012. See also Amer Al Hosaini, 'Social Corporate Responsibility' *Al Eqtisadiyah* (6 July 2011) <http://www.aleqt.com/2011/07/06/article_556178.html> accessed 16 October 2012.

⁸⁴¹ Geoffrey Williams and John Zinkin, 'Doing Business with Islam: Can Corporate Social Responsibility Be a Bridge Between Civilisations?' (October 2005) 1 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=905184> accessed 21 October 2012.

⁸⁴² Jean-Pascal Gond and Olivier Herrbach, 'Social Reporting as an Organisational Learning Tool? A Theoretical Framework' (2006) 65 *Journal of Business Ethics* 359, 371.

important and more organized initiatives.⁸⁴³ Such a broad duty could be tested with listed companies at first and could be expanded eventually to include private companies.⁸⁴⁴ Multinationals could be encouraged to commission social audits to give greater external credibility to the process.⁸⁴⁵

Socially-oriented legislation could make it an obligation onto companies to dedicate a specific percentage of net profit towards social programs the same way they must direct funds towards the amassment of a legal reserve as per the Companies Law of 1965. Such obligation could be made applicable only to companies of a certain worth and could be made progressive. Such obligation also could translate into social programs which inject directly into the company itself as opposed to the community at large, such as employee-stock programs.

According to research findings, CSR is more effective when efforts are pooled around a common agenda.⁸⁴⁶ A governmental board may be established with the mandate of helping corporations devise joint and concerted CSR programs. Companies may be required to submit a social responsibility strategy to such board and defend the adequacy and efficiency of their efforts.

⁸⁴³ *Ibid*, 366.

⁸⁴⁴ Regarding requirements for the disclosure of social and environmental information, see European Commission, 'A Renewed EU Strategy for 2011-2014 for Corporate Social Responsibility' (25 November 2011) 11-12 <<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2011:0681:FIN:EN:PDF>> accessed 22 October 2012.

⁸⁴⁵ It was reported that the Danone group has commissioned PricewaterhouseCoopers to conduct social audits. See Gond and Herrbach, *supra* note 842, 367.

⁸⁴⁶ Martinuzzi, et al., *supra* note 836, 77.

SAGIA has launched the Responsible Competitiveness Initiative ("**RCI**") to help build "medium-term growth potential through social and environmental performance."⁸⁴⁷ The criteria utilized by the RCI for the assessment of companies' sustainable development and social responsibility efforts revolve mainly around the following: (i) transparency and fairness of the work environment, (ii) improvement of the staff and the nation's skills and abilities, (iii) compliance with international laws and/or standards for the safeguard of health and safety and the protection of the environment (through sustainable development and non-pollution) and consumers, (iv) encouragement of local suppliers; (v) quality of the products and safety thereof; (vi) maturity, transparency, and responsibility in public relations; and (vii) service to the community.⁸⁴⁸

4. COOPERATIVES

Cooperatives have been strongly praised for their potential socio-economic yields.⁸⁴⁹ They provide 100 million jobs worldwide, 20% more than multinational enterprises.⁸⁵⁰ Contrary to what some may believe, cooperatives are not altruistic in nature and are different than charitable organizations. International Co-operative Alliance defines cooperatives as:

⁸⁴⁷ 'The Announcement Will Be Limited to Three Companies, Ranked by the Competitiveness Index As Having the Best Performance' *Al Eqtisadiyah* (Riyadh, 28 October 2008) 28. See also: 'Al-Turki: The Index Encourages Efforts to Implement Corporate Programs for Sustainable Development', *Al Eqtisadiyah* (Riyadh, 28 October 2008) 28.

⁸⁴⁸ 'Criteria for the responsible Competitiveness Index: International with Local Considerations', *Al Eqtisadiyah* (Riyadh, 28 October 2008) 28.

⁸⁴⁹ Henry Hansmann, 'Cooperative Firms in Theory and Practice' (1999) *Finnish Journal of Business Economics* 387, 387.

⁸⁵⁰ International Co-operative Alliance <<http://www.ica.coop/coop/index.html>> accessed 11 September 2008.

"An autonomous association of persons united voluntarily to meet their common economic, social, and cultural needs and aspirations through a jointly-owned and democratically-controlled enterprise".⁸⁵¹

A cooperative is usually owned by persons who usually have a common interest in a particular type of transaction. These persons create the cooperative to enter into the transaction in question, on their behalf, and benefit, in the process, from cost saving and/or greater bargaining power.⁸⁵² For instance, consumer cooperatives will help cooperative members acquire particular products from the cooperative at more beneficial terms. At the same token, producer cooperatives will help cooperative members sell products to the cooperative at more beneficial terms. In other words, whereas in the case of a regular corporation, its owners are capital lenders thereto, in the case of a cooperative, its owners are typically either its suppliers or customers. Sophisticated consumer cooperatives may even acquire the supplier to further reduce ultimate costs.⁸⁵³

The Companies Law of 1965 has actually devoted an entire chapter to cooperative structures.⁸⁵⁴ The Companies Law of 1965 does not directly define the term 'cooperative'. According to Article 189 of the Companies Law of 1965:

⁸⁵¹ *Ibid.* Co-operatives UK <<http://www.cooperatives-uk.coop/live/welcome.asp?id=2335>> accessed 11 September 2008. See also Kimberly A. Zeuli and Robert Cropp, *Cooperatives: Principles and Practices in the 21st Century* (University of Wisconsin-Extension 2004).

⁸⁵² Helen Markelova and Esther Mwangi, 'Collective Action for Smallholder Market Access: Evidence and Implications for Africa' (2010) 27(5) *Review of Policy Research* 621, 636.

⁸⁵³ Hansmann, *supra* note 849, 383

⁸⁵⁴ See Part IX of the Companies Law of 1965.

"A joint stock or a limited liability company may be formed in accordance with cooperative principles if it aims at (the attainment of) the following objects for the benefit or for the benefit and through the joint efforts of the members:

- a) Reduction of the cost, purchase, or sale price of certain products or service, by engaging in producers' or brokers' business.*
- b) Improvement of the quality of products or the standard of services provided by the company to its members, or by the latter to consumers."*

A new law on cooperatives, the Cooperative Associations Law, was issued in 2008 to stipulate greater details regarding the process for the establishment, management, and dissolution of cooperatives.⁸⁵⁵ Article 30 of the Cooperative Associations Law of 2008 even grants subsidies to newly established cooperatives to assist with some of their operating costs. The new law has still not drawn much public attention, but it does attest the great consciousness of the Saudi Arabian government of the potential contribution that cooperatives could offer to the socio-economy.

Cooperatives in Saudi Arabia are actually extremely rare and are practically only utilized in the field of insurance. Saudi Arabian Islamic scholars have, as mentioned earlier, long prohibited insurance activities, considering these were deemed to be alike gambling, except where policy holders participate in the profits of the insurer. In the case of insurance companies, the cooperative structure was therefore mandated by law and its principle was even enshrined in the law's title: The Cooperative Insurance

⁸⁵⁵ The Cooperatives Associations Law, issued pursuant to Royal Decree No. M/14, dated 18 March 2008.

Companies Control Law of 2007. According to Article 70(2)(e) of the Implementing Regulations to the Cooperative Insurance Companies Control Law:

*“10% of the net surplus shall be distributed to the policyholders directly, or in the form of reduction in premiums for the next year. The remaining 90% of the net surplus shall be transferred to the shareholders’ income statement”.*⁸⁵⁶

The ten percent reserved profit share allocated to policy holders is the essence of the mechanism through which cooperative benefit is achieved by the clients of Saudi Arabian insurance companies. That said, typical Saudi Arabian insurance companies are not true cooperatives, neither in the ordinary meaning of the term, nor in the meaning of the Companies Law of 1965. This is because, even though some of the insurer's profit is redistributed to its clients, said clients are not themselves owners of, or shareholders in, the insurer. The interests of the clients are therefore overridden by, or are at least in clash with, the lucrative considerations of the owners.

The cooperative structure assumes that the members or owners of a cooperative have a common need or aspiration, which often goes beyond the objective of realizing profit on an investment and resembles rather the safeguard of an interest. Members of a cooperative are therefore motivated differently from the shareholders of a corporation, although both types are in pursuit of some type of advantage. As described by Oliver Hart and John Moore:

⁸⁵⁶ Implementing Regulations to the Cooperative Insurance Companies Control Law, issued pursuant to Royal Decree No. M/32, dated 31 July 2007.

“Most businesses have outside ownership: the people who own and run the firm are typically not the same people who buy and use the firm's product. That is, contrast to a members' cooperative, ownership is not bundled with the right to consume.”⁸⁵⁷

Cooperatives should be less vulnerable to continuity risks than regular companies, since its body of owners will overlap with at least one of the company's major classes of stakeholders. Since the owners of a cooperative draw benefit not only from dividends but also from the activities of such company, the cooperative model is capable of narrowing the divide between the lucrative interests of its owners and the social interests of some of the entity's stakeholders. Cooperatives could yield even greater social benefits if they are vertically integrated. For example, milk consumers would be more favored as members in a milk production cooperative, if said cooperative also owned the bovine farms from which the milk is sourced. The end-consumers would be able to reduce the price of their products on the store shelf.

Cooperatives can however be difficult to manage, especially if their members are numerous and if such members are not preoccupied by the cooperative objectives pursued.⁸⁵⁸ It may be difficult to amass serious interest in a cooperative's objectives and to determine the criteria for membership. Given the absence of the equivalent of the Securities Depository Center, the entry and exit of cooperative members can also be difficult to manage if they are great in number and if the cooperative is not sophisticated. If the interests of individual cooperative members are represented by

⁸⁵⁷ Oliver Hart and John Moore, ‘The Governance of Exchanges: Members’ Cooperatives Versus Outside Ownership’ (1996) 12 Oxford Review of Economic Policy 4, 53.

⁸⁵⁸ Markelova and Mwangi, *supra* note 852, 628.

tradable shares, it may be difficult to determine the value of such shares, since, for some of the members of the cooperative, the pursuit of profit may then override the pursuit of the cooperative's objectives.

Some scholars have observed that Islamic equity financing modes such as Mudarabah and Musharakah are cooperative in nature and should be marketable more easily than non-cooperative financing modes since both the funders and the fund manager have direct rights in the profit derived, and possibly also in the assets utilized to achieve such profit.⁸⁵⁹ A system could be devised to narrow the divide between the classical corporation and cooperatives. This should be the focus of future studies. It would be worthwhile, if studies are encouraged to identify instances in Saudi Arabia where the use of cooperatives could help unlock higher levels of socio-economic yields. Such studies could be carried out at the level of the MEP and the MoCI.

5. TAXATION

5.1. Role

The primary intention of taxation could be the reallocation of capital to prioritized sectors but could also be the inducement of a particular behavior.⁸⁶⁰ According to the OECD, tax policy can contribute to the removal of barriers to international trade and investment, foster domestic resource mobilization, promote corporate governance and

⁸⁵⁹ Boualem, Bendijalo, *Assessment of the Practice of Islamic Financial Instruments: The Case of IDB Unit Investment Fund and Islamic Banks' Portfolio* (Research Paper No. 35, IRTI 1996) 46.

⁸⁶⁰ Rahul Dhumale, 'Incentive v. Rule-Based Financial Regulation: A Role for Market Discipline', in Ferran and Goodhart, *supra* note 175, 71-72.

counter money laundering and corruption.⁸⁶¹ Taxation therefore is an invaluable tool in attempting to invigorate socio-economic development. It was described by some as the "*cornerstone of the modern welfare state*".⁸⁶² It is up to each jurisdiction to tailor its tax policy (including type, rates, exemptions, thresholds, etc.) properly so to obtain the best yield.⁸⁶³

5.2. *Tax Reliefs to Incentivize Listing*

It is possible in some instances to encourage listing through taxation. In Italy, for instance, tax benefits are granted to firms going public. It was observed that the tax relief did not represent any loss of revenue for the Italian government since listed companies tended to report larger earnings than their private counterparts.⁸⁶⁴ The Italian experience is not easily replicable in Saudi Arabia since the Saudi Arabian taxation regime differentiates between Zakat (a Sharia-imposed tax, calculated at a flat rate of 2.5% on assessable income) and the taxation on the income of non-resident investors conducting business through permanent corporate establishments (calculated at a rate of 20%).⁸⁶⁵ The problem in the replication of the Italian experience lies in the fact that Zakat is compulsory under Sharia and may not ordinarily be reduced.

5.3. *Tax Reliefs to Incentivize Investment*

⁸⁶¹ OECD, 'OECD's Current Tax Agenda' (April 2011) 1 and 20.

⁸⁶² Jonas Edlund, 'Attitudes Towards Taxation: Ignorant and Incoherent?' (2003) 26(2) Scandinavian Political Studies 145, 146.

⁸⁶³ *Ibid*, 38.

⁸⁶⁴ Giancarlo Giudici and Stefano Paleari, 'Should Firms Going Public Enjoy Tax Benefits? An Analysis of the Italian Experience in the 1990s' (2003) 9(4) European Financial Management 513, 514.

⁸⁶⁵ Zakat Decree, issued pursuant to Royal Decree No. 61/5/1, dated 29 May 1963. See also Article 7, Income Tax Law, issued pursuant to Royal Decree M/1, dated 6 March 2004.

Saudi Arabia announced a fifty percent reduction in corporate taxes, for the next coming years, for foreign companies operating out of the country's new economic cities.⁸⁶⁶ Such a measure is a clever attempt to attract and compete more efficiently for new investments.

5.4. Capital Gains Tax

Capital gains taxes are a simple way to steer investment behavior.⁸⁶⁷ The rate of the tax may be varied and could be tied to a threshold of gained capital or to a timeframe. As an example of how capital gains tax could be utilized, the US Congress had, in 1993, attempted to lower the cost of capital to small businesses by reducing the capital gains tax by one half if a small business stock is held for more than five years.⁸⁶⁸

In Saudi Arabia, a 20% capital gains tax is imposed on the disposal of shares in a resident company. As an exception, however, capital gains taxes on the disposal of listed shares are only applicable if these shares were acquired prior to 2004.⁸⁶⁹ Such exemption has a strong supporting rationale. The Saudi Arabian capital market is still growing and the tax system should not discourage new investments. Investors should be lured by the maximum possible levels of return. Similar experimentation in other

⁸⁶⁶ Salameh, M., 'Conditional Tax Breaks For a Ten-Year Duration For Investors in Six Saudi Areas' *Al Eqtisadiyah* (Riyadh, 25 November 2008) 1 and 4.

⁸⁶⁷ Dean Hanlon, and Sean Pinder, 'An Empirical Investigation of Whether Australian Capital Gains Tax Reforms Influence Individual Investor Behaviour' (2007) 15(5) *Pacific-Basin Finance Journal* 481, 481-482.

⁸⁶⁸ David A. Guenther and Michael Willenborg, 'Capital Gains Tax Rates and the Cost of Capital for Small Business: Evidence from the IPO Market', (1999) 53(3) *Journal of Financial Economics* 385, 386.

⁸⁶⁹ Article 7 of the Income Tax Regulations, issued pursuant to Ministerial Resolution No. 1535, dated 28 July 2004.

jurisdictions have confirmed the linkage between reductions in capital gains taxes and increases in the volume of share transactions.⁸⁷⁰

In order to make investment in listed securities even more attractive, the Saudi Arabian legislator should consider imposing a capital gains tax on the profit derived from the sale of real estate. The rationale for this is that investment in real estate is the main competitor to investment in listed stock and dissuading one option will induce the other.⁸⁷¹ Real estate taxes could also be useful, although it would be preferable to limit these to unexploited land and avoid the taxation of residential units. Since the purpose of the tax is behavioral manipulation and not revenue generation, it is not advisable to adopt any measures that would reduce net household incomes. Limiting real estate taxes to unexploited land could accelerate the development of productive projects. Actually, a proposal for such taxes is currently under study by the Shoura Council, although it is not clear whether it will amass sufficient support.⁸⁷²

6. COMPETITION LAW OF 2004

Monopoly is prohibited in Islam. prophet Mohamed said: "*Is wrong he who monopolizes*". This is because monopoly constitutes an impediment to socio-economic growth. Competition helps improve the quality of products and services offered, including securities products and services by authorized persons, and helps drive down

⁸⁷⁰ Hanlon, and Pinder, *supra* note 867, 482.

⁸⁷¹ Amer Al Husaini, 'Huge Saudi Liquidity and the Awaiting Profiteers' *Al Eqtisadiyah* (5 April 2012) <http://www.aleqt.com/2012/04/05/article_643710.html> accessed 15 October 2012.

⁸⁷² 'The Shoura Council Declines to Vote on the Imposition of Zakat on Vacant Lands' *Al Eqtisadiyah* (Riyadh, 17 September 2012) <http://www.aleqt.com/2012/09/17/article_693702.html> accessed 15 October 2012.

costs.⁸⁷³ Competition helps elevate commercial standards and, in doing so, it constitutes a great driver of market self-regulation. That said, it should not be concluded that the positive effects of competition can be achieved merely by the increase of the number of market participants. Minimum conditions are necessary for the access to markets of various market participants. Market participants must be well-informed of the nature, details, and implications of the transactions that they are concluding and must enjoy some degree of sophistication. It would be inconceivable for a regulator not to set conditions for the establishment of an authorized person, for the sole sake of competition.

Article 2 of the Competition Law of 2004 defines market hegemony or dominance as:

“[t]he situation through which an installation, or group of installation, is capable of affecting the current price in the market through the control of a certain rate of the total supply of a specific commodity or service in the industry in which it practices its activity.”

It is unquestionable that preventing market dominance would ultimately be the best way to avoiding anti-competitive practices. One way to prevent market dominance would be to encourage mergers amongst SMEs so that they can benefit from economies of scale and better compete against dominant entities.⁸⁷⁴ SMEs which are best candidates to diffuse a hegemonistic market may be given support through facilitated finance, reduced tax rates, etc.

⁸⁷³ Abdelhamid Brahimi, *Eradication of Poverty and Development in an Islamic Perspective* (IRTI 1995) 137-138.

⁸⁷⁴ MEP, *supra* note 11, 138-139.

In some instances, a dominant entity may capture Saudi Arabian market share simply through the export of products into Saudi Arabia or through the remote provision of services, without having any local presence. The distant manufacture of products or provision of services implies the loss of an opportunity for the Saudi Arabian labour market to acquire valuable know-how and technical skills. Foreign entities which are behind the market dominance could be encouraged to invest in the Saudi Arabian market and relocate some of their activities. The SAGIA should target such industries and promote market investment or relocation in the Kingdom.

Obviously, dominant companies pose great threats to the consumer market, but, at the same time, present an interesting added-value to capital markets. The adverse effects of market abuse could actually be mitigated through the listing of dominant entities. Indeed, any dominance-caused inflation in consumer markets could be offset, at least in part, by corresponding investment returns in capital markets. The Saudi legislator should consider devising policies to persuade and if necessary compel shareholders in a dominant company to list it. For instance, it may be stipulated that dominant companies would not be considered to be in violation of the Competition Law of 2004 if they have listed more than a certain proportion of shares.

7. LOCAL PROCUREMENT AND HIRE REQUIREMENTS

Pursuant to the Government Procurement and Tendering Law of 2006, governmental entities must prioritize local products and services. Obviously, such prioritization aims at boosting the development of the local economy and private sector, and specifically SMEs. Such prioritization would also help in replenishing public funds since the Saudi

Arabian government would recoup some of its spending in the form of income tax collection. Such a recoup would not be available in case of supply from foreign sources. Indeed, foreign suppliers are not subject to income tax while any withholding taxes imposed on payments to such foreign sources would most probably be contractually passed on to the local client.

Although emerging economies may have more incentive to adopt local procurement obligations, countries such as the United States of America have recently been attempting to resort to such programs to surmount the financial crisis. Indeed, the Obama Administration included a “Buy American” requirement in the American Recovery and Reinvestment Act of 2009.⁸⁷⁵ Pursuant to such requirement, the maintenance, repair, and construction of any federal, state, or municipal public building or work could only be performed using iron, steel or products manufactured or processed in the United States.⁸⁷⁶ Numerous US trading partners contested such measure, claiming that it constituted illegitimate trade protectionism. In response, the United States included a waiver in the law for products originating from trade partners vis-à-vis which the United States had extended commitments under the NAFTA and WTO’s Agreement on Government Procurement.⁸⁷⁷

⁸⁷⁵ American Recovery and Reinvestment Act of 2009 (111th Congress Public Law 5, signed into effect on 17 February 2009) <<http://www.gpo.gov/fdsys/pkg/BILLS-111hr1enr/pdf/BILLS-111hr1enr.pdf>> accessed 23 October 2012.

⁸⁷⁶ Sections 1605(a)(b)(c) of the American Recovery and Reinvestment Act of 2009.

⁸⁷⁷ Section 1605(d) of the American Recovery and Reinvestment Act of 2009. See also John Linarelli, 'Global Procurement Law in Times of Crisis: New Buy American Policies and Options in the WTO Legal System' in Sue Arrowsmith and Robert Anderson (eds), *The WTO Regime on Government Procurement: Challenge and Reform* (Cambridge University Press 2011) <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1710908> accessed 26 October 2012.

Government procurement is explicitly excluded from the key national treatment obligation under the main multilateral trade rules of the WTO.⁸⁷⁸ Contrary to the United States, Saudi Arabia has not acceded to the WTO's Agreement on Government Procurement, and only acts an observer to said agreement.⁸⁷⁹ The Government Procurement and Tendering Law of 2006 should not therefore be in violation of any of Saudi Arabia's commitments to the WTO. Nevertheless, Saudi Arabia must obviously carefully evaluate whether any local procurement requirements that it imposes would constitute a violation of any of its commitments under any trade treaty.

8. CORRUPTION

Prophet Mohamed said: "*May the curse of Allah be upon whoever pays a bribe and whoever receives one.*"⁸⁸⁰ Corruption eradicates the usefulness of law-setting. It may allow the carrying-out of activities otherwise illegitimate and that may be harmful to public safety.⁸⁸¹ It may also result in the skewed allocation of resources and/or the reduction of government income.⁸⁸²

⁸⁷⁸ WTO, 'General Overview of WTO Work on Government Procurement' <http://www.wto.org/english/tratop_e/gproc_e/overview_e.htm> accessed 26 October 2012.

⁸⁷⁹ *Ibid.*

⁸⁸⁰ Sunan Abudawud (24:3573).

⁸⁸¹ Vito Tanzi and Hamid Davoodi, 'Corruption, Public Investment, and Growth' (October 1997) International Monetary Fund, 1.

⁸⁸² Paolo Mauro, 'Corruption and Growth' (1995) 110(3) The Quarterly Journal of Economics 681, 681. On the eradication of the usefulness of law-setting, SEC Commissioner Luis Aguilar has said that: "[R]ules alone, without proper implementation and enforcement, are meaningless. How many countries around the world have rules on the books that are directly contradicted by the corrupt practices that take place - and where the regulators are nowhere to be found?" See Aguilar, *supra* note 241. See also Vito Tanzi and Hamid Davoodi, *ibid*, 8.

Saudi Arabia ranked the 50th on the 2010 Corruption Index of Transparency International.⁸⁸³ Also, Saudi Arabia obtained a score of 4.4 out of 10 on the 2011 Corruption Perception Index.⁸⁸⁴ Since low scores indicate high corruption, Saudi Arabia's score is actually quite alarming. As an example of corruption scandals that have come to light in Saudi Arabia, in 2008, the Saudi Minister of Social Affairs admitted that financial discrepancies have revealed that millions of Saudi Riyals were either paid to undeserving people or embezzled.⁸⁸⁵

The Saudi Arabian legislator issued the Anti-Corruption Law of 1992 which exposes individuals involved in acts of bribery to an imprisonment term of up to two years and a fine of up to SR 50,000. The sentencing limit may be doubled in case of a recurring violation that occurs within 5 years from a previous conviction.⁸⁸⁶ Additionally, individuals convicted pursuant to the Anti-Corruption Law of 1992 become inadmissible for work in the public service.⁸⁸⁷ Likewise, companies involved in bribery acts are exposed to a penalty equivalent to 10 times the amount of the bribe, in addition to becoming ineligible from bidding for government procurement contracts.⁸⁸⁸

⁸⁸³ Simon Rogers, 'Corruption Index 2010 from Transparency International' *The Guardian* (26 October 2010) <<http://www.guardian.co.uk/news/datablog/2010/oct/26/corruption-index-2010-transparency-international#data>> accessed 19 October 2012.

⁸⁸⁴ Transparency International, 'Corruption Perceptions Index 2011', (2011) <<http://cpi.transparency.org/cpi2011/results/>> accessed 14 October 2012.

⁸⁸⁵ Rashid Al Fouzan, 'Corruption Uncovered' *Arab News* (24 July 2008) <<http://archive.arabnews.com/?page=13§ion=0&article=112088&d=24&m=7&y=2008>> accessed 25 November 2011.

⁸⁸⁶ Article 11 of the Anti-Corruption Law of 1992.

⁸⁸⁷ Article 13 of the Anti-Corruption Law of 1992.

⁸⁸⁸ Article 19 of the Anti-Corruption Law of 1992.

Whistleblowers are incentivized by a reward of a minimum of SR 5,000 and a maximum of half of any confiscated bribe.⁸⁸⁹

As a result of the various scandals that became public and as a result of the widespread negative perception, the government of Saudi Arabia realized the pressing need to tighten its laws on the safeguard of public funds, especially in light of current privatization initiatives and current administrative, economic, and financial reforms. First of all, measures were adopted to raise the quality of audits. The Office of Financial Inspection mandated two firms to improve the government's accounting system and to ensure the adoption of the International Public Sector Accounting Standards ("IPSAS").⁸⁹⁰ Additionally, more frequent audits of administrative bodies have been required. Internal audit units were actually established in government agencies and public institutions to monitor administrative efficiency and adherence to rules, regulations, instructions and financial procedures.⁸⁹¹

9. CONCLUSION

The development and invigoration of capital markets is only one of many ways to achieve and/or maintain socio-economic returns. This Part gave the example of just a hand few of alternative engines that achieve the same objective.

⁸⁸⁹ Article 18 of the Anti-Corruption Law of 1992.

⁸⁹⁰ Al Jibreel, A., 'Two Companies Study the Governmental Accounting System To Prevent Embezzlement of Public Funds', *Al Eqtisadiyah* (7 September 2008) 7. See also, Institute for International Public Sector Accounting Standards <<http://www.ipsas.org>> accessed 12 September 2008.

⁸⁹¹ Council of Ministers Resolution No. 129 dated 24 April 2007.

This Part explained that the government of Saudi Arabia made significant efforts to attract foreign direct investment. The accession of Saudi Arabia to the WTO has reduced barriers to entry. Despite this, there remain margins for further improvement. This Part offered a proposal to reconsider the sanctions imposed on unlicensed foreign investments. As argued, the forced liquidation of violating enterprise could unnecessarily amputate the socio-economic contribution of such enterprise, and alternative penalties should be favored.

This Part also presented CSR. It was argued that, although CSR programs are not compulsory, their philosophy can nevertheless be encouraged by mandating reporting on CSR engagement. Such reporting could place CSR as a basis for reputation building and could, in the process, unlock significant wealth reallocation.

This Part also presented cooperatives. Cooperatives help in pooling the leverage of one class of market participants so that they achieve greater transactional margins. The Saudi Arabian government should conduct studies on the opportunities that could be sought in different business areas through cooperatives.

Taxation is perhaps the most renowned tool for behavioral control and resource reallocation. This Part described how capital market investments could be encouraged through taxation on real estate.

This Part also explained that the adverse socio-economic effects of anti-competitive practices could be mitigated if companies with market dominance are encouraged to list.

The Saudi Arabian legislator should evaluate granting listed companies exemptions to engage into limited anti-competitive practices, to the extent that any public harm caused by such practices can be offset by the public benefit realized on the stock market. Alternatively, a strategy could be adopted to encourage mergers amongst SMEs, so to strengthen their competitiveness and reduce the leverage of dominant companies.

This Part then briefly described how local procurement rules can benefit local businesses and how, in the context of international trade, such rules can constitute illegitimate protectionist measures. From that perspective, it was wise of Saudi Arabia not to have acceded to the WTO's Agreement on Government Procurement.

Finally this Part described the dangers of corruption on the socio-economic fabric of the Saudi Arabian society. The government of Saudi Arabia has been deploying and should continue deploying all possible eradication efforts.

PART X - CONCLUSION

Because capital markets can link human masses and collectivities with the projects or sectors that they value most, capital markets have the ability to invigorate socio-economic development. If a drop of water is trapped out of its cycle, it will never evaporate from earth to sky and will never fall as rain from sky to earth. Likewise, capital must be placed in a cycle, otherwise its intended beneficiaries may be deprived therefrom. If a jurisdiction is unable to link and place the right opportunities and protections for finance and investment seekers, these will turn abroad for their needs.

The ingredients for a healthy business environment generally exist in Saudi Arabia, although not to optimal levels. Currently, Saudi Arabia's corporate sector is very active, liquid, and rich in opportunities, for both foreign and local investors. Taxes, labor, and energy costs are cheap, and, despite non-negligible poverty, there is strong market demand for all quality grades of products and services, including securities. While it is true that the promotion of Saudi Arabia's capital markets is one of the goals stated in the economy plan, the ultimate purpose of such goal must revolve around the promotion of the socio-economic welfare of Saudi Arabian nationals and residing expatriates.

As was shown in this thesis, the institutions created by capital market laws and regulations will only have clients and will only perform if placed atop the proper legal and regulatory foundation. The regulatory framework is still being built-up. Certain instruments were very recently issued (e.g. the Prudential Rules of 2012). Other

instruments are still in the process of being issued (e.g. the draft Credit Rating Agencies Regulations).

This thesis explained that, although Sharia is Saudi Arabia's constitution, neither the CMA nor Saudi Arabia's legislative and executive levels of the government have preoccupied themselves in setting the Sharia standards applicable to the corporate and capital market spheres. This thesis argued that it would be preferable that the formulation of Sharia standards be driven by international non-governmental organizations. NGOs should also take the lead in setting the criteria for the formation and functioning of scholarly panels, either at the level of the NGOs themselves or at the level of corporations. Indeed, since the formulation of interpretations by NGOs would involve the consolidated participation of a wider body of Muslim scholars, formulated interpretations should receive greater international consensus and should assist in creating a more dynamic cross-border transactional climate.

Capital markets can only deliver endeavored objectives if systemically efficient. Systemic efficiency maximizes and safeguards proceeds generated from capital market transactions. This thesis explained that systemic efficiency is dependent on transparency and good investor protection. Investors must be protected not only from non-performing issuers and incompetent securities firms, but also from other investors. Examples of prejudicial acts that could take place within the investor class include insider trading, market manipulation, and abuse by majority shareholders. This thesis provided an overview and an explanation of those prejudicial acts and explained the importance of setting out and enforcing thorough and dissuasive legal restrictions. This thesis also

explained the importance of good corporate governance practices within corporations, in order to balance out the interests of majority shareholders with those, not only of the minority shareholders, but also the community at large, including employees and customers. This thesis emphasized the need to improve corporate governance practices in Saudi Arabia, especially in what concerns the fiduciary duties of managers at the level of limited liability companies. The current framework governing the managers of limited liability companies is very poor and needs to be enhanced to at least expressly prohibit conflicts of interests.

The CMA is aware of the importance of enhancing the sophistication of investors and market participants in general. Such sophistication should create more reliable self-regulation since market participants would have a greater ability to recognize and avoid intolerable risks. This sophistication should also help foster a self-regulating environment, which would reduce the burden on the CMA's resources.

As explained in this thesis, it is essential for the market to be protected from crises. Efficient self-regulation stands as one of the tools to prevent crises. In this regard, the CMA must also assess the strength of its resources to detect and react to build-ups of systemic risks. The recent financial crisis is full of lessons which the CMA can benefit from. For instance, the failure to detect the fraud of Bernard Madoff has shed light on deficiencies in the American regulatory apparatus. The CMA should monitor and, where appropriate, replicate, palliation measures adopted by US authorities in this regard.

It is clear that sectoral diversification on capital markets helps mitigate damages resulting from crises. The CMA should attempt to prioritize listings that achieve such a diversification. The CMA should also avoid the offering of securities that are unduly complex and that may exceed the level of sophistication of all market participants involved.

This thesis described the efforts undertaken towards greater integration of GCC capital markets. Such an integration could contribute to greater socio-economic yields. As per the experience of the EU, the best starting point for such integration would be the agreement by the GCC states on the minimal capital market rules to be contained in national systems. As the level of harmonization increases, and as market players in different GCC member states reach more even levels of sophistication, a passport concept could be introduced. Pursuant to such a concept, a securities firm in one member state could be allowed to offer services in another member states. Similarly, a company established in one member state, and authorized by the regulatory authority in that state to offer shares, could be allowed to offer securities in another member state, without need for further authorizations. Eventually, and provided that smaller-scale integration efforts prove successful, the GCC may then assess the consolidation of regulators. Clearly however, such a level of integration is premature at this stage.

As argued in this thesis, the CMA should not act as a mere application processor and rule enforcer, but should formulate strategies to direct capital towards its most productive use, calculated in terms of anticipated socio-economic rewards (e.g. employment rate, per capita income, etc.). The CMA should prioritize and even

encourage the channeling of capital to companies that have a greater (actual or potential) socio-economic contribution. The CMA should prioritize the international competitiveness of Saudi-based multinationals or companies with strong export capabilities. In light of the current inflation of basic staple food products, the CMA should for example consider prioritizing the capitalization of food and agro-based industries. As another example and in light of the currently high unemployment rates, the CMA should also consider prioritizing the capitalization of labor-intensive and training companies.⁸⁹²

This thesis argued that equity-based securities offer greater potential for socio-economic rewards and should therefore be favored and promoted. There is historical evidence that since World War II, stocks have generally produced higher returns than bank accounts, bonds, or even bullion.⁸⁹³ Actually, since Islamic law favors profit-sharing over fixed returns-on-capital, equity-based securities should represent the preferred mode of finance in Islamic societies.⁸⁹⁴ The CMA should not completely disqualify SMEs from capital market financing. At present, it may be difficult and systemically risky to establish a stock market for SME stocks. However, foreign direct investment and investment funds could direct capital towards the most performing SMEs and could help these fill any moderate financing gaps that they may face in order to implement any promising growth strategies or projects. The CMA could also prioritize the listing of large companies that intend to acquire and consolidate smaller companies. Based on

⁸⁹² MEP, *supra* note, 174-177 and 545.

⁸⁹³ Iqbal, *supra* note 78, 54.

⁸⁹⁴ *Ibid*, 50.

the premise that small companies tend to operate in rural areas and second-grade urban pockets, this should allow greater penetration of services into these areas.

This thesis also encouraged the widening of the ownership base of giant family enterprises. As argued in this thesis, public participation in family enterprises may palliate their inherent vulnerability to succession disputes and to the assignment of managerial positions on the basis of kinship rather than aptitude. Public participation may lead to greater business discipline and improved corporate governance resulting in greater financial performance.⁸⁹⁵

Finally, this thesis placed capital markets in a greater context of efforts that could be utilized to improve the Saudi Arabian socio-economic environment. The most notable findings of this thesis are the need for the Saudi government to encourage CSR initiatives, explore any benefits that could be achieved through the utilization of cooperative structure, explore the possibility to steer the behavior of capital market participants through taxation, continue the fight against corruption, and mitigate the adverse effects of hegemonies through the encouragement of mergers amongst SMEs and the extension of incentives to dominant companies if they are listed.

⁸⁹⁵ Chapra and Ahmed, *supra* note 56, 23.

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1.3 *Non-Saudi Instruments*

1.3.1 *US Instruments*

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1.3.2 *UK Instruments*

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1.3.3 *EU Instruments*

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Regulation (EC) No 1060/2009 of the European Parliament and of the Council on rating agencies of 16 September 2009 <http://www.esma.europa.eu/system/files/L_302_1.pdf> accessed 23 October 2012.

2. REGULATIONS, CIRCULARS, RESOLUTIONS

2.1 Saudi Instruments

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Council of Ministers Resolution No. 73 dated 9 March 2009 regarding the Conditions Governing the Off-Plan Sale of Residential, Commercial, Office, Service, or Industrial Units.

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