Towards "Shareholder Spring" in the Middle East?

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Abstract The events witnessed in the Middle East and North Africa (MENA) region over the past 3 years have resulted in a profound questioning of the economic and social pact in some countries of the region. And yet, the role of corporations as main actors of wealth generation and distribution has not been subject to much debate. As a result, corporate governance, as a field of research, has rarely found its place in the discussion on how to improve the productivity and integrity of MENA economies.

Good corporate governance is clearly a part of the solution to both immediate and longer-term challenges of the region. Examining some of the largest companies in the region – listed and state-owned – this chapter seeks to highlight key developments in their governance and demonstrate how these might have impacted their profitability, integrity and the maintenance of the "new pact" between governments and citizens in the region in the wake of the Arab Spring.

The key premise of this chapter is that unlike in other jurisdictions, developments in governance in the MENA region are driven almost entirely by regulation. Despite complaints against corruption, crony capitalism and other decisions taken against shareholders interest, the region has seen virtually no shareholder engagement. And yet, for corporate governance to serve the interest of companies and societies, it cannot be imposed through regulatory requirements only: shareholders, especially large institutional actors, also need to be part of the ongoing debate on the role of corporations in the future of the region.

The opinions expressed in this article do not reflect the official views of the OECD or its member countries.

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1 Introduction

The analysis of the recent financial crisis has led to the now widely accepted conclusion that weak corporate governance practices, especially in the banking sector, exacerbated its extent (OECD 2010). One of the main concerns raised is that shareholders, including institutional actors, were at best insufficiently active in key decision-making processes or at worst absent. This observation has motivated a number of important corporate governance reforms in North America and Europe in particular, designed to provide shareholders with more say (e.g. Dodd Frank Act), as well as to encourage them to take advantage of their newly afforded powers. Say-on-pay provisions are now common in a number of countries, and proposals such as additional rights for long-term shareholders are now being seriously considered in several capitals.

While policymakers and corporations in the MENA region have been relatively slow to perceive good corporate governance as a policy priority, this has changed significantly in the new millennium, as countries have moved to introduce corporate governance codes and endow their securities regulators and stock exchanges with powers to enforce existing rules (Amico 2011). During the last few years, we have seen a growing emphasis on compliance with the newly imposed requirements and, in parallel, a further nuancing of laws or regulations where loopholes in companies' adoption of these requirements were noted. At the same time, and despite the demands voiced in the midst of the Arab Spring, shareholders have not been active in exercising their rights and demanding better governance of companies.

1.1 The Economic Face of the Arab Spring

The Arab Spring has now gone through a few seasons and has no end in sight as the conflict in Syria rages on and the situation in Bahrain, Yemen and Lebanon remains fragile. While much has been said about the desire of the Arab people for freedom of expression and political representation, not much – and certainly not enough – has been said about the economic roots of the events. And yet, if we look at the map of these revolts, it is clear that the frustrations on the streets of Tunis, Cairo and Damascus were as much linked to economic inequality and injustice as they were to political misrepresentation and repression of certain groups or ideologies. Many experts on Arab economies consider crony capitalism and a growing socio-economic divide among key sources of the events we have seen transpire.

At the heart of these frustrations is the debate about the role of the state and business elites in the concentration of economic power, be it through monopoly rents, fraudulent procurement procedures or sale of state assets below market prices. Be it state-owned enterprises, private local or foreign companies, no corporate form has escaped the wide-scale criticism of the citizens of Arab countries concerning their role in perpetuating the social divide. Corporations, as much as political groups, are therefore parties to the ongoing debate on the future of the Middle East and North Africa.

And yet, the corporate world has been largely left on the side of the road as popular debate continues to focus on political emancipation and representation, ethnic and religious balances and other issues tightly linked to preserving the delicate social balance in some of these countries. With the exception of Tunisia and Egypt, where companies controlled or suspected to be controlled by the former regime continue to be investigated,[1] the thrust of the efforts to combat corruption, address inequalities and improve the transparency of the decision-making has focused on the public, as opposed to the corporate sector.

Time has come to examine the role of corporations – in particular paying attention to how and in whose interest they are run – in the past and in the future of the Middle East, because as much as some might have been a part of the problem, they are clearly a part of the solution to both immediate and longer-term challenges. While the corporate world of all MENA countries is dominated by small to medium sized, family controlled companies, the focus of future debate in the region should arguably be on larger listed and state-owned enterprises, if not for any other reason than their size.

If investors perceive significant deficits in transparency or quality of reporting or opaque ownership arrangements in these large companies, their appetite for investing in the region would be reduced. The controlled nature of most companies and the low free float in most MENA markets, exacerbate the potential risk for investors in these markets. These concerns, taken into consideration in conjunction with existing investment restrictions for foreign investors in some markets, imply that the quality of governance in the region matters potentially more than in other markets and that consequently, companies with governance structures superior to the "baseline scenario" can potentially obtain significantly higher valuations (ISS 2012).

1.2 Corporate Governance: Evolving Interest in the Region

Corporate governance began seriously attracting the interest of policymakers in the region about a decade ago, and with the turn of the millennia a number of countries in the region, led by Oman and Egypt, have started to introduce corporate governance codes and regulations (Amico 2011). Today, securities regulators have been established in all but one MENA country (i.e. Yemen), and a number of them have dedicated corporate governance expertise or even departments to oversee the implementation of the local governance code and related requirements. For instance, the regulators in Saudi Arabia and Oman have specialised corporate

[1] For results of preliminary investigations carried out in Tunisia, please refer to 2011 Report by the Tunisian Anti-Corruption Commission.

governance departments and other regional regulators have expertise on corporate governance.

Initially, the attention to corporate governance was motivated by a broader interest of MENA governments to align with international standards, especially financial sector standards, in order to establish themselves as financial hubs in the region. As the race to become the region's financial hub between Bahrain, Dubai, Qatar, Saudi Arabia, Turkey and more recently Casablanca intensified, harmonisation of local standards and practices with international benchmarks (e.g. FSB and G20 standards) in financial reporting, governance and related areas was only natural.

Unlike Asia, where the 1997–1998 financial crisis has highlighted governance weaknesses and hence the need to review related standards and practices, the role of crises in underlying the need for better corporate governance in the MENA region has been relatively limited. The explosion of the market bubble in 2006, especially pronounced in the Gulf Cooperation Council (GCC) countries, has certainly reinforced the notion that governance is important. However, the sharp fall of GCC markets – where many households lost their savings[2] – is difficult to attribute to governance failures per se. As during the recent global financial crisis, the absence of effective risk management procedures and the failure to implement other good practices, have contributed to this stock market downturn, but were not a motivating factor.

The interest in corporate governance is increasingly related to the anti-corruption drive insofar as better governance arrangements are increasingly seen as relevant to reducing the opacity of ownership and managerial decision-making. In Egypt for instance, following the revolution, listed companies were required to disclose to the regulator and the exchange their beneficial owners to determine if the latter had any improper ties with political figures under investigation (Abdel Salam 2011). The Egyptian Financial Services Authority is estimated to have received approximately 400 complaints from the public in 2012. In Jordan, the securities regulator is also considering measures to introduce mandatory corporate governance requirements, above and beyond its comply-or-explain corporate governance code, in part with a view to target corruption in listed companies.

The corporate governance debate has over the years shifted from barely looking at the international good practices that would suit the local ownership landscape and customs to reflecting on how governance can actually serve the interests of individual companies and markets. In so doing, securities regulators are increasingly delving into technical issues, beyond governance structures such as the presence of certain board committees or the separation of CEO and Chairman posts. There appears to be a greater emphasis on governance behaviours that can mitigate key risks such as abusive related party transactions, tunneling of assets or

[2] Financial education and "know your customer" rules in these countries are developing and at the time of this crisis banks would not prevent unsophisticated investors from investing their entire savings into the capital market.

concentrated lending practices. Governance, anti-corruption and risk management are increasingly seen as part of the same equation.

Over the years, the interest in governance has shifted and with it, the idea that good governance is a "foreign concept" has dissipated, giving way to recognition that more rigorous governance requirements would address undesirable practices such as tunneling by controlling shareholders, excessive executive compensation or inefficient boards. The impetus to impose such requirements has come principally from securities regulators, stock exchanges and central banks, the latter being pioneers in introducing standards of governance in the region.[3] A number of surveys of governance arrangements of companies in the MENA region demonstrate that banks are on average better governed than other companies, including listed companies (IFC-Hawkamah 2008).

While the banking sector was historically the most regulated in terms of governance practices, policymakers have in recent years broadened their interest to include all types of privately owned (listed and unlisted companies) as well as state-owned enterprises. In a number of countries of the region, separate guidelines were created to address the peculiarities of different types of companies. For instance, Morocco has issued separate governance codes targeting listed companies, family owned companies and SMEs, credit establishments and SOEs. Egypt also has two separate governance codes for SOEs and for privately held companies and other countries of the region are increasingly looking to introduce further granularity in recommendations for different owners, sectors and economic contexts.

1.3 Better Governance of SOEs of Growing Interest

Policymakers across the region are starting to pay a particular attention to governance of state-owned enterprises (SOEs), an issue that only a few years ago was not a subject to a great level of interest. The Dubai debt crisis in 2008–2009 placed a spotlight on the difficulties of a number of high-profile real estate SOEs, prompting a better definition of what is and what is not a state-owned company. Only a few years ago, the term "government-related enterprise" was in common use and creditors of these companies assumed that in providing funding to them, they would benefit from a blanket state guarantee. In the past few years, governments have sought to more clearly define the scope of their ownership. For instance, in October 2012, the government of Abu Dhabi issued new decree requiring state-owned enterprises to apply for explicit sovereign guarantee before issuing debt.

[3] Considering the size of the banking sector in MENA countries and the implications of a potential banking crisis, this sector has historically been the most rigorously regulated, with "fit and proper" requirements for board members, mandated board structures and requirements for review of related party transactions.

There is also a growing interest to review the ownership arrangements for SOEs, considering that historically ownership has been decentralised, resulting in significant variance between standards imposed by different national entities (OECD 2012a). In parallel, concerns in Tunisia and Egypt that privatisations of SOEs were not conducted on an arm's length basis has prompted a re-evaluation of local institutional structures that would facilitate the most transparent and efficient oversight of SOEs. These types of concerns, coupled with pressures on governments to provide employment in the public sector (including through SOEs) have resulted in a significant slowdown in the privatisation drive in the region, with the possible exception of Tunisia and Iraq.

This implies that government ownership in the region is positioned to, at the minimum, stay at its current levels, and potentially even increase in the coming years. Increase in state ownership in the region could be motivated by a number of factors, not least the ongoing establishment of SOEs,[4] the growing orientation of sovereign wealth funds to local capital markets[5] and the fact that governments in the region are continuing to use SOEs key drivers of their industrial and developmental strategies.[6]

Indeed, a number of trends in the region point to a growing appetite for governments to ensure that SOEs are profitable, or if they are loss making, that they fulfill important social objectives.[7] The evidence of this shift in thinking is that in a growing number of jurisdictions, corporate governance guidelines recognise the particularities of SOE governance. A first clear sign of political will to bring state-owned companies to a higher governance standard emanated from Egypt, which introduced a code of corporate governance for SOEs already in 2006. This initiative was followed by similar guidelines in Morocco, followed by Lebanon, Bahrain and most recently the United Arab Emirates. Oversight of SOEs has also been strengthened by endowing state audit institutions with greater powers to conduct pre-audits and operational audits (as opposed to financial audits only).

The Abu Dhabi Accountability Authority, for instance, began in 2012 to provide reporting on its oversight of SOEs and the Moroccan state audit entity (Cour des Comptes) is planning to issue a report specifically dedicated to SOEs this year. This is in fact not a standalone phenomenon as indeed the anti-corruption agenda is gaining importance in SOEs as well. The interest in propriety of SOEs has grown in recent years as part of the general debate facilitated by the Arab Spring on

[4] In Morocco for instance, between 2001 and 2010, 350 additional SOEs were established (Semmar 2012).

[5] Although exact figures are unavailable, recent research and discussions with SWFs highlight that their capital allocations have in recent years been re-oriented towards domestic policy objectives, to some extent at the expense of international investments (Invesco 2012).

[6] Refer for example, to the UAE's federal and emirate-level competitiveness strategies.

[7] For instance, the state-owned cotton and weaving companies in Egypt are highly unprofitable, however they are situated in areas where they are the only source of employment and given the labour intensive nature of the industry, successive governments have been reluctant to restructure or privatise them despite their high cost to the public purse.

governance more generally, and more specifically on how and in whose interest state-owned companies are run.

As a result, the SOE anti-corruption agenda is now being addressed by both state audit bodies (SAIs) and national anti-corruption commissions. While state audit bodies in most countries – with notable exceptions of Morocco and Oman – a few years ago had no particular mandate or powers to oversee the efficiency and propriety in SOE operations, this is starting to change. As a general rule, the state audit bodies in the region have the right to review companies where the state has at least a 25 % stake. The anti-corruption commissions are also being vocal about SOE governance practices. Anti-corruption bodies in some countries such as Tunisia are also playing an important role in uncovering cases of corruption in SOEs and in facilitating prosecutions.[8]

1.4 Listed Companies as Ambassadors of "Corporate MENA"

Keeping with the objective to promote the development of local equity and debt markets, policymakers have in parallel continued their work on improving the governance of listed companies. While the motivations behind improving corporate governance in listed companies may have evolved in recent years along with the methods adopted by regulators, the focus on the listed sector has not waned, in part because governments have few mechanisms to impose governance requirements on privately held firms, and in part because listed companies, despite the recent decline in IPOs, continue to be the public face of the region's corporate world.

Over the past decade, the body of regulation for listed companies in the region has grown remarkably – albeit from a relatively low starting point – with the introduction of new corporate and securities laws, tightening of insider trading rules, the emergence of "comply-or-explain" corporate governance codes and the revision of listing requirements. Unlike their private and state-owned peers, listed firms are held to a higher and clear regulatory standard which makes an assessment of their ability to contribute to future development of MENA economies more objective.

Taken as a whole, over 1,400 companies are listed today on regional stock exchanges and already, a number of Gulf-based enterprises such as SABIC and Qatar National Bank feature in Financial Times' Global 500 list, highlighting that some regional champions are emerging on a global scale (Financial Times 2012). Indeed, the popularity of brands such as Emirates Airlines (a large non listed SOE) – are no longer confined to the perimeter of the region. Adding the non-listed hydrocarbon companies to those already part of the FT's list, the presence of the region in the global corporate space is not negligible.

[8] Refer, for instance, to the annual report of the Tunisian Anti-Corruption Commission (2011).

It is perfectly plausible to suggest that regional capital markets are positioned to grow in the next few years. While banks have historically been the primary source of capital for companies in the region, the role of capital markets is positioned to increase as high-growth enterprises find equity financing more attractive than debt. Corporate interest in capital markets might be also encouraged by the decline in the private equity industry in the region, from an estimated $6 billion USD in 2007 to $700 million in 2011 (MENA PE Association 2012). In addition, there is a growing concern that the banking sector may not be in position to satisfy the credit requirements of high growth, entrepreneurial enterprises.

Stock exchanges in the region have reacted to this observation by establishing special listing tiers or regimes for SMEs (Egypt, Dubai, Qatar), lowering free float requirements to address concerns of controlling shareholders, and providing other incentives for listing. So far, the impact of these initiatives has been limited, which is not inconsistent with the success of SME listing tiers globally. In addition, a number of stock exchanges (e.g. NASDAQ Dubai and Bahrain) have recently reviewed their listing requirements. These reviews are guided by exchanges' growing interest to attract small and medium, and family-owned companies through differentiated listing tiers.

Almost every major city in the region, from Dubai, to Amman to Casablanca is trying to establish itself as a financial center. Some markets such as the Casablanca Stock Exchange and the Saudi Tadawul are seeking to attract listings from abroad in order to establish themselves as centers of finance. In the case of the Casablanca Stock Exchange, its future growth model is predicated in a large part on being able to attract listings from other African countries with less developed market infrastructure.

From OECD's work with heads of MENA stock exchanges, it is clear that a number of the region's stock markets are looking for ways to re-invent and re-position themselves through internal governance changes. A number of stock exchanges such as the Kuwait Stock Exchange are looking to follow the path set out by most of the world's largest exchanges, in converting to private companies. Other markets such as the Casablanca Stock Exchange are demutualising in order to broaden its shareholding structure and add dynamism to the market. Boursa Istanbul has recently undergone significant structural changes that saw it established as a state-owned company as opposed to a governmental entity.

1.5 Yet Bourses Lack Dynamism

And yet, all these seemingly positive trends do not for the moment add up to vibrant MENA capital markets, temporarily putting on hold the hope that they might act as an effective mechanism of wealth redistribution in the region. A number of stock markets with potential to attract investment such as Lebanon principally act as a listing venue for government and bank bonds as opposed to a real alternative to corporate financing. Exchanges in countries such as Algeria and Syria are only at their very early stages of development, while certain larger, more liquid markets in the Gulf are restricted for non-GCC investors. Traditionally active markets such as Egypt have suffered from ongoing political instability. New listings are scarce and the turnover of these markets remains low.[9]

Given the family controlled nature of MENA companies, exchanges have faced enormous challenges convincing company owners to look beyond the regulatory requirements to better understand the value of listing to the growth prospects of their companies. Ownership structures are not the only obstacle to listing. The current regional geopolitical challenges, coupled with the global financial crisis, have created a difficult climate for MENA companies and stock markets. In 2012, 12 IPOs were conducted in the region, the vast majority of them in Saudi Arabia (MEED 2013). Although this is an improvement on the 2011 performance which has seen even fewer equity offerings, this lack of activity on the regions' stock exchanges is certainly a cause of concern.[10]

An arguably more alarming trend is that large MENA corporates are shying away from local markets and seeking their primary listings outside the region, primarily on the London Stock Exchange. While the issuance of depository receipts on the London Stock Exchange (LSE) was not uncommon for MENA companies seeking to tap into larger, more liquid pools of institutional capital, the primary listing of shares of Dubai Ports in 2011 on the LSE demonstrates the appetite for large MENA companies to list abroad. Clearly, at least some companies in the region are willing to accept higher governance requirements such as those imposed by the UK Combined Code in order to tap into the liquidity offered by the London Stock Exchange.[11]

Interestingly, this goes against the general trend in today's capital markets whereby companies domiciled in emerging markets raise capital domestically (OECD 2013). A significant part of the answer as to why local companies are listing on foreign stock exchanges is linked to low levels of liquidity in local markets and ineffective price discovery. A recent study demonstrated that indicators of price synchronicity are high by international comparison (World Bank 2011). The quality of price discovery is low especially in companies outside the main benchmark index. Only 12 % of MENA listed companies are currently followed by analysts (Elalfy 2013) and the level of trading in firms not followed is very low.[12]

[9] Overall, the turnover ratio of Arab stock markets stood at 64 % regionally or 17 % excluding Saudi Arabia in 2012 (Elalfy 2013).

[10] With the exception of the Tunis Stock Exchange, which has received a number of listing applications in 2012–2013, relative to the size of the exchange and the activity in neighbouring markets.

[11] Indeed, a recent study demonstrates that there was a reduction in the liquidity (measured by turnover) in MENA markets in the post crisis period and attributed it to poor corporate governance (Farooq et al. 2013).

[12] Some exchanges such as the Egyptian Stock Exchange have de-listed many illiquid firms which were initially lured to list by the fiscal incentives offered to listed firms.

And yet, unlike MENA companies, local investors have generally stayed loyal to local markets. Observing the fluctuations of most markets affected by recent political instability, it appears that beyond short periods of high volatility, capital flight from the stock exchanges in Egypt, Tunisia and other countries has not occurred on a major scale. A key explanation for this phenomenon is that MENA exchanges are characterised almost entirely by controlled companies, whose owners "understand" local circumstances, are less prone to panic and also have much at stake. Seen from this perspective, the relatively low level of foreign investment in the region can be argued to have been beneficial from the perspective of long-term stability of these markets.

1.6 Ownership Characteristics of MENA Markets

The controlled nature of MENA companies is by no means exceptional. Indeed, in markets all over the world (with the notable exception of the US, the UK and Australia) controlling ownership is prevalent and indeed is often said to mitigate key agent-principal problems. While the principal-agency problems are clearly different in controlled companies, a plethora of legal instruments such as the possibility for minority shareholders to approve related party transactions or to elect a director representing them have been developed.

Controlled ownership, somewhat contrary to some Anglo-Saxon corporate governance literature, does not necessarily give rise to governance failures.[13] The controlled nature of MENA companies has generally also meant that short-termist behaviors are less frequent than in jurisdictions with dispersed ownership. While the legal provisions designed to protect minority shareholder rights are perhaps not as developed as in Canada or Sweden where controlled ownership is also the norm, they arguably commensurate with the sophistication of local markets.

Taking away controlled stakes, the free float of MENA listed companies tends to be low, especially when the entire market – beyond a handful of most liquid companies – is considered. This free float tends to be dominated by retail investors: in Saudi Arabia for example, retail investors are estimated to account for approximately 90 % of market turnover, whereas in other markets such as Qatar or Egypt this figure stands at 60–80 % (World Bank 2011). This market structure obviously raises the question of whether MENA listed companies have adequate incentives to adopt good governance practices. In other words, what kind of corporate governance arrangements should they be adopting and in whose interest?

Although concentrated ownership and group structures are extremely common in the region, the possibility of minority shareholder abuse is limited by the fact that

[13] Refer to Hofstetter 2005 for a detailed explanation of benefits of controlled ownership structures.

one-share one-vote rule is the commonly accepted system in the region.[14] Furthermore, shareholder rights are protected via legal provisions enabling minority shareholders to table resolutions at annual shareholder meetings and vote on board appointments individually (not as a slate). More recently, a number of countries have reviewed their legal rules to enable shareholders to participate in company decisions virtually through electronic voting. Only last year, Saudi Arabia and Turkey moved to require all listed companies to enable electronic voting.

Despite these mechanisms, real shareholder engagement remains low, both due to regulatory barriers and to passive investor behavior. Shareholders in the region are not known to "vote with their feet" or to take on large blockholders by launching proxy fights. Only one shareholder-sponsored proposal was put forth in the region in 3 years ending 2012 despite the fact that the rate of negative recommendations by proxy advisors is not particularly low.[15] Inefficiencies in the judicial process effectively also present a barrier to proxy fights and other types of legal action by shareholders, an issue to which a number of regulators such as the Dubai Financial Services Authority (DFSA) and the Qatar Financial Center Regulatory Authority (QFCRA) have reacted to by establishing separate commercial courts.[16]

1.7 Obstacles to Effective Shareholder/Stakeholder Engagement

The absence of the relevant precedents, the lack of a litigation culture, and the lack of institutions such as shareholder associations all act as barriers' to effective exercise of shareholder rights. While shareholders are generally placid, conflicts between large shareholders are beginning to be treated in courts. In Kuwait for instance, the court of cassation has recently settled a long running board dispute in Kuwait's national telecom company, Zain. The court ruled against a member of the ruling family in the case of a board re-shuffle, effectively ending a long-standing dispute that prevented the company from making strategic acquisitions or divestments.[17]

These types of cases remain rare in the region, despite major revisions of legal frameworks regulating the composition of company boards, whereby a number of

[14] In several jurisdictions such as Egypt, Morocco and Tunisia multiple share classes exist, as do non-voting shares.

[15] For instance, according to the Institutional Shareholder Services, their rate of negative recommendations reached 19.8 % in Morocco and 22.2 % in Tunisia in 2012 (ISS 2012).

[16] Interestingly, in 2011, the jurisdiction of DIFC courts was expanded to cover commercial cases arising from disputes between companies not registered in DIFC provided they both agree to this in advance.

[17] In April 2012, the board member in question was voted off the board and was replaced by a Chairman of the Kharafi Group. Upon the request of the said board member, the board was dissolved by the lower court but on appeal, the court ruled that the discrimination lawsuit filed by the member of the royal family alleging an unfair board selection process was unfounded.

MENA jurisdictions have moved to require a percentage of the board to be composed of independent or at least non-executive directors.[18] Evidence from the region continues to point to the fact that practically, independent board members are not able to fulfill their duties due to the presence of powerful executive chairmen or instructions from controlling shareholders. Identifying and nominating independent board members in small jurisdictions such as Oman remains a challenge even conceptually, considering the tribal and social links in corporate circles. To address this issue, better definition of fiduciary and loyalty duties will be necessary in most jurisdictions.

Addressing the representation of key groups other than minority shareholders in the board is subject to an ongoing debate. Employees are generally not represented on boards of regional companies unlike for instance in Germany, and this has been a source of grievance in some countries. In Egypt, for example, employees of state-owned companies can elect some board members and the union representative has the right to attend board meetings. In Algerian companies, employees can sometimes participate in board deliberations and in Morocco, they are consulted on material matters affecting the company. These are, however, relatively isolated examples and given that unions are not permitted in all MENA countries, other mechanisms for fostering the participation of employees and stakeholders in company governance processes might be useful.

1.8 Tougher Enforcement Coming to Town

Improvements in company governance practices in the region can be seen as a by-product of increasingly rigorous corporate and securities laws and regulations, but also the result of a growing threat of enforcement by securities regulators. So far, the region has seen very few large enforcement cases, beyond relatively small penalties given by securities watchdogs or stock exchanges, usually as a result of late or inadequate disclosure. Exceptions to this rule include Egypt and to some extent also Kuwait, where a large number of companies were de-listed over the past few years for failure to disclose the required information (OECD 2012b).

A few high profile enforcement cases in the Gulf have recently raised public interest in securities market regulation. In Saudi Arabia, the legal battle of Algosaibi Group against the Saad Group has been ongoing for a number of years with lawsuits in Saudi Arabia, the United Kingdom, Cayman Islands, Bahrain, and the United States.[19] In the United Arab Emirates, the Damas case was perhaps the

[18] In Saudi Arabia for instance, a third of the board is required to be independent.

[19] It is alleged that Mr Al Sanea of the Saad Group has arranged unauthorised borrowing, provided by over 100 banks and amounting to over $9 billion USD, in the name of the Algosaibi Group. The outcome of the case remains unclear and the regulator has not officially issued any penalties, pending investigation of a committee constituted by the King of Saudi Arabia to look into this matter.

single most prolific enforcement example, where the regulator ordered the controlling shareholders of the famous jewelry and watch retailer to repay the sums embezzled from the company. While the $700,000 USD penalty imposed on the brothers in March 2010 was a first tough stance taken by the Dubai Financial Services Authority, it is relatively “soft” by international standards, especially considering that the application of most of this penalty was actually suspended.[20]

Such cases demonstrate that at least some regulators and stock exchanges in the region are “growing teeth”. The Saudi Capital Market Authority is perhaps the most rigorous in the region in publishing its enforcement actions, which in 2011 exceeded 300 cases against listed companies, most of them related to corporate governance breaches, particularly the failure to disclose market-sensitive information. The Egyptian and Tunisian security regulators have also issued many penalties in recent years and the level of public scrutiny has grown.

A key question is whether this “regulatory compliance” approach to corporate governance is effectively sufficient to achieve the sought after corporate governance outcomes. With regulatory forbearance being the only threat, and in the absence of other real incentives, what can we realistically expect of companies? Often, the answer in the region, and indeed elsewhere, has been for companies to tick the boxes that the regulator has requested. With this approach, “governance on paper” has arrived, but “governance in spirit” is still missing in many, if not most firms of the region.

1.9 The Corporate Governance Equilibrium

The question of incentives for corporations to adopt better governance practices requires us to revisit the equilibrium theory. Transposing the concept of equilibrium to the corporate governance debate begs the question of incentives for better corporate governance. Theoretically, incentives that companies face to raise the standards of their governance can be generally categorized as supply-side incentives arising from regulatory requirements, and demand-side incentives arising from investor expectations. In the MENA region, the significant governance advances accomplished in the past 5 years have been driven almost exclusively by regulatory action.

The initially voluntary governance standards recommended were in a number of cases converted to comply-or-explain codes and some requirements were made mandatory with time. Egypt and Saudi Arabia are both examples of gradual regulatory tightening, resulting in growing awareness and sophistication of governance arrangements, especially among listed companies. The listing requirements in Egypt were tightened in recent years by virtue of the integration of key provisions

[20] On the other hand, the governance breaches that this penalty intended to address were severe. The Abdullah brothers used the accounts and goods of this company as their personal assets, despite the fact that the holding company under which it operated was listed.

of the corporate governance code in them. In Saudi Arabia, the Capital Market Authority has been revising corporate governance standards through regular circulars aiming to address issues of priority, in addition to those already covered by the code.

While the quality of regulation and supervision has had a visible impact on the quality of governance practices of firms, the investment and asset management community has not been a party to the corporate governance debate in the region. A number of explanations can be advanced to explain this phenomenon. First, the weight of investment funds in the region's capital markets is incomparable to their presence in European or North American markets. In the United States, institutional investors are estimated to hold over half of the total value of US public equities and 73 % of the equity of the 1,000 largest US corporations (Conference Board 2010). For the moment, MENA countries host less than 900 privately managed funds with approximately $67 billion USD of assets under management (World Bank 2010).

The development of insurance, pension and mutual funds in the region is expected to raise their weight in the capital markets, especially if regulations limiting their exposure to capital markets are revised. Likewise, foreign institutional investors typically do not allocate much of their portfolios to the region and hence have a limited impact on creating a corporate governance culture in the region. Going forward, domestic and foreign institutional investors are positioned to increase their participation in local stock markets and consequently, affect the governance debate.

1.10 Attracting Institutional Capital to the Region

With an increasing proportion of their assets allocated to emerging markets, MENA capital markets stand much to gain by positioning themselves competitively. If we consider only OECD-based institutional investors, with an estimated $65 trillion USD under management, they clearly could be important players in the region in the long term. Discussions with large institutional investors and asset managers demonstrate however, that the region does not receive the allocations that would be in line with its economic contribution to global GDP. This is attributable to the fact that MENA listed companies provide limited disclosure and most of them are not covered by analysts.

Given this limited understanding of MENA companies, large foreign investors tend to invest in the region through index products. Only Morocco and Egypt have been included in the emerging markets category by MSCI and other index providers, while other markets in the region are categorised as frontier markets and hence receive an even smaller portion of international investment portfolios that increasingly follow index-tracking strategies. Qatar and the UAE have been seeking an upgrade to the emerging markets category and the MSCI granted this request in

2013, however it is not clear whether the upgrade will have a significant effect on foreign capital inflows.[21]

As a mechanism to attract index investors, a number of markets in the region such as Abu Dhabi have launched exchange-traded funds (ETFs) to provide investors products which mirror the composition of local markets. The launch of ESG indices is another example of measures introduced to lure institutional investors to the region. The proliferation of indices that aggregate governance with other variables in order to select “best” performing companies has arguably not achieved its objectives and index providers no longer draw a positive relation between company performance and index selection criteria. It is questionable whether these products and strategies will bring greater institutional capital to the region.[22]

Until sufficient incentives are found to draw additional institutional capital to the region, retail investors will remain dominant shareholders in the region. McKinsey estimates that MENA households hold $2.7 trillion USD of assets, of which only 14 % are invested in fixed income and 18 % in equities (McKinsey 2011). While these figures illustrate the potential growth and influence of retail investors in MENA markets, they also highlight that unless savings of MENA households are channeled to capital markets through institutional funds, the levels of investor engagement might not increase given that retail investors (unless they possess sizeable stakes) can rarely influence governance processes in companies.

While small private investors can technically lodge complaints with regulatory bodies, regulators in the region are generally not empowered to launch derivative suits on behalf of investors or to support class actions.[23] Minority shareholders can also complain directly to companies which increasingly have investor relations departments and expertise to deal with the general public. However, and as elsewhere in the world, the real power of small retail investors to improve governance is insufficient in controlled companies. Indeed, their behavior might not be so dissimilar to banks engaging in “name lending” in that they might be tempted to “bet” on the success of the controlling shareholder based on family reputation or proximity to the elites. This strategy has proven financially lucrative in other markets

[21] A study conducted by the DIFC in 2012 shows that a change in market classification of the UAE and Qatar would not have much impact on capital flows to these markets (DIFC 2012). Other studies estimate that if Qatar and the UAE are upgraded, they can be expected to receive combined inflows of up to $5.4 billion out of the $380 billion USD invested in emerging markets funds (Healey 2011).

[22] Instead, academic studies suggest that institutional quality, investment restrictions and the level of bilateral trade are important variables to address in order to increase foreign portfolio investment (Abid and Bahloul 2011).

[23] That said, they have a number of alternative mechanisms for addressing shareholder rights infringements. For instance, the new Kuwait Companies Law issued in January 2013 allows the Ministry of Commerce and Industry, responsible for overseeing compliance with the Law, to appoint an external auditor or convene AGMs to repair any perceived weaknesses.

where political connections are shown to contribute to as much as 20 % of firm valuations.[24]

In summary, it is unclear whether MENA investors have either the incentive or the opportunity to engage with investee companies. Little information is available on investor behavior in the MENA region. This is unsurprising because unlike their counterparts in other countries, institutional investors in the region do not have a duty to disclose the nature of their voting policy or their voting results. It is plausible that large MENA investors, sovereign or private, do take into consideration governance characteristics of firms that they invest in. This would particularly be the case for private investors in state-owned firms, who would want to ensure adequate board representation and ability to affect key corporate decisions.

1.11 The Role of Large Investors

In the absence of developed mutual, pension and insurance fund industry, sovereign and private funds have a leadership role to play. Sovereign funds in the region already have large exposures to local capital markets and were estimated to have stakes in over 130 listed companies in GCC (Markaz 2008). This estimate can be revised upwards given the SWFs' domestic investment orientation in recent years (Invesco 2012). Private players such as the Saudi Kingdom Holding (with estimated $25 billion USD of assets under management) can also have enormous potential impact on the operation of MENA markets. Family offices is another category of investors with significant potential and a number of them already screen their investments according to governance criteria (e.g. SEDCO in Saudi Arabia).

These domestic investors, coupled with foreign institutional investors, collectively hold the power necessary to make MENA markets more attractive for themselves and for others. Although foreign investors currently hold small stakes in MENA companies, it is plausible to suggest that they can be convinced to increase the level of their investments, especially if greater disclosure was available beyond a handful of large listed companies in each of the markets. The development of electronic disclosure platforms such as the Tadawulaty platform in Saudi Arabia or the Public Disclosure Platform in Turkey will increase the availability and ease of access to key corporate information. At the same time, the introduction of Extensive Business Reporting Language (XBRL)[25] in United Arab Emirates and Saudi Arabia is also expected to facilitate analyst coverage of MENA companies.

[24] Refer, for example, to Fisman (2001) who demonstrates using the announcements concerning Suharto's health that in the period studied, over 20 % of the value of Indonesian firms was derived from political connections.

[25] XBRL allows the tagging of financial data and information reported by companies in order to allow comparisons between companies by analysts and potential investors. For additional information on the benefits of XBRL, please refer to: http://www.xbrl.org.

Fundamentally, these measures can only be as successful as the quality of the underlying corporate disclosure. While it has been improving, with the IFRS now being a common standard for listed companies (or banks and financial institutions at the minimum), some gaps remain particularly in the area of disclosure of related party transactions and beneficial ownership. For example, BATELCO, the national Bahraini telecom company, does not disclose its beneficial shareholders, indicating that 20 % of its equity is held by an owner in Cayman Islands. Obtaining information on beneficial owners of MENA companies remains a challenge and further policy measures are required to address this gap, beyond the existing standards requiring ownership disclosure for stakes exceeding 5 %.

These types of challenges need to be treated in dialogue between the investment management community on the one hand, and securities regulators and stock exchanges on the other. A precondition to the effectiveness of this dialogue is a robust discussion among large investors in the region and with their global counterparts. So far, a fundamental challenge to effective investor activism in the region is that it has no platform and therefore no coherent voice. And yet, experiences from investor collaboration experiments demonstrate clear benefits in terms of sharing costs of monitoring.

Investors in the region, whether local or foreign, could explore and leverage successful models of institutional investor coordination existing in the Netherlands (Eumedion), Australia (ACSI) or Switzerland (Ethos) to spread monitoring and engagement costs and to amplify their voice.[26] Likewise, launching investor associations might be effective in boosting levels of shareholder engagement. For the moment, no country in the region has a functioning shareholder association.

Another measure that could be complementary to such investor engagement is to require large institutional investors to disclose their voting record, or at least their voting policy, so as to ensure that they are indeed acting in the best interest of their ultimate beneficiaries. This is currently not required in the region whereas it is a common obligation in other countries. For example, in Chile, the sectoral regulator (i.e. the Pension Superintendence) can request information related to funds' position on issues such as board elections. In the United States, the Securities and Exchange Commission requires mutual funds adopt written policies on proxy voting.

Naturally, introducing such reporting requirements implies that institutional investors and their asset managers must have the capacity to monitor the governance of their investee companies. Further work on introducing such competencies in investment funds and their asset managers would be required. That said, placing further reporting requirements on institutional investors in MENA markets might be useful to understanding their position in the market and their role as change

[26] The risk of potential free riding is addressed by virtue of the structure of these organisations which help to keep the cost of engagement down while maximizing shareholder voice. It would still make sense for some large investors to do the necessary due diligence on some of their investee companies as it would give them a source of competitive advantage.

agents. Such requirements would enable a better understanding of investor experiences and would be useful in the context of a broader global debate on the role of large institutional investors in corporate governance.

A number of recent research studies point to the fact that institutional investors in developed markets such as UK and US have failed to live up to expectations of acting as stewards of assets they were entrusted with and that the incentives they have favour increasing size under management and asset churning as opposed as careful selection of companies based on their performance and risk profile (Gilson and Gordon 2013). Although these issues are not yet relevant in the MENA region, they are important to consider as the institutional investor industry develops in the region.

Requirements on local institutional investors to disclose their voting policy and their voting record in shareholder meetings will be increasingly beneficial when they become sufficiently large to make an impact in the market. In the interim, pilot projects aimed at introducing such disclosure requirements in government pension funds may demonstrate the potential impact of this measure. This piecemeal approach may be more realistic and hence preferential to initiatives that would seek to subscribe local funds – private or sovereign – to a set of single stewardship requirements such as the UK Stewardship Code. In particular, requiring large domestic institutional investors such as SWFs to disclose their voting policy would not be palatable.

While putting excessive hope in the hands of institutional investors may not be realistic in light of their recent behavior during the financial crisis (OECD 2012, 2013; Heineman and Davies 2011), it would be difficult to stimulate companies' interest to adopt better corporate governance practices exclusively via regulatory pressure. Market expectations need to play a role. If shares of badly governed companies were actually trading at a discount, and if large investors voted with their feet when they detected governance abuses, the "corporate governance equilibrium" in the region might become more balanced. A key question therefore is how can large private and sovereign investors be persuaded that considering governance in investment decisions is profitable.

1.12 Concluding Thoughts

The suggestions advanced in this paper are intended to address the demand-side of the corporate governance equilibrium. This equilibrium is important for a number of reasons. First, regulatory forbearance can only be as effective as the quality of enforcement and it might result in changes in governance form as opposed to culture. Companies might move to introduce audit committees and even populate them with independent directors but if all board members know that the Chairman makes the final decisions, the sought change in the governance behavior would not be achieved.

Engaging investors is necessary to target corporate behaviour as opposed to governance formalities. Today, it is unheard of for a general shareholder assembly of a MENA company to vote against a remuneration policy or to reject a board candidate. It is equally rare for investors to initiate proxy fights. As the complacency before the outbreak of the global financial crisis has aptly demonstrated, this is not necessarily an indication of the house being in order but more likely a sign that nobody is home to do anything about it. Greater shareholder activism and collaboration is necessary to address this vacuum and it is in the interest of existing local and foreign investors in MENA markets.

Regulators will have their side of the bargain to uphold by ensuring that at the minimum, companies do provide adequate level and quality of disclosure. Instances where large listed companies release their annual reports after the institutional investors' deadline need to be avoided. At the same time, regulators might wish to carefully consider the role of new products such as exchange traded funds and ESG indices that might look attractive but in the end might detract the focus away from corporate governance fundamentals at the company level. After all, it is important to recognise that investors may judge the overall market to be as strong as its weakest link.

But the buck cannot stop with the securities watchdogs, central banks and stock exchanges. They have already started to fulfill their side of the bargain. The ball is now in the court of large investors – sovereign wealth funds, family management offices, pension and insurance funds and their asset managers – to create a demand for better governed, transparent companies. This is a task hefty enough that its costs are prohibitive individually but profitable when undertaken collectively. When investor collaboration and engagement begins, other smaller investors might be tempted to “jump on the bandwagon” and shareholder spring might just blossom in the MENA region.

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