Institute of International Finance, Inc.

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HAWKAMAH
THE INSTITUTE FOR CORPORATE GOVERNANCE

IIF Equity Advisory Group

Comparative Survey of Corporate Governance in the Gulf Cooperation Council

– An Investor Perspective

Task Force Report
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Corporate Governance in Gulf Cooperation Council Countries—An Investor Perspective

PREFACE

In view of the importance of portfolio equity flows to emerging markets, the Institute of International Finance (IIF) established in January 2001 the IIF Equity Advisory Group (EAG), consisting of senior executives from leading asset management firms throughout the world. The EAG, chaired by Edward Baker, Chief Investment Officer of Global Emerging Markets, AllianceBernstein L.P., is seeking implementation of its Code of Corporate Governance (the "IIF Code") in key emerging market countries that are of particular interest to the Institute's membership base. The IIF Code, which was first released in February 2002 and revised in May 2003,[1] endeavors to improve the investment climate in emerging markets by establishing practical guidelines for the treatment of minority shareholders, the structure and responsibilities of the board of directors, and the transparency of ownership and control of companies.

The strategy for promoting the implementation of the IIF Code, as the standard by which the company/ shareholder relationship is measured, is country and regional focused. Country Task Forces have been set up for Brazil, China, India, Lebanon, Mexico, Poland, Russia, South Africa, South Korea, and Turkey. Reports on all these countries have been published, including second reports on several countries.

In June 2006, the IIF entered into a partnership with Hawkamah, the Institute for Corporate Governance,[2] to jointly conduct a two phase corporate governance survey of countries in the MENA region. Phase 1 of the survey covers countries in the Gulf Cooperation Council (GCC) – Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates (UAE). The motivation for such a survey was prompted by the extraordinary growth in GCC equity markets over the past few years, growing international interest in the region and the importance of helping officials in the GCC identify areas of weakness and potential improvements in current corporate governance frameworks. In phase 2, the survey will be extended to other countries of the MENA region.

In July 2006, the GCC Task Force held meetings in Abu Dhabi, Manama, Doha, Dubai, Kuwait, Muscat and Riyadh to assess the corporate governance practices in GCC countries. Meetings were held with senior officials from the capital market authorities, central banks and stock exchanges, local fund managers, lawyers, experts, accountants and management consultants involved in corporate governance in GCC countries. Keith Savard, Director Global Economic Analysis, IIF and Dr. Nasser Saidi, Executive Director, Hawkamah, co-chaired the GCC Task Force. Other Task Force members include Nicolai Nadal and Rashid Bin Shabib of the Hawkamah staff and Rakhi Kumar of the IIF staff.

[1] Investors' poor experience in a generally weak corporate governance environment in many emerging markets led to relatively strict and comprehensive original IIF guidelines. Nevertheless, more detailed standards were considered desirable in a few areas in light of far-reaching new legislation such as the Sarbanes-Oxley Act passed by the U.S. Congress in the summer of 2002. The revised standards offer guidance to emerging market officials as they decide what rules and regulations must be put in place to satisfy investors.

[2] The Hawkamah Institute for Corporate Governance is an autonomous, international association, hosted by the Dubai International Financial Center (DIFC), and serving the MENA and Central Asia countries. Hawkamah was launched in partnership with the Organisation for Economic Cooperation and Development (OECD), the International Finance Corporation (IFC), the Dubai International Financial Centre (DIFC), the World Bank Global Corporate Governance Forum, the Center of International Private Enterprise (CIPE), the Union of Arab Banks (UAB), Young Arab Leaders (YAL) and the countries participating in the OECD-MENA Investment Programme. Its mission is to assist the countries and companies of the region to develop sound and globally well-integrated corporate governance frameworks. It provides technical assistance and cooperates with decision makers to coordinate and sequence the designing, planning and implementation of corporate governance reforms and monitoring the outcome of corporate governance policies at the private sector level. See www.Hawkamah.org

The aim of this report is to offer an assessment as to where countries in the GCC stand relative to the investment environment that members of the IIF Equity Advisory Group would like to see develop in key emerging market countries. Since this is a first-time survey of corporate governance frameworks in the region, the report does not treat all relevant corporate governance matters in depth. Instead, it focuses on the important initial steps that need to be taken to improve the investment environment in GCC countries. We will review at a future date the corporate governance regimes in more detail to assess progress. This report focuses on corporate governance standards and practices only in GCC countries and not those in dedicated free zones like the DIFC, which operates to international best practices. It is not meant to provide an exhaustive survey of corporate governance in the GCC and, as with other Task Force Reports, neither the Task Force nor the IIF or Hawkamah can in any way attest to or guarantee the accuracy or completeness of the information in the report despite the best effort that has been made. To the extent guidance is given, or advice is inferred, the reader is urged to fully apprise him/herself of the relevance of such content to current or contemplated operations.

TENETS OF THE IIF CODE AND BASIC DIFFERENCE WITH THE OECD PRINCIPLES OF CORPORATE GOVERNANCE

Through its Equity Advisory Group (EAG), the IIF published a code of corporate governance in February 2002 which was revised in May 2003. IIF's analysis of a country's corporate governance framework focuses on five broad areas – (i) minority shareholder rights, (ii) structure and responsibilities of the Board of Directors, (iii) accounting and auditing, (iv) transparency of ownership and control, and (v) the regulatory environment. A detailed explanation of these areas can be found in the "Comparative Analysis of Corporate Governance Frameworks in the GCC" section. These key ideas appear in the OECD Principles of Corporate Governance and the OECD Corporate Governance Guidelines that accompany it. However, the IIF Code has constructed a more detailed set of guiding principles in order to enhance their practical usefulness.

For example, with regards to minority shareholder rights, the IIF Code clearly endorses the one-share one-vote principle and proxy voting. In addition, the IIF Code supports cumulative voting for director elections. However, while the OECD Principles emphasize the importance of giving equal voting rights to all shareholders and allowing votes to be cast by nominees when agreed upon with the share owner, cumulative voting is not addressed. Furthermore, the IIF Code clearly defines independent directors and requires that at least one-third of the board be independent. The OECD Principles require that board members disclose whether they are regarded as independent by the company, but do not specifically identify how many members should be independent, nor what characteristics classify them as independent.

The IIF Code also requires that conflicts of interest for board members and key executives be disclosed publicly and that the head of the audit committee never have a conflict of interest. The OECD Principles agree that this information must be disclosed, however, they limit the scope of disclosure to the board of directors. Because it views accurate accounting and auditing as the core of transparency and good corporate governance, the IIF Code requires that semi-annual reports be filed in addition to the annual audited financial report. The OECD Principles, in contrast, only require an annual audited financial report.

Both the IIF Code and the OECD Principles encourage the implementation of good corporate governance practices, however; the IIF Code was created to promote specific actions and criteria, which, if followed, will help promote the health and stability of emerging market economies.

OVERVIEW

In general, the economic and business environments within the Gulf Cooperation Council (GCC) countries have not been conducive to the development of effective corporate governance practices. With the exception of Oman and to a lesser extent Kuwait and Saudi Arabia, the current corporate governance frameworks of GCC countries do not meet the threshold sought by international investors. Although an awareness by authorities as to the importance of having a good corporate governance environment has spread throughout the GCC region in recent years, accompanying actions to bring about improvements have been somewhat slow in coming. The recent growth of equity markets in the region followed by a sharp correction of equity prices this year as well as GCC participation in the globalization process could well turn out to be real catalysts for change. However, strong leadership and strict enforcement will be required by authorities in the region if corporate governance is to meet international standards.

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Sharp corrections in most GCC stock markets earlier this year have created an environment suitable for implementing changes to current corporate governance frameworks (Chart 1 and 2). Some authorities took steps to encourage widespread public participation in IPOs, and the public's enthusiastic responses led to a huge run-up in stock prices. Therefore, when prices started falling, governments came under pressure to intervene in the market. Various measures were in fact taken to support the markets, including stock splits, new rules facilitating share buybacks and, in the case of Saudi Arabia, allowing expatriates to invest in the market. Many of these measures are of recent origin and it will take some time to assess their full impact. In the meantime, while acknowledging that the recent stock market correction was not directly related to poor standards of corporate governance, regulators with the firm backing of political authorities are using this opportunity to "upgrade" the corporate governance framework in their countries by adopting best practices that are now considered standard in many emerging markets. In general, governments have stayed out of direct intervention in equity markets, although state investment funds have stepped in when they have identified buying opportunities.

Chart 1: Weekly Indices of GCC Stock Markets
(US$ returns, Jan. 2003 = 100)

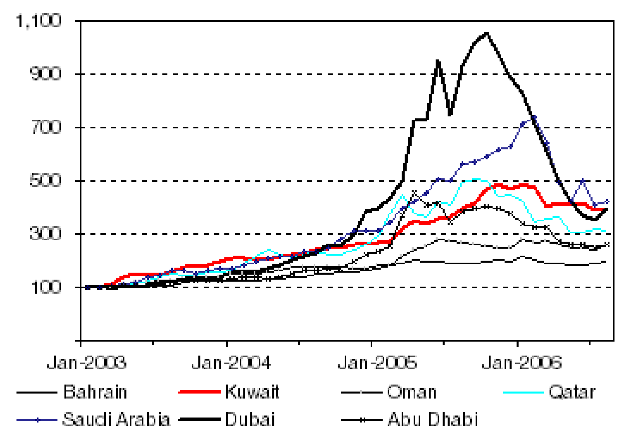
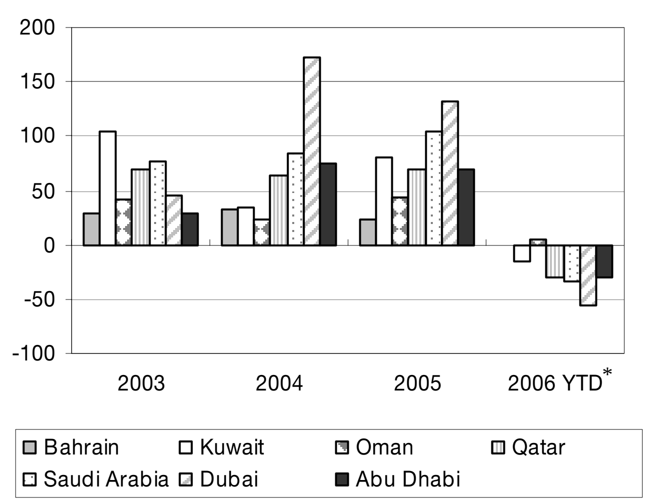


Chart 2: Percentage Change in GCC Stock Market Indices
(US$ returns, in percent)



*2006 YTD is through end-August.

Nevertheless, if regulators are to reduce the risk of future stock market bubbles, more needs to be done by way of investor education, including programs to enhance the awareness of the importance of corporate governance. Small investors in the region can benefit from focused awareness-raising campaigns and training sessions on diverse issues related to investments. For example, regulators in Oman and the UAE are already taking steps to educate investors about the dangers of acting on the basis of rumors and suspect financial information. Mechanisms for addressing investor grievances should be introduced and strengthened. Authorities will also need to take measures to rebuild investor confidence, by requiring higher financial reporting standards and strengthening rules on disclosure and transparency. However, many small- and medium-sized companies in the GCC do not invest in formal management information systems, making it difficult for them to produce accurate financial reports. Most GCC governments, with the exception of Oman and Qatar, do not tax corporate incomes (Bahrain only taxes incomes of oil and gas companies, while the UAE taxes the profits of foreign banks), compounding the weakness in financial reporting.

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Globalization has been another catalyst for change in the region's attitude toward corporate governance. As GCC companies integrate into the global economy, through acquisitions, mergers and/or trade, exposure to international business practices is bringing about change. For example, some GCC companies such as Jumeirah and Majid Al Futtaim Groups in the UAE have voluntarily improved their corporate governance frameworks as they look to expand their businesses beyond the Middle East region. However, weaknesses in company law in several countries in the GCC need to be addressed if GCC companies are to become global players. For example, UAE's company's law does not recognize or promote holding company structures. This results in group companies having complicated cross-holding ownership structures that are opaque to investors. Moreover, majority shareholders can exploit cross-holding structures and enter into self-dealing and related-party transactions between individual companies. Nevertheless, several conglomerates in the UAE have adopted a holding company-like structure, by adopting practices such as preparing financial accounts on a consolidated basis.

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In general, with the exception of Kuwait and Oman, there is a lack of equity culture in the region. Since GCC economies are dominated by state-owned enterprises, the state plays a large role in influencing business operations and governance culture and has only recently begun investing in good corporate governance practices. Equity markets in the GCC have, to a large extent, been closed to foreign investors. With the exception of Bahrain, Oman and the UAE, foreign investors can buy stock in GCC companies only through mutual funds. By limiting foreign investors' access to equity markets, regulators in GCC countries have not benefited from the analytical knowledge and "push" for better corporate governance that is generally sought by such investors.

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Abundant liquidity in the region, due primarily to high oil prices, has also had an adverse impact on the equity culture. Companies' easy access to capital obviates the need to raise funds through public offerings in the equity market where listing requirements call for greater disclosure, transparency and increased regulation. Abundant liquidity has also made it difficult for regulators to enforce even basic corporate governance requirements for listed companies as sought by international investors. Moreover, there is little incentive for well-managed family companies to dilute ownership by issuing shares in equity markets. This has slowed development of equity markets in the region as listed companies generally have poor corporate governance structures and tend to resist legislative and regulatory changes. In addition, the enforcement of existing rules and regulations is often poor or non-systematic. The lack of professional and skilled staff also limits the effectiveness of local regulators, hindering the development of equity markets.

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Ownership structure and financing patterns of GCC countries have delayed progress in corporate governance. Historically, bank financing and retained earnings have been the main sources of funding for a majority of GCC companies. However, unlike in German or Japanese corporate governance structures where banks play an important role in providing oversight, GCC banks do not perform the same function. In recent periods, this has been in part due to excess liquidity in the region forcing banks to compete to give loans, making it difficult for them to introduce tougher lending covenants. More generally, since many GCC companies are either owned by the state or by prominent families with close links to political authorities, most banks in the GCC practice name-based lending. In these circumstances, it is not likely that banks in the region will voluntarily require companies to follow better corporate governance practices unless obligated to do so by regulators.

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Although self-initiated progress has been made by some prominent banks in the Middle East, corporate governance changes in most GCC banks have been mandated by their central banks in order to comply with Basel I and II requirements. Central banks in all six GCC countries have amended their banking regulations to include corporate governance-related requirements such as separation of chairman and CEO positions, establishment of board level audit and credit committees and improved risk management. According to central bank representatives, a majority of GCC banks are already in compliance with Basel II corporate governance requirements. Banks now include information in their annual reports regarding their corporate governance practices. The willingness of banks to adopt better corporate

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governance practices to comply with Basel II regulations shows that companies can change practices if required to do so by regulators. The IIF-Hawkamah Task Force believes that GCC companies will adopt better corporate governance if required by law that is actively enforced.

Equity markets in most GCC countries are in transition with regard to regulatory structures, commercial/company laws and corporate governance frameworks. With the exception of Oman, none of the GCC countries have adopted a code of corporate governance for listed companies, although many are now formulating draft versions. In February 2006, the Abu Dhabi Securities Market (ADSM) in the UAE issued a corporate governance code for public comment. Similarly, in May 2006, the Capital Markets Authority of Saudi Arabia issued a draft code of corporate governance inviting public comments with hopes to issue a finalized code by the end of 2006. Regulators in Bahrain, Kuwait, Qatar and UAE are drafting corporate governance codes or requirements, which are expected to come into effect in 2007. In addition, Oman, Bahrain, and the UAE are currently reviewing their commercial/company laws, while Kuwait has drafted a new capital market law.

Organizational structures of capital market regulators are also undergoing significant change in most GCC countries. With the exception of Oman and more recently Qatar, which have independent regulators (similar to the FSA in the UK) and stock exchanges, the remaining four countries have less developed regulatory structures. Saudi Arabia recently spun off its stock exchange as a separate entity and is in the process of strengthening its surveillance and enforcement functions at the regulator level. Furthermore, Saudi Arabia has announced plans for an IPO of Tadawul, its stock exchange, in the near future. In Kuwait and Bahrain, stock exchanges also serve as regulators and are responsible for surveillance, enforcement and regulation of equity markets. The Kuwait Stock Exchange has a management committee of government representatives that regulates the market. The UAE has a separate regulator, appointed by the government, which supervises both the Abu Dhabi and Dubai stock exchanges. The organizational structure of capital market regulators is expected to change in the context of the progress in corporate governance frameworks and practices that countries hope to achieve.

Improvement in the overall corporate governance frameworks of GCC countries will be possible only with the strong backing of political leaders and regulators. In general, to significantly improve the corporate governance environment in the region, all GCC countries' regulators need to implement the following changes:

- Develop a strong regulatory structure by clearly separating and defining the roles of the regulator and the stock exchange
- Increase effectiveness of regulators by making them fully independent of government
- Issue meaningful corporate governance codes and require mandatory compliance
- Build institutional capacity and strengthen surveillance and enforcement mechanisms to ensure compliance
- Strengthen the underlying corporate governance infrastructure by updating laws and creating specialized courts to deal with financial cases
- Promote training programs for directors of listed companies
- Promote investor education and enhance public awareness of good corporate governance principles and practices
- Introduce corporate governance best practices for state-owned and family-owned companies
- Grant foreign investors full access to equity markets and promote shareholder activism by foreign and domestic institutional investors and the media
- Create a regional level corporate governance task force to promote convergence and harmonization of laws and codes among GCC countries

KEY CORPORATE GOVERNANCE ISSUES

Efforts being made to improve overall corporate governance framework

The IIF-Hawkamah survey found that, in general, governance frameworks in GCC countries lag significantly behind international corporate governance best practices. However, the survey found a great degree of variance among the corporate governance frameworks in the six countries. Oman appears to have the strongest corporate governance framework in the region with corporate governance requirements complying with about 70 percent of IIF's guidelines, followed by Kuwait and Saudi Arabia with about 50 percent compliance, and Bahrain and the UAE, with 40 percent compliance with IIF guidelines. The greatest room for improvement was found in Qatar, where current corporate governance requirements comply with only 35 percent of IIF guidelines.

However, efforts are being made to strengthen corporate governance in the region. The IIF-Hawkamah survey identified three key factors that are driving the introduction of improved corporate governance practices:

- Policy-makers' reaction to volatility and decline in asset prices
- Increased importance of IPOs in the growth of GCC equity markets
- FDI as a factor leading to compliance with international corporate governance principles and practices

Oman is the only country in the region that had adopted a code of corporate governance. Recognizing the need to improve the integrity of its market, the Abu Dhabi Securities Market issued

Table 1: Corporate Governance Reforms in the GCC

Bahrain	• The Ministry of Commerce in Bahrain has drafted a new Commercial Companies Law and a new code of corporate governance that will be enforced in the near term.
Kuwait	• A new Capital Market Law will incorporate corporate governance-related requirements for companies.
Oman	• The Capital Market Authority plans to reassess current corporate governance requirements in fall 2006. • Authorities are considering privatization of Muscat Securities Market.
Qatar	• Doha Securities Market will introduce a code of corporate governance by end 2006. • Authorities are strengthening regulator's surveillance and enforcement of stock exchange and companies; they also created an independent regulator in 2005.
Saudi Arabia	• The Capital Market Authority issued a draft code of corporate governance for public comment. It hopes to finalize and implement the code by end 2006.
UAE	• The Emirates' Securities and Commodities Authority, the regulator for UAE, is currently drafting a code of corporate governance for listed companies. • Abu Dhabi Securities Market recently issued corporate governance guidelines for listed companies for market feedback. • Dubai Financial Market has drafted corporate governance guidelines for listed companies, which should become enforceable by fall 2006. • The Ministry of Economy has drafted a new company law which includes corporate governance principles.

corporate governance requirements for listed companies in February 2006, which are awaiting implementation. Corporate governance frameworks in the remaining countries are undergoing transitions. Authorities in Kuwait, Saudi Arabia, Bahrain, Qatar and the UAE are either amending or introducing commercial/company laws, securities laws, listing requirements and codes of corporate governance. In addition, capital market authorities are reevaluating existing regulatory structures and, in some cases, trying to strengthen regulatory oversight by separating stock exchanges from capital market authorities. Table 1 on the previous page shows the proposed corporate governance reforms currently under way in each of the six GCC countries.

In addition to changes in regulatory and legal frameworks, business culture in the Middle East is also undergoing subtle change. As GCC economies integrate with the world economy, businesses are exposed to international standards and practices that, in some cases, conflict with local practices. Companies are dealing with demands for audited financial statements, quarterly earnings forecasts and credit ratings that require them to share information previously considered proprietary. As a result, financial disclosure and transparency in the region has improved, albeit at a slow pace.

Nevertheless, companies continue to resist substantial corporate governance changes, especially in regards to the role and responsibility of the board of directors. Like in many other emerging markets, companies in the GCC are often considered private preserves of controlling families. Families appoint friends to serve as independent directors, and while some controlling shareholders have created audit committees few companies have compensation or nomination committees. State-owned companies almost always include senior government officials as board members. This can create significant conflict of interest and authority problems as regulators overlook their responsibilities in order to avoid embarrassing government officials who fail in their fiduciary duties as directors.

Weak equity culture – newly developed capital markets

The GCC has a weak equity culture that tends to undervalue minority shareholder rights. There has been little time for an equity culture to develop in the GCC, with the exception of Kuwait. The strength of corporate governance frameworks in most GCC countries is directly related to the longevity of equity markets in the region. The

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IIF-Hawkamah survey found that countries with older equity markets such as Kuwait and Oman, which were established 44 and 18 years ago respectively, have better corporate governance frameworks than those of Qatar and UAE. Equity markets in the latter countries were established 9 and 6 years ago, respectively. Moreover, Kuwait has stronger minority shareholder protection laws than other countries in the GCC as it experienced a financial scandal in its equity market in the 1980s. Kuwait seems to have developed a better corporate governance framework based on its experiences.

However, Bahrain and Saudi Arabia's corporate governance frameworks do not exhibit these characteristics seen in Kuwait, Oman, Qatar and the UAE. Bahrain's equity market was established 17 years ago but, to date, regulators in the country have not institutionalized international best practices into its corporate governance framework. In contrast, although Saudi Arabia's equity market established just 5 years ago is the youngest equity market in the region, its corporate governance framework incorporates some criteria considered important by international investors.

Both Dubai and Qatar have established new financial centers that serve as investment zones for international banks, financial institutions and foreign companies. Both the Dubai International Finance Center (DIFC) and the Qatar Financial Center (QFC) have established jurisdictions and legal/regulatory frameworks that are independent of local authorities. Regulations in the DIFC and QFC follow international best practices and are largely based on regulations devised by the UK's Financial Service Authority. The DIFC and QFC can help foster change in corporate governance best practices in the region. However, real and significant change in corporate governance practices of the region will take place only when local authorities strengthen enforcement, and require mandatory compliance with improved corporate governance-related laws and regulations.

More information on the DIFC and the QFC is provided in the box on the next page.

The lack of an equity culture also stems from the high level of ownership concentration. Most companies in the GCC are controlled through a majority owner—often the state or a family. In general, whenever there is strong concentrated company ownership, there is a danger that majority owners will ignore the rights of other shareholders.

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Table 2: Equity Market Capitalization and Concentration

Country	Market capitalization as percent of GDP (July 2006)	Top 10 companies as a percent of total market (June 2006)	Total number of companies (March 2006)
Bahrain	126%	78%	47
Kuwait	154%	48%	161
Oman	38%	71%	124
Qatar	175%	82%	33
Saudi Arabia	140%	75%	79
UAE – Abu Dhabi/ Dubai	106%	64%	92- (59/33)

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Box 1: Dubai International Finance Center (DIFC) and Qatar Financial Center (QFC)

The Dubai International Financial Center (DIFC) has gained some traction since its launch in September 2004. The Center, which was conceived to help position Dubai as a financial hub bridging Europe and Asia, is a purpose built financial free zone with a self-contained regulatory, legal and judicial region based on international best standards and practices. This means that no UAE civil or commercial laws apply in the DIFC and it specifically has its own employment law and independent court and independent financial services regulatory authority. The DIFC's regulatory authority the Dubai Financial Services Authority, is modeled on the UK's Financial Services Authority, and is the sole integrated regulator for the DIFC. The DIFC has attracted 22 banks, 13 asset managers, 7 private equity firms and 2 insurers as of July 2006. However, the actual volume of business conducted at DIFC is still relatively small.

Interest in the Dubai International Financial Exchange (DIFX), which opened in the Center in September last year, has been subdued. It had hoped to attract a large number of bonds, sukuks (Islamic bonds) and new issues by the end of 2006, along with a draft of secondary listings of companies from various countries. It is still unclear what impact the DIFX will have on the domestic exchanges. Regulatory requirements are stricter for those companies listed on the DIFX, which is looking to attract regional and international firms. If a local company can meet these requirements, it could be advantageous for it to list on the DIFX, as new listings will be priced independently of the ministry of economy and a minimum stake of only 25 percent has to be listed, compared with a 55 percent minimum on the domestic market.

The Qatar Financial Center (QFC) has been gaining attention since its inauguration in May 2005. QFC was conceived to attract major international financial institutions to the country in order to enhance financial intermediation and, more specifically, provide financing for some of the $55 billion in energy and public infrastructure projects that will be coming on line in the medium term. QFC is an onshore entity; participants enjoy a three-year tax holiday, after which they are liable to a 10 percent tax on profits.

In order to provide the regulatory comfort that international institutions demand, QFC has its own regulatory authority and court system, which are independent of the central bank, as well as its own employment and immigration laws. QFC claims that its regulations are an amalgam of global best practices. The independence of the regulatory authority and the tribunal is reinforced by the fact that they are answerable not to one minister but to the entire Council of Ministers. There is likely to be some diffusion of best practices to the local market as QFC members will come armed with new products and services. Many believe that over time the QFC's regulatory structure will become dominant in Qatar, and the financial system as a whole will begin to operate on international lines.

Despite their short existence the stock exchanges of the GCC, with the exception of the Muscat Securities Market, have a high market capitalization as a percent of GDP relative to the OECD average of 95 percent. In addition, equity markets in the region are highly concentrated with the top ten companies accounting for over 70 percent of total market capitalization in all GCC countries except for Kuwait and the UAE (Table 2, previous page).

Despite several weaknesses in corporate governance, the lack of alternative investments has led to high equity market capitalization as a percent of GDP, particularly in Qatar, Saudi Arabia and the UAE. Governments have used equity markets to price initial public offerings low enough to stimulate public participation and ensure solid returns. As a result, many investors who lacked understanding of financial markets liquidated other assets and invested money in stock markets creating the bull market of 2005. Recent market corrections have hurt minority shareholders, who have called for governments to use revenues from high oil prices to intervene to cushion corrections in local equity markets.

Governments have so far tried to minimize direct financial intervention and have focused instead on strengthening capital market laws and

introducing concepts of corporate governance. Good corporate governance can help protect minority shareholders' financial interests, particularly laws on disclosure of ownership, control and related-party transactions, accounting standards, and cash buyouts during reorganizations. However, governments also need to do more by way of investor education to build an equity culture in the region.

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Easy access to capital provides little incentive for change

In general, companies that have little need to rely on equity markets have no incentive to provide the protections for minority shareholders that lie at the heart of many of the IIF corporate governance guidelines. Without a corporate culture that values these protections, strategic investors are less likely to see the equity market as a good way to invest their money. There are several reasons for the relative lack of interest by large companies in tapping equity finance. Most importantly, there is abundant liquidity in the market stemming from overflowing oil revenues. Also, companies historically have relied on retained earnings to fund growth and expansion, with bank financing being the main source of external funding. Some of the largest companies in the GCC are controlled by the state and are engaged in natural resource extraction and sale. These companies are currently benefiting from high energy prices with resulting revenue flows that are more than sufficient to meet investment needs. However, in order to further the development of capital markets, the state has encouraged joint stock companies to list on the local stock exchange.

Table 3: Asset Size of the Banking Sector Relative to Size of GDP

Country	Commercial Bank Assets to GDP (Dec 2005)
Bahrain	126%
Kuwait	92%
Oman	48%
Qatar	73%
Saudi Arabia	65%
UAE	125%

The banking sector in the GCC is well-developed (Table 3). Most regional banks are controlled directly by families or governments that have strong ties to the business community in the GCC. Banks are very liquid and can meet the financing needs of most businesses. Name-based lending is prevalent among banks, although most central banks, to minimize default risk in the region, place a limit on the maximum exposure to individual businesses. Given the ready availability of bank financing in most GCC countries, family controlled companies prefer to increase debt levels rather than access equity markets so that they can avoid ceding control to outsiders. Sharia law also is important in regards to the issue of control as under the law directors and management of a company retain independence in conducting business operations. However, companies are required to provide full access to their financial records, which under Sharia law treat returns differently than traditional western accounting practices.

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As GCC economies diversify and mature and incorporate more sophisticated risk management techniques, more small- and medium-sized companies are likely to seek equity financing. It is important for authorities to promote good corporate governance in order to attract equity investors to small-and medium-sized companies that cannot finance expansion through retained earnings. This will be a key factor in bringing about future growth in the economy.

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Banking sector seen as a yardstick for better corporate governance

Over the past three years, banks and financial institutions in the GCC have significantly improved internal corporate governance practices. As a result, corporate governance practices in the banking sector are significantly better than those practiced in non-banking sectors. The impetus for change can be attributed to implementation of Basel I & II, which requires banks to comply with the risk management guidance of the Basel Committee. Central banks across the GCC have revised regulatory requirements that require GCC banks to put in place a board-level audit committee, appoint independent directors and establish a risk management system. For example, in Kuwait, audit committees exist only in banks and financial institutions under the supervision of the Central Bank of Kuwait. Banks are also required to obtain prior approval from their central bank before appointing a director. Banks must provide corporate governance-related information to central banks as part of their annual reporting cycle.

"The impetus for change can be attributed to implementation of Basel I & II, which requires banks to comply with the risk management guidance of the Basel Committee."

The adoption of improved corporate governance practices by GCC banks suggests that contrary to popular perception, corporate governance in the region can improve and companies will adopt best practices if required by regulators. Capital market regulators/ authorities in the GCC should follow the lead of central banks and require compulsory compliance with improved corporate governance requirements. Regulators should anticipate some push-back from companies against new regulation but should not give into such pressure. Instead, they should offer education pointing out why it is in the self-interest of companies to adopt better corporate governance practices.

"Capital market regulators/authorities in the GCC should follow the lead of central banks and require compulsory compliance with improved corporate governance requirements."

Weak enforcement

Weak enforcement of mandatory rules is a challenge in GCC countries. With the exception of Oman, regulators in the region do not have sufficient power to strictly enforce compliance with legal requirements. IIF guidelines invite countries to establish a strong and transparent regulatory environment in order to create a credible foundation for corporate transparency, good accounting practices and protection of shareholder rights. In addition, an essential element of credibility in the regulatory environment is that regulators must not be perceived to be under the control or influence of any particular interest group. Most countries in the region have yet to set up fully independent regulators (Table 4).

Regulators in the GCC have been hobbled by an inefficient and often ineffective legal system. Building capacity is important since the lack of sufficient skilled and professional staff also limits the effectiveness of local regulators.

Limited media influence

The GCC is also notable for the general weakness of the financial press, which in many other emerging markets plays an important role in promoting good corporate governance and minority shareholder rights through its reporting on company operations. In many emerging markets, the press not only exposes companies that break the rules but also lauds those that follow good governance practices. In the GCC, the financial press has had limited influence on changing corporate governance practices or on putting pressure on regulators to take action when wrongful practices have been discovered. However, the situation seems to be improving with some news channels providing continuous coverage of financial and economic news.

Table 4: Regulatory Structures in GCC Countries

Country	Regulatory Structure
Bahrain	The Bahrain Stock Exchange (BSE) is an autonomous organization that regulates itself. Its Board of Directors is made up of representatives from the Bahrain Monetary Authority, Ministry of Commerce, and Ministry of Finance.
Kuwait	Kuwait Stock Exchange (KSE) is an independent financial institution. The Market Committee within the KSE regulates the exchange. Kuwait does not have an independent regulator.
Oman	In 1998, Oman became the first GCC country to establish a separate regulatory body—the Capital Market Authority (CMA). The CMA regulates the Muscat Stock Market.
Qatar	Doha Securities Market (DSM) has been regulated by the Qatar Financial Markets Authority (QFMA) since 2005. QFMA is an independent regulatory agency.
Saudi Arabia	Tadawul, Saudi Arabia’s stock market, was established in 2001 and is an independent organization. In 2003, the government created the Capital Markets Authority (CMA), which regulates the Tadawul. CMA is a government organization, but has financial, legal, and administrative independence.
UAE	The Emirates Securities & Commodities Authority (ESCA) was established in 2001 to regulate the Abu Dhabi Securities Market (ADSM) and the Dubai Financial Market (DFM). ESCA is a government organization, but has financial, legal, and administrative independence. ADSM is a legal entity of autonomous status with financial and managerial independence. DFM is a public institution having its own independent corporate body.

OUTLOOK AND RECOMMENDATIONS

The IIF-Hawkamah survey reveals that, on average, the corporate governance framework in the GCC, as it pertains to laws and listing requirements for companies, is significantly weak when compared to IIF guidelines. However, the IIF-Hawkamah Task Force expects corporate governance frameworks in the GCC to improve in the near term as countries amend existing company laws, strengthen accounting frameworks through introduction of IFRS, and introduce corporate governance requirements for companies. Nevertheless, even with an "upgrade" of laws, corporate governance as practiced in the majority of GCC companies will continue to remain weak compared to other emerging markets unless regulators require mandatory compliance with corporate governance-related laws, strengthen enforcement, and build a strong equity culture.

A strong commitment to better corporate governance from the political authorities as well as from senior government officials involved with capital market development is needed for real change to take effect. Regulators should quickly introduce corporate governance reforms in state-controlled companies (SCCs), which constitute a majority of companies in the GCC. Governments can also use SCCs to extend better corporate governance practices to non-government companies. SCCs can require suppliers to adopt good corporate governance practices if these companies wish to conduct business with SCCs. Specifically the IIF-Hawkamah Task Force would propose the following reforms in SCCs:

- Increased autonomy for management—include a sufficient number of non-executive and independent members, limit the number of state representatives to serve as directors on the board
- Independent board-level nomination committees to appoint directors
- Discourage practice of ownership by the state and the undue political interference and influence by government
- Adoption and implementation of specific guidelines for corporate governance of SCCs,[3] ensuring that the governance of SCCs is carried out in a transparent and accountable manner, with the necessary degree of professionalism and effectiveness

Regulators in the region need to work together to strengthen equity markets in the GCC. With the exception of Saudi Arabia and Kuwait, equity markets in the region are relatively small and lack depth of listings. The IIF-Hawkamah Task Force calls for the creation of a **regional GCC corporate governance task force comprised of regulators and market participants.** The mandate of the task force would include:

- Harmonizing capital market laws to help build a GCC standard of corporate governance, on par with international best practices
- Promote cross-listing of stocks on multiple exchanges within the GCC with the long-term aim of creating a unified GCC equity market
- Eliminating structural weakness in GCC equity markets by:
  - ⇒ Requiring companies to obtain credit ratings for debt issuances
  - ⇒ Developing stronger IPO markets through book-building measures with the help of investment banks
  - ⇒ Providing better oversight of mutual fund managers to prevent front running
  - ⇒ Developing insider trading laws
  - ⇒ Promoting investor education

[3] An example is the OECD Guidelines on Corporate Governance of State-Owned Enterprises, OECD, Paris 2005.

Other recommended corporate governance-related reforms include:

- Promote shareholder activism in the region by creating a class of institutional investors who can take up corporate governance-related causes as significant shareholders; this should include opening equity markets to foreign investors

- Improve corporate governance-related reporting by requiring companies to provide information to shareholders in annual reports and on company or stock exchange websites

- Establish specialized courts to deal with enforcement of securities laws; this would expedite the delivery of justice for securities and finance-related offenses and reduce the cost of litigation

- Require members of boards to participate in director training programs to develop a pool of trained independent directors

- Increase financial transparency by harmonizing financial reporting requirements, especially pertaining to the information provided in annual reports to shareholders

- Establish country-specific associations of accountants who can spearhead development of accounting practices and regulations in the region

- Establish registrars of companies, requiring all companies (from sole proprietorship to joint stock companies) to provide financial information; this would help non-listed companies develop better financial reporting practices

- Introduce ethics and corporate governance in business school curriculums to create awareness and educate future business leaders on best practices

Although corporate governance frameworks in the region differ widely, specific improvements to the existing corporate governance frameworks should include:

- Introduce cumulative voting for director elections

- Define director independence and require that at least one-third of directors on the board be independent

- Introduce board-level committees—audit, compensation and nomination

- Require audit committee oversight of risk assessment and management for all listed companies

- Introduce holding company structure for conglomerates

- Require buyout offers to minority shareholders when ownership exceeds a specific percentage

- Increase financial transparency by requiring disclosure to shareholders of the following:

  ⇒ Share buybacks

  ⇒ Director remuneration

  ⇒ Off-balance sheet transactions

  ⇒ Business risk factors

  ⇒ Consolidated financial reporting for holding companies

COMPARATIVE ANALYSIS OF CORPORATE GOVERNANCE FRAMEWORKS IN THE GCC

While there is great variation among countries within the GCC, on average, these countries as a group comply with about half of the IIF's corporate governance guidelines. The IIF-Hawkamah survey found that disclosure requirements pertaining to ownership and control of a company were strong in the region. Areas of weakness include structure of the board of directors, accounting and auditing, and regulatory environment, where current rules and regulations meet less than half of IIF guidelines. However, variations exist among the six countries and a comparative analysis for each area of assessment is provided in Table 5 on page 18. Country-specific compliance can be found in individual country reports.

MINORITY SHAREHOLDER PROTECTION

Minority shareholder rights are at the core of corporate governance. Investing in markets with poor corporate governance leaves open the possibility that minority shareholder rights will be ignored, or even worse, that insiders will conspire to expropriate company assets at the expense of outside investors. Whereas some issues of minority shareholder protection are more or less self-evident, such as the right to vote on important matters, others are less obvious, such as issues related to share buybacks. Collectively, GCC countries comply with about two-thirds of IIF's minority shareholder protection guidelines.

The IIF's analysis of Minority Shareholder Protection focuses on three main areas:

1. ***Voting rights*** - In principle, all GCC countries allow proxy voting. However, in Bahrain only shareholders who own 10 percent or more of share capital are allowed to appoint a proxy. This restriction is not in the interest of minority shareholders as it prevents them from appointing a proxy. In Qatar only current shareholders/members can be appointed as proxies and in UAE proxies cannot hold more than 5 percent of the company's capital. All six GCC countries also follow the one-share, one vote principle. However, in Qatar, voting rights are capped such that no one shareholder or representative's vote can count for more than 25 percent of total votes represented at the meeting.

   At present, none of the six countries provide for cumulative voting for director elections. However, proposed corporate governance guidelines in Saudi Arabia call for cumulative voting in director elections.

2. ***Changes to the company and its capital structure*** - Only Kuwait and Saudi Arabia have prescribed takeover/buyout/merger procedures and have pre-emptive rights that meet with IIF guidelines. Requirements in Bahrain and Oman comply with less than one-third of IIF guidelines in this area.

3. ***Shareholder meetings and other issues*** - With regard to the structure of shareholder meetings, which includes issues such as rights of shareholders to call for a special meeting and receive meeting agendas, requirements in Kuwait and Oman comply with about 70 percent of IIF guidelines. With the exception of Bahrain and Oman, all the remaining four countries limit foreign investment in companies.

STRUCTURE AND RESPONSIBILITIES OF THE BOARD OF DIRECTORS

Company performance and shareholder value can suffer from a lack of oversight and excessive power of senior executives. Absolute power held by senior management can breed complacency, lack of competitiveness, as well as, nepotism, cronyism, and theft. Thus, boards of directors need to be structured so that they provide an independent check on management. Therefore, it is vitally important that a significant number of board members be independent from management. It is also important that boards of directors be responsible for disclosure of information to shareholders. This facilitates corporate transparency and more accurate assessments of the value of a company.

The IIF-Hawkamah survey found that Oman, with a code of corporate governance, complies with over two-thirds of IIF guidelines. Bahrain, Kuwait and Saudi Arabia comply with about one-third and the UAE and Qatar comply with less than one-third of IIF guidelines. However, all five countries are in the process of introducing corporate governance guidelines for listed companies and we expect that, once introduced, overall compliance in this area will increase significantly.

The IIF's analysis of the structure and responsibilities of Boards of Directors focuses on four main areas:

1. ***Structure of the board and board committees -*** Oman complies with over two-thirds of IIF guidelines pertaining to the structure of the board of directors. All other countries comply with about one-third or less of IIF's guidelines.

Compliance with IIF guidelines in this area can be strengthened by requiring companies to reserve at least one-third of board seats for independent directors, by setting criteria for the definition of independence, and by requiring companies to establish audit, compensation and nomination committees at the board level.

2. ***Disclosure -*** Qatar complies with less than one-third of IIF guidelines, Kuwait and the UAE with about two-thirds, and Bahrain and Saudi Arabia with about four-fifths of the IIF's disclosure requirements. Oman is the only country which complies with all IIF guidelines with regard to financial disclosure. This includes guidelines for immediate disclosure of information that affects share prices, procedure for information release and disclosure of remuneration of directors.

3. ***Other responsibilities -*** Under other responsibilities of the board, IIF guidelines call for directors to follow procedures in the event of a conflict of interest, for companies to have an internal control and risk management system under the preview of the audit committee, for investor relations programs to be adopted, and for companies to make a policy statement concerning environmental issues and social responsibility.

Collectively all countries comply with only about one-third of IIF guidelines in this area. Oman and Saudi Arabia have the highest compliance in the region, albeit complying with about one-half of IIF guidelines.

ACCOUNTING AND AUDITING

Accurate accounting and auditing are at the core of transparency and good corporate governance. Thus, the accounting standards that a company adheres to, as well as the structure and independence of the audit committee, are extremely important. Capital providers in setting the criteria used in making financing decisions have a strong influence on accounting and auditing practices. With the exception of Oman, which complies with over three-fourths of IIF's accounting and auditing guidelines, Bahrain, Kuwait, Qatar, Saudi Arabia and the UAE comply with less than one-half of IIF guidelines.

The IIF's analysis of accounting and auditing practices focuses on two main areas:

1. ***Accounting Standards*** **–** Kuwait, Oman and Saudi Arabia comply with slightly more than two-thirds of IIF guidelines. The remaining three countries comply with less than two-thirds of IIF guidelines. Compliance with IIF recommended guidelines can improve in the region by requiring companies to disclose off-balance sheet transactions and by requiring the audit committee to issue a statement to shareholders regarding risk factors facing the business.

2. ***Function of audit committee*** **–** Only Oman meets IIF guidelines pertaining to audit committees, which call for audit committees of large firms to be chaired by qualified independent directors with a financial background and for the committee to have relationship/communication with the internal and external auditors. Requirements in all other countries were found to be extremely weak in this area.

TRANSPARENCY OF OWNERSHIP AND CONTROL

Disclosure of significant shareholdings is crucial in evaluating whether company actions, such as the sale of substantial assets, are being made in the best interest of shareholders constituting a majority of the company's capital or in the interest of controlling parties.

The IIF's analysis of transparency of ownership and control focuses on whether firms are required to disclose accurate, adequate, and timely information so as to allow investors to make informed decisions about acquisitions, ownership obligations and rights, and the sale of shares.

The IIF-Hawkamah survey found that requirements in Saudi Arabia comply with about 90 percent of IIF guidelines in this area. Requirements in Kuwait and Oman comply with about 70 percent of recommended IIF guidelines. Disclosures pertaining to transparency of ownership and control are weak in Bahrain and the UAE, where requirements comply with less than one-half of IIF guidelines and are very poor in Qatar where compliance is less than one-fourth.

REGULATORY ENVIRONMENT

To create a solid foundation for corporate transparency, good accounting practices, and protection of shareholder rights, the regulatory environment must also be credible and transparent. In order to maintain credibility within the regulatory environment, it is imperative that regulators not be perceived as under the control or influence of any particular interest group.

The regulatory environment in the GCC is undergoing change in most countries. With the exception of Oman and more recently Qatar, the regulatory environment in the GCC countries is, in general, weak. Regulatory structures in GCC countries have been discussed in detail under the topic *Weak enforcement* on page 11.

Summary of the Corporate Governance Environment in each GCC Country

Bahrain: Corporate governance-related rules and regulations in Bahrain comply with less than one-half of IIF guidelines, earning the country an overall score of 2 out of 5 possible points. However, efforts are being made to improve corporate governance in Bahrain. The Bahrain Transparency Association, an alliance of various market participants including, lawyers, accountants, academics and government representatives, has been working over the past few years to improve Bahrain's corporate governance framework. Improvements in the country's corporate governance framework will depend on the Bahrain Monetary Agency, which regulates the capital market, introducing new corporate governance-related requirements for listed companies.

Kuwait: With an overall score of 3 out of 5 for compliance with IIF's corporate governance guidelines, Kuwait has a better corporate governance framework than most other countries in the GCC. While the country has strong laws protecting minority shareholder rights, the overall regulatory environment in the country is weak. Improvements to Kuwait's Commercial Companies Law were made following the financial scandal in the 1980s. However, since then laws have not been updated. Efforts are under way by regulators to amend the existing Commercial Companies Law and to include corporate governance-related requirements in the new Capital Markets Law. The one significant advantage Kuwait has over other countries in the GCC is its court system. In general, the judicial system in Kuwait is well regarded. Judges are independent and well versed in laws. Moreover, verdicts are provided in a timely manner.

Oman: Oman is the only country in the GCC to get an overall score of 3.5 out of a possible 5, the highest among GCC countries. The high score is attributed to Oman being the first country in the GCC to adopt a code of corporate governance in 2002 and for being the first country in the GCC to establish an independent capital market regulator. However, there is room for further improvement in Oman. The corporate governance framework of the country complies with roughly two-thirds of IIF guidelines. An area that needs strengthening is minority shareholder protection.

Qatar: The IIF-Hawkamah survey found that Qatar had the weakest corporate governance framework in the GCC, earning the country an overall score of 2 out of 5. However, The IIF-Hawkamah Task Force expects the corporate governance framework in Qatar to improve in the near term as authorities are taking steps to improve corporate governance practices in listed companies. In addition, the regulatory environment in Qatar is currently being restructured to strengthen surveillance and enforcement functions. At the end of 2005, authorities established an independent regulator – the Qatar Financial Markets Authority (QFMA)—prior to which surveillance and enforcement functions were carried out by the Doha Securities Market.

Saudi Arabia: Saudi Arabia complies with about one-half of IIF's corporate governance guidelines, earning the country an overall score of 3 out of 5. However, with the expected adoption soon of a new code of corporate governance for listed companies, improvement in the country's corporate governance framework appears imminent. Nevertheless, Saudi Arabia continues to be the least transparent and investor-friendly country in the GCC. In practice, capital markets in Saudi Arabia are closed even to GCC nationals. Meaningful changes in the country's corporate governance environment will depend importantly on the authorities opening and integrating the Saudi capital markets with other GCC and global financial markets.

UAE: The IIF-Hawkamah survey analyzed the corporate governance frameworks of Abu Dhabi and Dubai Emirates as these are the only Emirates that have established stock exchanges. Due to its federal structure, the corporate governance framework in the UAE could differ among the Emirates. The UAE's corporate governance framework is laid out in the UAE company law that applies to all companies incorporated in the UAE and in the listing requirements of the Abu Dhabi Securities Market (ADSM) and the Dubai Financial Market (DFM). The Emirates Securities and Commodities Authority (ESCA) regulates capital markets in both Abu Dhabi and Dubai.

The IIF-Hawkamah survey found that the corporate governance frameworks of Abu Dhabi and Dubai listed companies are similar. The UAE earns an overall score of 2 out of 5 in the IIF-Hawkamah survey. However, ESCA, ADSM and DFM plan on introducing their own codes of corporate governance for listed companies, which should improve the UAE's overall corporate governance framework.

Table 5: Comparison of Corporate Governance Frameworks in the GCC with IIF Guidelines

(on scale of 1-5 with 5 being fully compliant)

	Bahrain	**Kuwait**	**Oman**	**Qatar**	**Saudi Arabia**	**United Arab Emirates**
Minority Shareholder Protection	2.0	4.0	3.0	2.5	3.5	2.5
Voting Rights	1.5	3.5	3.5	2.5	2.0	3.5
Firm/Capital Structure	1.5	4.5	1.0	2.0	5.0	2.0
Shareholder Meetings/Other Rights	3.0	3.5	3.5	3.0	3.0	2.5
Structure and Responsibilities of the Board of Directors	2.0	1.5	3.5	1.5	2.0	1.5
Board Structure	1.0	1.5	3.5	1.5	1.0	1.0
Disclosure	4.0	3.5	5.0	1.5	4.0	3.5
Others	1.0	0.5	2.5	0.5	2.5	0.0
Accounting and Auditing	2.0	2.5	4.0	2.0	2.5	2.0
Standards	3.0	3.5	3.5	3.0	3.5	2.5
Audit Committee	0.5	0.0	5.0	0.0	0.0	0.0
Transparency of Ownership and Control	2.5	3.5	3.5	1.0	4.5	2.5
Regulatory Environment	2.0	2.0	4.5	2.5	2.5	2.0
OVERALL ASSESSMENT	**2.0**	**3.0**	**3.5**	**2.0**	**3.0**	**2.0**

IIF scoring methodology: The IIF corporate governance score assesses the level of compliance of a country's corporate governance framework laid out in its company law, securities law, listing requirements and code of corporate governance with the IIF's corporate governance guidelines. The level of compliance is divided into five categories. Each of the 56 IIF corporate governance guidelines is assigned a weight based on its importance to international investors as defined in Policies for Corporate Governance in Emerging Markets: Revised Guidelines (May 2003). This weighting scheme is used to provide a cumulative corporate governance score for each country.

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