Compliance Insider

A Springer Media Publication www.complianceinsider.com May 2010

Corporate Governance in the Middle East: A Changing Landscape

By
Robert N. Walton and Michael L. Whitener
VistaLaw International LLC

Corporate governance has been the subject of much discussion and focus in the developed world since at least the Enron-era scandals in the early 2000s. It remains a focus of the government and business communities in the wake of the economic meltdown of recent years, particularly in the United States, where Congress appears to be on the verge of passing significant financial reform.

Despite the seeming elusiveness of sound corporate governance practices in at least some sectors in the West, however, regulatory bodies and corporations in the Middle East and North Africa (MENA) are increasingly recognising that the governance standards in their region are significantly behind those of the advanced economies. In recent years, and in the wake of a few corporate scandals of their own, countries throughout the region have made significant efforts to improve corporate governance practices and make their corporate workings more transparent and accountable.

The primary reason for this development is the changing economic picture brought about by globalisation. The MENA region and the companies in it are increasingly less isolated and more globally focused than even a few years ago. Telecommunications is arguably the vanguard industry in this regard, as it has been significantly privatised and opened up to competition in the last few years. As recently as 2004, the then largely state-owned telecoms monopolies in the six Gulf Cooperation Council countries (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates) operated in only six markets outside of the GCC. According to a recent article by the Al Bawaba news organisation, GCC telecoms are now doing business in 78 markets.

For companies like these, as well as those aspiring to operate on the global playing field, adopting and adhering to sound corporate governance practices is increasingly crucial to their ability to compete and survive.

The Benefits of Good Governance

Of the perceived needs and ultimate benefits of sound corporate governance and financial transparency in MENA, the first and perhaps most significant is the ability to foster investor confidence in the reputation and sustainability of an enterprise, which in turn expands its access to capital and potentially lowers the cost of equity.

Second, good governance is increasingly being seen as a means to improve the performance and stability of a company by requiring stronger risk management and financial practices, clarifying management and board responsibilities, and monitoring director performance.

Finally, attaining these first two objectives helps meet an equally important third goal, which is to expand operations, create jobs and attract the best talent. On these points, it is clear that many of the growing companies in the region do not simply want to be in the game, but aim to be serious players. Qatar Telecom, to take one example, publicly has announced its '20/20 Plan,' which is to be 'among the top 20 telecommunications companies in the world by 2020.'

The region's embrace of sound corporate governance is coupled, however, with a number of hurdles to achieving it. A 2008 survey of chief executive officers of banks and listed companies in the region, conducted by the Dubai-based Hawkamah Institute for Corporate Governance and the Washington, D.C.-based International Finance Corporation of the World Bank (IFC), found that a great majority of respondents – seventy-six percent of banks and sixty-seven percent of listed companies – cited corporate governance as 'important' or 'very important' to their businesses. Despite this, fifty-three percent of respondents were not able to select the appropriate definition of corporate governance ('a system by which companies are directed and controlled') and instead opted for definitions that more closely described corporate management or corporate social responsibility. Perhaps most ominous, only three percent of those surveyed followed what could be described as 'good practice,' while ninety-two percent fell under what the survey called 'emerging practice' or 'improved practice.'

Pro-Governance Groups and Efforts

The seriousness with which the region is taking corporate governance is evidenced by the proliferation of organisations and initiatives focused on the subject. The OECD Initiative on Governance and Investment for Development, a regional effort initiated and led by MENA countries, has embraced a broad agenda that includes improving and modernising governance structures and operations, enhancing the investment climate and fostering regional and international partnerships in order to 'promote sustainable economic growth throughout the MENA region.'

Hawkamah, through partnerships with the IFC and other international and regional organisations and corporations, has taken a lead role in advocating for good governance practices and policies. Its various efforts include regional task forces on governance in banks and state-owned enterprises. Similarly, the Mudara Institute of Directors, which was established by the Dubai International Financial Centre in 2008, is a membership organisation that seeks to raise the level of board member quality throughout MENA by 'facilitating professional development through education, research, information, networking and dialogue.'

Another group that has taken an active role at both the regional and national level is the Washington, D.C.-based Center for International Private Enterprise (CIPE). In 2007, it launched a two-year regional corporate governance program in with the support of the Middle East Partnership Initiative of the U.S. Department of State. CIPE also works with local partners throughout MENA, with the aim of promoting 'indigenous efforts to lay the foundations for corporate governance best practices.' Its regional efforts include helping to establish the Egyptian Institute of Directors (EIOD) in 2004 and launching (in partnership with L'Institut Arab de Chefs des Enterprises or IACE) the Tunisian Center for Corporate Governance in 2009, the latter of which is the first organisation of its kind in North Africa.

New Governance Codes

Advocates of reform have seen concrete accomplishments in the form of corporate governance codes, the most recent of which, in the United Arab Emirates, became effective as of April 30. The UAE code applies to public joint stock companies established in the UAE and companies listed on the Dubai Finance Market (DFM) and Abu Dhabi Securities Market (ADX), as well as their boards of directors. Aiming to bring internationally accepted corporate governance standards to UAE companies, the code sets out detailed requirements with respect to board membership, the role of the chairman, required committees (at least two: audit and nomination and remuneration), external auditor and shareholder rights. While acknowledged to be a work in progress and not yet applicable to private joint stock companies, the code is a significant step in the direction of comprehensive governance practices.

Beyond the UAE, corporate governance codes are in various stages of development and adoption throughout the region. Bahrain announced the launch of its code in March and it will go into effect on January 1, 2011. The Qatar Financial Markets Authority (QFMA) announced in February 2009 its board approval of a corporate governance code for public and listed companies in that GCC country. Codes also have been adopted in Oman, Egypt (for firms and state-owned enterprises), Lebanon (for small and medium enterprises), Morocco and Saudi Arabia, while others are in process, including Morocco, Jordan (for banks and public companies) and Lebanon (for public companies). Initiatives to establish corporate governance are also underway in Tunisia, Palestine, and Syria.

In many, if not most of these efforts, the MENA codes adopt the 'comply or explain' model, which is followed in the UK and a number of European countries. In contrast to the rules-driven approach in the U.S., 'comply and explain' is less prescriptive and requires companies to give an explanation if they do not comply with the recommendations to meet the principles set out in the code.

Corporate Governance 'Success Stories'

The increased attention to governance in the region is having an effect. In April 2010, the IFC released a new report on MENA entitled 'Corporate Governance Success Stories,' focusing on effective measures taken by eleven companies in the region to improve their corporate governance practices. On the whole, the companies studied reported improvements throughout their organisation as a result of the changes they implemented. The report identified several common themes underlying and reinforcing regional efforts to improve corporate governance.

With respect to board level improvements, many of the companies made changes to the board's composition, clarified the respective roles of the board and management, increased board effectiveness through improved procedures, set up more formal committees to assist the board with its work and established more formal board nomination and evaluation processes.

At the management and operational level, almost all of the companies made changes to their risk management practice in order to improve monitoring and mitigation at all levels. Many strengthened their internal audit function and implemented significant improvements to their finance function, internal management analysis and reporting capabilities. Several addressed management succession planning and nearly all sought to increase transparency through enhanced disclosures via their websites and/or in the non-financial portions of their annual reports.

In terms of the impacts of the changes they implemented, nearly all of the companies surveyed cited a strong or substantial impact on their ability to access finance. Moreover, they reported a positive impact on their firms' reputations, based on feedback from stakeholders, shareholders, customers and business partners. A majority reported a strong or substantial impact on organisational efficiency and several found that governance changes improved their ability to control costs and manage liquidity, which has been critical during the recent financial crisis.

Finally, and significantly, the IFC report included input it sought from three regional private equity firms, which characterised good governance as essential prior to investment and as a 'key component to the value creation process' after investment.

More Work Ahead

The number of initiatives in MENA in recent years, along with the positive results reported in the IFC study, suggests that there is real momentum behind improving corporate governance in the region. But only two years have passed since the Hawkamah/IFC survey of CEOs, so it is reasonable to assume that many of the issues identified in survey report remain challenges today. Work remains to be done.

For example, banks and financial companies can and should play a critical role in the region's efforts to lift governance standards across the board. Banks in the Middle East constitute a significant proportion of the stock market capitalisation in the region and comprise around 50 percent or more of the listed companies in the GCC. As Dr. Nasser Saidi of Hawkamah has pointed out, good governance practices in the banking sector will inevitably influence the corporate sector.

Similarly, while corporate governance efforts have focused primarily on listed companies, family-controlled businesses account for approximately 95 percent of all private sector companies throughout the Middle East. These companies, too, are finding themselves subject to increasing competition and see the benefits that better governance, strong internal controls and financial transparency can bring to company performance. Given the role that family businesses play in their respective economies, the countries in which they are based would be wise to extend their governance efforts to these entities.

The region's State Owned Enterprises (SOEs) also play a major role in the economic system. They encompass a wide range of businesses in the industrial and financial sectors in the region, including many of the banks and financial institutions noted previously. As Hawkamah Director Nick Nadal pointed out at a meeting of the Global Network of SOEs in March, better corporate governance in SOEs 'will lead to mutually reinforcing multiple rewards of significant efficiency gains, improvement in the quality of public services, greater transparency and better protection of the State's interests.'

Beyond these broad areas, other areas identified by corporate governance advocates as warranting further attention include greater protection of minority shareholder rights, increased independence of regulators and greater board diversity, including gender diversity. On the latter point, the 2008 CEO survey revealed that 78 percent of the MENA banks had no female directors and only one percent had more than one.

It is possible that the global financial crisis will spur even greater focus on transparency and sound governance. Certainly, the region has not been immune to the meltdown, as Dubai's recent troubles make plain. The lesson of the crisis, the IFC observed in its report, is that good governance is now an imperative, not an option.

The Importance of Performing a Corporate Governance Audit

Against this backdrop of regional developments, it should be clear to a company looking to compete and succeed in MENA that having a robust corporate governance program is increasingly vital. To put one in place, a company might consider conducting, with the assistance of outside specialists, a thorough governance review or audit to identify areas in which existing practices need to be improved. When undertaking such an audit for our MENA clients, we typically proceed as follows.

1. Conduct a complete review of existing corporate governance documents.

The initial task is to gain a comprehensive understanding of the client's existing corporate governance policies and procedures, in particular the following:

- Governing documents: including Memorandum and Articles of Association, shareholder agreements, intercompany agreements
- Board structure and function: including election, roles, meetings, committees and committee charters
- Authority and approval processes: including finance, procurement, human resources, strategy and business development, contracts, and marketing

2. Benchmark the company against regulatory requirements and best practices.

The second task is to benchmark the client's corporate governance practices against requirements or recommendations of the local financial authorities, as well as best practices as reflected in model codes and/or recommended by groups such as Hawkamah, OECD, and IFC. This exercise will clarify those areas where the client's current corporate governance is adequate, and those areas where improvement is required or recommended.

3. Make necessary changes to corporate governance documents and procedures.

The final task is to utilise what was learned in the review and benchmarking exercises to implement meaningful improvements in the client's corporate governance status. This undertaking will generally include making proposed revisions to, or drafting new versions of, such governance documents as:

- Board committee charters
- Company corporate governance manual, including a code of conduct, procurement policy, human resources policy, employee confidentiality and ethics agreement
- Financial authorities rules/matrix
- Other approval matrices

At the end of this process, the client can expect the following beneficial outcomes:

- Improved decision-making, as a consequence of clarified/simplified internal roles, responsibilities, authorities and processes
- Clear and consistent corporate policies
- Compliance with both regulatory requirements and global best practices

It is tempting to view the renewed focus on corporate governance, in the MENA region as well as globally, as a burden that must be reluctantly borne. The reality is quite different. MENA companies that are dedicated to corporate governance improvements are finding that corporate governance goes hand in hand with quicker decision-making, clarity of vision and improved profits.

Robert Walton and Michael Whitener are principals in the Washington, D.C. office of VistaLaw International LLC (www.vistalaw.com), a global legal services firm. This article was published in the online newsletter *Compliance Insider* in May 2010. *Compliance Insider*'s logo is used with permission from and is copyrighted by the Springer Media Group.