Legal Regulation of the Saudi Stock Market
Evaluation, and Prospects For Reforms

By

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University of Warwick, School of Law

January 2000
To My Parents
To My Wife
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My love and thanks to my wife for putting up with me over the past two years. Thanks also go to my family for their love and support.
Declarations

Except where otherwise indicated, this thesis contains an account of my own independent research undertaken in the Law School, University of Warwick, under the supervision of Professor Joseph McCalhery.

It is being submitted for the degree of Doctor of Philosophy at the University of Warwick in England. It has not been submitted before for any degree of examination in any other university.
Abstract

The aim of this thesis is to explore which laws and institutions are essential for a strong, well-developed and efficient securities market in Saudi Arabia. In connection with understanding the significance of the subject matter, this dissertation seeks to explore the development of the modern securities market, assess the recent efforts to create new rules and institutions that could modernise the market, and offer suggestions for reforms that could stimulate further market development. This addresses the issues of coherence in regulatory and supervisory rules and norms at national level. The Saudi market is not as competitive as other regional markets. It is a bank-dominated system in which several large institutions exert significant influence on the pattern and structure of market activities. The absence of non-bank intermediaries within the financial system has meant that the Saudi market is structurally less well developed. Indeed, the lack of competition in the market, due to the absence of market makers, has led to acute problems in the area of finance, where the lack of competition in the market has resulted in higher prices and a lower level of liquidity. At the same time, there are serious regulatory problems associated with a bank-dominated system. Recent work on these markets has shown that they are characterised by insufficient transparency, wide bid-ask spreads insider self-dealing and market manipulation. This thesis examines the transformations taking place in the regulation of the Saudi stock market and considers them against the backdrop of increased competition from other national exchanges in the Gulf region. This work also investigates the pressure to remove protectionism regulation put on the national supervisor by large investors seeking more accurate and timely information and the limitation of insider trading by structural insiders. This thesis will seek to show that the introduction of regulatory reforms could yield significant benefits for investors. The prospect of greater transparency and public disclosure of information about companies could enhance the relative liquidity of the Saudi Arabian exchange and lower the cost of transactions.
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<td>AFBBD</td>
<td>Association of Futures Brokers and Dealers</td>
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<td>CSA</td>
<td>Central Share Account</td>
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<td>CTU</td>
<td>Central Trading Unit</td>
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<td>DTI</td>
<td>Department of Trade and Industry</td>
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<td>EMF</td>
<td>Emerging Markets Factbook (IFC)</td>
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<td>ESIS</td>
<td>Electronic Securities Information Service</td>
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<td>FIMBRA</td>
<td>Financial Intermediaries and Brokers Regulatory Association</td>
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<td>FSA</td>
<td>Financial Services Act</td>
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<tr>
<td>GCC</td>
<td>Gulf Cooperation Council</td>
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<td>GDP</td>
<td>Gross Domestic Product</td>
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<td>GIF</td>
<td>General Investment Fund</td>
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<td>GOSI</td>
<td>General Organization For Social Insurance</td>
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<td>IFC</td>
<td>International Finance Corporation</td>
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<td>IMRO</td>
<td>Investment Management Regulatory Organisation</td>
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<tr>
<td>IPO</td>
<td>Initial Public Offer (of securities)</td>
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<td>ISIN</td>
<td>International Securities Identification Number</td>
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<tr>
<td>ITSA</td>
<td>Insider Trading Sanction Act</td>
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<td>ITSFEA</td>
<td>Insider Trading and Securities Fraud Enforcement</td>
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<tr>
<td>LAUTRO</td>
<td>Life Assurance and Unit Trust Regulatory Association</td>
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<tr>
<td>MOC</td>
<td>Ministry of Commerce</td>
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<tr>
<td>Acronym</td>
<td>Full Form</td>
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<tr>
<td>MOF</td>
<td>Ministry of Finance</td>
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<td>MOIE</td>
<td>Ministry of Industry and Electricity</td>
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<tr>
<td>NASD</td>
<td>National Association of Securities Dealers</td>
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<td>NASDAQ</td>
<td>NASD Automated Quotation</td>
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<td>NCCI</td>
<td>National Cooperative Company For Insurance</td>
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<td>PF</td>
<td>Pension Fund</td>
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<td>PIF</td>
<td>Public Investment Fund</td>
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<td>RIE</td>
<td>Recognised Investment Exchange</td>
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<td>RPB</td>
<td>Recognised Professional Body</td>
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<td>Saudi Arabia Basic Industries Corporation</td>
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<td>Saudi Arabian Investment Fund</td>
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<td>Saudi Share Registration Company</td>
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Chapter 1

Introduction

1. Introduction

The aim of this thesis is to explore which laws and institutions are essential for a strong, well-developed and efficient securities market in Saudi Arabia. In connection with understanding the significance of the subject matter, this dissertation seeks to explore the development of the modern securities market, assess the recent efforts to create new rules and institutions that could modernise the market, and offer suggestions for reforms that could stimulate further market development. In the main, the thesis provides an assessment of the quality and effectiveness of the operational and regulatory infrastructure of the securities market in Saudi Arabia.

The Kingdom's securities market is well established and its growth has been impressive. In 1999, market capitalisation was SR 200 billion. This level of total market capitalisation makes it the largest securities market in the Arabic region. Banks play a central role in the Kingdom's systems of finance for investment. The financial sector is said to possess the same basic characteristics of those in continental Europe, which are regarded as 'bank-based' systems. The supposedly strong involvement of Saudi banks in the development of the stock market is widely regarded as having made an important contribution to the successful growth and evolution of the market. Whilst most research has focused

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1 For a description of the continental approach, particularly Germany, see J. Edwards and K. Fischer, Banks, Finance and Investment in Germany, Cambridge, Cambridge University Press, 1994.
traditionally on the relationship between banks and economic growth, recent work has pointed to the link between financial intermediation, long-term economic growth and the emergence of useful financial information.

A successful national equity market, which functions well in terms of size, liquidity and integration with the world capital markets, requires strong securities laws and institutions. Information is essential for efficient markets, and markets will be well-informed only if all market participants are able to obtain information at reasonable costs. Whilst there are various impediments to non-bank financial intermediaries and institutions in developing countries, the absence of disclosure of accurate financial information about companies is without doubt the most serious. Thus, if a national securities market is to develop, policymakers need to establish adequate disclosure and transparency standards.

Even with good public disclosure, such as exists in the USA, there will be limits to the degree to which market discipline can create an overall climate of stability in the securities market. As securities markets in developing countries continue to mature, institutions will need to bear a great part of the responsibility for maintaining and sustaining active securities markets. Regulators will have to adapt their legal and institutional frameworks to suit them to the changed circumstances in the market. This suggests that developing countries will need to

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undertake a number of developments simultaneously in order to create a consistent and unified framework. If such a strategy is to succeed in strengthening the stock market, it will need to protect investors from being poorly informed, aid in the promotion of the efficient allocation of capital, and assist generally in managerial agency cost reduction.\(^5\)

Certainly, diverse jurisdictions have securities law regimes that differ in the relative burden of information disclosure, regulation of financial intermediaries, surveillance of trading systems, enforcement of the rights of investors, and control of capital balances percentages of firms over their investments.\(^6\) The new comparative research on securities markets has shown that some legal systems give investors more protection against fraud and expropriation than others and has suggested that controlling information asymmetry is an essential precondition for building a strong capital market.\(^7\) For example, differences in the level and scope of the regulation of financial intermediaries could be far more useful to investors in ensuring market transparency. The premise of this new research is that the relative importance of the higher priority accorded to protecting minority investors against appropriation correlates positively with the strength of a country’s capital market.\(^8\) Given the

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positive relationship between the quality of the legal environment and the development of the financial market,⁹ the critical question becomes: What are the essential laws, standards and institutions that are critical for the establishment of capital market development positively associated with long-term economic growth?¹⁰

This thesis addresses three main issues. First, it seeks to understand the ways in which regulatory and economic domains are interdependent in the Saudi financial markets. Regulatory authorities interact with market actors in the establishment of an institutional regime which forms a regulatory framework for the national financial market. There is a clear linkage between particularistic economic interests, working through but not confined to the commercial activities of banks and other financial market participants, and the policy processes which regulate and supervise the national securities market. The rules of the securities market are contestable, even though the financial regulators in Saudi Arabia have very little control over the ways in which banks and other players respond to the institutional framework that is already in place. Understanding these linkages and the role of the changing relations among financial actors in the market calls for a socio-legal approach to the subject matter, so as to understand not just the patterns of institutions and rules themselves, but also the very mainsprings of their emergence and transformation.


Second, this research raises the question of the interaction of competing national regulatory strategies in the context of a global market economy, which poses problems for regulator cooperation. Government tends to respond to largely domestic constituencies. Despite the emergence of a global capital market, the interests of policy communities operating in contrasting domestic regulatory and market systems may well conflict, leading to tension and competition, rendering cooperation difficult. Nevertheless, the capacity of national regulators to resolve policy problems regarding their securities market is in no doubt. The role of private sector actors is again crucial, since transnational corporate actors have led to increasing economic interdependence in a system of competitive regulatory regimes. This dissertation will aim at improving our understanding of the regulatory strategies within Saudi Arabia that seek to improve market opportunities for national constituencies and to enhance the attractiveness of the Saudi Arabian market to foreign investors. In this regard, it seeks to ascertain whether the stepped-up competition in global securities markets and regulatory regimes have been responsible for the innovations in the institutional patterns of regulation and supervision at national level. This approach brings a unique view on the possible extent to which patterns of securities regulation are affected by competing regulatory and domestic market changes.

Third, this study addresses the issues of coherence in regulatory and supervisory rules and norms at national level. The Saudi market is not as competitive as other regional markets. It is a bank-dominated system in which several large institutions exert significant influence on the pattern and structure of
market activities. The absence of non-bank intermediaries within the financial system has meant that the Saudi market is structurally less well developed.\textsuperscript{11} Indeed, the lack of competition in the market, due to the absence of market makers, has led to acute problems in the area of finance, where the lack of competition in the market has resulted in higher prices and a lower level of liquidity. At the same time, there are serious regulatory problems associated with a bank-dominated system. Recent work on these markets has shown that they are characterised by insufficient transparency, wide bid-ask spreads, insider self-dealing and market manipulation.\textsuperscript{12} This thesis examines the transformations taking place in the regulation of the Saudi stock market and considers them against the backdrop of increased competition from other national exchanges in the Gulf region. This work also investigates the pressure to remove protectionist regulation put on the national supervisor by large investors seeking more accurate and timely information and the limitation of insider trading by structural insiders. This thesis will seek to show that the introduction of regulatory reforms could yield significant benefits for investors. The prospect of greater transparency and public disclosure of information about companies could enhance the relative liquidity of the Saudi Arabian exchange and lower the cost of transactions. Attempts at reforms along these lines have been problematic in the past. This dissertation will seek to understand the patterns of conflict within the regulatory field against the background of national-based financial interest which currently dominate the system of control towards the reform of regulatory policies.

2. The Importance of this Research

As noted earlier, the financial system plays a major role in economic development, mainly by linking up capital providers and capital users. Several economic writers, such as Cameron, Gurley and Shaw, and more recently Levine, have suggested the existence of a strong relationship between financial development and economic growth. Gurley and Shaw have argued that the relationship between the financial system and economic growth is due to the significant benefits accruing to the economy from the institutionalisation of savings and investments that diversify channels for the flow of loanable funds and multiplies varieties of financial claims. The absence of a developed financial system tends to limit the efficiency with which savings can be used. Since there is no way to transfer funds from savers to investors, the only way an individual can invest is to rely on personal savings, or an investment scheme that directly links savers with users. The problem with such direct investment is that there is no mechanism for reconciling the savings needs of savers with the investments needs of users, which makes it difficult for savers to find users whose needs match their requirements with respect to highest yields, lowest risks and maximum liquidity. Patrick has shown how the financial system could solve these problems by creating a wide variety of financial claims that would serve as assets

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for savers, with claims being differentiated in terms of liquidity, yield, maturity, divisibility, risk of default or change in value, and other services. In that way, via the bridge that financial intermediaries provide, capital providers would be encouraged to save and reinvest their income in line with their requirements, while capital users, on the other hand, would find the capital they need for their investment. In fact, the real economic benefit of a well-developed financial system lies in the fact that it helps to accelerate savings, to improve funds allocation by channelling them to the most productive investments, and to reduce the cost of transferring savings. A developed financial system also tends to help in channelling funds towards the most productive investments.

Recently, economists have argued that a strong securities market can facilitate economic growth in that it becomes easier for companies to raise capital. In this regard, securities markets, in contrast to markets dependent on banks, offer companies greater flexibility and allow them to grow more rapidly. Of course, creating a strong capital market is difficult and requires strong institutions and effective rules. The shortcomings of bank finance and securities regimes run by conglomerate banks were, in part at least, responsible for many of the recent problems in Asia.

Only limited prior work has been done on the legal prerequisites for strong securities markets. Black advanced a theoretical argument that a country whose

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laws and institutions protect minority shareholders and provide good information to investors will tend to support the development of a strong national securities market.\footnote{B. Black, 'The Legal and Institutional Preconditions for Strong Stock Markets: The Non-triviality of Securities Laws', working paper 1999.} La Porta, Lopez de Silanes, Shleifer & Vishny produced evidence that legal protection of minority investors tends to correlate with the strength of a country's capital market.\footnote{R. LaPorta, F. Lopez de Silanes, A. Shleifer & R. Vishny, 'Law and Finance', 106 J. Pol. Econ., 1998, pp. 1113-1155.} La Porta et al. show that the level and development of legal protection of a securities market depends on the nature and origins of the country's legal system. More recently, Coffee has argued that securities laws that protect minority investors are valuable to investors. He observed that investors from countries with weak legal protection are able to solve this problem by listing their shares in markets of developed countries with high-quality legal protection.\footnote{J. Coffee, 'The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications', Northwestern Univ. Law Review 93, 1999, pp. 641-707.}

This is the first work of its kind that provides extensive socio-legal evidence regarding the effectiveness of certain reforms in the laws and institutions of a developing country's securities regime. Unlike earlier work, this thesis acknowledges that promoting an adequate legal foundation is necessary for the development of a broader and deeper securities market but accepts as inevitable that reforms can proceed only as quickly as the incumbent groups themselves benefit from changing the rules.\footnote{See, generally, L. Bebchuk and M. Roe, 'A Theory of Path Dependency in Corporate Ownership and Governance', Stanford Law Review (forthcoming).} Creating new institutions is, after all, difficult in developing countries whose legal traditions are at best weak in enforcement and in financial intermediary development.\footnote{R. Levine, 'Law, Finance, and Economic Growth', p. 22.}
3. The Importance of the Securities Market to Saudi Arabia

The evolution of a country's financial system cannot be analysed in isolation from the state of that country's general economy. The maturity of the financial system determines the efficiency of the allocation of savings and investments in the economy, and sustainable economic growth. It is hard to imagine a country being able to have, at the same, a sophisticated financial system and an underdeveloped economic system. Usually, economic development goes hand in hand with, innovations in the financial system. Although governments may initially attempt to compensate for the imperfections of the financial system by acting as the leading investor, in the longer run they have to adapt the financial system to the level of economic development. In particular, for liberalisation of the trade and capital account, adjustment of the regulatory system is required. A study of innovation in a country's financial system must therefore be accompanied by an analysis of its economic development. The next section (3.1) will present an analysis of the Saudi economy, showing the need for the development of a sophisticated stock market.

3.1 The Saudi economy

Economic growth in Saudi Arabia since 1945 has been closely tied to the level of oil production and the movement of oil prices. Following its discovery in 1938, oil quickly became the main source of revenue. Although the Kingdom's oil production and income was initially modest (around 11,000 barrels a day), this

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27 Prior to the discovery of oil in the 1930s, the Saudi economy revolved around pilgrimage in the western region together with subsistence farming and pearling in the eastern region.
early oil income did stimulate the government to finance major infrastructure works and modernise its economy. In the 1960s, as a result of the stable 'posted prices' and given the growing oil production, oil income could only increase. The oil production of both Saudi Arabia and Iran outpaced the growth in world production, while other major producing countries underperformed as a result of the market management policy of their major oil-producing companies. In 1960, Venezuela, Iran, Kuwait and Saudi Arabia attempted to create a stronger negotiating position with the international oil companies in order to be able to protect themselves against the stick-and-carrot policy that oil companies had hitherto applied in their dealings with individual governments. The tug of war over price and production levels with the international oil companies changed pace in the early 1970s, when price increases were negotiated in the Teheran and Tripoli agreements. The First Five Year Plan dates back to this period. However, massive investments to stimulate economic development and the modernise the economy only became possible after the price increase of 1973-1974, when oil prices rose by 400%.

Initially, investments were predominantly geared towards developing the physical infrastructure. The lack of roads, ports, airports and a telecommunication system were major impediments to modernising the economy. However, it seems that the high, easily earned revenues resulting from oil price levels during

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30 Ibid.
this period meant that there was less inducement for the government to pursue any serious policy of diversifying the economy away from its reliance on oil.  

The result was that the infrastructure for the oil industry served this one industry only, and did not serve the wider economy. The Saudi economy was very much a two-track affair, with a modern sector functioning in isolation from the traditional rural economy.

The halcyon days of the oil boom quickly came to an end in the mid-1980s when oil prices fell sharply, reducing the Kingdom's revenues and bringing the phase of generous spending on infrastructure to an abrupt halt. Fortunately, by that time, the government had almost completed its infrastructure programme. The sharp decline in world oil prices left the Saudi budget in deficit. The first serious deficit, of SR 23.8 billion, appeared in 1983, the first year of several in a row in which the budget was in deficit. As a result, the government was forced to reduce its expenditure, a move which led to an economic slowdown. This sharp cut in government expenditure led the private sector to look for sources of profit other than government contracts. Surprisingly, the Saudi economy had bounced

33 Wilson, *The Economies of the Middle East*, p. 40.
34 The Kingdom's OPEC quotas restrain its current production to only 8 million barrels. According to the International Energy Agency (IEA) estimation, Saudi Arabia's total production capacity is 10.25 million barrels per day, making it by far the largest producer in the world. Furthermore, the Kingdom has in the order of 260 billion barrels of proven recoverable crude oil reserves, representing more than 25% of the world's total crude oil reserves. At the current rate of production, Saudi reserves would last for approximately 100 years. The Kingdom's gas reserves were 190 tcf (trillion cubic feet) at the end of 1995, representing 3.8% of global gas reserves, putting Saudi Arabia in third place behind Russia. Finally, recent studies have shown that the Kingdom has the largest mineral deposits in the Arabian Peninsula, including deposits of gold ore, copper and phosphates. N.A. Rashid and E.I. Shaheen, *Saudi Arabia and Gulf War*, International Institute of Technology, 1992 and A. Johany, M. Bome & Mixon Jr., *The Saudi Arabian Economy*, Croom Helm, London, 1986.
36 Ibid. Al-Dukhiel states that the first deficit after the oil boom years appeared in 1977 with an amount of SR 7.5 billion; that amount rose in the following year to SR 16.5 billion. These deficits were financed by drawing on government reserves, and no adverse effect was felt on the economy.
back by the end of the 1980s. During this time, the government managed to
reduce its budget deficit from SR 69.7 billion in 1987 to SR 34.9 billion in
1989.\(^\text{37}\)

Unfortunately, this upturn in the Saudi economy was briefly disrupted by
the Gulf War. The fiscal impact of Iraq’s invasion of Kuwait and the subsequent
Gulf War was great and added to the budgetary deficit. For 1990 and 1991,
budget data show total expenditures of SR 476.5 billion, with a deficit of SR
160.1 billion.\(^\text{38}\) The impact of the expenditure on the war was so far-reaching that
it resulted in work on urgently needed programmes and projects in the Kingdom
being delayed. However, from 1993 through to 1995, the government took tough
measures to curb the deficit. The government’s budgeted expenditure was
reduced by approximately 24%, from approximately SR 195 billion to SR 150
billion. At budgeted production levels, Saudi Arabia crude oil prices needed to
average some US$ 14 per barrel in order to meet 1996 budget plan revenue
objectives and to bring the fiscal deficit down to somewhere in the region of only
SR 15 billion. Oil prices in 1996 were higher than assumed in the annual budget
statement, as was actual expenditure, but the actual deficit turned out to be lower
than planned.

The Saudi economy showed strong growth during 1996, with GDP
growing by 8.6% in current prices. At the end of 1996, GDP was SR 510 billion,

\(^{37}\) Ibid.

\(^{38}\) The substantial costs of the Gulf War and the enormous outflow of related payments, the Saudi
payment deficits was reduced, despite the oil exports decline by 1.2%. Non-oil exports, however,
rose sharply by 18.6 percent. However, the Kingdom benefited from oil price rises in 1995 and
1996. The balance of payments showed a remarkable improvement during 1996, with the current
account showing a surplus. Preliminary estimates indicate that oil exports increased by 15.4%.
During this year, Saudi Arabia posted a small surplus on its current account for the first time in 13
compared to SR 469 billion in 1995. The private sector’s contribution to economic activities continued to grow. Private sector GDP grew by 3.5% in 1996, making up 35% of total GDP in current prices. This increase is notable considering that both the oil sector and the government sector also grew in 1996. The favourable economic conditions in 1996 continued into 1997. During 1997, GDP grew by 7.1% in current prices, which meant that positive growth was recorded for the fourth consecutive year. At the end of 1997, GDP was SR 547 billion, compared to SR 510 billion in 1996. The private sector also recorded a growth of 4.1% in 1997.

As noted earlier, the Kingdom’s economy is highly dependent on public sector spending, which in turn is dominated by oil revenues. Consequently, when, in 1998, oil prices fell to a 25-year low and Brent crude fetched as little as $11 a barrel (40% less than it had done on 31 December 1997), the Kingdom’s economic growth was seriously affected. The 1998 budget statement said that government income amounted to SR 143 billion in 1998, 23% less than in 1997. Unlike previous years, when government expenditure had consistently exceeded the amount budgeted, actual expenditure in 1998 fell by 3.6% of the original appropriation. Although, following the reduction of the deficit in 1997 to only SR 6 billion, the government was hoping to balance its budget in 1998, the fall in oil prices during the year pushed the deficit up to SR 46 billion, postponing the hope of balancing the budget to the next decade.

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40 Ibid.
According to the 1998 budget statement, the Kingdom’s real GDP is estimated to have grown by 1.6%, while the nominal GDP dropped sharply by 10.8% to SR 487.5 billion. The large gap between the real and the nominal growth is attributed to the decline in oil and petrochemical prices.\textsuperscript{42} The sharp drop in oil prices in 1998 is estimated to have led to a 34.8% contraction in the nominal oil-sector GDP in 1998. The performance of the non-oil sector is estimated to have been stable. The private sector grew by 2.2%, contributing nearly 39% of nominal GDP in 1998. The Kingdom’s non-oil exports are expected to have fallen by approximately 10% to SR 24.9 billion, which is mainly attributed to the decline of petrochemical and cement prices.\textsuperscript{43}

The sharp decline in oil prices in 1998 and its huge impact on the Kingdom’s economy show that no lessons were learned from the experience of the decline in oil prices in the early 1980s. All incentive to implement serious measures to reform and diversify the Kingdom’s economy soon disappeared when oil prices improved again. Today, history is repeating itself, and the Kingdom’s economy is still dominated by the petroleum sector, which for the past two decades has contributed an average of nearly 40% of GDP, 75% of government revenues and more than 90% of export receipts. Furthermore, the Kingdom has

\textsuperscript{42} Ibid., p. 4.

\textsuperscript{43} Over the past two decades, the Kingdom has managed successfully to control inflation. In 1990-1991, inflation rose to about 5% because of the rapid expansion of domestic demand in the aftermath of the invasion of Kuwait, which presented the government with a real challenge. In 1992, inflation levels fell to a small negative percentage, and in 1993-1994 it was around 1%. In 1995, the government decided to reduce some of the subsidies in gasoline prices and electricity and telephone rates. Inflation again rose to about 5% for a short time, reflecting these one-off measures. In 1996 and 1997, inflation returned to its very low rate. In 1998, inflation is estimated to fall by 0.2%. See SAMA Thirty -Fourth Annual Report, Riyadh, 1998.
had a budget deficit every year since 1983; and the private sector is still playing a negligible role, lagging behind the public sector.44

3.2 A new era and the role of the stock market

In face of the current weak economic situation, the Saudi government has announced a set of initiatives that represent a wide range of economic reforms for the coming five years. First, the government has embarked on a comprehensive privatisation programme,45 which it has started by announcing the transfer of the Saudi Telecommunications and Postal Services agency to a joint-stock company called Saudi Telecommunication Corporation.46 Recently it has also been announced that certain services and utilities will be sold to the private sector, including Saudi Airlines, local newspapers, and most of the utilities (i.e., water,

44 The Sixth Five Year Development Plan 1995-2000 states that “the longer-term development of the Saudi economy is becoming increasingly dependent on the ability and willingness of the private sector - with appropriate government support - to recognize and grasp emerging opportunities to engage in new and more complex economic activities whose returns on investment may be longer and may carry more risk than earlier ‘safe’ investments in real estate and trading activities.”

45 The Sixth Five Year Development Plan 1995-2000 set forth the main objectives of the privatisation programme. It stated that the first stage should concentrate on the mobilisation of private sector funds for investment in new and ongoing public-sector projects which, due to budgetary constraints, are experiencing financing difficulties. Second, it called for the granting of more opportunities to the private sector to manage and operate public-sector projects. Third, it recommended the gradual sale to the private sector of government shares in joint-stock companies, to be implemented following in-depth studies of each individual case, so that the social and economic costs and benefits can be properly evaluated and timing determined when appropriate conditions prevail. Finally, it called for the promotion of a favourable climate for private investment through extending and increasing the effectiveness of the market mechanism.

46 See Council of Ministers’ resolution of 15 December, 1997. Minister of Post, Telephone and Telegraph stated that the company will begin operations as a joint-stock company within six months of the date of the resolution. However, during the first two years, the government will retain 100% ownership and only subsequently begin to sell its equity to private investors in tranches. The government believes that in this way it can ensure that the commercial structure of the governmental agency will be fully in place and the agency will be able to operate properly in the private sector.
transport and power). It is anticipated that bringing these concerns to market will yield the government proceeds exceeding $100 billion.

The second major initiative is the liberalisation of the country's economy. The government has recently announced that reforms of the tax code and other rules that discriminate against foreign investors are now under review. The Sixth Five Year Development Plan calls for serious study and evaluation of which rules and regulations are needed to attract more funds to the domestic market both from Saudi and foreign investors. The Kingdom's commitment to extensive liberalisation of the Kingdom's economy has been prompted by its ongoing efforts to join the World Trade Organization (WTO). Membership of the WTO should result in freer access to world markets for Saudi oil and petrochemicals exports. It may also entail further reforms to the country's trade regime. Saudi Arabia is seeking to join the organisation as a developing nation, a status which would grant it a period of grace of 5 to 10 years within which to adapt its legislation and trading practices.

The Kingdom is also committed to altering the ownership structure of firms which are dominated almost exclusively by unlisted family-owned companies. A recent statistic published by the Riyadh Chamber of Commerce revealed that more than 200 well-established companies with an average of $100

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47 The Minister of Industry & Electricity has announced the unification of the four regional Scesscos (Consolidated Electricity Companies) into one company which will be sold entirely to the public by the year 2000. The new company will require an investment of SR 48 billion by 2000 and a staggering SR 438 billion by 2020, which is clearly beyond the means of the government alone.

million capital are willing to go public. As in Europe, it seems that, if reforms are implemented successfully, the family-based system of ownership will shortly come to an end. Most of the founders of such companies have reached retirement age, and it is doubtful whether their successors (assuming they decide not to liquidate) are in fact capable of running the companies successfully. Hence, the only option for these companies if they wish to remain strong in the market is for the family to sell some of their shares to the public. This will ensure the continuation of the company in a market-based rather than a family-based context.

For the Kingdom to enter a new stage of economic development, it must develop new institutions to guide the legal reform of the stock market. An efficient and well-regulated stock market will help the government in its plans to diversify the economy. It will allow the greater foreign participation in the stock market that will be required to make the privatisation programme a success, which, in turn, enhancing as it does the role of the private sector in the economy, is a prerequisite for the Kingdom to gain membership of the World Trade Organization.

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49 The Chamber of Commerce Study of Private Sector Activities, Riyadh, 1997. The study reveals that the adoption of free-market principles, low-rental factories, low utility costs, an exchange rate fixed against the US dollar for over ten years and free capital mobility has promoted the growth of the private sector in the last decade. During this period, there were a total of 2,637 factories, an increase of over 100%. The number of operating companies increased from 1,473 companies with a total capital of SR 7 billion in 1975 to 7,743 companies with a total capital of SR 120.7 billion in 1996. Over the last two decades, the contribution of the private sector to GDP has risen from 21% to about 45%, increasing its contribution of the Kingdom’s non-oil GDP to 72%. Furthermore, there was an increase in the private sector share of fixed capital formation: this rose from 34% in 1975 to 67% in 1994. Finally, jobs in the private sector increased from about 1.4 million in 1970 to more than 6 million by the end of 1996, with the result that in that year 88% of the Kingdom’s 6.9 million workers were employed in the private sector.
4. Methodology

The aim of this dissertation has been to assess the genesis and development of the regulatory structure of the market. To achieve this, we have employed socio-legal fieldwork techniques in order to find appropriate explanations to the questions addressed. Due to the fact that the Saudi stock market is relatively new, there was little in the way of secondary literature on the subject matter. This lack of academic sources also meant that fieldwork was an essential source of information. Furthermore, conducting interviews with market participants provided us the opportunity to get to know the views of insiders concerning the current situation of the Saudi market. The research relied on two essential research tools: documentary research and field work. The field work consisted of two aspects, namely semi-structured interviews and field observation.

4.1 Documentary research

In terms of documentary research, official papers, statistics, position papers/consultative documents of associations and institutions, newspapers and secondary work in the financial press, and scholarly journals were the main sources. Beside computer documentary research in collecting our primary and secondary sources, we consulted the libraries and research centre of the following institutions: Universities of Warwick, Oxford and Cambridge; Institute of Advanced Legal Studies; University of Birmingham; King Saud University; Institute of Public Administration; Institute of Banking; Ministry of Commerce; Ministry of Finance; SAMA; Riyadh Chamber of Commerce; American embassy
in Riyadh; Riyadh Bank; Bakheet Advisors; Consulting Centre for Finance and Investment; King Fahd Public Library; GCC Centre; and the Middle East Centre in London.

4.2 Field work

The questions asked in the interviews naturally reflect the main concerns of this thesis. After consulting a number of experts, I worked on acquiring further technical knowledge of social scientific fieldwork methods. This led to a deeper understanding of the complexities of obtaining good-quality information regarding the effectiveness of the legal regime of the Saudi stock market.

The research itself took place in two stages. To start with, our research project required substantial preparation. The relevant associations and institutions had to be identified, contacts had to be made with the most appropriate individuals and the atmosphere at the place of the field work had to be tasted.

The initial stage was therefore organised as a pilot project to clarify the vague environment of the field work and to test the suitability of our field work techniques. It also clarified which areas I should concentrate on and where there was general consensus.

The second stage of the research was the actual field work, which involved more in-depth study and avoided the mistakes and errors that happened during the pilot project. This stage was started on 1 November 1997 and ended on 11 February 1998.
4.2.1 Semi-structured interviews

For the semi-structured interviews, a broad range of industry officials and high-level government policymakers were contacted. This required substantial preparation and the first few months of the project were devoted to this work.

Face-to-face interview questions were then drawn up to collect more information from government officials and other stock market participants. Although we had arranged to interview a large number of people, the limitation of travel distance and time forced me to reduce the number of the interviewees to 27 and limit the area to only those people who lived in Riyadh City. Despite the limitation of the number of our interviewees, the group we worked with still represented an almost ideal sample because we made sure that the interviewees covered most of the major market players. They came from both the government and the private sector. We therefore divided our interviewees into two groups: government and private sector. While governmental interviewees were less happy to be taped, private sector interviewees had no problem with that. And although the private-sector employees accepted the structured and semi-structured approach to interviewing, some of the governmental interviewees were unhappy with it and only wished to answer the general questions.

First, we interviewed members of the government agencies involved in the Saudi stock market. In particular, the focus was on a number of specific institutions:

1. The Saudi Arabian Monetary Agency (SAMA), the main governmental body responsible for the regulation and supervision of trading on the Saudi stock market. Given the considerable involvement of banking firms in the Saudi stock market, it was necessary to investigate the Banking Control Department
within SAMA as the body responsible for regulating and supervising banks and investigating complaints and disputes involving banks. Our interview focused on regulatory practices developed in the Share Control Division of within SAMA. Special attention was given to assessing the effectiveness of the design of regulatory policy concerning the collection of trading information by market participants.

2. The Ministry of Commerce, a governmental body responsible for the supervision of companies and the regulation of the issuance of securities. Importantly, we had to determine whether there was pressure from private interest to influence the government regarding attempts to establish regulation according to the international standards.

3. The Ministry of Finance and National Economy, the main financial and economic policymaking body within the Kingdom.

Two to three weeks were spent in each agency. We interviewed certain players who were responsible for developing policy and rules of the Saudi financial markets. The interviewees included the Minister of Commerce and member of the Ministerial Committee, Mr. Osama Faqih; the Governor of SAMA and member of the Ministerial Committee, Mr. Hamad Al-Sayari; the Vice Governor of SAMA, Dr. Mohammed Al-Jassér; the Deputy Governor of SAMA and member of the Supervisory Committee, Mr. Jammaz Al-Suhaimi; the Deputy Minister of Finance and member of the Supervisory Committee, Mr. Mansoor Al-Mayman; the General Director of Companies in the Ministry of Commerce, Mr. Ail Al-Ottiby; and the Assistant Director of the Companies Department, Mr. Suleman Al-Mohammed. From the Securities Control Department, we spoke with Mr. Abdulrahman Al-Rashed, General Director of the Securities Control
Department, Maurice Gorman, Ayash, Al-Ayed, Al-Qarnni, Al-Amree and Al-Sobai. The interviews were conducted in the offices of the interviewee. Only four of them were recorded on tape. I was permitted to take hand-written notes.

In order to obtain a balanced view of the effectiveness of Saudi securities regulations and their implementation, it was necessary to talk to market participants who have been the most affected by such rules, and who had no role in drawing them up. In order to avoid a one-sided view of the market regulations, interviewees from the private sector were selected from various backgrounds and groups, such as banks, consulting agencies, investment agencies, companies, large traders and small traders. In order to get a good number of interviews from each sector, we tried to reach as wide a group of interviewees as possible. We were able to talk to many people from the private sector, including:

Mr. Yousef Al-Mobarak, Secretary General of the Saudi Organisation for Certified Public Accountants; Mr. Basher Bakheet, General Director of Bakheet Financial Advisors; Mr. Radi Haddad, Assistant Senior Manager of the Investment Service Department at Riyadh Bank; Fahad Al-Mobarak, General Director of Rana Investment Company; Mr. Nasser Al-Tewajiri, Manager of Brokerage & Custody Services at Arab National Bank; Al-Qamdi, Central Trading Unit Manager at the National Commercial Bank; Abdul Aziz Al-Dukhiel, President of the Consulting Centre for Finance and Investment; Abdullah Al-Qahtani, Operation Manager of the Saudi Registration Company SSRC; Abdulaziz Al-Gudai the Manager of Equity Services for Local Shares in The Saudi British Bank; Bandar Al-Muhareb, Central Trading Unit Manager of the Investment Group at Saudi Hollandi Bank; Khalid Al-Bassam, Investment, Sales and Marketing Department Manager of Al Bank Al Saudi Al Fransi;
Ahmad Al-Routea, investor; Hesham Al-Mossa, investor; Sami Al-Souage, investor; and Saud Al-Qahtani, investor.

Interviews with private-sector players offered a balanced view of the operation of the market. As noted earlier, we found easier to address question to private sector interviewees. All the interviews were carried out on the interviewees offices. All interviews were tape recorded and then transcribed.

4.2.2 Field observation

Field observation has been one of the most important sources of information. As noted earlier there is a little secondary literature on the Saudi stock market. Therefore, we had to use observation as one of our tools to gather information. This tool was mainly applied for the collection of information about the functioning of the SCD and the ESIS trading system. I spent ten days working closely with each division of the SCD. On the market side, I spent six days working with the Central Trading Unit at the National Commercial Bank and the Central Trading Unit at the Saudi Hollandi Bank.
5. Structure of the Thesis

This thesis can be divided into three main parts and is structured as follows. Part I (i.e., Chapters 1-3) is mainly concerned with providing a framework for and putting into context the matters to be discussed in Parts II and III.

Chapter 2 describes the growth of the Saudi stock market. Its evolution over three decades is divided into four distinct stages of development.

Chapter 3 deals with the current legal and judicial system in the Kingdom. The focus is on analysing the legal regime that governs the stock market. Salient features of the recently introduced legislative reforms are discussed and analysed here. This chapter also introduces the system of agency regulation and explains how the financial is currently controlled.

Part II (i.e., Chapters 4, 5 and 6) of this work deals with the main aspects of the Kingdom’s infrastructure and regulatory structure.

Chapter 4 assessed the Kingdom’s existing regulatory arrangements for the primary and secondary markets.

In Chapter 5, the characteristics of the supply-side of the Saudi market are discussed. Here, the benefits of institutional shareholding are discussed in the context of the dynamics of the current market. The chapter describes the recent stock market development, showing that it is characterised by an operating environment that is currently unable to fulfil the role in the economy that it should. In particular, the absence of key market intermediaries and foreign investors means that it is unable to raise the amount of new capital that it must to
adequately support private sector growth. In assessing the current level and form of institutional participation in the market, various reform issues are identified and discussed.

Chapter 6 examines the development of the Kingdom's electronic trading platform and clearing system, and emphasises the importance of these structures for the development of an efficient market. This chapter also examines the legal rules which structure day-to-day trading in the market.

Part III of the thesis (Chapters 7, 8 and 9) looks at the possibility of developing of an enforcement regime and examines the needs of participants in the market.

Chapter 7 is a crucial chapter in that it deals with the functioning of the disclosure regime in the Kingdom. In particular, it raises questions about whether the government requires too little disclosure and allows too much room for issuer discretion. Institutional and small investors are beginning to demand more information from companies. Thus, it is argued that without positive changes in the regulation of disclosure, the relative opportunities for development of the market will be constrained.

Chapter 8 investigates the rules regulating insider trading. The analysis of the Disclosure Rules shows that the regime needs to be further developed as an important part of the reform of the Kingdom's policy on securities enforcement.

Chapter 9 is concerned with the development of a single regulatory agency that would, in the broadest sense, play the role of a securities market regulator in the Kingdom. The consolidation of regulatory authority in a single agency would bring benefits in terms of developing a unified approach to market regulation and enforcement.
Chapter 10 provides, by way of conclusion, an evaluation of the overall direction of the market and the regulatory reforms that Kingdom policymakers could undertake in order to enhance the structure of the market.
Chapter 2

Evolution of the Saudi Stock Market

1. Introduction

Despite its relatively short history, the growth of the Saudi stock market has been impressive. In less than 15 years, the Saudi equity market evolved from an underdeveloped market into the largest market in the Arabic world, due to the presence of well-developed banks and advances in telecommunications and computer technology. The development of the Saudi stock market, like many other markets, started with its first activities in the primary market in the mid-1930s. Since then, the Saudi stock market has passed many intermediate stages of development to reach its current level of functioning and market size. Each stage of the development has had its impact on the structure, shape and regulations of the stock market. This chapter documents the development of the Saudi Stock Exchange, analysing the four formative stages in the growth of the market. The analysis of the growth in the market provides a basis for systematically assessing the current situation and prospects for reforms.

This chapter explores the importance of policies affecting the development of the stock market in the Kingdom. It further gives a broad institutional account of this development to outline the general characteristics of the four stages of development of the Kingdom's equity market. This approach complements the research on the relationship between stock market development and policy reform.¹ Based on the results of this research, it is observed that there

are four stages in the development. The formative phase (1935-1964) covers the early establishment of joint-stock companies that offered shares to the public by way of a simple charter granted by the Saudi government and without any licensing or disclosure requirements. The second phase (1965-1984) spans the period following the enactment of the Companies Act which introduced the first disclosure and securities regulations in the country. The third phase (1984-1989) includes the formation of the Saudi stock market and the enactment of the Executive Rules to regulate dealings in stocks and shares in the Kingdom. The fourth phase covers the period from the introduction of the electronic trading system in 1990 until the end of 1999.

This chapter is built up as follows. Section 2 provides a review of the initial stage of development of the Saudi market. Section 3 presents the second stage of growth of the market. Section 4 investigates the reforms that define the third phase of the equity market evolution. Section 5 covers the last period of stock market reform.

2. The First Stage (1935-1964)

This section introduces the analysis of the early development of the Saudi stock market. The evolution of the Saudi stock market can be traced back to the mid 1930s, when the first joint-stock company was established.\(^2\) During this period, the Kingdom was in the process of building a new country, and as a result, central

\(^2\) The Arabian Automobile, quickly liquidated, was the first joint-stock company established in the Kingdom in 1935 with a capital of SR 12 million divided into 26,300 shares.
development elements were mostly missing. Some government agencies had only just been founded and there was a lack of regulations and rules governing the operations of the commercial sector. The government also faced socio-economic challenges. The lack of financial resources at that time handicapped and slowed down the economic development of the Kingdom. The discovery of oil in 1938 provided the country with annual income. However, the oil income was not sufficient to support the government’s development plans. The financial difficulties the government faced in this decade affected growth in economic sectors as well as the primary market. The primary market continued a slow pace of development for the next two decades.

The early 1950s witnessed many serious policy steps taken by the government in order to transform the Kingdom from a subsistence economy into a modern one. In the 1950s the government began its programmes to build the country’s physical infrastructure. The plan commenced with the completion of government agencies and other major institutional structures the country still lacked at that time. The basic changes in the structure of the government influenced the activities of the private sector. The changes brought about by the introduction of institutions and rules were manifested by the increased economic

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5 The Kingdom’s production of oil in the early years was too modest (approx. 11,000 barrels a day) to enable the government to involve in major advance infrastructure reforms and modernisation of its economy. The early oil income helped the government to take the basic steps toward that goal. See S.A. Banafe, Saudi Arabia Financial Markets, Ayyoube Printers, Riyadh, Saudi Arabia, 1993, pp. 13-14.
activity that occurred in the early 1950s when the relative lull in market activity was broken. For example, three electricity companies went public, followed in 1954 by the establishment of the Arabian Cement Company. These joint-stock companies were formed in the 1950s by a charter granted by the Council of Ministers. As such, no disclosure or other process was required for a company to offer its shares to the public.

The period from 1955 to 1964 saw the establishment of 11 new public companies with a capital of SR 2,012 million and 19.6 million shares. It also saw the establishment of the first joint-stock company in the financial sector. Riyadh Bank was founded in 1957 with an initial capital of SR 50 million divided into 50,000 shares with a par value per share of SR 1,000. This period also witnessed the establishment of joint-venture companies such as ABSCO company, which was incorporated in 1960, with a capital of SR 6 million. It can be seen that most of the companies established in this period were in the cement and electrical power sectors or provided other basic facilities needed to meet the requirements for these services and facilities in the country.

In this ten-year period there was little active share trading and the secondary market was nearly dead. There were many reasons for this. First, joint-stock companies were still new in Saudi society, as result of which share trading was largely unknown and was limited to a few people. Second, the lack of regulation of joint-stock companies reduced public confidence in investment.

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9 Filmban, *Share Investment in the Kingdom of Saudi Arabia*, p. 79.
Third, the few people who were actively investing in joint-stock companies were long-term investors. Finally, the available number of shares for trading was limited, due to the small number of issued shares. Due to the absence of new initiatives with respect to regulatory institutions on the part of the government, it is doubtful whether any material change could have been introduced.

3. The Second Stage (1965-1984)

The next decades saw the establishment of the Saudi stock market. The transformation of the market was influenced by three major events. By the early 1960s, it had become clear that, in order to facilitate economic growth, the government would need to enact company law legislation. It was the enactment of the Companies Act in the mid 1960s which first organised the primary market and regulated and supervised all the companies that wished to go public. The Companies Act introduced disclosure requirements, which provided investors with necessary information about the incorporated companies. Furthermore, the rapid increase in oil prices in the 1970s provided the country with massive revenue. Finally, there was the establishment of the government’s Five-Year-Development Plans, which had as their main objective to achieve high growth rates in all sectors of the economy and to increase the role of the non-oil sectors of the economy to create the conditions for the country’s eventual reduction of its dependence on oil revenues. In order to avoid the problem of the ‘Dutch

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15 Filmban, Share Investment in the Kingdom of Saudi Arabia, p. 99.
16 The Companies Act was issued under Royal Decree No. M/6, 1965 and amended under Royal Decree Nos. M/5 in 1967; M/23 in 1982; M/46 in 1985; and M/22 in 1992.
disease’, the government developed a plan that was designed to stimulate the Saudi private sector, starting with the ‘Saudisation’ of some of the foreign firms, especially banks.\textsuperscript{18}

Between 1965 and 1975, 37 new joint-stock companies were established. By the end of 1974, there were more than 54 joint-stock companies with a total capital of SR 6,509 million, divided into 44.8 million shares.\textsuperscript{19} Despite the large number of new companies that subscribed, the shares of only 14 companies were traded in the secondary market. The establishment of many new companies had little effect on the increasing liquidity in the secondary market.\textsuperscript{20} By 1975 it had become clear that an active interest in trading and in the local stock market was emerging. Table 2.1 shows that, during the period 1975-1980, there was a substantial increase in the number of joint-stock companies in the Kingdom. More than 43 new companies were established in different sectors.

The nucleus for growth was supported by a number of factors. The first and most important factor was the injection of private liquidity generated from the government’s spending on the development of the infrastructure and the distribution of oil revenues directly or indirectly to the Saudi public.\textsuperscript{21} The revenues from the oil boom mainly supported the government’s spending on infrastructure projects, costing approximately SR 658 billion, an increase of more than 800% compared to the first plan.\textsuperscript{22}

\textsuperscript{19} Filmban, \textit{Share Investment in the Kingdom of Saudi Arabia}, p. 81.
\textsuperscript{20} Ibid.
\textsuperscript{22} Ibid., pp. 28-29.
Second, the economic transformation of the secondary market benefited from the conversion of foreign banks into joint-stock companies. One event that significantly affected the activities on the Saudi stock market was the Saudisation of foreign banks, which began in 1976. Nine foreign banks were converted into joint-stock companies with a total capital of SR 1,750 million and more than 17 million shares. Saudisation was a strategy of the government to deepen the integration of the national financial services sector. According to this strategy, all banks operating in the Kingdom were required to have a minimum participation of 60% by Saudi nationals within a period of one year. In 1975, the National Bank of Pakistan was Saudisised and renamed Al Jazirah bank with a capital of SR 10 million. The Saudi Investment Bank was established in 1976 with a capital of SR 30 million, with the Commerzbank and Chase Manhattan Bank both having substantial equity stakes in the bank. A year later, the Saudi French Bank was established with a capital of SR 200 million. In 1979, the British Bank was established, with a capital of SR 100 million. In the same year, the Saudi Cairo Bank and Arab National bank were established. All of these banks are joint-venture banks with a maximum of 40% foreign ownership.

Third, the local stock market benefited from the partial offering of certain government holdings, especially in the electricity and industrial sectors. Significant mergers in the electricity sector had the further effect of stimulating local market activity. Continuing its support of the industrial sectors, the

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23 Ibid., p. 42.
25 Ibid., p. 61.
26 Ibid.
27 Filmban, *Share Investment in the Kingdom of Saudi Arabia*, p. 82.
government created the largest joint-stock company in the country, the Saudi Arabian Basic Industries Corporation (SABIC), which was established with a capital of SR 10,000 million divided into 10 million shares.\textsuperscript{28} A significant development occurred in the transportation sector when two shipping and transport companies were founded. In 1978, the Saudi National Shipping Co. was established, with a capital of SR 500 million, and the Saudi Pub. Transp. Co. (SAPTCO), with a capital of SR 1,000 million. In response to the demand to meet the simulation of growth, three new cement companies were established.\textsuperscript{29} The development of these sectors was due to the strengthening of the domestic economic system, which required the implementation of Saudi company law and the efficient allocation of resources. It is important to realise that the success of this plan can be seen by reference to the proliferation of joint-stock companies in new sectors, such as construction materials, food processing, tourism and agriculture.\textsuperscript{30}

Table 2.1 The development of Saudi joint-stock companies

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of companies</th>
<th>Number of shares (million)</th>
<th>Capital in Saudi Riyal (million)</th>
</tr>
</thead>
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<tr>
<td>1935-1954</td>
<td>6</td>
<td>9.3</td>
<td>943</td>
</tr>
<tr>
<td>1955-1964</td>
<td>11</td>
<td>19.6</td>
<td>2,012</td>
</tr>
<tr>
<td>1965-1974</td>
<td>37</td>
<td>15.9</td>
<td>3,554</td>
</tr>
<tr>
<td>1975-1979</td>
<td>43</td>
<td>141.8</td>
<td>27,124.6</td>
</tr>
<tr>
<td>1980-1984</td>
<td>13</td>
<td>52</td>
<td>1,113.7</td>
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<tr>
<td>1984-1989</td>
<td>9</td>
<td>37.2</td>
<td>2,862</td>
</tr>
<tr>
<td>1990-1997</td>
<td>12</td>
<td>51.22</td>
<td>4,509.5</td>
</tr>
</tbody>
</table>

Source: Companies Department, Ministry of Commerce

\textsuperscript{28} SABIC (Saudi Basic Industries Corporation) was established in 1976 in order to add value to the Kingdom's hydrocarbon reserves by developing petrochemicals, fertilisers and other industries. SABIC is now the third largest producer in the world of chemicals, petrochemicals and plastics, and accounts for 5% of global output. Only 30% of SABIC's equity was sold to the public.

\textsuperscript{29} Filmban, Share Investment in the Kingdom of Saudi Arabia, pp. 83-84.

\textsuperscript{30} Ibid.
The period 1975-1980 is also regarded as the moment of the foundation of the whole Saudi economy. It is very clear that this was also the case for the secondary market. The economic events described above had a significant effect on the pattern of market trading in both the primary and the secondary market. This is due to the changed attitude of Saudis, who, during the 1970s, began to understand that stock market investment offered both short-term and long-term investment opportunities. The change of attitude of investors was supported by a rapid increase in the number of joint-stock companies, which resulted in an increasing number of secondary market participants. The increase in stock market activity led to the creation of financial intermediaries who specialise in the selling and buying of stock to investors. Typically, this new class of intermediary operated by buying shares as dealers and then reselling them for a profit. Their offices were also licensed to engage in business activities other than the selling and buying of shares.

In our view, the large number of shares that were offered to the public at that time increased the number of shares in the hands of investors. As a result, the fact that more shares were available for trading stimulated a greater number of investors to participate in selling and buying shares, which explains the creation of the informal market. The initial stage of share trading in the Kingdom was characterised by personal relationships among businessmen or relatives. Due to

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31 Ibid., pp. 100-101.
34 Ibid.
35 A. Desuqi, Al muasherat Al alamiaa Le alasehum ma Enshaa Muasher khaas bel asehum al saudia, ('The International shares indexes and the Saudi shares Index), King Saudi University Press, 1989, p. 75.
the fact that this manner of trading does not give the seller or buyer many choices, reducing investors’ options of obtaining a better price and quantities of shares, thousands elected to place adverts in one or more of the daily papers. There is much anecdotal evidence that suggests that traders continued to do this throughout the period to solve difficulties in locating the right offers or the bids that matched their requirements. First, simply arranging a meeting between the seller and the buyer was sometimes very hard. Second, the prices and quantities of shares were difficult to match. Third, the assessment of share prices was complex, due to a lack of information about the volume of trading in the market. In any event, it is for these reasons that the demand for a market place where buyers could meet sellers emerged. It was the lack of an organised place for selling and buying shares that gave real estate and other agencies a significant role in share trading. These brokers provided investors with a place to meet other investors and offered a degree of transparency through the provision of better communication with other offices, giving investors more accurate information about market prices.

During the period 1980-1984, a major share offering was made to the public. Two new commercial banks were established, the Saudi American Bank in 1981, with a capital of SR 300 million, and the Saudi Commercial Bank in 1983, with a capital of SR 250 million. This period also witnessed the establishment of five agriculture companies with a total capital of SR 1,500 million and 15 million shares. In addition, new cement companies were

36 Ibid.
37 Ibid., pp. 75-76.
39 Filmban, Share Investment in the Kingdom of Saudi Arabia, pp. 84-86.
established, with a total capital of SR 1,200 million. The early 1980s saw a significant increase in the capital of most of the older companies in the market. For example, the Arab Cement Co. increased its capital from SR 25 million to SR 1,050 million in less than 15 years, and almost all the other companies increased their capital by similar margins. At the same time, the largest joint-stock company, SABIC, sold 30% of its shares to the public in 1983. For most IPOs in this period, the government insisted that the offering of the new shares had to be at a par value, which was far below the actual value of these shares.

The period from 1980-1984 also witnessed a high demand for trade in securities. The increasing number of participants led to more and more transactions, reaching 150,000 transactions in one month in 1981. In our view, there are many reasons for the huge stock market activity during this period. First, there had been a substantial increase in individuals' savings during the years of economic growth. Second, over-investment in real estate had led to an over-bought market, as a result of which investors fled from the fixed property investment sector and went for equities instead. Third, there were other investments that required significant capital outlay that could not be satisfied by smaller financial seller institutions. Finally, the fact that most companies, even though they were making only a little profit, were paying out good dividends to their shareholders also enhanced the rapid development of the stock market.

Although the Companies Act was enacted in 1965 to regulate and supervise the activities of companies, including joint-stock companies, share
trading in the secondary market was not covered by the Companies Act. Thus, trading in the secondary market continued its operation without regulation until 1984. Until then, share transactions continued to be conducted by personal relationships or by third parties that were not legally permitted to do such business. The lack of regulation governing the secondary market encouraged the creation of an informal stock market among various business agencies such as real estate agencies and exchange offices, which stepped into the market gap by playing the role of a broker.

The lack of rules governing stockbrokers' activities, supervision, capital, or of any conditions for these offices to operate, along with the lack of investor awareness on both sides, created a suitable environment for the appearance of opportunistic and illegal practices. In an interview, Basher Bakheet, General Manager of Bakheet Financial Advisor, argued that:

"It is virtually impossible to assess the effect of the absence of securities regulation on the process of stock market activity. Nevertheless, it is reasonably certain that many investors suffered loss from fraud, manipulation, false trading, omission, dishonesty and rumours which were spread by unsavory brokers to manipulate investors in order to make their profits. The failure on the part of the government to regulate led to higher costs for investors."

Despite the prevalence of illegal activities that appeared in the market at that time, stock offices played a highly influential role in the development of the

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44 Ibid., p. 47.
47 See interview with Mr. Basher Bakheet, General Manager of Bakheet Financial Advisor, Riyadh, 12 December 1997; Mr. Bakheet went on to say:
"...the experience of the lack of market regulation created unstable market conditions. The market was subject to volatile swings in prices, rising sharply with no apparent reason that reflected the real situation of the companies in the market, then falling sharply also without apparent reason. To be sure certain, some agencies joined to prevent the deleterious effects of stock market by increasing investors' awareness. Some newspaper even started to publish activities prices weekly.
Saudi stock market. First, they offered investors with an organised place to trade, which was missing due to the lack of formal market. Second, these offices also ‘made’ the market because most of them bought and sold for their own account, which provided the market with much needed liquidity. Finally, they supplied investors with brokerage services, which facilitated trading in the market.\textsuperscript{48}

It was the Kuwaiti Souk Al-Manakh crash in September 1982 that stimulated the Saudi government to consider and evaluate the current situation in its own, informal market.\textsuperscript{49} An intensive study of the Saudi stock market conducted by the Ministry of Finance & National Economy showed that (1) there was a lack of investing awareness between market participants caused by the lack of experience in conducting such business, (2) the market suffered from illegal practices due to the lack of regulation and supervision, (3) the market was fragmented among many offices and brokers, without sufficient links to provide investors with the necessary information, (4) there was a huge increase in the number of unlicensed brokers, (5) the stockbrokers operated without a licence or any operation requirements, (6) due to the lack of governing law, most of these offices only operated for a short time and disappeared as soon as they failed without being caught by the law, and (7) some of the illegal activities conducted by brokers was against the interests of the market participants and put the market in danger of collapse.\textsuperscript{50} The Saudi government’s strategy for strengthening the stock market was designed in the wake of the Kuwaiti crisis. The Saudi

Yet even this form of assistance was of little assistance, since papers depended on the informal brokers to obtain their information.\textsuperscript{46}

\textsuperscript{50} Al Ajmi, ‘Gulf Equity Markets: Comparison of the Structure and Performance’, pp. 50-54
authorities recognised that some initiative was necessary to build the financial architecture necessary to insulate the economy from the negative repercussions of a stock market crisis. The next section assesses the reforms introduced by the Saudi government in that period.


From the perspective of the Kingdom's policy makers, the crash of Souk Al-Manakih in 1982 had a strong effect on the Saudi market and other regional markets in the Arabic region. In light of the subsequent volatility and instability, the Saudi government attempted to provide a regulatory response to the collapse of the Kuwaiti market. The government designed a set of stringent measures to restrict the explosive effects of concentrated capital flows on its small market in order to prevent destructive volatility and liquidity constrictions in the market. Government officials determined there were various reasons that could likely have been responsible for the collapse of the Kuwaiti market. First, the Kuwaiti market had lacked a strong settlement system. Generally, the banks and the market together provided the settlement infrastructure. The Kuwaiti market was operating mainly on the basis of credits, including forward deals of 6, 12, and 24 months in the form of postal cheques. In the Kuwaiti bourse, one would rarely hear about immediate settlements. Brokers were simply selling shares they did not own to buyers who did not have the money to buy them. Second, the illegal

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53 Ibid.
54 Ibid., p. 10.
activities of brokers and other market participants was due to the lack of regulations and adequate supervision.\textsuperscript{55} For example, some brokers were selling shares of non-existing companies. Third, there was evidence of highly speculative and aggressive activities, which increased share prices of companies in often perverse ways. Some companies that were performing badly and were actually earning very little, still saw their share prices rise by 500\% during 1981.\textsuperscript{56}

The Saudi stock market remained informal until 1983, when the Saudi government formed a Ministerial Committee consisting of representatives of the Ministry of Finance & National Economy, the Ministry of Commerce, and the Saudi Arabia Monetary Agency (SAMA) in order to improve regulation and the development of share trading within the Kingdom.\textsuperscript{57} In mid-1984, The Ministerial Committee enacted, within its authority to legislate market development, what is called “The Executive Rules to Regulate Share Dealing in Company Shares Through Commercial Banks”.\textsuperscript{58} These Executive Rules not only regulated the market, but also established the Saudi stock market. Unlike other stock markets in the area, the Saudi government decided to emulate the German and Swiss market models, which left trading in the hands of the Saudi Banks.\textsuperscript{59} Furthermore, the new Rules required that all transactions made through the market be paid in cash. Forward trading was prohibited. The prohibition against forward trading and margin trading reflected the conservative policy of Saudi authorities in building

\textsuperscript{55} Ibid.
\textsuperscript{56} Ibid.
\textsuperscript{57} The Ministerial Committee was created by the Royal Decree No. 1230/8 dated 11/07/1403, April 1983.
\textsuperscript{58} Executive Rules To Regulate Share Dealing In Company Shares Through Commercial Banks, SAMA’s circular to all banks, The General Banking Control Department, Saudi Arabia, December 1984.
\textsuperscript{59} Banafe, \textit{Saudi Arabia Financial Markets}, p. 177.
up their stock market. The Executive Rules formalised the Saudi stock market by providing share investors with a regulated market place, bringing together purchasers and sellers of shares within the Kingdom. The Rules also restricted the duty of buying and selling shares of Saudi joint-stock to Saudi commercial banks.

In answer to question concerning the main reasons for choosing the current trading system in Saudi Arabia, Abdul Aziz Al-Dukhiel, President of The Consulting Centre for Finance and Investment, explained:

"Choosing banks to constitute the Saudi exchange and the only brokers in the market at the same time is in my view related to an extension of the financial policy of the country. The financial policy in Saudi Arabia is built on centralization. Everything related to financial policy comes under the control of the Ministry of Finance & National Economy. And SAMA is a part of the Ministry of Finance, and therefore it was chosen to be the agency in charge of the market. Therefore, our market follows from an extension of this policy, putting everything in the hands of banks and eliminating all other market players.

The new Rules reflected the government's concern to give safety priority over profit. This also explains why share trading became limited to banks. Under the new rules, only banks can perform the role of mediator on behalf of clients directly and share dealings can only take place through their mediation. Hence, the purpose of restricting all but banks from being mediators was

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60 Drafting the Executive Rules directly through the Ministerial Committee and not by Royal Decree as a main law within the country was justified by the idea that the stock market was new, and its structure and shape had not reached its final stage. As a result, issuing its rules by royal decree would not have been appropriate for the nature of the stock market, which requires fast and easy procedures for rules, initiatives and amendments.

61 Executive Rules 1984, Article 1, p. 15.

62 See Transcript of Interview with Dr. Abdul Aziz Al-Dukhiel, President of The Consulting Centre for Finance and Investment. 12 December 1997.

63 See Royal Decree No. 1230/8 Dated 11/7/1403, April 1983.

64 Executive Rules 1984, Art. 1, p. 15.
obviously to eliminate informal stockbrokers and other intermediaries from conducting trade in the market. The double role created by the government for commercial banks was successful in soon causing most other intermediaries to exit the market.\textsuperscript{65} Abdulrahman Al-Rashid, Manager of Securities Control Department, noted that:

"Although law prohibits anyone other than the commercial banks to act as mediator or broker in shares transactions, the government did not rush to close other informal brokers' offices. Instead it encouraged banks to provide better services and let the clients feel the difference."

In December 1984, the formal market commenced operations with the expectation that the new market would satisfy the interests of the government as well as the market participants. The Ministerial Committee had made considerable resources available to guarantee the success of the market. In anticipation of the market’s opening, private banks established 11 CTUs in Riyadh city to handle the transactions.\textsuperscript{67} Shortly after its inception, the market had achieved 51 listings with a market capitalisation of SR 52 billion. In February 1985, the National Centre for Financial and Economic Information inaugurated the (NCFEI) market index at 100 points.\textsuperscript{68}

Despite the considerable effort that was put into establishing the market on a good footing, market operations did not satisfy expectations. In retrospect, the market clearly failed to build on its initial success and manoeuvre

\textsuperscript{65} Al-Jeffery, \textit{Investment in the Saudi Stock Market}, p. 11.
\textsuperscript{66} Interview with Mr. A. Al-Rashid, Manager of the Securities Control Department, Riyadh, 17 August 1997.
\textsuperscript{68} The National Centre for Financial & Economic Information index (The NCFEI) is an overall price index developed by the Consulting Centre for Finance and Investment along lines similar to that of the Standard and Poor’s Index in the United States.
accordingly. Indeed, the following two-year period between 1985 and 1987 saw a sharp drop in share prices and the number of transactions overall.\textsuperscript{69} The NCFEI share index continued to decline to a level of 63 points in September 1986, the lowest level of the index in its history. There were many reasons for the market’s difficulties. First, it was highly fragmented among 11 different banks, which operated without any efficient intercommunication or shared trading system. Each bank handled transactions on its own, without any coordination with other banks.\textsuperscript{70} In essence, the execution of any transaction depended on the bank’s own employee’s efforts to match selling orders with buying orders within the same Unit. This meant that it was possible to have as many as ten different prices for the same share. If a trader recommended matching the order outside the Unit, it had to be sent to another bank’s Unit to be matched.\textsuperscript{71} All these complications meant that transactions could only be handled manually, which resulted in delays in trading and registration. As a result, the average time that one transaction might take was two to three weeks.\textsuperscript{72} And if this was not enough, there was evidence of illegal activities being carried out by bank employees at several branches and in CTUs. The major information gap enabled the bank employees to take advantage of the trading system and exploit their positions for personal gain.\textsuperscript{73}

Ironically, to the extent that the system failed to operate as intended, the position of the informal brokers was actually strengthened. While the founders

\textsuperscript{69} See Al-Dukhiel, ‘The Development of the Saudi Stock Market’, p. 57.
\textsuperscript{72} Ibid., p. 123.
had intended that the Executive Rules 1984 would restrict the brokerage activities
to banks, the rules were not followed precisely. Therefore, it does not come as a
surprise that, despite the government’s prohibition, informal brokers were still
carrying out brokerage activities without a licence.74 By the end of 1985, more
than 30% of the transactions and more than 47% of the trading volume was
conducted through the informal stockbrokers.75 Most of these transactions were
executed through informal brokers. The primary beneficiaries of this system were
the sellers and buyers, who paid lower commissions.76

In order to provide market investors with a more efficient trading system,
the government opened a trading floor on 11 May 1987. The long-awaited Central
Trading Hall was opened with the wish to resolve the problems associated with
the earlier efforts to establish a formal exchange. SAMA was authorised to
regulate the floor operations of the exchange. For the first time, the establishment
of the trading system offered Saudi brokers the opportunity to trade face to face.
Yet, the government, which opened the new floor relatively quickly, failed to
alter or reform the market rules.77 Hence, the government’s plan to modernise
trading was frustrated. The restrictive policy favoured banks over informal
brokers, who used to control 30% of the market, resulting in less-than-ideal
trading circumstances. For example, trading was still handled manually and no
effort was made to make use of new technologies. Each bank had to send two

74 Former brokers continued to operate under the cover of Article 19b, which permitted face-to-
face transactions for the transfer of ownership from the companies' registration offices without
the mediation of banks. In the meantime, informal brokers had established strong relationships with
company registration departments, giving them strategic advantage over banks, which resulted in
their clients obtaining faster registration and transfer of ownership. See Al-Maydani, 'Financial
Markets in Saudi Arabia', p. 121.
76 Ibid.
representatives with the selling and buying orders collected from its branches and the matching was done in an auction base with the other banks' orders. Although the 1987 trading floor system was intended to eliminate the problems of the old system\textsuperscript{78}, it failed to do so.

Upon the opening of the trading floor, the number of shares traded fell from the average of more than 200,000 units a day to just 102,304 with a decline in value of around SR 30 million.\textsuperscript{79} This decline, as noted above, was due to the slowness in the execution and registration of transactions. At the same time, due to their lack of staffing and expertise, banks were unable to meet the daily trading requirements of the market. In response, SAMA attempted to install an electronic trading system, which, for technical reasons, failed to function properly. It was the decline in the traditional floor operations that led the government to prefer to revert to the old system.\textsuperscript{80}

The reversion to the old system was partly responsible for the recovery of the market. Indeed, by mid-1988, the market recovered and the index rose by 22%. Transactions increased by 115% and the number of shares traded increased by 128% compared to the previous year's performance.\textsuperscript{81} Two years after the closure of the trading floor, SAMA introduced an automated clearing and settlement system. This new system certainly contributed to the record increase in transactions that followed.\textsuperscript{82} At the same time, there were a number of new IPOs

\textsuperscript{78} Ibid.
\textsuperscript{79} The Financial Times, 'Riyadh Exchange Closed', Wednesday 10 June 1987, p. 34.
\textsuperscript{80} The new trading floor was closed indefinitely by the market authorities because of reported technical and procedural difficulties. However, The Financial Times reported that some sort of jurisdictional disagreement over the market and the trading hall had also arisen between the Ministry of Finance, under which SAMA falls, and the Ministry of Commerce.
\textsuperscript{81} In this year, more than 12,012,324 shares were traded with a total trading value of SR 1,685,517,397, a 103% increase compared to the year before.
\textsuperscript{82} The Saudi Stock Market Annual Report, Securities Control Department, SAMA, Riyadh, 1990.
coming to the market. In this regard, Al-Rajhi Banking & Investment Co. was established in 1987 with a capital of SR 1,500 million, Taibah Investment & Real Estate Co. was established in 1988 with a capital of SR 3,000 million, and Makkah Constr. & Development Co. went public in 1989 with a capital of SR 1,448 million. At the end of 1989, the NCFEI index rose by 20%, breaking the psychological barrier of 100 for the first time since the establishment of the formal market.\textsuperscript{83}

The 1984-1989 period produced major changes in the market. Table 2.2 shows how the modernisation drive led to increases in almost all market activities. For example, market capitalisation rose from SR 67 to SR 107 billion, breaching the psychological barrier of SR 100 billion for the first time in the history of the market. Moreover, the number of transactions increased from 7,842 to 110,030. Finally, there was a significant rise in the market’s turnover by 400%. From 1984 to 1989, a total of 15,271,853 shares were traded with a total value of SR 3,363,686,168 million.\textsuperscript{84}

<table>
<thead>
<tr>
<th>Year</th>
<th>Transactions</th>
<th>Shares Traded</th>
<th>Market Cap(mm)</th>
<th>Share Value (SR)</th>
<th>All Share Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>1985</td>
<td>7,842</td>
<td>3,936,338</td>
<td>67,000</td>
<td>759,976,565</td>
<td>69.09</td>
</tr>
<tr>
<td>1986</td>
<td>10,833</td>
<td>5,263,001</td>
<td>63,400</td>
<td>830,748,970</td>
<td>64.6</td>
</tr>
<tr>
<td>1987</td>
<td>23,267</td>
<td>12,012,324</td>
<td>72,800</td>
<td>1,785,517,397</td>
<td>78.06</td>
</tr>
<tr>
<td>1988</td>
<td>41,951</td>
<td>14,641,327</td>
<td>85,900</td>
<td>2,036,786,694</td>
<td>89.2</td>
</tr>
<tr>
<td>1989</td>
<td>110,030</td>
<td>15,271,853</td>
<td>107,300</td>
<td>3,353,686,168</td>
<td>108.68</td>
</tr>
</tbody>
</table>

Source: SAMA, SCD

This stage was easily the most traumatic period in the history of the Saudi stock market. As we have seen, Saudi authorities established a new trading floor in the wake of the Kuwaiti market collapse. The attempt to protect the market


\textsuperscript{84}The market turnover rose by 400% compared to the year 1984, a total of 15,271,853 shares were traded with a value of SR 3,363,686,168 million.
from a crash by limiting trading to banks and licensed brokers provided both a technical and market failure. Despite the attempt to modernise the market, SAMA was forced to revert to the old system of trading.

We can see that this market was primitive and fragmented, with an average of two weeks’ trading time and a 14% average variation in prices of the same share. The market was also undeveloped. For example, although the Companies Act permitted firms to issue bonds and other types of securities, only common stock was traded in the market. There was little liquidity in the market. Indeed, the number of companies listed was small, according to international standards. While there were 52 listed companies in the market, only ten companies were trading, and this was done on an infrequent basis. Overall, the market was thin and shallow. Less than 2% of the total number of shares issued were traded. This was due to the high concentration of ownership of shares in the Saudi market, most being held by government institutions and other major investors.

Interestingly, the market during this period showed no reaction to international economic events. Events that shocked the world financial markets had no significant impact on the Saudi stock market. For example, in 1987, there was a crash in most of the world’s stock markets and a massive decline in the interest rate for the US dollar. In contrast, share prices in the Saudi market

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86 Ibid.
87 Ibid., pp. 122-124.
88 Al-Dukhiel, ‘The Development of the Saudi Stock Market’. Al-Dukhiel states that more than 60% of the total shares are held by government institutions and foreign partners, and only 38% of the total shares are held by the private sector. Even these latter shares are controlled by a few major investors whose main interest is not in trading but in holding a strong position in the shares of certain joint-stock companies.
were rising. The market in this period can be described as a seasonal market.\textsuperscript{90} Most market participants were individual investors and not institutional investors. Hence, the market did not maintain the same level of trading during the entire year. In this system, there are certain times of year when trading drops sharply, especially during the summer vacation, when most businessmen travel abroad.\textsuperscript{91} The relatively unsophisticated nature of the market was also reflected in the information given by the financial services industry. As a result, investors were forced to rely on imperfect information published by non-professional advisors.

5. The Fourth Stage (1990-1999)

The present stage of development is marked by a rise in the technical level of the market’s infrastructure and the need to make regulatory improvements. After the termination of the traditional floor system, the SAMA introduced a modern, electronic trading system. The electronic trading system was first developed in the back office, and the settlement and clearing system was introduced to the market 1989.\textsuperscript{92} In mid-1990, an electronic trading system was introduced to the market, making the Saudi market the first electronic market in the region. The new electronic system, known as the Electronic Securities Information System (ESIS)\textsuperscript{93}, was introduced to eliminate the problems of fragmentation, widely

\textsuperscript{90} Ibid.
\textsuperscript{91} The Fourth Development Plan (1985-1990), Ministry of Planning, Riyadh, 1985, described the stock market and the stock exchange mechanism as rather slow and very complicated, as the processing of a stock issue could take up to two years. Individual stock transactions required between one week and two months to complete and, more often than not, the buyer had to reach the seller by his own means. Thus, blocks of shares could not be broken up to match the needs of buyers. These obstacles resulted in significant gaps between bid and asking prices, thus indicating that the price mechanism was not working efficiently.
\textsuperscript{92} See Banafe, Saudi Arabia Financial Markets, p. 179.
\textsuperscript{93} The Electronic Securities Information System (ESIS) was built and developed by SAMA in cooperation with the American company Arthur Anderson in 1989.
differing prices, delays in trading and registration, weak transparency, efficiency and liquidity. The new system concentrates all local equity trading into a single electronic market by using central computers within SAMA and terminal workstations within the banks, providing a floorless, continuous, order-driven market, with up-to-the-minute information about price, volume and company dissemination. The automated system matches the placed order bid or offer with the best available bids or offers according to price/time priority.⁹⁴

To improve the new trading system, SAMA issued what were called the Instructions to Central Trading Unites to govern all market operations.⁹⁵ The Instructions to CTUs describe in detail the regulations and procedures to be followed by banks in order to complete securities transactions through ESIS. Unfortunately, the introduction of the new electronic trading system was shortly followed by the Gulf Crisis, which meant people did not have enough time to experience and judge the new system. During the Gulf Crisis the market index fell sharply.⁹⁶ The NCFEI index recorded 159 points just before the crisis, then sharply dropped to 117 points in July, and subsequently dropped sharply again to just 95 points in September 1990, recording a decrease in the index of more than 19%. There was also a sharp decrease in the number of transactions and market turnover in general.⁹⁷

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⁹⁵ Electronic Securities Information System Instructions to Central Trading Units, SAMA, Securities Control Department, Riyadh, 1990. The Instructions are mixed of explanations of how does the electronic system works and some rules which have to be followed by banks. The Instructions to CTUs have amended many times to meet the need of any new release or changes in ESIS.


⁹⁷ Ibid.
By the end of the Gulf war, the market had started to recover again. In fact, it picked up dramatically, recording a sharp rise in share prices and trading volume. By the end of 1991, the ICFEI index rose by 80%, indicating the return of confidence to the Saudi stock market. The number of shares traded rose by 82% and the value of the shares rose by 94% to reach SR 8,527,306,505 million. Despite the impact of the Gulf war, the year 1991 witnessed a great improvement in most companies' performance due to their participation in the war operations. As a result, more than 58 companies made a profit that year, with total net profits of SR 8,700 million; 49 companies distributed dividends. Sectors that recorded an abnormal increase in profits included the services sector, which rose by 223%, and the petroleum industry, which rose by 114%.

The market continued to recover sharply and increased to breach the level of 200 points, reaching an historical high of 233.82 points in April 1992. The new electronic trading system recorded a significant jump in the market index, making for a historical record. The number of transactions rose by 200% to reach 272,075 for the first time. Also there was an increase in the number of shares traded to reach 35,199,907, (with a value of SR 13,698,831,745 million) for the first time. The capitalisation of the market reached an historical SR 238,800 million ($ 60 billion).

Despite the success of the market, there was still a significant shortage of market professionals and financial advisors who could provide investors with the much-valued information needed to make investment decisions. This situation

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100 Ibid.
was particularly acute for small investors, who did not have time or experience to
invest in the market. Partially to overcome this information and risk asymmetry,
SAMA, in mid-1992, permitted local banks to establish mutual funds for
investing in the local market for the first time. These mutual funds were to be
regulated and supervised by SAMA.\textsuperscript{102}

This period also witnessed a significant number of shares being offered to
the public. More than 10 joint-stock companies offered shares to the public, either
for the first time or to increase their capital.\textsuperscript{103} These public offerings were
oversubscribed. For example, Mubarrad, a relatively unknown company, issued
shares worth SR 180 million that were oversubscribed by more than 300%. Savola was oversubscribed more than 13 times.\textsuperscript{104}

There are many reasons for the abnormal activities in the stock market
during the period 1991-1992. As we noted earlier, this period was marked by
significant upward movement in share prices. First, the unexpected shock of the
Gulf War operations suffered by Saudi companies stimulated the share activities
of many listed Saudi companies.\textsuperscript{105} Second, the wartime operations and the
government led to a significant increase in the flow of capital to the market. The
money supply rose from SR 176 billion in 1990 to SR 204 billion by the end of
1991. Correspondingly, the increase in oil prices during the 1991-1993 period
added to the transfer of funds to the region. Moreover, return of funds to the

\textsuperscript{102} Rules and Procedures for the Establishment and Regulation of Saudi Mutual Funds, Minister of
Finance Decision No. 2052 dated 24/7/1413, SAMA, Securities Control Department, Riyadh, 1992.
\textsuperscript{103} The Saudi Stock Market Annual Report, Securities Control Department, SAMA, Saudi Arabia,
1994.
\textsuperscript{105} See Chamber of Commerce & Industry Report, The Saudi Stock Market, Eastern Province,
1995, pp. 5-8.
region was high during this time (i.e., SR 50 billion returned from abroad). Third, Saudi Banks allowed certain clients to receive loans, guaranteed by up to 50% to 80% of the market prices of their shares as collateral. Finally, the central bank loosened monetary policy as evidenced by the decrease in the Saudi Riyal interest rate, which slid from 8.7% in 1988 to 4.5% in 1993.

The abnormal increase in market prices through mid 1992 introduced fear of a market collapse due to a perception by market analysts that share price levels were not justified economically. In order to prevent a significant correction in the market, the government undertook action to limit further increase in share price levels. For example, the government permitted many companies to go public in a short period of time to absorb some of the outstanding capital remaining in the hands of investors. For its part, SAMA set a collateral ceiling at 50% of the market share prices in order to reduce liquidity arising from the banks’ flexible lending policy to market investors. Finally, the government increased the interest rate on short-term loans in order to pressure banks to reverse their loose lending policy, which had stimulated investment in the stock market (see Figure 2.1). The government’s coordinated policy of tightening credit led to a contraction in the market for loans. The success of the policy was reflected in the market index, which dropped to 188.87 by the end of 1992.

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106 Ibid.


The tightening of credit available from banks occurred at the same time when the government revealed the full fiscal impact of the Gulf War, which had led to a significant deficit in the government's budget. For the aggregate fiscal years of 1990 and 1991, total government expenditure was $127 billion, with a two-year deficit of $42 billion. The policy of fiscal expansion was supported by the drop in oil prices. Figure 2.1 shows that the market was especially sensitive to the drop in oil prices and to the interest rate level. Both factors affected market prices. By the end of 1993, the NCFEI fell to 179.33. Despite the decrease in share prices, there was ironically an increase in the number of shares traded, which reached 60 million with a total value of SR 17,500 billion.

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110 See Al-Dukhiel, 'The development of the Saudi stock market', pp. 3-5.

The market index continued its downward trend in 1994 with a sharp drop in share prices of most listed companies. By the end of 1994, the NCFEI index fell to 127.52, recording an almost SR 100 billion drop in market capitalisation.\(^{112}\) The decrease in market prices was a response to the earlier sharp increase in share value, which had attracted significant amounts of money in the market. In retrospect, these inflows were not justified on any grounds, economic or otherwise. Naturally, the sharp correction in share value led to a reduction in some companies' share prices, well below book value for certain companies. The market too confirmed record increases in the number of transactions, and turnover also increased (i.e., by 152% in the number of shares traded and 43% of the value of these shares).\(^{113}\)

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\(^{113}\) Ibid.
At the beginning of 1995, there had been no change in the direction of the market. This became evident when the index reached 115 in May, recording the lowest point since the Gulf Crisis, and a 50% decrease in market prices since 1992. However, in June 1995, the index revised the earlier trend, rising 13% over the month before. The NCFEI continued in a positive direction and ended the year at 136.7 points, a 7% increase over the 1994 closing.114

The transition into a bull market continued in 1996. This was partially explained by the superior performance of Saudi companies coupled with a budget announcement for the fiscal year 1997, which also indicated that the budget deficit was decreasing.115 Figures from the National Statistics offices showed that the GDP for 1996 was up by 8.6% versus 4.3% for 1995. Furthermore, the inflation rate was well contained. Finally, the government’s payment of a total of SR 22,000 million to the agriculture and contracting sectors served to introduce much needed liquidity to the market. The money supply (M2) was also up by 10.5% compared to January 1995 figures, which reflected an improvement in the liquidity of the market. Positive profit developments also added to the rise of the Saudi market.116 Fiscal policy and corporate earnings encouraged the market significantly. Indeed, the market increased by 23.9% in the second half alone, contributing to a healthy year and general recovery for the whole market index, as shown in Figure 2.3.117

115 Ibid.
117 Ibid.
In general terms, 1996 was a turning point for the market in that it recorded an increase in all the market indexes, as shown in Table 2.3. As for turnover, more than 137.8 million shares were traded, 18.2% more than the previous year, with a total value of SR 25.4 billion, 9% more than the year before. Large banks dominated trading in the market. In fact, more than SR 10.4 billion worth of bank shares were traded, representing 41% of the market trading value. In this regard, the services sector dominated turnover in the market. For example, in terms of number of shares traded, services sector firms traded 48 million shares, representing more than 35% of the total shares traded in 1996.118 Naturally, the massive increase in total turnover was reflected in stock market prices. In this regard, compared to the previous year, the NCFEI index rose by 12% more.119

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119 The maturation of the market also depends on the development of the financial services section and professionals and analysts, who support its operations. Today, there are more than 30 specialised offices and agencies carrying out analyses and providing investors in the market with the necessary information and investment opportunities within the Kingdom, whether directly or indirectly, by publishing their monthly, quarterly and annual reports and documents containing detailed analyses of operations of the stock market and related subjects. Furthermore, there are two daily papers which specialise in the economic events in the Kingdom, including a daily report of all market events.
Table 2.3  

<table>
<thead>
<tr>
<th>Year</th>
<th>Transaction Shares</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Shares Traded</td>
</tr>
<tr>
<td></td>
<td>Market Cap.(m)</td>
</tr>
<tr>
<td></td>
<td>Value of Shares All</td>
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<tr>
<td></td>
<td>Shares Index</td>
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<tr>
<td>-------</td>
<td>--------------------</td>
</tr>
<tr>
<td>1990</td>
<td>85,298</td>
</tr>
<tr>
<td></td>
<td>16,938,386</td>
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<tr>
<td></td>
<td>97,300</td>
</tr>
<tr>
<td></td>
<td>4,403,235,482</td>
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<tr>
<td></td>
<td>97.98</td>
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<td>1991</td>
<td>90,559</td>
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<td>30,758,077</td>
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<tr>
<td></td>
<td>180,800</td>
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<tr>
<td></td>
<td>8,527,306,505</td>
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<tr>
<td></td>
<td>178.77</td>
</tr>
<tr>
<td>1992</td>
<td>272,075</td>
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<td>35,199,907</td>
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<td></td>
<td>206,100</td>
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<td></td>
<td>13,698,831,745</td>
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<tr>
<td></td>
<td>188.87</td>
</tr>
<tr>
<td>1993</td>
<td>319,582</td>
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<tr>
<td></td>
<td>60,307,628</td>
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<td>197,900</td>
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<td>17,360,034,465</td>
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<td>1994</td>
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<td>1995</td>
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<td>116,617,939</td>
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<td>1996</td>
<td>283,759</td>
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<td>137,832,560</td>
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<td></td>
<td>171,982</td>
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<td></td>
<td>25,397,329,810</td>
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<tr>
<td></td>
<td>153.1</td>
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<tr>
<td>1997</td>
<td>460,056</td>
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<td>313,975,338</td>
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<td>222,698</td>
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<td></td>
<td>62,060,355,885</td>
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<tr>
<td></td>
<td>195.78</td>
</tr>
<tr>
<td>1998</td>
<td>376,617</td>
</tr>
<tr>
<td></td>
<td>294,637,204</td>
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<tr>
<td></td>
<td>159,907</td>
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<tr>
<td></td>
<td>51,509,159,079</td>
</tr>
<tr>
<td></td>
<td>141.31</td>
</tr>
</tbody>
</table>

Source: SAMA, SCD

If 1996 was a significant change of direction for the market, the following year was a watershed year in the Saudi market history. A new sort of event occurred, which influenced the shape and direction of the market. In the regulatory sphere, the government, through the Ministerial Committee, announced regulations regarding market disclosure and insider trading.\(^{120}\) The new rules, which were enacted to protect individual investors and to ensure the free and efficient operation of the market, were designed to facilitate the flow of information to the market, and provide investors with equal access to necessary market information.\(^{121}\) Concerning the insider trading rules, the government, following the dominant policy in western jurisdictions, prohibited public trade in securities based on improperly obtained information which is not presently accessible to the market. The new rules went on to prohibit the manipulation or the creation of false markets, or any action which would be likely to mislead or distract the market.\(^{122}\)


\(^{121}\) The new disclosure rules were intended to ensure that managers of listed companies could at least be held partially responsible for regulating the firm, by placing on them the obligation to announce to the market any major events or information that could reasonably be expected to affect share prices.

\(^{122}\) Disclosure Rules 1997, Art. 4.
Another significant change has been the enactment of the new rules regarding the Gulf Cooperation Council (GCC), governing citizens’ rights of owning and trading shares of public corporations in other GCC countries. At the same time, the government enacted new rules regarding the conversion of companies into joint-stock companies. In order to meet the policy drawn up by the government to enhance stock market operations, the Ministry of Commerce, as the agency responsible for the primary market, issued new regulations establishing the procedures and requirements that should be followed by any company that wishes to convert into a joint-stock company. The main purpose of the enactment of the new conversion rule is to facilitate and simplify the process of conversion. It is anticipated that this new regulation will increase the number of listed companies in the market.

Perhaps one of the most significant developments has been the opening up of the market for foreign investment. In 1997, the Saudi Arabian Investment Fund (SAIF) was launched by the Saudi American Bank, giving foreigners the opportunity to invest in the Saudi stock market for the first time. Opening the market for foreign investment, initially through a country fund reinforces the liberal orientation of the national economy. The new SAIF was an instant success.

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123 The Council of Ministers resolution no. 16, dated 20/1/1418. This resolution approves the resolution of the GCC 15th meeting regarding GCC citizens’ right to own shares of public corporations in GCC countries and trade shares in accordance with the amended rules attached to the resolution, 1997.


125 See the consent of the Saudi Arabian Monetary Agency for the establishment of the Saudi Arabian Investment Fund (SAIF). Pursuant to SAMA Circular No. MA 1274 of 3/12/1413 H, covering the rules and regulations relating to all Collective Investment Schemes issued pursuant to Ministerial Decision No. 3/2052, dated 24/7/1413H.
It attracted $250 million, which makes it the largest closed-end, single-country offshore fund launched in recent years.\(^{126}\)

The great performance of the Saudi market during 1997 was soon influenced by the turmoil in the Asian markets and the sharp fall in oil prices. First, the turmoil hit emerging markets, especially the Asian markets in 1997, and the uncertainty over the Russian and Brazilian economy shocked the whole world, spreading its impact to the Saudi market.\(^{127}\) Second, and most importantly, was the sharp decline in oil prices to its lowest level in 25 years. 1998 saw the decline of the spot price of Brent crude by 33.3\%, averaging $12.71 a barrel compared to $19.06 a barrel in 1997.\(^{128}\) Figure 2.2 shows that the Saudi stock market index closed at 141.3 points in December 1998, recording a decline of more than 28\% in the market and showing one of the worst performances since the establishment of the market in 1984. The total value of shares traded during 1998 reached SR 52 billion, recording a decrease of 17\% compared to the same period in 1997. The average daily value traded declined by 18\%, recording only SR 171.70 million.\(^{129}\) Although the Saudi market recorded a poor performance during 1998, the market has still offered positive returns to long-term investors during the past decade. From 1988-1998, the Saudi market index rose at an


\(^{128}\) The effect of the drop in oil prices was expected to be severe on the Saudi stock market mainly due to the fact that the Saudi economy is still relying heavily on public sector spending, which is in turn directly tied to the movement of oil prices and government revenues from oil sales.

\(^{129}\) During 1998, the International Finance Corporation (IFC) and the Ministry of Finance and National Economy jointly announced the creation of the IFC Global Saudi Index and inclusion of 65-75\% of the total valuation of the Saudi stock market in the IFC's Global Index.
annual average rate of 5.8% and gained a yearly average cash dividend of 5.5%.\textsuperscript{130}

Figure 2.4

![All Market Index (NCFET) 1985-1998](image)

Source: SAMA & BFA

6. Summary

In this chapter we have examined the main aspects of the Kingdom’s stock market history. Clearly, the market has managed to develop significantly over the past three decades. There have been significant increases in liquidity, capitalisation and institutional development. Between 1985 and 1998, the number of transactions, volume and value of trading increased more than 32-fold. Market capitalisation has increased by more than 160%, making the Saudi market by far the largest market in the region. Despite the relative success of the Saudi market, its development, while notable, is still considered modest in comparison with other emerging markets in developing countries. Despite the technical growth, the

\textsuperscript{130} Al-Shaikh, 'The Saudi Arabian Economic Outlook', p. 9.
Saudi market has played an unimportant role in the development of the Kingdom's economy. Less restrictive barriers to international capital flows should create rapid improvement in the market. It is also clear that there is ample reason to believe that improvement in the regulatory regime will enhance stock market activity.
Chapter 3

Legal Framework of the Saudi Stock Market

1. Introduction

A primary indicator of stock market development in general is the degree of regulation imposed on the market and its participants.¹ A growing body of literature pertaining to market theory describes the relevance of institutional structures and legal rules and development of the stock market.² Recognising the importance of this relationship, between 1980 and 1990 SAMA, and the Kingdom’s policy makers, began devoting increased effort towards creating policies intended to enhance the framework for trading.

During the last three decades, the Saudi government has embarked on a well-organised modernisation campaign of its legal system.³ The central achievement in the initial period was the successful enactment of the Companies Act in 1965. Nearly two decades later, in 1984, promulgation of the Executive Rules for Share Dealings provided much-needed reform of the stock exchange.


³ G. Sfeir, ‘The Saudi Approach to Law Reform’, in The International Journal of Comparative Law, A Quarterly, Vol. 36, 1988, p. 729. George Sfeir wrote “the modernisation of the Kingdom’s legal system is reflected in enactments which today regulate such fields of activity as trade and commerce, business and banking, labour and social security, customs and taxation, and the settlement of commercial disputes and arbitration-fields that, until recently, were the exclusive preserve of traditional Islamic law”.

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Recently, the government, under pressure to liberalise its securities market, introduced measures against insider trading and market manipulation. The government has endeavoured to design a modern stock market supported by a clear system of rules. The aim of this chapter is to analyse the legal framework of regulations that govern the Saudi stock market. As a precursor, it is essential to introduce the main features of the Saudi legal system and briefly survey its unique aspects in order to provide an accurate understanding of the current system of stock market regulation. This chapter is divided into four sections: first, the legal and judicial system in Saudi Arabia will be discussed. Secondly, the Companies Act will be surveyed, particularly legislation covering joint-stock companies and the primary market. Thirdly, there will be an analysis of the Executive Rules, which are the regulations governing the market. The ESIS Instructions, which are the rules which govern daily trading in the Saudi stock market, will then be examined, followed, in the last section, by an assessment of the new Disclosure Rules introduced in the market in 1997.

2. The Saudi Legal System

Saudi Arabia is the birthplace of Islam and guardian of that religion’s two holiest cities, Makkah and Madinah. The Kingdom is the spiritual home to more than 1,200 million Muslims throughout the world and plays host to more than one and a half million pilgrims each year.4 As the protector of the Holy Places, the Kingdom performs its responsibilities in serving, protecting and caring for the two Holy Mosques, thereby fulfilling its vital and unique duty to Islam and

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Muslims throughout the world. Islam is, in fact, the true strength of the Kingdom and influences and forms key aspects of government policy.\(^5\) As the leading Islamic nation, Saudi Arabia has always provided a strong and inspiring example by strictly adhering to Islamic principles through a governmental system based on the Holy Quran and Sunnah as the constitution of the country.\(^6\)

The influential role of Islam is reflected in all aspects of life in the Kingdom. Since its foundation, the Kingdom has based all its political, economic and social development efforts on the principles and faith of the Islamic religion and has followed the Shariah law as its governing code.\(^7\) Therefore, the fundamental source of law in Saudi Arabia is the Shariah, as the divine law of God.\(^8\) The Islamic Shariah is the national law of Saudi Arabia and the basis of the legal system of the country.\(^9\) The Shariah is derived from three main sources, the Holy Quran, Sunnah and Ijma.\(^10\) The Quran is the Muslim Holy book, which consists of 6,237 verses, which are God's ordinances to the people as received by the Prophet Muhammad 1,400 years ago. The Sunnah consists of proverbs, teachings and actions of the Prophet. Ijma is the consensus of Islamic scholars and authorities.\(^11\)

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\(^7\) Ibid., p. 105.
\(^8\) See A. Al-Kannas, ‘Islamic Influence in Saudi Company Law in Regulation to Corporate Finance and in Comparison with British Company Law’, a dissertation submitted in partial fulfilment of the requirements for the degree of L.L.M. in International Law, University of Hull, 1992, p. 4.
\(^9\) G. Sfeir, ‘The Saudi Approach to Law Reform’, p. 730. Sfeir wrote: ‘Historically, the Shariah developed as a composite of religious rites and legal duties, a distinction between otherwise equally normative categories, the core of which was the revealed word of God contained in the Holy Quran, supplemented by the spoken word of the Prophet, the Sunnah’.
Although the Islamic Shariah is the law of God and as such is sufficient to cope with events and matters at all times and in all places, the Shariah rules are not comprehensive in covering all of life's events which pertain to people. The Shariah does not address all those aspects that impact the welfare and well-being of the people. Therefore, the Islamic Shariah also recognises Al-Massaleh Al-Mursalah as one of the sources of Islamic legislation. Al-Massaleh Al-Mursalah allows the authorities in any Islamic country to enact new regulations to meet the needs of the people. In Saudi Arabia, the King is the head of the Kingdom, and he has the power to enact, or to order the enactment of, new regulations which reflect changes within the society, and which meet the needs of the people. Any such regulations, however, must be compatible with Shariah law, and not in conflict with it. As a result of this duality, legislative enactments govern a great deal of the activities in the Kingdom today.

The Kingdom's legislative enactments go back to 1931 when the first major piece of legislation was promulgated by King Abdul Aziz. The Commercial Court Regulation was enacted in 1931 and consisted of 633 provisions separated into four chapters. The provisions covered land and maritime commerce, bills of exchange and a commercial tribunal. Since then, the Saudi Government has introduced many regulations to meet the ever-changing economic conditions, especially the expansion of business relations. In

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14 G. Sfeir ('The Saudi Approach to Law Reform') wrote "not only did the statutory enactments steer clear of any provision which might conflict with the Shariah, they often made it a point to state in their explanatory memoranda that the modern concept introduced by the statute was in conformity with the Shariah".
16 Ibid., pp. 20-25.
Saudi Arabia, statutory law regulates many fields and activities, such as trade and commerce, business and banking, labour and social security, custom and taxation. Statutory enactment has succeeded in supplementing a substantial segment of the traditional legal structure without compromising any of the requirements of the provision of the Islamic Shariah.

Until recently, the Saudi Council of Ministers, presided over by the King, held both legislative and executive powers in the Kingdom. As there was no written constitution in Saudi Arabia, the Council of Ministers' regulation had served as the constitution of the country, by providing the basic system necessary to rule the Kingdom. Referring to the term legislation as the 'Nizam', the Council of Ministers' regulation defined the term of Nizam as any regulation issued by Royal Decree and approved by the Council of Ministers. The Council has passed many regulations since its foundation, including the Commercial Papers Regulation, Regulations for Companies (Companies Act), Foreign Capital Investment Law, Commercial Agencies Regulation, The Banking Control Regulation and the labour law.

There was no written constitution in the Kingdom until 1992, when King Fahd announced a series of constitutional reforms that have had a significant effect on the political and legal system of the Kingdom of Saudi Arabia. Firstly, the government announced the Al-Nizam Al-Assasy, or Basic System of Ruling,

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20 The Council of Ministers was established by the Royal Order No. 5/19/1/4288, dated 1/2/1373. Then it was reorganised by Royal Decree No. 38, dated 22/10/1377, which set up the Council of Ministers regulation as the basic rules governing the country.
22 Ibid.
which was the first written constitution in the Kingdom’s history. The Basic System of Ruling is composed of 83 articles setting out the ruling system of the Kingdom, including rules governing the succession to the throne and other powers within the country. Furthermore, it calls for the establishment of Nizam Al-Muqata’at, or provincial government, to decentralise the power of the government and to enable the leadership of the provincial population to take a more active role in the development of their province. Finally, the constitutional reforms called for the establishment of Majlis Al-Shura, ‘the Consultative Council’, as the first independent legislative body in the Kingdom. The announcement of the first written constitution and the establishment of the Consultative Council as the first independent legislative body were considered major shifts in the structure of the legal system of the Kingdom. With the Shariah as the basis of the legal system, and which continues to exercise a restraining influence over the content and validity of the new laws, Saudi legislators have enacted statutory laws that regulate and govern trade and commerce, business and banking, labour and social security, customs and taxation.

Although the Consultative Council has been established as the Kingdom’s legislative body, it has, as yet, not exercised its legislative authority. The Council

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25 Since its establishment in 1993, the Consultative Council has not functioned as a traditional legislative body, rather it has focused on playing a major role in building up political consensus in the Kingdom.
26 R. Aba-Namay, ‘The Recent Constitutional Reforms in Saudi Arabia’, p. 299. Aba-Namay argues that several factors have led to these recent constitutional developments, the most important of which was the economic growth as a result of the oil boom, now in its twentieth year. This has transformed a highly illiterate traditional society into a wealthy, urbanised and educated one, and effectively incorporated the masses into political society.
of Ministers continues to hold both legislative and executive powers. The enactment of new legislation in Saudi Arabia varies based on its type or function. In general, there are three types of statutory legislation in the Kingdom.

Foremost is the Supreme or Royal Order legislation. This type of legislation is issued as a royal decree directly from the King and does not require the approval of the Council of Ministers.\textsuperscript{28} Legislation such as \textit{Al-Nizam Al-Assasy}, 'the Constitution', which deals with the form and function of government, as well as separation of its powers, is usually issued by Royal Order from the King, without requiring prior approval from any legislative or executive bodies. Such decrees are effective as of their published date.\textsuperscript{29} The Royal Order is a written decision by the King only and never passes through the Council of Ministers. The Royal Order is reserved to enact the most important legislation necessary within the Kingdom.\textsuperscript{30} This form of legislation has precedence over any other laws, rules and regulations.\textsuperscript{31}

The second type of legislation are statutes, which are the basic regulations and rules issued by the Council of Ministers and cover all types of economic, social, commercial and labour activities within the country.\textsuperscript{32}

The third type of legislation are the normal, or subsidiary, acts, which are usually enacted by the executive body directly, utilising power delegated from the Council of Ministers.\textsuperscript{33}

\begin{footnotesize}
\begin{itemize}
\item M. Omran et al., \textit{Introduction to Regulation in the Kingdom of Saudi Arabia}, p. 103.
\item E. Al-Gohni, \textit{The Saudi Council of Ministers}, p. 104.
\item Ibid.
\item M. Omran et al., \textit{Introduction to Regulation in the Kingdom of Saudi Arabia}, p. 104.
\item Ibid.
\end{itemize}
\end{footnotesize}
2.1 The process of the enactment of new regulations

With the notable exception of the Royal Orders, all major legislation is issued by the Council of Ministers. The ‘Council of Ministers Regulation’ establishes the procedures which must be followed prior to the enactment of a new piece of legislation within the Kingdom.\(^{34}\) The first stage in the legislative process is known as the ‘motion stage’ or ‘proposal stage’. Article 22 of the Council of Ministers Regulation provides that any Minister has the right to propose new regulations dealing with matters that come under the Ministry’s jurisdiction to the Council of Ministers. The Minister also has the right to propose regulations for the general welfare of the public to the Council. These ministerial suggestions are usually limited to matters within their powers and jurisdiction.\(^{35}\)

The new regulations are usually drafted by the legal department of the Ministry. Subsequently, the Minister will propose the new regulations to the Council of Ministers. After the new regulations have been presented to the Council of Ministers, the Council will transfer the new regulations to the Consultative Department.\(^{36}\) The Consultative Department is the highest legal body in the country, under the jurisdiction of the Council of Ministers. The Consultative Department consists of a number of legal experts and advisers, charged with the study and evaluation of the proposed regulations, following

\(^{34}\) R. Aba-Namay, ‘The Recent Constitutional Reforms in Saudi Arabia’, p. 309. Aba-Namay wrote that “the absence of a distinct and separate legislative body in the Kingdom in the past may be because the concept of legislation, or Tashri’a, is not accepted by many Muslims, including Saudis. Tashri’a is considered to be alien to Islam: it is perceived as inconsistent with a Shariah based legal system, since Shariah is regarded as the highest law. Only God is the supreme legislature. Human beings can only interpret God’s law, not make their own. This view has been followed in Saudi Arabia. Throughout its existence, the government has never claimed the right to legislate, only to ‘regulate’ in order to supplement, though not contradict, the Shariah.


\(^{36}\) Ibid., p. 120.
which a final draft of the regulations is prepared and a report on the new regulation submitted to the Council. These experts also periodically evaluate previous legislation and draft new amendments as required.\(^37\)

Following presentation of the Consultative Department’s report to the Council, the second stage of the legislative process begins. As a legislative body, the Council of Ministers will review the final draft of the report, making suggestions on the proposed regulation. When this process is complete, the Council will vote on the proposed set of regulations.\(^38\) If a proposed regulation is rejected by the Council of Ministers, it cannot be reconsidered until the requested amendments have been made, unless the Council requests otherwise.\(^39\) However, if the Council of Ministers vote in favour of the proposed regulation, the project will be transferred to the Royal Bureau for the approval of His Majesty the King, and for the issuance of a Royal Decree.\(^40\)

Most statutory enactments provide broad rules for particular areas, such as taxes, banking, commerce and labour relations, and are issued by a Royal Decree approved by the Council of Ministers and promulgated by the King.\(^41\) The approval of the Council of Ministers is not sufficient to officially pass the legislation as law without the approval of the King. If the new project is approved by the King, it will then be issued as new legislation by Royal Decree.\(^42\) The third stage is called the Issuance Stage. The issuing of the new regulation is done by

\(^{37}\) Ibid., p. 123.
\(^{38}\) The Council of Ministers Regulation, Art. 21.
\(^{39}\) M. Omran et al., Introduction to Regulation in the Kingdom of Saudi Arabia, p. 106.
\(^{40}\) Ibid., p. 106. The King has the right to reject the project within one month, giving the reason for the rejection.
\(^{42}\) The Royal Decree is the King’s decision of issuing the new rules after the approval of the Council of Ministers.
order of the president of the Council of Ministers. As head of all governmental agencies, he has the power to enforce new regulations. As noted above, all new regulations at this level are issued by Royal Decree.\textsuperscript{43} The final stage is the publication of the Decree in the Official Gazette of the Kingdom. The new regulations must be published in the official gazette, \textit{Umm Al-Qura}, and are effective as of the date of publication.\textsuperscript{44}

Other regulations, known as Subsidiary regulations, are often issued by government agencies, and serve to elaborate on the Statutes and provide more specific details to existing legislation. This type of regulation is enacted directly utilising powers delegated by the Council of Ministers to one or more of the Council members.\textsuperscript{45} This level of legislation does not need royal approval, nor does it require approval of the Council of Ministers. This type of regulation allows government agencies to issue rules that are necessary to effectively perform their duties and allow them to conduct business in a more streamlined fashion, without requiring them to consult the legislative bodies over these matters.\textsuperscript{46} Since the Subsidiary regulation is the lowest form of rule on the Saudi legislative ladder, any such rule must be consistent with higher legislation which already exists, and must not amend, nullify or contradict this higher legislation. Subsidiary legislation is usually issued by the Council of Ministers, the Minister concerned, or any person who is authorised to enact new rules within the agencies.\textsuperscript{47}

\textsuperscript{43} M. Omran \textit{et al.}, \textit{Introduction to Regulation in the Kingdom of Saudi Arabia}, p. 106.
\textsuperscript{44} The Council of Ministers Regulation, Art. 24.
\textsuperscript{45} M. Omran \textit{et al.}, \textit{Introduction to Regulation in the Kingdom of Saudi Arabia}, p. 107.
\textsuperscript{46} Ibid.
\textsuperscript{47} See the Council of Ministers Resolution No. 746, dated 1389.
As noted earlier, Shariah is the national law governing all aspects of life for Muslims in the Kingdom of Saudi Arabia. However, Shariah covers the unchanging, or constant, aspects of people’s lives and leaves those aspects which are subject to change to be governed by rules enacted by the people themselves. This legislation, therefore, plays a major role in the legal system of the Kingdom of Saudi Arabia today.\textsuperscript{48} As noted, the Supreme legislation in Saudi Arabia is law that is issued by Royal Order. These serve as the fundamental rules of government, establishing the governmental structure and allocating power among the different governmental levels. This form of legislation is issued directly by the King, without passing through other judiciary channels or requiring additional approval. All other laws in Saudi Arabia are subordinate to Supreme legislation.

Statutes other than Supreme legislation are issued by Royal Decree. This legislation must pass through the legislative body, consisting of the Council of Ministers and the Consultative Council, before being passed to the King for his approval. The lowest level of legislation in the Kingdom is Subsidiary legislation, which is a body of rules and decisions issued by the Council of Ministers, or any Minister acting as the head of a governmental agency, for the welfare of the general public within the jurisdiction of that Ministry and consistent with previously passed legislation (as outlined above).

The growth of statutory amendments and regulations governing such activities as trade, commerce, business, banking, labour, customs and taxation, has required the establishment of special tribunals to settle disputes arising from this legislation. This has had significant effect on the judicial system and

organisation of the courts of the Kingdom, as will be explained in the next section.

3. The Saudi Judicial System

The Saudi judicial system consists of general courts and specialised tribunals.\textsuperscript{49} The Shariah court system, under the jurisdiction of the Ministry of Justice, are the Kingdom's general courts, with jurisdiction over all disputes unless the law specifies otherwise. The Civil Tribunals under the jurisdiction of the Board of Grievances and other agencies have the exclusive power to decide upon disputes concerning government contracts, commercial, labour, taxation and banking issues.\textsuperscript{50}

3.1 The Shariah court system

Due to the fact that the Saudi legal system is based on Shariah law, the Shariah court system, under the jurisdiction of the Ministry of Justice, serves as the country's general courts, and Shariah judges preside over any dispute arising within the Kingdom unless these disputes are excluded by law.\textsuperscript{51} The first organisation of a Shariah court system goes back to 1927 when King Abdul Aziz

\textsuperscript{49} The establishment of a number of civil tribunals outside the Shariah court system was justified by the Fourth Development Plan 1985-1990, which states that "As numbers of economic transactions have increased, the need for a formal and permanent procedure for the settlement of commercial disputes has also increased. In the past, the private sectors hesitated to utilise judicial service due to different practices and attitudes, and time delays. New precedents are being established as cases become more complex. Judicial services will have to engage in an appropriate pattern of response and procedures. See, The Fourth Development Plan 1985-1990, Ministry of Planning, Riyadh, 1985, p. 364.

\textsuperscript{50} G. Sfeir, 'The Saudi Approach to Law Reform', pp. 742-743.

\textsuperscript{51} Saudi judicial regulation, issued under the Royal Decree No. 64, dated 14/7/1397, Art. 26 states that Shariah courts have exclusive jurisdiction over all disputes and crimes except matters that are excluded by Rules.
issued a Royal Decree unifying the judicial system in the country. The first organisation of the court system classified courts into three categories: Expeditious Courts, Shariah Courts, and the Commission for Judicial Supervision. This system has remained the main basis for the judicial system in the Kingdom. At present, the Shariah court system consists of the Higher Judicial Council, the Courts of Appeal, the Shariah Courts and the Courts of Expedition.

3.1.1 The Higher Judicial Council
The Higher Judicial Council is the Kingdom’s highest judicial tribunal, consisting of ten members appointed by Royal Order. The Council has two principal missions, administrative and judicial. The Council’s first mission is administrative and concerns supervision of the work of the courts, including the appointment, promotion and dismissal of judges. The second mission is judicial review. The Council’s judicial functions include the review of matters requiring determination of general Shariah principles at the request of the Minister of Justice and reviews conducted at the request of the King. These generally concern serious matters for which it is deemed necessary that the Council express an opinion, reviews of judgements imposing the death sentence or other severe sentencing, those conducted at the request of the Minister of Justice, and those matters requiring preparation of opinions pertaining to the judiciary.

54 Ibid.
3.1.2 The Courts of Appeal (Tam'ees Court)

The second level of the Shariah court system is the Tam'ees Court or the Court of Appeal. The Saudi government has established two Courts of Appeal in the Kingdom, one in Riyadh and one in Makkah. The Court of Appeal has the general mandate to hear all appeals from the Shariah Courts and Expeditious Courts and review decisions related to cases of trust and wills.\textsuperscript{56} The Court of Appeal usually hears cases with three judges, except those concerning severe sentencing, which must be heard by five judges. All judges are appointed by the Minister of Justice, upon consultation with the Higher Council of Justice.\textsuperscript{57}

3.1.3 The Shariah Courts

The Shariah Courts are the general trial courts in the Shariah court system. Most cases therefore begin in the Shariah Court, since this general court has jurisdiction over all subject matters, with the exception of those matters which are excluded by the law.\textsuperscript{58} A Shariah Court consists of one or more judges who are appointed by the Minister of Justice, and who hear all serious crime cases which are punishable by imprisonment in a penitentiary or by death.\textsuperscript{59}

\textsuperscript{56} The Saudi Judicial Regulation 1977, Article 8.

\textsuperscript{57} The Saudi Judicial Regulation 1977, Articles 11 and 13.

\textsuperscript{58} The Saudi Judicial Regulation 1977, Article 26, states that the Shariah Courts are the general courts in the kingdom and they have general jurisdiction over all matters except matters excluded by the law.

3.1.4 The Courts of Expedition

The Courts of Expedition constitute the lowest tribunal within the Shariah court system. Each court at this level is composed of one judge, appointed by the Minister of Justice. The Court of Expedition decides on the least serious criminal and civil matters. It also has jurisdiction over some special cases, such as those involving nomads.

3.2 The Civil Tribunal System

Besides the Shariah court system, which falls under the jurisdiction of the Ministry of Justice, the Saudi government has established a number of civil tribunals. These tribunals, which fall under a different jurisdiction, have the exclusive power to decide disputes in matters other than those covered by the Shariah court system. Although Shariah is the basis of the legal system in Saudi Arabia, developments in the national economy, trade and commerce and the complex relationship with the international world have placed significant pressure on the Saudi Government to modernise its legal system. There has also been a growing need for more specific regulations to govern foreign and domestic investments and other commercial activities. In order to maintain the pace of international and internal development, the Saudi government has pursued a modernisation strategy for its legal system which has resulted in the enactment of significant levels of new legislation and the adoption of a statutory law regulating

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60 Ibid., p. 205.
61 Ibid.
64 Ibid., pp. 319-320.
the majority of civil and commercial activities.\textsuperscript{65} The Saudi Development Plans show that there is a great deal of demand for the enactment of regulations concerning business enterprises and the adjudication of commercial disputes. These regulations were required to meet the demands of changing economic conditions and modern business issues. The modernisation of the Saudi legal system further reveals the need for changes in the judicial system to keep pace with the new regulations.\textsuperscript{66}

To cope with the adoption of the Commercial Court Regulation, the Commercial Court in Jeddah was established in 1931.\textsuperscript{67} In 1960 a Royal Decree was issued empowering the Ministry of Commerce to assume jurisdiction over the Commercial Court and assigning the Ministry responsibility for application of the Commercial Court Regulation and all other commercial legislation.\textsuperscript{68} The Minister of Commerce and Industry subsequently issued a decision establishing the Commission for Resolution of Commercial Disputes, replacing the Commercial Court.\textsuperscript{69} The enactment of the Companies Act 1965 provided for a commission for the settlement of commercial disputes arising from the application of the Companies Act’s provisions. As this resulted in two commissions with the same duties, the two commissions were merged into the Commission for the Settlement of Commercial Disputes, which is now the predominant tribunal with jurisdiction over these matters.\textsuperscript{70}

\textsuperscript{65} Ibid.
\textsuperscript{67} The Commercial Court Regulation covered maritime commerce, bills of exchange and commercial tribunals. The provisions of the Commercial Court Regulation were derived from the Ottoman Commercial Law 1850.
\textsuperscript{68} See Royal Decree No. 228, 2/6/1380.
\textsuperscript{69} Ministry of Commerce Resolution No. 27, 25/12/1382.
\textsuperscript{70} G. Sfeir, 'The Saudi Approach to Law Reform', p. 743.
The Commission for the Settlement of Commercial Disputes was not the only civil tribunal within the country at that time. The Customs Regulation established the Customs Committee to deal with cases involving smuggling. Another commission outside the Shariah court system is the Commission for Settlement of Banking Disputes. This commission was established under the jurisdiction of SAMA in 1986 to settle disputes between banks and their customers. Local banks were largely responsible for the introduction of this commission, as they were becoming increasingly concerned about the non-payment of loans in full, due to their difficulty in enforcing interest claims under the Shariah rules. In addition to the commissions mentioned above, there are others, including the Commission on Forgery, the Commission on Bribery, the Commission for the Impeachment of Ministers, and the Commission on Labour Disputes.

The Board of Grievances, or Diwan Al-Mazalem, is the most important tribunal outside the jurisdiction of the Ministry of Justice. The Board of Grievances was established in 1955 to review various administrative decisions.

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71 The anti-interest payment in the Shariah legal environment had resulted in many banks bearing the scars of heavy losses during the 1970s and the early 1980s due to their inability to enforce their claims on borrowers. The process of obtaining a court judgement and actually collecting under loan agreements used to take years, during which interest was not paid, heavy recovery costs were incurred and only partial recovery was ultimately obtained. Stung by such experience, bankers responded with greater demands for the establishment of a special court, which resulted in the establishment of the Commission for the Settlement of Banking Disputes in 1986, as the only court within the Kingdom with the power to hear and decide the banking dispute cases. See, P.W. Wilson, *Question Interest*, Westview, Boulder, Colorado, Oxford, 1991.


73 Ibid.


74 The Board of Grievances was established by Royal Decree No. 2/13/8759, dated 1374. By 1982, a revised regulation of the Board of Grievances was issued under Royal Decree No. M/51, dated 17/7/1402.
receive citizen’s grievances, investigate complaints submitted to it by disgruntled civil servants and the public at large, and report on its findings to the minister or the head of the agency concerned. However, its jurisdiction has expanded and grown to reach many fields far beyond its original mandate. This has given it far greater judicial powers than was originally foreseen. The power of the Board of Grievances led to the Board gaining one of the most important roles in the Saudi Judicial system, presently serving as the equivalent to the French Conseil d’Etat. The Board of Grievances now has jurisdiction over many cases and many of the other Commissions fall under its jurisdiction, such as the Commission of Labour Disputes, the Commission for the Settlement of Commercial Disputes, and the execution of foreign judgements. It also has jurisdiction over certain criminal offences, such as forgery and bribery cases.

4. Stock Market Regulation

In order to understand the current status of the market regulations, it is essential to review how they have been developed in response to market events and other influences. Since the foundation of modern Saudi Arabia in 1932, the enactment of legislative law has become the primary source of new laws and social change in the commercial and financial sectors in the country. As was explained previously in this chapter, Shariah law is the national law of Saudi Arabia, yet increasingly emphasis has been placed on the enactment of legislative or statutory

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77 G. Sfeir, 'The Saudi Approach to Law Reform', p. 745. Sfeir notes that some of the matters were clearly falling within the province of criminal law, and as such should be dealt with by the Shariah
laws, thereby satisfying the need in Saudi Arabia for social and economic changes.\(^7\) While Shariah rules cover most of the unchanging aspects of society, such as criminal law, property law, wills and trusts and family law, commercial and financial control is largely statutory, and judges have to rely heavily on these regulations as the primary sources of settling disputes arising in these areas.\(^7\) No exception to this is the Saudi stock market, which has been governed exclusively by legislatively enacted laws.

Unlike other areas of jurisprudence, Saudi authorities did not enact only one article of legislation to govern their stock market.\(^8\) Instead, four different rules and acts govern trading securities today. The Saudi Companies Act, the Executive Rules to Regulate Share Dealing through Commercial Banks, the Instructions to Banks Central Trading Units and the Disclosure Rules constitute the principle legislation that regulates share trading in the Kingdom. Importantly, each law has been enacted by a different agency and for a different purpose.

### 4.1 Primary Market Rules

This section identifies the rules and processes governing the initial public offering (IPO) of equity securities in Saudi Arabia. The initial sale of securities from the courts, their identification with the statutory enactment favoured their inclusion among judicial responsibilities of the Board.


\(^8\) In this regard, most emerging markets have enacted one law to deal with all securities market activities. For example, in Oman, a new draft capital markets law was formulated in 1996, detailing the authority of the market regulatory agency and the newly privatised exchanges. The law sets out the functions of the market authorities, which include protection for small investors and regulations of all securities market activities, including the initial flotation of shares taking place in the primary market and mutual funds activities. See H. Azzam, *The Emerging Arab Capital Markets: Investment Opportunities in Relatively Underplayed Markets*, Kegan Paul International, London, 1997, pp. 169-171.
issuing corporation, or other body, to the public is called a primary distribution. In many jurisdictions, companies are obliged to give adequate and factually correct information about the securities which are being offered for sale to the public. In Saudi Arabia, securities being offered to the public are governed by the Companies Act 1965. The Companies Act, administered by the Ministry of Commerce, is a crucial piece of legislation in the Kingdom’s securities market. Any company wishing to go public, whether for the first time or to increase its capital, must therefore comply with Companies Act requirements.

The Companies Act has its origins in the Commercial Court Regulation. The Commercial Court Regulation, which was promulgated by King Abdul Aziz in 1931, was the first major piece of legislative law in the Kingdom to address the increased need for the uniformity and codification of commercial law. The Commercial Court Regulation was drawn on the Ottoman Code of 1850, which was itself drawn on the French Commercial Code of 1807. It was a composite of 633 articles governing regulations on company activities. Most of the provisions were primitive and inadequate to cope with all matters relating to companies, their incorporation or, dissolution and liquidation, or the manner in

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83. Companies Act was issued under Royal Decree No. M/6, dated 23/3/1385 (1965). Amended under Royal Decree Nos. M/05 on 12/2/1387, M/23 on 28/6/1402, M/46 on 04/1405, M/63 on 26/11/1407, M/22 on 30/7/1412, and 1417.
84. Commercial Court Regulation was issued under Royal Decree No. 32, dated 15/1350.
85. A. Al-Kannas, ‘Islamic Influence in Saudi Company Law in Regulation to Corporate Finance and in Comparison with British Company Law’, pp. 10-11. Al-Kannas suggests that Saudi Arabia did not adopt British law, in view of Britain’s influence in the Gulf region in that time, because the common law came too late to influence the Islamic system. Furthermore, the idea of law being revealed through a series of cases seemed strange to people who were accustomed to using treaties. Finally, the major western commercial influence in the region, Britain, made the task more difficult by never translating the common law into Arabic.
which they conducted their businesses. The Commercial Court provisions were certainly inadequate to cope with the development and growth of companies in Saudi Arabia.

The deficiencies of the Commercial Court Regulation in covering the activities of companies revealed the need for a comprehensive set of regulations designed to set forth exact provisions governing the activities of Saudi companies. Hence, the Saudi Companies Act was enacted, containing 233 articles, which applied to all types of companies. The rules covered all aspects of corporate law, including incorporation, dissolution and liquidation. The Act also determined the extent of the powers of the Ministry of Commerce, outlining the Ministry’s control and supervision in order to safeguard public interest and protect private funds invested, and prescribing penalties for violation of such provisions.

The Companies Act provides for the establishment of new joint-stock companies and the initial distribution of shares, which led to the Act becoming a cornerstone in the legislative framework of the Saudi Stock market. All provisions governing joint-stock companies are set forth in Articles 48 to 148 of the Saudi Companies Act. These articles deal primarily with offerings to potential investors, exclusive power over joint-stock companies, regulated disclosure requirements, general meetings, tender offers, mergers, accounting rules,

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88 See Al-Bogomi, 'Sharekat Elmosahamah fe Alnedaam Al Saudi, Joint-stock Companies in the Saudi law', Comparative Study with the Islamic Law, Umm Al-Qura University, Makkah, 1986, p. 259.
90 Ibid.
shareholders’ rights, all material information and protection of companies from misuse by directors and officers. The Companies Act extends beyond the issuance of new securities to cover all activities of joint-stock companies and their directors, officers and shareholders.91

4.1.1 Going public

In order to be able to offer its shares to the public, a firm must be established as, or converted into, a joint-stock company pursuant to the terms prescribed by the Companies Act.92 The Companies Act defines a joint-stock company as a company with capital divided into negotiable shares of equal value, with the members thereof responsible only to the extent of the value of their shares, with their members not less than five.93 The Act also sets out the joint-stock company’s principal attributes. Firstly, it is a legal entity with separate rights and liabilities that are distinct from those of the shareholders. Secondly, the company is a legal entity and is therefore liable for payment of debts from its own assets, with company shareholders only having pro-rata liability. Thirdly, the shares of a joint-stock company may be freely transferred by sale, gift or pledge. Fourthly, the joint-stock company has perpetual existence and does not terminate upon the death, withdrawal or addition of a shareholder, director or officer. Finally, the


92 Companies Act 1965, Art. 64, states that if the joint-stock company is not incorporated in the manner prescribed in the Companies Act, the subscribers may recover the amounts paid or contributions in kind made by them, and that the founders shall be jointly responsible for fulfilment of this obligation and for the damages, if necessary. The responsible (founder) shall also bear all the (preliminary) expenses incurred for the organisation of the company, and shall be jointly responsible to third parties for all acts performed by them during the period of organisation.

93 Companies Act, Art. 48 & 49.
joint-stock company is considered a legal ‘person’ and therefore has citizenship and can sue and be sued.\textsuperscript{94}

The incorporation of a joint-stock company begins with the filing of an application, signed by at least five founding members, submitted to the Department of Companies (DoC) at the Ministry of Commerce, requesting that body’s authorisation to establish a joint-stock company.\textsuperscript{95} The law prohibits any offer or invitation for subscription in the company shares, or transfer or trade in the company’s shares prior to the decision of the Minister of Commerce authorising the company’s incorporation.\textsuperscript{96} The purpose of this prohibition is to provide investors with adequate and accurate disclosure of financial and other information.

Companies may be incorporated under the Companies Act in two ways. Firstly, by virtue of an authorisation issued in a Royal Decree based on the approval of the Council of Ministers and by the recommendation of the Minister of Commerce for the following joint-stock companies:

1. Concessionaire Companies;
2. Companies managing a public utility;
3. Companies receiving subsidy from the Government;

\textsuperscript{94} Companies Act, Art. 12, 13, 48 & 64.

\textsuperscript{95} In situations where an existing company wishes to convert into a joint-stock company, the company must meet the requirements of the Guidelines for Conversion to Joint-stock Companies issued by the Ministry of Commerce Reference No. 495, dated 25/3/1418 (29/7/1997).

\textsuperscript{96} See Legal Memorandum (no. 1238/11, dated 6/5/1410, no. 1470/11, dated 11/6/1411, no. 1551/11, dated 18/6/1410) and The Explanatory Memorandum for the Regulations of Companies, Riyadh Chamber of Commerce, 1994, p. 76.
4. Companies in which the Government or any other public legal entity participates, with the exception of the General Organisation of Social Insurance and the Retirement Pension Fund;\(^{97}\)

5. Companies engaged in banking activities.

Other corporations may be incorporated only by authorisation issued by the Minister of Commerce and published in the Official Gazette.\(^{98}\)

There is a minimum IPO capital requirement for corporations to offer stock to the public, which should not be less than SR 10 million.\(^{99}\) The capital required to be paid in upon the incorporation of the company shall not be less than one-half of the prescribed minimum, and the par value of each share shall not be more than SR 50 and not less than SR 10.\(^{100}\) The founders of a company wishing to offer its shares to the public must offer the shares for which they did not subscribe for public subscription within thirty days of the date of publication of the Royal Decree or Minister of Commerce’s decision authorising the incorporation of the company.\(^{101}\)

The incorporation of a company shall be in a manner prescribed by the Companies Act, otherwise the founders are jointly responsible for monies paid by subscribers, including damages and they are also jointly responsible to third

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\(^{97}\) Article 52 of the Companies Act was amended by Royal Decree no. M/22, dated 30/7/1412, permitting the General Organisation of Social Insurance and the Retirement Pension Fund, both government-owned public corporations, to incorporate and own shares in joint-stock companies without special approval from the King.

\(^{98}\) Companies Act, Art. 52, paragraph 2.

\(^{99}\) Companies Act, Art. 49. Although the minimum capital is SR 10 million, the Ministry of Commerce usually did not look at any application unless the capital was at least SR 50 million.

\(^{100}\) The minimum bar value used to be SR 50 which is considered high by international standards. Therefore, this article was amended to allow companies to issue stock with a value of SR 10 as a minimum in order to simplify the trading and increase the trading volume.

\(^{101}\) Companies Act, Art. 54. If necessary, the period of subscription may be extended by a decision from the Minister of Commerce, but not for more than ninety days.
parties for all acts performed by them during the period of organisation.\textsuperscript{102} The subscription by the public must be effected through local banks designated by the Minister of Commerce. Founders must provide banks with sufficient numbers of copies of the prospectus and the company's bylaws.\textsuperscript{103}

The Companies Act sets out the disclosure requirements with which companies must comply before they go public. Therefore, founders are required to include important relevant company information in the invitation for public subscription. The invitation must be set out in a prospectus, which contains the important data as set forth in the application for authorisation. The prospectus contains important information such as the founders' names, addresses, occupations and nationalities, the company's name, objectives and head office, the company's capital, the classification of stock, stock value, and particulars concerning the contributions in kind and the rights attached thereof.\textsuperscript{104}

The Companies Act requires that the prospectus be published in a daily newspaper distributed in the locality of the company's head office for five days before the opening of the subscription.\textsuperscript{105} The Act states that the subscription shall be open for not less than ten days and not more than ninety days\textsuperscript{106} and shall be final and unconditional.\textsuperscript{107} If the subscription demand exceeds the total number of shares offered for subscription, the shares will be allotted to subscribers in proportion to their individual subscriptions.\textsuperscript{108} As noted above, the Act does not require the use of an underwriter when issuing securities. In most

\textsuperscript{102} Companies Act, Art. 64.
\textsuperscript{103} Ibid., Art. 55.
\textsuperscript{104} Ibid., Art. 55, paragraph 3.
\textsuperscript{105} Ibid., Art. 55, paragraph 4.
\textsuperscript{106} Ibid., Art. 56.
\textsuperscript{107} Ibid., Art. 57.
\textsuperscript{108} Ibid., Art. 59.
countries, underwriters play a major role in the distribution of securities to the public, especially in certifying the issuing company's share price.\textsuperscript{109} In this regard, the Ministry of Commerce, in direct negotiation with the promoters and after reviewing feasibility studies containing financial projections for the future performance of the company, will decide the company's share price and issues related to the offering.\textsuperscript{110}

The Saudi Companies Act does not stipulate that there are any requirements for trading the stock after the public subscription. Subscribers other than the founders are allowed to trade their shares immediately after the issuance of their share warrants. However, the founders of the company are not allowed to trade cash shares subscribed or shares for contributions in kind, as well as founders' shares, before the publication of the balance sheet and the profit-and-loss statement for two complete financial years.\textsuperscript{111}

The Companies Act's jurisdiction over joint-stock companies is not limited to the primary market. Indeed it extends to companies even after they are listed in the stock market. With the exception of banks, all Saudi joint-stock

\textsuperscript{109} An underwriter is defined generally as a person who helps a company to sell its shares to the public through arranging the offering prices, number of shares to be offered and changes in existing company structure. This function is usually accomplished in one of three ways: in "the firm commitment" underwriters purchase the securities as principal from the issuer and resell them to dealers for retail sale to the public. In "standby underwriting" a company directly offers its existing security holders the right to purchase additional securities at a given price, and underwriters agree to purchase from the company any securities that are offered to the securities holders but not purchased by them. In a "best-efforts" underwriters simply agree to try to sell as many securities as they can, receiving a commission from the issuer for the securities sold. See, for instance, Booth & Smith, 'Capital Raising, Underwriting and the Certification of Hypothesis', Journal of Financial Economics, 1986, Vol. 15, p. 261.

\textsuperscript{110} 'The Explanatory Memorandum for the Regulations of Companies', Riyadh Chamber of Commerce, 1994, Sections 4-12, p. 77.

\textsuperscript{111} Companies Act, Art. 100. Nevertheless, shares owned by founders can be transferred during the suspension period from one founder to another.
companies must adhere to the Companies Act. The Companies Act sets out in detail the regulations that govern all aspects related to joint-stock companies. Firstly, the Companies Act elaborates upon the provisions that govern the shareholders. In theory, shareholders have significant powers over joint-stock companies. They are permitted to elect directors, approve certain extraordinary matters, approve corporate transactions that invalid unless ratified, and bring suits to enforce these rights. In this regard, a shareholder who holds twenty shares or more in any Saudi joint-stock company is entitled to attend general meetings, discuss and vote on the matters listed in the agenda of the meeting, and address questions to the directors and auditor in respect to them.

4.2 Secondary Market Rules

This section offers a brief overview of the secondary market rules of the stock market. The secondary market is the market in which stocks are traded after they have been issued in a primary market. Prior to 1983, trading in the Saudi secondary market was not regulated. People traded their shares through an informal stock market that consisted of 35 unlicensed stockbrokers who were not covered by capital or credential requirements. In April 1983, a Saudi Royal Decree was issued, establishing the Ministerial Committee, consisting of the

112 Due to the speciality of banks and their importance to the national financial system, they have to comply with requirements of SAMA and the Regulation of the Banking Control Law in addition to the Companies Act requirements.
114 Companies Act, Art. 83, 84, 93 and 94.
Minister of Commerce, the Minister of Finance and National Economy, and the Governor of SAMA, with the power to regulate and develop share trading in the Kingdom.\textsuperscript{117} In December 1984, the Ministerial Committee enacted the Executive Rules to Regulate Share Dealings as the first stock market law in Saudi Arabia.\textsuperscript{118} In 1990, SAMA introduced the Instructions to CTUs as the regulations to govern trading through the ESIS. Finally, the Ministerial Committee enacted the Disclosure Rules in 1997.

4.2.1 Executive Rules to Regulate Share Dealings

The Executive Rules to Regulate Share Dealing reflect the conservative bias of Saudi policy makers in the design of the Kingdom’s exchange, which focuses more on preventing stock market collapse rather than establishing the means for a sophisticated market to develop in the national economy. As a result, Saudi authorities focused on different measures limiting the role of market players whilst building up a very strong settlement and clearing system.\textsuperscript{119}

To achieve their goals of building up a safe and sound market, the authorities decided to model their market upon those of European countries that have built up their stock exchange within the banking system. Instead of developing a traditional stock exchange like those of other countries in the region, the Executive Rules determined that the local commercial banks would, by restricting trading of shares in the Kingdom to only 11 licensed banks, constitute

\begin{footnotesize}
\item[117] Royal Decree No. 1230/8, dated 11/7/1403 (April 1983).
\item[118] Executive Rules to Regulated Share Trading in Company Shares through Commercial Banks, Circular No. 123219/m/a276, December 1984, General Banking Control Department, SAMA, Riyadh, Saudi Arabia.
\end{footnotesize}
the marketplace. Furthermore, the Executive Rules restricted the role of broker activities, allowing no other parties to perform the role of mediator on behalf of clients except the banks. Banks are the only brokers in the market and no share trading is allowed to take place without their mediation. The brokerage commission for banks was fixed at 1% of the value of shares traded. To conduct their brokerage activities, each bank was required to designate a separate Central Trading Unit (CTU) in Riyadh City, supported by Saudi employees, to receive requests from branches and complete share transactions with other banks. However, banks were not allowed to take positions in the market unless they received permission from the Ministerial Committee.

Secondly, instead of having an independent body supervising the market, the Ministry of Commerce remains the main body in charge of joint-stock companies and the primary market. SAMA is responsible for the day-to-day supervision and regulation of stock market operations through the Securities Control Department (SCD), which was established within SAMA. Furthermore, the Executive Rules, which established the Supervisory Committee, ensured that banks would comply with the regulations and instructions formed by the Ministerial Committee and provide SAMA with much-needed support in its mission.

Finally, it was decided that trading in the market would be restricted to Saudi citizens, and that transactions should be paid in cash. As a means of

120 Ibid. Al-Dukhiel states that building up the securities market under the umbrella of the banking system will ensure the full control by Ministry of Finance and SAMA of the management and operation of the Saudi stock market.
121 Executive Rules 1984, Art. 1.
122 Executive Rules 1984, Art. 3.
123 Executive Rules 1984, Art. 2 f.
124 Executive Rules 1984, Art. 2.
avoiding speculation and insider trading, advance trading and the acceptance of post-dated cheques was strictly prohibited. Restricting settlement to cash only reflects the significant effect that the Kuwaiti stock market collapse has had on the regulation of the Saudi market. To complete its plan to enhance the back office and the settlement and clearing mechanism, the market authorities supported the establishment of the Saudi Share Registration Company (SSRC) to provide the market with central registration facilities for joint-stock companies, settling and clearing all equity transactions.

The Executive Rules set forth that trading may occur only through banks. The Executive Rules further impose that only Saudi joint-stock companies can be listed in the market. Each company has to publish quarterly information on the financial position of the company and its operating activities in the two daily papers. Banks rely on fast communication methods, such as telex and facsimile between the branches of a bank and the Central Unit, as well as between the Central Units of all banks, to meet the daily trading requirements. According to the Executive Rules, clients wishing to either buy or sell shares are required to approach designated bank branches to place their orders. A trader takes the order and sends it to traders in the Central Trading Unit (CTU) in order for it to be matched with other orders the CTU may have received from their branches, or

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126 Saudi Share Registration Company is a limited liability partnership company formed jointly by 11 Saudi banks with SR 11 million.

127 Executive Rules 1984, Art. 19 Section D.

from the CTUs of other banks. Related documents are exchanged through a dealing room created specially for that purpose at SAMA.\textsuperscript{129}

\subsection*{4.2.2 Instructions to Central Trading Units}

The Instructions to Central Trading Units (Instructions to CTUs) form the third cornerstone of the Saudi stock market.\textsuperscript{130} In 1990 SAMA introduced the Instructions to organise and govern share trading through the Electronic Securities Information System (ESIS). The purpose of the Instructions is to assist banks in handling the operation of the new electronic system. As the main market regulator, SAMA introduced the Instructions to ensure that market operation was consistent with the Executive Rules and the policies established earlier by the Ministerial Committee. The Instructions were issued to banks, even though companies are also members of the stock market. Hence, companies are not bound by the terms of the Instructions.\textsuperscript{131} The central purpose of the Instructions is to set forth the procedures for trading through the ESIS. In particular, the Instructions establish the steps to be followed by bank employees when conducting a securities transaction. The Instructions have been amended many times to meet the changes in the electronic trading system (ESIS).

\textsuperscript{129} Executive Rules 1984, Art. 10, 11, 12 and 13.

\textsuperscript{130} Instructions to CTUs, Securities Control Department, SAMA, Riyadh, 1990. The instructions were first issued for the internal use of banks and were not published.

\textsuperscript{131} The main purpose of the Instructions was to give guidance to banks while executing transactions through ESIS. The Instructions have therefore been amended many times to fit every new release or changes in ESIS.
4.2.3 Ministerial Committee Disclosure Rules

The fourth major piece of legislation dealing with the Saudi stock market is the Ministerial Committee Disclosure Rules.\textsuperscript{132} As indicated previously, neither the Executive Rules nor the Instructions to CTUs mandate disclosure requirements. As a result, the market and the government were relying heavily on requirements set out in the Companies Act. The lack of clear and strong disclosure regulations in the stock market resulted in certain market investors and company authorities supplying false and potentially misleading information to the public to disguise dubious dealings within the company, or to mislead the public for their own personal gain. In response, the Ministerial Committee introduced another layer of regulations to provide market participants with more protection. The Ministerial Committee enacted the Disclosure Rules in 1997 to strengthen the Saudi disclosure regime.

In contrast to the earlier regime, the Disclosure Rules place more responsibility on the chairman or managing directors to announce any major events or information that could reasonably affect share prices directly or indirectly, and to publicise decisions that could possibly affect share prices. The company must release this information immediately to the Securities Control Department of SAMA for dissemination via ESIS, and to the mass media.\textsuperscript{133} The enactment of the new disclosure rules came as a response to demands from a wide majority of market participants to increase the quality and the flow of information to the market.

\textsuperscript{132} Ministerial Committee Disclosure Rules, Minister of Commerce Circular Reference No. 2222/221/9/3340, dated 8/11/1417.
\textsuperscript{133} Ministerial Committee Disclosure Rules, Art. 2.
The new legislation was designed to serve the primary purpose of any stock market regulations, which is to protect market participants and foster public confidence in the stock market through enhanced disclosure. The Rules state that should a company make an announcement, the announcement must include any important information necessary for investors to get a clear picture of the issuer’s financial position, as well as include any major developments affecting the issuer, which could lead to major changes in the assets or liabilities, or in the financial situation of the issuer. Furthermore, the Disclosure Rules require the board of directors, managers and executive employees not to make statements or comments or offer information to the public unless the statement or comments or information truly reflect the current state of affairs of the company.\textsuperscript{134}

The Disclosure Rules promote fairness in the market by prohibiting the misuse of inside information. Firstly, the rules prohibit short-swing trading by insiders.\textsuperscript{135} Managers and executive employees are not allowed to trade in the shares of their companies in the short term for speculative purposes, nor are they allowed to trade before, or within one day after, any announcement of a major event that is likely to affect the price of shares. Secondly, the Disclosure Rules contain the long-awaited insider-trading provisions which prohibit trading in the market, based on the use of advanced proprietary information. The Disclosure Rules prohibit any person from trading based on inside information that is not

\textsuperscript{134} Ministerial Committee Disclosure Rules 1997, Art. 2-b.

\textsuperscript{135} Short-swing trading is understood as the purchase and sale of equity securities of publicly held companies by insiders over short periods using information not available to the public. Short-swing provision tends to minimise the unfair use of inside information that makes the market unpredictable and is damaging to those who do not have that strategic information.
5. Summary

This chapter has provided a brief overview of the development of securities regulations in Saudi Arabia. The first two sections examined the Kingdom’s legal and judicial system. It has been shown that the Saudi legal system is a relatively unique system that relies heavily on Islamic Shariah and legislative law as its legal basis. There have been substantial changes in the regulatory environment in the past two decades in order to meet the demand of changing economic conditions and expanding business relations. This has resulted in a surge of legislation that has been enacted covering aspects of the commercial and financial sectors.

In section 3 the stock market rules were reviewed. The Saudi stock market is governed by a range of rules, that are often complex. Four different types of legislation regulate its operation. Each rule has a different purpose and, in most cases, a separate governmental agency is responsible for its implementation. In fact, it is probably more accurate to say that these rules have been enacted to regulate the activities of the market players, rather than the actual stock market itself.

The governance of the market, utilising different types of laws and numerous overlapping regulatory agencies, might have suited the market and the goals of its regulators in the past. However, the protection of market investors and

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the potential major role that the market could play in the Saudi economy necessitates the enactment of a single set of coherent and consistent regulations that addresses all issues pertaining to the stock market. Besides the fact that the current regulations contain basic, conceptual shortcomings, their fragmentation tends to reduce market efficiency and increase the potential of fraud and manipulation.
Chapter 4

Saudi Stock Market Authorities

1. Introduction

Regulatory and supervisory agencies can play an important role in the development of any stock market. By providing market investors with a transparent structure to obtain price information, and with protection from manipulation and other market abuses, regulatory authorities can foster investor confidence, while promoting the government's principal policy objectives. Many commentators have argued that the stock markets in Continental Europe are less attractive to ordinary investors than in Anglo-Saxon countries, because regulators are less resolute in repressing insider trading and offering protection to minority shareholders. As a rule, the number of participants in the market is a direct measure of the degree of security felt by investors in a particular trading environment: the more safeguards provided to protect assets, and the more liquid the market, the greater the number of traders. Unlike


4 Ibid. Pagano states that this insight has been elaborated upon in several models of asset markets where participation externalities give rise to coordination failures. In these models, market
many other countries, the Kingdom’s stock market does not have an independent regulatory body in charge of its operation. Direct regulatory responsibility for the securities market is divided mainly between two government agencies, the Saudi Arabia Monetary Agency (SAMA) and the Ministry of Commerce. The primary market is regulated by the Ministry of Commerce whilst the secondary market is regulated and operated by SAMA. The Ministerial Committee, an executive committee, and its subcommittee, the Supervisory Committee, provide the mechanism for coordinating the activities of the two agencies.

The authorisation for the regulation of the primary market was promulgated in 1965 through the Companies Act. The Act has subsequently been amended to reflect changes in the market. To regulate the secondary market, in 1984 the Ministerial Committee as the highest regulatory committee issued a regulation based primarily on the Executive Rules to Regulate Dealings in Company Shares through Commercial Banks. As noted previously in Chapter 3, the Kingdom does not have one single regulation with respect to the licensing and supervision of financial intermediaries and market professionals who participate in the market. These activities, therefore, which include banking, corporate finance and other securities participation moderates the risk of the security [Chatterjee (1988), Allen and Gale (1991)] or the sensitivity of prices order flow [Pagano (1989a)] or both [Pagano (1989b)].


The Companies Act issued under Royal Decree No. M/6 dated 23/3/1385 (1965), amended under Royal Decree Nos. M/05 on 12/2/1387, M/23 on 28/6/1402, M/46 on 04/1405, M/63 on 26/11/1407, M/22 on 30/7/1412, and 1417.

The Executive Rules to Regulate Share Dealings in Company Shares through Commercial Banks, Circular No 123219/m/a276 in December 1984, the General Banking Control Department, SAMA.
market transactions, are diverse and would be shared by a number of regulators, including SAMA, the Ministry of Commerce, and the Ministry of Finance.

The aim of this chapter is to examine the regulatory structure, institutional framework and legal rules that have affected stock market development in the Kingdom. This chapter consists of four sections. In the first section, the focus will be on the role of the Ministerial Committee as the supreme power in the market. In the second section, the emphasis will be on the role of the Supervisory Committee in coordinating the activities of the agencies. The third section will focus on the role of the Ministry of Commerce. Section four will study the role of SAMA. The last section will evaluate the current situation of the market authorities, examining possible gaps and weaknesses in the regulatory structure and evaluating the demands for new regulators in light of changes in the market. The main issues addressed concern whether, because of divided regulatory responsibility, a new unified structure is required, or whether the structure of the agencies concerned should be reformed and amendments made to account for changes in market structure. This would be done without altering the fundamental division of regulatory control over the market and its participants.

2. Regulatory Structure of the Saudi Market

Presently, the regulatory responsibility in the Kingdom for the securities market is divided between two main agencies: the Ministry of Commerce, which regulates the formation of companies, the public offer of securities and the operation of financial
institutions (excluding banks); and SAMA, which regulates the secondary market and the subsequent buying and selling of shares. A joint Ministerial Committee and a Supervisory Committee, with delegates from the Ministry of Commerce and the Ministry of Finance and National Economy, as well as SAMA, were formed to provide a mechanism for coordinating the activities of the two agencies. Figure 4.1 shows the present supervisory arrangement for the Saudi stock market.

We first turn to examine the high-level Ministerial Committee that is responsible for coordinating the respective agencies.

**Figure 4.1 Present Supervisory Arrangement**

**The Ministerial Committee**
An executive committee consisting of:
Minister of Finance & National Economy
Minister of Commerce,
and Governor of SAMA
With the overall mission of regulating and developing the Saudi stock market.

**The Supervisory Committee**
Consisting of officials lower ranking than the upper Ministers from Ministry of Finance & National Economy, Ministry of Commerce and SAMA.
With the mission to link up SAMA and Ministry of Commerce with the Ministerial Committee.

**The Ministry of Commerce**
The agency in charge of trade and commerce activities in the Kingdom
With the full responsibility to regulate and supervise all types of companies including joint stock companies and their publicly offerings.

**The Saudi Monetary Agency**
SAMA
The Kingdom Central Bank with the main mission to regulate and supervise trading in the secondary market through the Securities Control Department.

**Listed Companies**

**SSRC**

**Banks**
2.1 The Ministerial Committee

This section examines the role of the Ministerial Committee in monitoring and coordinating the activities of the Kingdom's regulatory activities. The regulatory structure of the Kingdom has been developed over a 25-year period.\(^8\) In the early 1980s, in the wake of the Kuwait crisis, the Council of Ministers formed an internal committee consisting of the Minister of Finance and National Economy, the Minister of Commerce and the Governor of SAMA to review the informal stock market situation and recommend ways to improve its structure and regulation.\(^9\) The selection of these three members was not surprising, as their agencies had been originally responsible for the regulation and supervision of financial and trade activities.

The Ministry of Commerce is the government agency responsible for the supervision of all commercial activities within the Kingdom, including all types of companies. Through the Companies Act, the Ministry of Commerce is empowered to regulate and supervise the establishment of joint-stock companies and govern the approval of initial public share offerings to the public.\(^10\) SAMA is the Kingdom's Central Bank charged with the main task of controlling the financial institutions and designing the monetary policy within the Kingdom.\(^11\) It is the Banking Control Law that authorised SAMA to regulate, supervise and set up all the processes and requirements for the establishment and operation of banks within the Kingdom.\(^12\)

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\(^10\) Companies Act 1965, Article 2.
\(^11\) The Saudi Arabia Monetary Agency (SAMA) was established as the Kingdom's Central Bank under Royal Decree on Rajab 1371.
\(^12\) Banking Control Law, issued under the Royal Decree No. 23, dated 23/5/1377.
The third agency involved in this special committee is the Ministry of Finance and National Economy. The Ministry of Finance is the government agency responsible for the overall economic and financial affairs within the Kingdom.\textsuperscript{13} For a long time, the Ministry of Finance and National Economy was considered one of the most powerful government agencies within Saudi Arabia.\textsuperscript{14} The Ministry of Finance is responsible, at a more general level, for a wide range of high-level macro-economic tasks and in particular, is charged with developing the economic policies for the Kingdom.\textsuperscript{15}

Previously there were no regulatory controls over market activities. The government, in developing the complex structures necessary to control the wide range of market activities, designed a regulatory approach with protection for investors and financial market stability as the major policy goals.\textsuperscript{16} In order to establish a regulatory framework based on the involvement of these agencies, the Council of Ministers, following an assessment of the internal market and the characteristics of the market participants, developed a trading structure and a coherent regulatory mechanism that benefits a wide range of businesses in the market.\textsuperscript{17} The study of the market was conducted by the Ministry of Finance and served as the basis for a meeting of the Committee in March 1983, in which it was

\textsuperscript{15} Ibid.
\textsuperscript{17} Ibid.
decided that more specific arrangements were needed for the regulation of the market. Hence in April 1983, a Saudi Royal Decree was issued to approve the recommendation of three ministers and to establish a Ministerial Committee consisting of representatives of the Ministry of Finance and National Economy, the Ministry of Commerce and SAMA, as the highest committee of the stock market to deal with the task of regulating and developing the Saudi stock market. The Royal Decree of 1983 announced that the main reason for the establishment of the Ministerial Committee was that “the government wished to establish a committee comprising the Ministry of Finance, Ministry of Commerce and SAMA to execute rules to allow banks to provide this service [the buying and selling of shares] and the Committee should work on developing these arrangements in order to achieve the desired goals, including distribution of information and statistics in order to make the citizens continually aware of the situation of the companies.”

Pursuant to its rulemaking power, the Ministerial Committee developed the Executive Rules to Regulate Share Dealings, which was the first securities market law enacted within the Kingdom. The Executive Rules are designed to organise the regulatory bodies and their supervisory powers. In order to ensure adequate

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18 Al-Ajmi, 'Gulf Equity Markets: Comparison of the Structure and Performance', p. 50. The study of the market showed that prior to 1984 the market suffered from illegal practices due to the lack of regulation and supervision; the market is fragmented between many offices and brokers without sufficient connection linked to provide investors with the necessary information; the stockbrokers operate without licence or any operation requirements.
19 Royal Decree No. 12308, dated 11/7/1403.
20 Ibid.
21 Executive Rules to Regulate Share Dealings in Companies Shares through Commercial Banks, SAMA's Circular in December 1984, The General Control Department, SAMA, Saudi Arabia.
supervision of the market and provide specific rules, as well as to develop an enforcement structure, the Ministerial Committee provided the institutional basis for the development of best practices rules. Generally, the Ministerial Committee is the most appropriate institution to ensure that the market regulators carry out their tasks. In particular, the Committee ensures agency compliance with the Executive Rules and determines whether agencies require additional support, and reallocates functions and supervisory responsibilities. The Ministerial Committee operates as a Board of Directors, which monitors and approves the proposals of SAMA and the Ministry of Commerce. The Ministerial Committee naturally retains final authority to approve legislative initiatives and amendments.

Whilst the Ministerial Committee is the supreme regulatory power in the Saudi financial market, it does not function as a regulatory body in the same way as the Securities and Investment Board (SIB) in the UK or the Securities and Exchange Commission (SEC) in the US, which are fully devoted to the regulation and development of stock market activities. In this respect, Osama Faqih, Minister of Commerce & Member of Ministerial Committee, explained that:

"Rather, the work, undertaken by the Ministerial Committee is to co-ordinate particularly complex activities of the differently placed market regulators, while assessing, from the Government's

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23 Ibid. p. 12.
24 Executive Rules 1984, Art. 2-e, require other regulators to present a quarterly report on their activities to the Ministerial Committee and the approval of the Ministerial Committee for any changes in the regulation of share dealings.
25 The US Securities and Exchange Commission's mission is to administer the distribution of securities, the activities of brokers and dealers, the operations of stock exchanges and numerous other activities related to the operation of the securities markets. In the UK, the FSA stated that any investment business conducted had to be authorised and that the supervision of this investment business was to be placed in the hands of the Securities and Investment Board (SIB). See F. Oditah, The Future of the Global Securities Market: Legal and Regulatory Aspects, Clarendon Press, Oxford, 1996, pp. 157-183.
perspectives, the effectiveness of these institutions in delivering on their policy objectives."²⁶

Given the executive nature of the Ministerial Committee, there is no permanent building or professional staff to house and guide their activities. The Committee’s main task is to supervise the performance of the different regulatory organisations, and the this supervisory function is exercised at least once a year in a general meeting in which members undertake to review performance and approve new rules.²⁷

The Ministerial Committee consists of three members, with each member serving as the head of the agency he is representing. Membership of the Ministerial Committee is automatic²⁸, with the ministers holding their positions as long as they are heading their Ministries. For example, when a number of new ministers were announced in 1995, the two new ministers of Commerce and Finance were appointed to the Committee to replace the ministers who left.²⁹ The new members of the Ministerial Committee continued to carry the mission of the earlier Committee by working with market authorities on developing new regulations designed to ensure the protection of market participants. In this regard, the Ministerial Committee announced in 1997 new regulations regarding disclosure and insider trading.³⁰ The

²⁶ See interview with Osama Faqih, Minister of Commerce and Member of Ministerial Committee, Riyadh, 28 July 1997.
²⁷ Executive Rules 1984, Art 2-c, provide that the Ministerial Committee retains final authority to approve stopping any dealings in the market in the event this should last longer than one week.
²⁸ Royal Decree No. 12308, dated 11/7/1403.
²⁹ In 1995, King Fahd announced the appointment of new government in order to facilitate the growth in the national economy and to carry on the old development plan. The change in the Government members resulted in replacing the Minister of Commerce and Minister of Finance.
³⁰ See Ministerial Disclosure Rules, Minister of Commerce Circular Reference No. 2222/221/9/3340, dated 8/11/1417.
Committee also reviewed the foreign investment rules and decided subsequently to allow foreign investors to invest in the Saudi market for the first time, through country funds. The Ministerial Committee has also worked to provide investors with better services and better protection, while increasing market efficiency and liquidity by moving towards liberalising the market and opening it to Gulf Cooperation Council (GCC) citizens and other foreigners.

The Governor of SAMA and member of the Ministerial Committee, Hamad Al-Sayari, stated in an interview at the time:

"There are a number of objectives which the Ministerial Committee seeks to promote, including: sustaining confidence in the Saudi financial sector (working on an agreed basis with the SAMA and Ministry of Commerce to set the framework for co-operation in this area); protecting investors and other consumers by ensuring that banks are financially sound and can assure their customers of their integrity; promoting improvements in investors, understanding of risks and benefits of financial products and securities; monitoring and supervising the authorities in detection and prevention of financial crime; ensuring that these policy goals can be realised in an efficient manner that facilitates innovation and that takes account of the diverse financial interests within the market."

The Ministerial Committee recognises that to improve the regulatory processes further, it is essential to build upon the existing regulatory arrangement while augmenting the rules to take account of changes in the market structure.

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33 Interview with Mr. Hamad Al-Sayari, Governor of SAMA and Member of the Ministerial Committee, Riyadh, 4 September 1997.
2.2 The Supervisory Committee

This section describes the work of the Supervisory Committee, which is the second regulatory body involved with supervision of the Saudi stock market. The Ministerial Committee, which is responsible for coordinating and prioritising the government's goals, supports the work of the Supervisory Committee on a day-to-day basis.35 The Supervisory Committee, established by the Executive Rules to ensure compliance with market regulations, provides infrastructure support of the regulatory groups and assists the Ministerial Committee in coordinating the regulators' dealings with banks and other regulated firms and agencies.36 The Supervisory Committee consists of representatives of the Ministry of Finance, the Ministry of Commerce and SAMA. The membership includes officers holding a lower rank than members of the Ministerial Committee.37

The Supervisory Committee was established to fill the gap between market operations and the Ministerial Committee. In answer to a question concerning the Supervisory Committee's main function, Jammas Al-Suhaimi, Deputy Governor of SAMA and Member of the Supervisory Committee, noted that:

"The Supervisory Committee plays an active role in enhancing regulatory functions, by operating as an intermediary between the

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34 Ibid.
35 Executive Rules 1984, Art. 2, state that a permanent committee is formed to supervise share dealings (which is called the Supervisory Committee) which is made up of representatives of the Ministry of Finance, the Ministry of Commerce and SAMA.
36 Executive Rules 1984, Art 2-a, provide that the Supervisory Committee's main task is to supervise share dealings and ensure that the regulations and instructions from the Ministerial Committee are carried out.
37 Each member of the Supervisory Committee is holding a position as deputy minister in the agency that he represents. For example, SAMA's representative is the Deputy Governor and General Manager of the General Banking Control Department.
regulator of the secondary market operations and the regulator of the primary market, and the Ministerial Committee.38

Members on the Supervisory Committee remain until they step down or are removed by the agency which they represent.39 Members of the body are from regulatory agencies only, although some observers believe that liaison with private sector representatives could assist the government in continuing the development of its work in promoting the exchange of information and expertise.40

As with many government agencies of this type, the present members, representing the various ministries, have limited time and opportunity to devote to the task of regulating the stock market. The Supervisory Committee meets only once a month and accordingly has limited scope in handling many of the complex matters and enforcement concerns that confront the respective regulatory bodies.41 Despite these limitations, the Committee plays an important role in legitimising the Kingdom’s regulation of the stock market, and serves as a buffer to help the various agencies face the complex problems they encounter in performing their tasks. The Executive Rules state that the main purpose of establishing the Committee was to offer the market adequate supervision and ensure compliance with the Rules by

38 Interview with Mr. Jammas Al-Suhaimi, Deputy Governor of SAMA and Member of the Supervisory Committee, Riyadh, 24 September 197.

39 The Supervisory Committee members are like the Ministerial Committee’s members in that no member devotes 100% of their time to their membership because they have their main jobs beside the membership of the Committee. For example, the representative of MoC is both Deputy Minister of Commerce and General Director of the DoC.

40 See, for example, Malaikah, 'Saudi Arabia & Kuwait: A Study of Stock Market Behaviour and its Policy Implications', p. 138. Malaikah noted that a committee that supervises the Saudi stock market should be composed of key members from the Ministerial Committee and Supervisory Committee. In addition, it should include members selected from both the academic and professional fields in the areas of investment and finance.

41 Although Executive Rules 1984, Art. 2-d, provide that the Committee holds at least a monthly meeting, meetings can be called at the request of any member. Normally, the Committee does not meet every month due to the fact that members are too busy in their main jobs.
banks and other market participants. A secondary function assigned to the Supervisory Committee is the production of a quarterly report on market activities and operations to the Ministerial Committee. In order to assist the Committee in performing its functions, the Ministerial Committee has delegated some of its power to the Supervisory Committee. For example, the Supervisory Committee has the right to review rules and regulations relating to the organisation of share dealings, with the purpose of developing and increasing their effectiveness. Any changes in the Executive Rules or additional regulations, however, must receive the approval of the Ministerial Committee. To enable the Supervisory committee to perform its duties, it is also provided for in the Executive Rules that the Committee has the right to request all financial information relating to dealings from commercial banks and private firms. Furthermore, the Executive Rules empower the Supervisory Committee to halt dealings in shares of a company or to put a maximum limit on share offers or trading whenever necessary. This suspension, however, cannot exceed more than one week. Any suspension of trading activity lasting more than one week must be done with permission from the Ministerial Committee.

42 Executive Rules 1984, Art 2-a.
43 Executive Rules 1984, Art 2-e.
44 Executive Rules 1984, Art 2-e.
45 Executive Rules 1984, Art 2-b, state that the Supervisory Committee has the right to request all financial information relating to dealings from commercial banks or companies. The Commercial banks and companies are obliged to provide all the information that the Committee requests about share dealings.
46 Executive Rules 1984, Art 2-c.
47 Executive Rules 1984, Art 2-c, state that the Supervisory Committee has the right to stop dealings in shares of a company or to put a maximum limit on dealing in its shares if the general welfare so requires, on a temporary basis that does not exceed one week. Also the Committee has the right to halt stock dealings in the market altogether after obtaining the Ministerial Committee’s approval.
Although the Supervisory Committee is very capable of handling the supervision and other cooperative activities that take place between the Ministry of Commerce and SAMA, it is not the appropriate administrative body to deal with the daily supervision of the regulated institutions.

2.3 The Ministry of Commerce

This section examines the regulatory role of the Ministry of Commerce. Since the adoption of the Commercial Court Regulation in 1931, the Ministry of Commerce has remained the main government agency in charge of all trade and commercial activities within the Kingdom.\(^48\) Prior to 1984, the supervision of the informal market was the exclusive responsibility of the Ministry of Commerce. Although the Companies Act did not specifically allocate power over share trading in the Kingdom to the Ministry of Commerce, the Ministry derives its power in this instance from its role as the government agency with responsibility for the regulation of all companies, including joint-stock companies.\(^49\)

The Companies Act of 1965 allocated to the Ministry of Commerce full and exclusive power and jurisdiction over the primary market and all joint-stock companies, and all their activities.\(^50\) As we noted previously, the primary market is regulated by the Ministry of Commerce pursuant to the Companies Act, particularly

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\(^{50}\) Companies Act 1965, Article 52, states that all joint-stock companies may be established only by virtue of an authorisation issued in a royal decree based on the approval of the Council of Ministers and the recommendation of the Minister of Commerce or they may be established direct by authorisation issued by the Minister of Commerce.
Articles 48-148, and the guidelines relating to the conversion of company status from private to open joint-stock company, and to the offering of shares in such companies to the public.\textsuperscript{51} The Companies Act regulations simply provide a basic structure to process the conversion and offerings to the market. As noted in Chapter 3, because the rules governing IPOs are lacking in detail, the Ministry of Commerce exercises considerable discretion in processing applications, assessing valuations of share issues, and determining whether the prospective offerings are ultimately fair and non-discriminate in their effect on the market participants.\textsuperscript{52}

The broad discretion provided to the Ministry of Commerce in its supervision of conversions and proposed offerings could be justified in the early stages by the development of the Saudi stock market.\textsuperscript{53} In the 1980s there were few retail investors and the provision of securities services was restricted to under-capitalised financial intermediaries and banks.\textsuperscript{54} However, the expansion of the market, which was generally welcomed by the government, brought with it potentially greater risks to retail investors, who were given little incentive to obtain information about risk and return and who cannot be shielded by the information provided to the market by experienced, professional intermediaries. In this context, the Ministry of Commerce,

\textsuperscript{51} 'Guidelines for the Conversion of Companies to Joint Stock Companies', issued by Ministry of Commerce via Circular 495, dated 25/3/1418 (29/7/1997).
\textsuperscript{52} For example, The Guidelines for the Conversion of Companies to Joint Stock Companies 1997, Art. 2.4, states that in situations of converting a company into a joint-stock company and increasing its capital through public subscription or maintaining its capital and offering part of the capital for public subscription, departments of companies shall appoint one (or more) expert(s) with the objective of ascertaining the value of the company and specifying the rate of share prices of the proposed joint-stock company in accordance with the provisions of Articles 60 and 61 of the Companies Act according to common applicable accounting standards.
\textsuperscript{54} Ibid., pp. 141-142.
worried about the level of risk in the market, continued on its course of conservative management of market risk, anticipating that any difficulties could be controlled completely by its restrictive and, ultimately, costly intervention.

The evolution of the market in the later part of the 1980s, however, introduced new complexities for the Ministry of Commerce. The micro-structure of the market changed fundamentally with the introduction in the market of a new class of sophisticated investors generally familiar with the level of risk, volatility and rated return. Moreover, the government policy of stimulating private sector growth, derived from its five-year plans and intended to gradually diversify the economy from its traditional resource base in industrialisation, was successful in adding many new public companies to the Saudi share exchange. The emergence of a nascent IPO market thus contrasts sharply with the earlier stages of market development in which there were few companies sufficiently capitalised to bring new issues to the market. Hence, with the increasing maturity of the Kingdom's market, there was a correspondent introduction of a sophisticated infrastructure of financial intermediaries armed with information about securities, as well as the development of a financial advisory industry.

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Azzam, *The Emerging Arab Capital Markets: Investment Opportunities in Relatively Underplayed Markets*, p. 154. At present, there are more than 300,000 Saudi shareholders, 40 financial advisor offices, 11 mutual funds, and more than 50 unlicensed agencies.

For example, The Kingdom's Fifth Development Plan 1990-1995 stated that one of its primary objectives is to increase private sector investment in the national economy through selling selected government-owned enterprises to the private sector, selling shares in selected government-owned enterprises to the private sector, and encouraging the private sector to compete with certain government monopolies. The Sixth Development Plan 1995-2000 states that one of the plan's objectives is to study the feasibility of privatising some of the state enterprises with a commercial nature and to expand the use of private sector capital in financing some government projects.
The new market conditions contrast with the earlier environment in which the regulatory mission of the Ministry of Commerce was defined. It was assigned a highly interventionist role with as premise the fear that financial instability (due in part to the Kuwaiti market collapse and its resultant effect on the Saudi market) would place constraints on the growth and development of the market's capacity for new issues. 57

In light of the newly emerging market conditions, it can be seen that the conservative approach to new issues of the Ministry of Commerce is one of the main factors restricting market growth. 58 Typically, the review process of the Ministry of Commerce, which may take several months to complete, leads to uncertainty and ultimately to an unattractive offering price. It may be that the Ministry of Commerce procedures require revision in order to limit the costs and delays associated with the review process. 59

In this regard, the Kingdom's policymakers could eliminate the imperfections in the system by introducing a legal framework for new offerings that is based on the concept of regulation by disclosure rather than on the merit review approach, the details of which are discussed in Chapter 7. The benefits from such changes include

58 Bakheet Financial Advisors, 1998 Annual Report, p. 4. The report shows that only 74 companies are traded on the Saudi stock market, which is very deficient when compared to an average of 350 companies in other emerging markets. The report states that the reason for this small number of companies is the stringent listing requirements imposed by Ministry of Commerce which have mainly encouraged the listing of large well-established companies. During the last decade only 15 companies have offered their shares to the public.
59 See Azzam, The Emerging Arab Capital Markets: Investment Opportunities in Relatively Underplayed Markets, p. 153. Azzam states that scrutiny of companies that apply for listing is time consuming and the criteria for acceptance are not transparent. In most cases, it takes as long as two years for a company's application to be approved. By that time, everything may have changed, including the company's financials, rendering the original application obsolete.
lower costs, ensures that only the regulator is concerned with determining the price of the issue, and also determines whether the information disclosed is relevant to assessing the security on offer. The result is that the move to a new disclosure-based regime would mean that the regulators themselves must ensure that all valuations, financial and otherwise, made in the offering have a sound basis and are fully transparent. This scheme relies on the promoters and financial intermediaries to guarantee that the disclosures made are fair and sound. Penalties and other incentives will ensure that the parties take all necessary steps to meet compliance standards. This approach will fundamentally change the responsibility of the private sector and its intermediaries. Such a change in approach may dictate a different role of the Ministry of Commerce.

Surprisingly, the 1984 Executive Rules did not unify the supervision and regulation of the primary market and the secondary market under a single regulatory agency. Instead an exchange was created within the local banks, restricting share trading activity to the banks and establishing SAMA as the authority in charge of its operation. The Ministry of Commerce and SAMA together share the main responsibilities of regulating the Saudi securities market. We now turn to discuss the position of SAMA in its regulation of the secondary market.

2.4 The Saudi Arabian Monetary Agency (SAMA)

The aim of this section is to analyse the supervisory function and policy role of the Saudi Arabian Monetary Agency (SAMA). SAMA was established in 1952 as the
Kingdom's Central Bank.\textsuperscript{60} It not only issues the Kingdom's currency but is also responsible for macro-economic policy, regulating the banking affairs of the government (fiscal agency services), regulating activities of commercial banks and exchange dealers, and managing the country's official foreign exchange reserves.\textsuperscript{61} SAMA was also given the authority to regulate the stock market. This was a reasonable move, given that SAMA already regulated commercial banks, who were the primary players in the operation of the stock market.\textsuperscript{62}

The decision to grant SAMA an exclusive regulatory mandate created initial difficulties for the agency when dealing with stock market activities. For example, the absence of a formal listing agreement between issuers and SAMA, acting as secondary market regulator, meant that the source of regulatory control lay with the Ministry of Commerce, by virtue of its position as primary market regulator, and not with SAMA.\textsuperscript{63} In this regard, Abdul Aziz Al-Dukhiel, former Deputy Minister of Finance and President of the Consulting Centre for Finance and Investment, reported in an interview:

\textsuperscript{60} SAMA was established by Royal Decree No. 30.4.1.1047, dated 20 April 1952.
\textsuperscript{61} Royal Decree No. 23. on 23/5/1377 (1957) defined SAIvIA's powers as follows:
1. to issue and strengthen the Saudi currency and to stabilise its internal and external value,
2. to deal with the banking affairs of the Government,
3. to regulate commercial banks and exchanges dealers,
4. to manage the country's official foreign exchange reserves\textsuperscript{62}
\textsuperscript{63} In this regard, Malaikah 'Saudi Arabia & Kuwait: A Study of Stock Market Behaviour and its Policy Implications', p. 19, wrote that the SCD issued a circular which specified that corporations should report their quarterly financial statements within two months of the end of each quarter. The circular states that the Ministerial Committee has the right to suspend share trading for companies that do not comply with the quarterly disclosure requirements and are subject to penalties specified under the Companies Act. Some companies have complied with the quarterly reporting while the majority have not. Penalties have never been enforced on companies that do not comply.
“SAMA’s formal control of market activities was limited to its role as the main regulator for banks and their activities within the market. This awkward and cumbersome relationship, fuelled by turf battles between administrations, contributed, in the initial period, to limited coordination between the bodies, prompting firms to question which body was the main regulator for the market for securities.”

The initial division of regulatory authority between the two bodies was reasonable given the development of the Kingdom’s market. Until 1984, trading was conducted on an informal basis without comprehensive control by the government. Indeed, at that time, there were few companies being traded in the market and investors were relatively unsophisticated in understanding market risks.

With the growth of the market, SAMA introduced an electronic trading platform and operational infrastructure. These developments served as the basis for SAMA assuming more responsibility for supervision over the market. Gradually, SAMA’s authority increased as the market itself evolved and expanded into a significant regional exchange.

2.4.1 Securities Control Department (SCD)

This section discusses the monitoring and control of trading activity which SAMA undertakes for the equity market. A provision in the Executive Rules provided for the creation of the Securities Control Department (SCD) within SAMA. The SCD is

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64 See interview with Abdul Aziz Al-Dukhiel, former Deputy Minister of Finance and President of the Consulting Centre for Finance and Investment, Riyadh, 12 December 1997.


responsible for the daily oversight and control of the securities market.\textsuperscript{67} The SCD was established as a division of the Banking Control Department which provided it with a direct connection to, and power over, the commercial banks.\textsuperscript{68} Another interpretation is that, rather than creating regulatory competition between divisions within the bank, SAMA placed the SCD under the authority and control of the Banking Control Department. This decision somehow made sense in light of the fact that, after 1984, non-bank intermediates were effectively eliminated as market players.\textsuperscript{69}

Securities market activity is regulated by SAMA under the Executive Rules, particularly Articles 2-11, which relate to the daily trading in shares by investors. The Executive Rules set forth the condition for the role of the banks in share dealings in the market,\textsuperscript{70} leaving SAMA with considerable discretionary authority to fulfil its supervisory role in the market. More specifically, the Executive Rules provide that the SCD perform the following functions:

- define the working hours of dealings in the stock market;
- analyse the daily dealings which are returned from the bank’s Central Units;
- supervise the appointment of employees in the trading units of banks;
- review complaints from market participants and determine solutions or appropriate administrative procedures;

\textsuperscript{67} Executive Rules 1984, Art. 2-f, state that to be able to complete the daily supervisory role, the banking control department at SAMA has to establish a permanent control division which will be called the Securities Control Department.
\textsuperscript{69} Executive Rules 1984, Art 1, state that the duty of buying and selling shares of joint-stock Saudi companies are restricted to Saudi banks which are licensed to do so.
\textsuperscript{70} Executive Rules 1984, Art 1.
• advertise the prices of shares in the local papers and convey to the banks and the companies instructions issued by the Ministerial Committee and the Supervisory Committee about share dealing;

• issue informative publications and notes on share dealings; and

• provide the necessary secretarial work for the Supervisory Committee.71

The SCD commenced its activities in early 1985 with only a few employees, limited resources and facilities and with the mandate of establishing the new market within the banking system.72 Early activity was therefore focused on assisting banks in facilitating trade on the market, and providing market investors with information about transactions, quantities and prices through CTUs and local papers.73 As we noted earlier, the SCD and SAMA's power over the stock market was precarious until 1990, when SAMA introduced the Electronic Securities Information System (ESIS). ESIS is a market trading system which is regulated by the! Instructions to Central Trading Units.74 Prior to the introduction of ESIS, SAMA was less committed to the task of market regulation over the stock market operation. Whilst it was clear that the Kingdom enacted the Executive Rules to create an opportunity for SAMA to fill the regulatory gap by providing a basis for developing a legal and technical infrastructure, SAMA was forced to change its scope of reference in order

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71 Executive Rules 1984, Art 2-f.


73 Ibid.

74 Instructions to CTUs, Securities Control Department, SAMA, Riyadh, 1990.
to regulate these new types of activities, requiring specific knowledge, administrative skills and strong understanding of diverse financial market players.\textsuperscript{75}

Two events clarified and strengthened the power of SAMA, and subsequently the SCD, over the secondary market. Firstly, the automated matching system made the mission of the SCD easier and gave it a better chance to apply its supervisory powers over the market. The fact that SAMA designed and developed the system gave the SCD the exclusive authority to develop and solve all system-related problems.\textsuperscript{76} Furthermore, the new system, as noted earlier, links CTUs from all banks to the main computer at SAMA, which provides the SCD with access to all the market operations. Secondly, the Instruction to CTUs makes this supervisory authority more effective by making use of a central computer within SAMA which is linked to all other CTUs to observe the daily trading operations.\textsuperscript{77}

In order to increase the SCD's supervisory power, SAMA promulgated the Instructions to the CTUs. The CTU rules established an infrastructure process to send buy and sell orders for the market electronically through local banks. At the same time, a mechanism was thus established to monitor activities by CTU traders centrally. The Instructions to CTUs also gave the SCD the authority to levy penalties and pursue action against banks who violate the rules or in some other way affect the welfare of investors. For example, the SCD has the right to suspend any CTU or

\textsuperscript{75} Malaikah, 'Saudi Arabia & Kuwait: A Study of Stock Market Behaviour and its Policy Implications', pp. 16-17.
\textsuperscript{76} Al-Sheaebi, 'The Gulf Cooperation Council Stock Markets: Regulations Problems and Integration', p. 16.
\textsuperscript{77} Instructions to CTUs 1990, Article 2.4.3, authorised the SCD to suspend certain CTUs from trading in case of serious violations. Further, Article 2.4.4 empowers the SCD to suspend a particular trader from trading. Article 2.4.5 authorises the SCD to withdraw its authorisation to a particular CTU for
individual broker in case of a serious violation of the market rules. Furthermore, a CTU is entitled to cancel any transaction if it contravenes the trading regulations. These suspension and cancellation powers were new elements to facilitate the SCD’s mission as the primary agency in charge of stock market operations. In addition to several changes in the rules governing market regulations, the Instructions have, to a considerable degree, provided SAMA with the means to establish further authority over the market.

At present there are more than 50 local employees working closely with expert foreign consultants comprising the main department which is responsible for the regulation of the Saudi stock market. The SCD is divided into six different divisions that work under the management of SAMA. The Management Division, which is responsible for all SCD operations, coordinates the activities of the other five divisions and provides the line administrators with the procedures needed to successfully carry out their duties. The Statistics Division, which is one of the oldest divisions within SCD, is responsible for the collection of information about prices, turnover, dividends and other company-related data. The department updates

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78 Instructions to CTUs 1990, Art 8.
79 In addition to the authorisation of suspension provided by the Instruction to CTUs 1990, Art. 2.10 of Version 7 of the Instructions 1994, authorises the SCD to cancel the transaction, at the discretion of SAMA, for regulatory reasons, including if the transaction is a serious infringement of trading regulations, the intends to create a false market, is based on insider trading, or any other reason which in the view of SAMA justifies cancellation of the transaction.
81 The Management Division is provided with expert Saudi employees and other consultants for the United Kingdom with the main mission of reviewing and drafting the new regulations and recommendations before they are sent to the Supervisory Committee to be approved and signed.
and displays this information through ESIS.\textsuperscript{82} It was through ESIS, which is owned and operated by SAMA, that the Statistics Division assumed a more prominent role within SAMA. The division’s employees are responsible for supplying trading information, within minutes of the closing of the market, to the local papers and other media. Furthermore, the division is in charge of preparing reports on all market data.\textsuperscript{83}

The third division, the Companies Information Division, is responsible for the collection of all information concerning the listed companies in order to make such information available through ESIS. Real-time market and company information is disseminated to all designated branches, as well as information regarding publicly listed companies, such as quarterly reports, annual general meetings and other events which might be of importance to investors and affect their investment decisions.\textsuperscript{84} In answer to questions concerning the cooperation of listed companies with the Companies Information Division, Abdulrahman Al-Rashid, Manager of the Securities Control Department, noted that:

"Due to the fact that the division has less power over non-bank joint-stock companies, because they are under the jurisdiction of Ministry of Commerce, the division faces difficulties getting all the available information from the Ministry of Commerce or sometimes from the ."
company itself and entering the information into ESIS and sending it to the local papers to be published.\footnote{85}

The Systems Technology Division is responsible for the supervision and development of the ESIS system. The central mission of this division is to program and configure the bank’s computer system and its information systems. It is also responsible for solving any technical problems that may occur. The closed electronic system was developed within the Technology Division long before it was introduced to the market in 1990.\footnote{86} This division’s employees are responsible for the design of the system that interfaces with the CTUs, providing the system with links to the main computer of SAMA. ESIS PC was established to enable market investors to trade in one unified market between the 12 CTUs.\footnote{87} In the first instance, ESIS PC services were limited to Riyadh city. It is expected that the ESIS PC system, given the advent of the Internet, will be extended to provide on-line investment opportunities for all potential investors across the Kingdom. In this regard, SAMA introduced ESIS Line to provide investors with more electronic services by linking the system to more than 80% of all bank branches instead of only to the 12 CTUs.\footnote{88} Introducing ESIS Line assisted those investors who live in other parts of the country to participate in the

\footnote{85 Interview with Mr. A. Al-Rashid, Manager of the Securities Control Department. Riyadh, 17 August 1997.}

\footnote{86 Since 1990 SAMA has introduced more than 8 new releases in order to improve stock market trading technology.}

\footnote{87 The release of ESIS PC in 1990 linked all the CTUs and the market place with each other and all are linked to a central computer at SAMA. ESIS PC provides investors in all CTUs with all the information as one electronic market. The limitation of this release was that ESIS PC is limited to the 12 CTUs that are located in Riyadh City, and is not linked to any other cities. That deprives investors from other cities from being linked to the market.}

\footnote{88 Interview with Mr. Al-Ayed, System Technology Division, Riyadh, 7 September 1997.}
market through branches which had previously been restricted to Riyadh city. In 1992 the division introduced ESIS Net, which links some other branches directly to the central computers at SAMA, providing exactly the same services as the CTUs.

The Surveillance Division is responsible for the supervision of daily trading activities within the market. The ESIS system is linked to the this division, allowing employees within the division to obtain all relevant information about trading activities. More specifically, the agents are charged with the task of watching share movements, share quantities and market volatility. The system is designed to enable surveillance agents to be in immediate contact with all traders within CTUs and their designated branches. The surveillance agents are the only employees that have access to this sensitive information. SAMA restricts access to information about which CTUs or ESIS Net sites are posting request and bid orders, and it also withholds information about the identity of traders, shares sold, prices and the time of trades.

Together these regulatory structures are designed to ensure that the market transactions through ESIS are conducted in a fair and legal manner. The technical infrastructure allows the Surveillance Division to intervene immediately if there are

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89 The ESIS Line service is linked directly to almost all bank branches throughout the country. However, ESIS Line is not linked directly to the central computer at SAMA, and therefore it is slower than ESIS PC, because it is not live and direct, and only provides investors with prices and quantities, and not all the information.

90 SAMA is currently working on a new release called Real Time. The new release will reduce the time of a complete transaction to a few seconds, which will enable market investors to buy and sell in the same minute. This makes it one of the most advanced trading systems in world. However, the main question remains whether the Saudi system can continue working properly with the introduction of new services and the high increase in the number of daily transactions.

abnormal activities or suspected violations of the market rules. The Surveillance Division has been further delegated the function of monitoring mandatory fluctuation limits, ensuring that fluctuation does not exceed the 10% limit set forth by law. Furthermore, the division monitors traders in the CTUs, ensuring that they understand how to use the system, rules and instructions governing the stock market.

To supplement the surveillance and supervisory function of the SCD, an Investigation Division was established in 1988. This unit is charged with the task of investigating any suspicious events occurring in the market. Managers from SAMA believed that the Investigation Division could work best if it coordinated its efforts with agents within the Surveillance Division. If suspect activities were detected in the market, the Surveillance Division would report to the Investigation Division before undertaking its own inquiries into the events. The powers of the Investigation Division are limited, however, to those transactions conducted through ESIS. Its mandate does not extend to fraud, manipulation and other illegal practices conducted by non-bank participants. The Investigation Division is also responsible for

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92 In case of violations, the Surveillance Division is the division in charge of implementing suspension, whether for certain shares or a certain CTU.


94 Interview with Mr. Al-Rashid, Manager of SCD, Riyadh, 17 August 1997.

95 See interview with, A. Al-Qarnni, responsible for the Surveillance Division within the SCD, Riyadh, 12 August 1997. Mr. Al-Qarnni states that the SCD has full power over transactions through ESIS, however, the Investigation Division still might have the right to intervene in the event that there is a complaint from a bank or from one of the investors about the bank, or if the division feels that abuse, manipulation or suspicion are actively present within the market.
responding to any complaints related to trading through ESIS.\textsuperscript{96} Al-Amree, Manager of the Investigation Division explained that:

"The procedure for the hearing of disputes and complaints arising from trading through ESIS is triggered when an investor or market participant files a complaint to the Manager of the Securities Control Department or the General Director of the Banking Control Department (Deputy Governor and member of the Supervisory Committee). Upon receipt of the complaint, the manager of the SCD will pass it on to the Investigation division in order to begin an investigation. Inspectors in the division, upon instruction, will commence their work of collecting information about the matter and dispatching employees to the site so as to interview witnesses and complete the investigation. The division attempts to resolve and settle the matter amicably. If the matter can be settled, a full report with recommendations will be sent to the SAMA's Deputy Governor, for action. The Deputy, based on the report, may determine the proper cause of action. This can include sending the matter to court or releasing it to other agencies with jurisdiction over the matter."\textsuperscript{97}

3. Single vs. Dual Agency Regulation of the Market

This section analyses the Kingdom's regulatory arrangements of the equity market and the constraints to such regulations in the face of changing market conditions. Presently, the two main regulatory agencies are under increasing pressure by institutional investors due to demands being put upon them for developing new rules to suit present market conditions.\textsuperscript{98} As we have argued earlier, regulatory

\textsuperscript{96} Although Executive Rules 1984, Art 2-f, empower the SCD to register complaints of participants, provide solutions and undertake orderly procedures, the SCD has not yet set up a clear procedure for solving share transaction disputes.

\textsuperscript{97} Interview with Mr. Al-Amree, Manager of the Investigation Division within the SCD, Riyadh, 18 August 1997.

\textsuperscript{98} For example, at a recent conference held by the Riyadh Chamber of Commerce, the majority of speakers claimed that the market regulation needs to be reformed in order to suit the new role of the market in the growth of the Saudi economy. See, Riyadh Chapter of Commerce, Development of the Saudi stock market conference, November 1998.
competencies in the Kingdom are divided between SAMA, the Ministry of Commerce and the Ministry of Finance and National Economy.

The existing regulatory arrangements have evolved over the past fifteen years in response to the government’s policy initiatives undertaken to institute its control over the share market. The design of regulatory procedures by the Ministry of Commerce and SAMA, and subsequent amendments to the rules regulating their participation in the market, may in some part be dependent on the influence of groups that have an incentive to impose changes and ensure that the existing legal structure is tailored to their preferences. Legal and economic theorists have argued that regulatory structures are often designed to satisfy the short-term requirements of the market interests that support the position of the policymakers. Utilising this approach, interest groups and political decision-makers enter into a relationship that is mutually beneficial. In some circumstances, it is possible to explain the various regulatory structures with reference to the optional strategy of interest groups.

From the outset it has been clear that the powerful position of stock regulators is consistent with the creation of a market regulator with broad control over the groups over which it has authority. The government, in order to endow SAMA with the necessary independence to pursue its objectives, provided it with the Executive Rules as a powerful device to impose regulatory control. The Kingdom also delegated authority to the Ministry of Commerce to regulate companies desiring to be

listed on the exchange. The Ministry of Commerce is the traditional regulator of the companies themselves, whereas SAMA’s expertise is dominated by representatives of the financial services industry. The government could have avoided this division of regulatory authority by combining authority over securities and new issues into a single agency, as is done in many other emerging markets. The government chose not to follow this action, however, and its decision to do so cannot be viewed as random.

It appears the Kingdom’s policy makers may have anticipated that such a gap, and the subsequent confusion, would occur within the market regulatory structure. The government created a structural strategy for dealing with agency competition and coordination. Fahad Al-Mobarak, General Manager of RANA Investment Company, noted that:

"The Ministerial Committee and the Supervisory Committee were established to provide a link between the two agencies and authority to reduce the gap and avoid any conflict between the SAMA and the Ministry of Commerce. However, I think that the ability of the Ministerial Committee and the Supervisory Committees to simultaneously control both agencies is limited by their own manner of dealing with the agencies and the resources devoted to altering the method of regulator behaviour which is lacking."

SAMA’s role as the agency charged with regulating the operations of the stock market, but having limited power, has produced many side effects. Firstly, the Kingdom, by excluding SAMA from administrative power over the IPO process has

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104 Interview with Fahad Al-Mobarak, General Manager of RANA Investment Company, Riyadh, 2 October 1997.
created a situation in which the two agencies deal with the same companies from different points of view. Given the importance of legal rules to protect all interests, and since these affect the subsequent choices and advantages of these groups, it is crucial to explain why the regulatory structure persists. The isolation of SAMA from primary market operations has handicapped the growth of the market and reduced the number of companies wishing to raise money through the stock market.\textsuperscript{105}

Secondly, the current dual-regulatory structure creates some level of uncertainty for companies regarding the location of regulatory control. SAMA, for example, does not have complete control over the secondary market process and must rely on the Ministry of Commerce to supply information on matters involving non-bank listed companies.\textsuperscript{106} The restriction of SAMA’s regulation of market participants means in practice that market investors, including those who are at the heart of the market, are not directly under the regulatory control of SAMA. More importantly, SAMA has no formalised power over the activities of individual investors. This means that SAMA can intervene only if one of the parties involved is a bank. This can also be seen from the penalties that may be imposed by SAMA, which are limited mainly to suspension and cancellation of transactions.\textsuperscript{107}


\textsuperscript{106} The SCD faces difficulty collecting information from listed companies, which forces the department to rely on the help of the Ministry of Commerce to issue a circular to listed companies to provide the department with the information needed, including the quarterly reports of listed companies. In this regard, Malaikah (‘`Saadi Arabia & Kuwait: A Study of Stock Market Behaviour and its Policy Implications’, p. 19) states that the stock market disclosure rules are handled by the Ministry of Commerce.

\textsuperscript{107} See Al-Sheaeibi, ‘The Gulf Cooperation Council Stock Markets: Regulations Problems and Integration’, pp. 45-46. Al-Sheaeibi writes that the only penalty SAMA may impose is suspension of
limitation of SAMA’s regulatory power over the market permits many firms to operate without being supervised by SAMA. Many offices and companies that provide financial services and market information or invest directly or on behalf of clients are not being regulated by the market authorities. The effect of the re-emergence of unlicensed financial intermediaries has created risk both for firms and investors, who are subject to potential frauds, and the market, which is left unprotected for potential risk through their activities. In this regard, Jammas Al Suhaimi, Deputy Governor of SAMA and member of the Supervisory Committee states that:

"The public should not deal with unlicensed entities offering investment products and services. We are aware that a number of unlicensed entities operate within the Kingdom and we are, in conjunction with other government agencies, actively working to curtail their activities."

Fourthly, the absence of an integrated stock market regulatory body reduces the effectiveness of stock market rules and their enforcement. The current situation limits SAMA’s power to enforce market rules. In fact, the rules fail even to define SAMA’s power over fraud and manipulation and the violation of stock market rules. The problem of enforcement and credible commitment will be explained in Chapter 9. In contrast, the Companies Act provides the Ministry of Commerce with a strict set of rules regarding the litigation process supported by civil, administration

the CTU. What about the criminal and civil responsibilities? Can the injured person of this violation claim compensation?

108 See interview with Mr. Jammas Al Suhaimi, Deputy Governor of SAMA, in Personal Finance-Middle East, September 1997, pp. 72-73.
and criminal sanctions. Correspondingly, the stock market rules offer no guidance regarding the process and procedures for the dispute of cases rising from stock market activities.110

Finally, SAMA’s restricted role has led the Kingdom’s policymakers to pursue a conservative course of action, reducing the number of market participants to those who are under the direct supervision of SAMA, in order to guarantee the safety of the market.111 Since its establishment, the Kingdom’s authorities have limited the members of the market to the government, banks and individuals. In fact, the Executive Rules restrict brokerage activities to only 11 licensed agencies other than banks are not allowed to take up position in the market as brokers. The Executive Rules also restrict the trading of mutual funds to banks, and no other agencies are permitted to provide the services provided by banks. Accordingly, banks are the only bodies which can take a position in the market, resulting in a liquidity-constrained market.113

An independent stock market regulatory and supervisory body, with primary and full responsibility to regulate and supervise the stock market, including the responsibility of the IPOs, is perhaps the single reasonable option which could eliminate the problems outlined above and offer coherence to market regulations. Although the market has prospered from SAMA, particularly in respect to the

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111 Banafe, Saudi Arabia Financial Markets, p. 78. Banafe noted that stock brokering by banks was meant to eliminate the informal stock brokers in order to curb speculation and reduce price volatility.


development of its trading and settlement system, its truncated regulatory position has restricted the amount of trading in the market. It may be that the stock market, facing divided regulatory involvement which restricts its growth, could look to the private sector and encourage its participation in its regulation. Until recently there has been no participation from the private sector in the stock market.

4. Policy Reforms to the Market Regulatory Arrangements

This section discusses an important issue for the Kingdom’s policymakers: to what extent is it necessary, in order to achieve the proper level of regulatory action, to introduce changes to the regulatory structure in order to improve the effectiveness of the means of achieving the policy goals of the Kingdom. In this respect, Osama Faqih, Minister of Commerce and Member of Ministerial Committee, noted that:

"The regulatory structure of the Kingdom is shaped by the following regulatory objectives: the support for an honest and competent financial services industry; creation of appropriate measures for investor protection; the control and monitoring of systemic risk, supervision of risk management in relegated firms, the prevention of fraud, and insider trading, the (maintenance) of efficient markets, the assurance of consistency of regulations with international standards, and to support the Kingdom's competitive position in the financial markets."\textsuperscript{114}

Whilst these policy objectives have not always formed part of the Kingdom’s regulatory structure, government policymakers are intent on establishing a modern, unified framework for delivering an effective and efficient securities market regime.

\textsuperscript{114} See interview with Osama Faqih, Minister of Commerce and member of the Ministerial Committee, Riyadh, 28 July 1997
From the perspective of these government policymakers, the present regulatory arrangement, which consists of a complex structure involving a number of overlapping administrative functions, may not be the most effective means of delivering the various policy objectives. Central management of the diverse structures could be achieved from a strengthened Supervisory Committee. The benefits from this arrangement would be the increased monitoring and control of the Ministry of Commerce and SAMA, particularly with respect to their individual regulatory functions. Centralisation of market regulation may be desirable not only because it assists higher policy makers and politicians in monitoring the action of government agencies, but also in increasing the visibility of their actions, and making private information more available.

The question remains whether it is necessary to take significant steps towards centralised coordination without institutionalising regulatory power into a single institution. Separate assessment and monitoring by individual functional regulators is likely to be artificial and repetitive. Moreover, the ability of interest groups to manipulate and influence these arrangements increases when the agencies’ constituencies are willing to support the agency. Correspondingly, an agency’s ability to meet the needs and welfare of its own constituency is crucial to its ability to prosper. It may be that the Kingdom can avoid jurisdictional disputes between

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115 Ibid.
117 Ibid. pp. 96-97
118 Ibid. p. 105.
agencies by combining regulatory authority over the stock market into a single super agency.

In general, then, the idea of unification in this area should be especially welcome and important for the following reasons: creating a unified agency structure may tend to build a process of regulatory decision-making that responds to changes in the market while limiting politicians from intervening in the policymaking process. The Ministerial and Supervisory Committees would be in a position to control and monitor the performance of the agency by reliance on notification procedures. This supervisory role could be supplemented by a set of procedural rules that place constraints on the decision-making abilities of the agency, allowing the Ministerial and Supervisory Committees to utilise opportunities to intervene in the bureaucratic decision-making process. Furthermore, the Committees could create procedural rules for the agency that causes the agency's administrators to produce policy decisions that can be reviewed by the Ministerial Committee.

In light of the above analysis, it is not surprising that a modest re-design of the existing agencies, their structures and procedures would give the Kingdom's policymakers the opportunity of replacing a cumbersome arrangement with a regulatory structure that is responsive to technological and multiple industry interests, while minimising the diffuse interests of administrators. The re-design of agency structures and practices would also enable the Kingdom to create a mechanism for creating a regulatory apparatus which would put into effect its regulatory goals for the market while giving the ministers greater control over the
decisions generated by the agency. This ability to affect outcome would allow the Kingdom to increase the probability that the overall securities regulator will be able to give the market the best choice of market rules.

4.1 Designing regulatory solutions: losses and benefits

For the reasons outlined above, a single agency responsible for legislating and regulating the securities market will enable the Kingdom to extend its sphere of influence in pursuing its policy objectives for the market, while limiting the possibility of unexpected situations that presently create problems for the government. When pursuing its reform agenda, the Kingdom, at the most general level, must select the best institutional arrangement by choosing from those presently available. If this is to happen, SAMA would be the most suitable agency, due to its experience with the operation of the secondary market and its power over commercial banks.\textsuperscript{120} In fact, SAMA is the agency with the best developed organisational structure and one that can most easily be adopted to deal with new regulatory and administrative functions. It is also worth pointing out that SAMA is the best developed regulator for creating new mechanisms and rules to legislate, monitor and control the activities of banks and financial instruments.\textsuperscript{121}


\textsuperscript{120} At present, Singapore has such a structure where the Central Bank plays the main securities market regulatory role. See L. Leigh, 'Financial Development and Economic Growth: An Econometric Analysis for Singapore', International Monetary Fund, WP/96/15, Washington D.C.

\textsuperscript{121} For some time economists and policymakers have argued that a control bank should pursue a single objective-making policy. To the extent that a control bank pursues this objective effectively, it is presumed that all other objectives must be secondary goals. See, generally, R. Cranston, \textit{Principles of Banking Law}, Oxford, Clarendon Press, 1997, pp. 125-127.
It is likely that adding additional functions will also affect SAMA on a practical level. Regulatory staffing and quality are important factors in providing effective monitoring in the market. The launch of a new agency within SAMA could stretch the limits of the market for qualified staff, adding a degree of risk. In the higher levels of management, this shortage of qualified staff could easily result in problems when these regulators must be provided with a realistic understanding of market activities, possible constraints, and what must be done to overcome these obstacles. In addition, to the extent that SAMA’s overall policy mission would have implications for the responsibilities of securities market regulators, care will be needed in developing an approach to regulation and enforcement which provides protection against different regulatory practices.

4.2 New securities market agency

In many areas of jurisdiction, policymakers have found it more effective to create an independent agency with administrative and regulatory responsibility for the securities markets. Typically, such agencies have jurisdiction over primary and secondary securities markets, and other financial instruments. The Kingdom may

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123 Not only mature markets, but also many emerging markets have created an independent agency with jurisdiction over all matters related to stock market activities. However, most emerging stock market regulators still have to report to the Minister of Finance. For example, in Malaysia, the Securities Commission (SC) was established in 1993 as a watchdog organisation to centralise powers governing the regulation and supervision of the securities industry within one authority from the previously fragmented system of several regulatory agencies. The Malay SC has full responsibility over all securities market activities, including regulating the issue of securities, regulating designation of future contracts, regulating take-overs and mergers, supervising and monitoring the activities of any exchange, clearing house and central depository, and taking all responsible measures to safeguard the interest of persons dealing in securities or trading in future contracts. See, M. Abdullah, 'Behaviour of
want to consider this alternative since it is well known that the creation of an independent agency is a strong indication that policy makers are confident that industry groups will have the capacity to provide the agency with self-regulatory support, which is crucial to the aims and objectives of the agency.\textsuperscript{124}

Naturally, there would be several advantages to pursuing this course of policy change. Firstly, it would provide a clear and effective signal to industry groups that the Kingdom is likely to prioritise its concerns by arranging for the formation of an independent agency responsible for the creation and implementation of effective policy. Secondly, the commitment of time and resources would allow for the creation of a modern agency which could be pre-programmed to respond to the policy objectives.\textsuperscript{125} Naturally, this will require higher salaries so as to attract professionals who are well-informed, in order to develop a functional securities industry that is vital to the public interests of the Kingdom.

There are certain political problems associated with creating a new agency. Firstly, it should be noted that the creation of a new pattern of regulation will be potentially disruptive to the interests of many ministries who have set expectations about the approach and cost of securities market regulation. Whenever a new agency is created, private sector actors will be forced to adjust to new actors and policies, which in return will cause considerable uncertainty and re-adjustment costs.\textsuperscript{126} It is

\begin{thebibliography}{9}
\bibitem{125} Ibid. pp. 58-61.
\end{thebibliography}
also likely that other parties concerned, sympathetic to the earlier regulatory regime, will attempt to influence the new administrators, to make them sympathetic to their practices. At least in the beginning, professional associates and other industry professionals will be forced to expend considerable resources on establishing a relationship with the new agency as well as simultaneously developing a set of internal strategies within their own organisations to address the problems resulting from the new policies and enforcement strategies emanating from the agency.

Similarly, it seems plausible that subtle factors, such as changes in the personal style of key regulators, can introduce uncertainty to industry groups and banks. As is well known, the effectiveness of agencies can be traced to their ability to develop a reputation for commitment to a course of regulatory action. Thus, at the outset it will be difficult to ascertain if the agency has sufficient expertise, as well as power and influence, to fulfil its administrative mandate. Whilst a perfectly well-designed agency can provide the basis for implementing effective policy, this expertise alone may not be sufficient to ensure that well-meaning regulators will be able to articulate and implement their decisions. Against this concern, it must also be noted that the introduction of a new regulatory process, if it is properly researched and staffed, could be effective in implementing government policy. This productivity could be the basis for making changes in other agencies in order to

127 Ibid.
allow more private sector involvement within the sphere of regulatory decision making.\textsuperscript{130}

To ensure the proper level of expertise and management sophistication, particular attention will be needed in locating individuals from industry or government to reinforce these priorities. The reason an administrative agency is most likely to establish a reputation for high-quality delivery of regulation, especially from the perspective of the industry being regulated, is due to the quality of the agency's front-line staff. Perhaps more than anything else, experts drawn from the public sector must have the ability to conduct the agency's business in accordance with the expectations of the director and without being influenced by dominant industry representatives. It is not always possible to locate such people quickly, and therefore the government may initially have to rely on foreign experts who themselves can train groups of staff from the Kingdom. It would be expected that a new culture would develop, leading, as a result, to a highly professional group, headed and staffed by nationals. The approach recommended here obviously aims to limit the problems associated with a functionally divided regulatory policy. The implications of the approach for market integrity is significant since a unified strategy is thought to be central in delivering the regulatory goals of the Kingdom. It must be pointed out that this approach to market regulation assumes the presence of high-level incentives for regulators as it is essential for the delivery of efficient policy and compliance.

4. Summary

This chapter has assessed the Kingdom's existing regulatory arrangements and infrastructure as it has evolved over the past fifteen years. The first section focused on the division of regulatory authority between the Ministry of Commerce and SAMA. Control over the securities market follows now familiar differences in rules affecting corporate players; the primary market is regulated by the Ministry of Commerce, while the subsequent buying and selling of shares is regulated by SAMA. The government's ability to coordinate policy and determine the content of agency regulation is largely achieved by Ministerial and Supervisory Committees. Control over the division of agency compliance, while effective in earlier stages of market evolution, may no longer be effective in closely controlling the market's complex and evolving structure. If there were no financial intermediaries, SAMA could control the banks through legislation designed for these purposes (e.g., banking control). The opaque system of disclosure could also regulate IPOs, as long as the market does not expect significant amounts of capital to be passed through market offerings. With the inclusion of non-regulated, non-bank intermediaries in the provision of securities market services not covered under existing regulators, the viability of the regime has been called into question.

Thus, the changes in structure and operation of the securities market requires changes made to the regulatory structure. In an attempt to ameliorate the inconsistencies in regulation and limit the weaknesses of the current agency structure, it is essential that the Kingdom's policymakers introduce new legislation creating an independent agency which is ultimately controlled by SAMA. This
agency should have sufficient funding and resources to effectively modernise the rule-making process, subjecting it to greater industry-wide control. It is anticipated that a single agency will avoid jurisdictional disputes which have caused agencies to increase their jurisdictional authority without modernising the rules in light of changes in the market. The point of regulatory reform is to capture the benefits of improved agency output, achieved through the design of structures and processes that will more closely follow the needs of the Kingdom.
Chapter 5

Saudi Stock Market Investors

1. Introduction

This chapter has a two-fold purpose. On one level, it attempts to provide a detailed explanation of the sell-side of the Saudi securities market because, very simply, that experience has been a success story. But this chapter also has a second objective. For those interested in the role of institutional investors contributing to the creation of a broad and deep securities market, the Kingdom has been slow in creating the beneficial conditions for their operation.¹ What happens when the expansion of new offerings and the pattern of trading is such that they operate as potential constraints on the growth of institutional investors in the Kingdom? Or are there insufficient incentives to develop a new supply of securities for the market?

Answers to these questions would transcend the Saudi context. The role of institutional investors in stimulating the development of the supply-side of the market has been the subject of academic debate.² On the one hand, commentators have argued that institutional investors simply concentrate on constructing a portfolio of stocks that are designed to keep their specific risk low, and have few incentives to

¹ There are, as professor Bernard Black has noted, many different types of institutions, including corporate pension plans, public pension plans, open- and closed-end mutual funds, insurance companies, commercial banks, investment banks, management trusts, foundations and endowments. See B. Black, 'Agents Watching Agents: The Promise of Institutional Investor Voice', 39 UCLA Law Review, 811, 1992, p. 815.
become more actively involved in corporate governance issues or, in effect, to improve the market for other investors. On the other hand, another group of critics argues that institutional investors, if deregulated, would become more active monitors, attempting to reduce the problems stemming from separation of ownership and control, and seeking to influence policymakers to alter market rules so as to increase institutional influence. More effective institutional investors' involvement would, according to this view, lead to greater liquidity and transparency in the market.

Against this background, the Saudi experience is particularly interesting, because the trade-off between liquidity and control does not appear to play a role within the Saudi system. The stock market is thin, lacking in both liquidity and transparency. As a result, the Kingdom's institutional investors, notably the General Organisation for Social Insurance, the Retirement Pension Fund and the National Cooperative Company for Insurance, are marginally located in the market, and have few opportunities to become involved in making improvements in corporate

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3 E. Rock, 'The Logic and (Uncertain) Significance of Shareholder Activism', *Georgetown Law Journal*, Vol. 79, No. 1, October 1990, pp. 445-556. Rock noted that both money managers and outsider directors lack significant positive economic incentives to protect shareholder's interest, and that both even face significant disincentives. This suggests that the hope of discovering a shareholder champion with the ability to discipline management effectively, and an economic interest aligned with those of the shareholders, may be unachievable, at least in our economy.

4 B. Black, 'Shareholder Passively Re-examined', *Michigan Law Review*, Vol. 89, 1990-1991, pp. 520-608. Black argues that some monitoring is needed, because corporate managers need to be watched by someone. He provided it is enough here to raise the possibility that shareholder monitoring might work and might become an important part of the large web of legal and market constraints on corporate managers, if legal rules permit.

5 A. Bhide, 'The Hidden Cost of the Stock Market Liquidity', *Journal of Financial Economy*, Vol. 34, 1993, p. 43. Bhide states that US institutions do, however, derive considerable benefit from, and contribute to, market liquidity. Institutions' rate of trading has grown even faster than their share of stockholding. Trading by institutions, which accounted for 17-28% of the total NYSE volume in the post-war period through 1963, rose to 52% by 1969 and 70% by 1988. The stocks of firms like Digital
governance. In this regard, institutional investors are in a relatively poor position in a market that turns out to be a highly concentrated one. The task for reform-minded policymakers is to create sufficient incentives for institutional investors to invest in monitoring in the face of a concentrated market, while stimulating the supply of new issues, so as to encourage institutional investors, both old and new, to become more active in the market.6

The Kingdom’s institutional environment is relatively similar to those in markets such as Germany and the Netherlands, in which universal banks have played a role in corporate governance.7 There is a major difference, however, between the large western European main banks and the nature of Saudi banks’ involvement in the market, in that Saudi banks hold less than 3% of the outstanding shares in the market, and the mutual funds controlled by respective banks control less than 2% of the outstanding shares.8 The Kingdom’s pattern of bank influence in the market without significant ownership can create problems with respect to providing incentives for banks and institutions to become active participants in the market. The key financial intermediaries, which have the potential to inject greater liquidity and diversity to the Kingdom’s equity markets, have maintained a low level of involvement in developing new instruments which could lead to a gradual change.

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in the market. This policy is due to the low priority given to them by banks that derive most of their returns from attractive spreads on non-interest-bearing accounts.\(^9\) Recently, banks have been prompted by SAMA to create mutual funds, which have diverted monies away from the banks' traditional non-interest-bearing accounts.\(^10\)

The pace of change to the Kingdom's capital markets has been relatively slow, but two important developments could potentially usher in a change in the financial landscape; a privatisation programme (which began in 1998 with the Saudi Telecommunication Company, followed by Saudi Airlines and other utilities, and which is motivated in large measure by a desire to reduce the government's budget deficit),\(^11\) and a change in the Ministry of Finance's policy governing foreign investors' participation, designed to encourage the creation of closed-end mutual funds that provide a vehicle for foreign investors to participate in the market. These initiatives seek to provide more liquidity than can presently be provided by the concentrated system of ownership under which the government and leading

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\(^9\) NOMURA Equity Research, 'Arab Banking Markets: Accelerating Changes Driving Strategic Differentiation', January 1999, pp. 71-74. Nomura provides that the economics of banking in Saudi Arabia are dominated by the profitability of the sizeable non-interest-bearing deposit base and outsized capital ratios (double the non-interest bearing deposit minimum). During the past ten years, mutual funds have attracted more than SR 12 billion which Saudi banks believe was mostly transferred from the non-interest-bearing deposit.

\(^10\) Although banks in many countries may feel that the stock market will steal business, evidence points to the contrary. See A. Kunt & R. Levine, 'Stock Markets, Corporate Finance, and Economic Growth: An Overview', *World Bank Economic Review*, Vol. 10, No. 2, January 1996, p. 224. Kunt states that countries with better developed stock market also have better developed banks and non-bank financial intermediaries. Thus, stock market development goes hand in hand with other aspects of financial development.

\(^11\) Saudi Telecommunication Company has recently entered into a $4.1 billion contract with AT&T for the expansion of the Kingdom's telecommunication capacity. STC is expected to be the largest telecommunications company in the Middle East. However, selling its shares to the public will not take place until 2000 when the project is completed. See H. Azzam, *The Emerging Arab Capital Markets: Investment Opportunities in Relatively Underplayed Markets*, Kegan Paul International, London, 1997, p. 121.
individuals indirectly hold substantial control of most of the large companies that are listed on the exchange.

The government-stimulated system of closed-end funds for foreigners to invest in the market has contributed little to raising liquidity. In this regard, a privatisation programme that relies on closed-end funds will do little to alter the condition of the market. This can be seen from the Czech Republic’s experience with a privatisation programme that relied substantially on closed ends to trade shares of the privatised companies.\textsuperscript{12} Hence, significant involvement by non-bank financial intermediaries may be necessary to stimulate financial innovation and to increase liquidity. We should note that major privatisation programmes across Europe prompted the development of a new phenomenon in the form of attracting large institutional investors to the market. For example, the major privatisation programme begun in Italy in 1993, led to a rise in the capitalisation of the Italian Stock Exchange of Italian GDP from 19.39\% to 31.3\%.\textsuperscript{13} In this regard, it is expected that the Kingdom’s experiment in privatising its main industries, once implemented, will predictably have the effect of changing or altering the composition of the securities markets. At the same time, an aggressive privatisation programme will require allowing increased participation of both national and foreign intermediaries to enter the market in order to market and manage the sale of the newly privatised firms.\textsuperscript{14}


\textsuperscript{14} The Sixth Development Plan 1995-2000. Issued under Royal Decree No. 29, dated 5/2/1416. Ministry of Planning, Riyadh, 1995, pp. 158-162. The Sixth Plan states that the Government’s privatisation policy will concentrate on privatising selected government-owned commercial activities,
This extensive introduction is meant to show that there are regulatory issues involving the government’s policy regarding financial intermediaries that contrast with the Kingdom’s policymakers in connection with the restructuring of its financial market. A model for achieving greater development of the market which mirrors the transformations seen in other markets entails a move towards (1) the introduction of new financial entities that would be legally authorised to engage as underwriters, investment managers, traders and other activities, and (2) the introduction of new financial instruments that will more fully meet the needs of investors across the market.

This chapter starts by providing some background information on the profile of the Saudi stock market investors. Section 1 examines the link between liquidity and concentration of government ownership. Section 2 looks at the role of banks as financial intermediaries and some of their recent contribution in creating new financial instruments, such as mutual funds. In Section 3, the participation of individual investors in the market is evaluated. As noted earlier, institutional investors play an important role in equity markets. In Section 4, there is a discussion of the position of institutional investors in the Saudi stock market. The process of opening the Kingdom’s equity market to foreign investors, which may eventually yield increases in liquidity, is evaluated in Section 5. Section 6 summarises the main points and draws some policy implications.

such as telecommunication and SAUDIA and other utilities, which will be seeking up to SR 100 billion new capital over the next five years provided that such privatisation will be of real benefit to the national economy.
2. The Saudi Stock Market Investors

What forces shape the characteristics of the Saudi stock market? For the past decade or so this question has gone unasked as both scholars and practitioners accepted the answer that large investors determine the character of the market. Yet it is clear that ownership is more diverse than is usually assumed. This chapter looks at market investors and their characteristics in order to obtain a better understanding of the effect that regulation has upon their actions. This analysis takes as its starting point the standpoint that the policy and structure imposed by the Saudi authorities upon the establishment of the Saudi stock market had a significant impact on the type of investors that are involved in the market. In principle, the initial policy of the government had considerable impact by prioritising certain investors over others in the market.

It is commonplace to assume that investors are the backbone of the equity markets. The argument, given by Demsetz and Reilly, suggests that markets tend to function better when more investors enter it, since they ensure greater market depth and liquidity. In contrast, a shortage of influential market players tends to limit a market due to lower trading volume and higher risks of trades execution. In this regard, the main aim of policymakers is to design regulations that tend to attract more

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16 The breakdown of shareholders as of 31 December, 1996 based on the type of holder recorded with the Saudi Share Registration Company was as follows: Individuals 48%, Government 33%, Banks 5%, Foreign 8%, Other Institutions 6%.
investors to the market, and to eliminate barriers and distractions that might affect their participation. A policy regime that increases the confidence of investors will tend to enable significant investment opportunities, while promoting growth opportunities for banking and securities industries.

From their subscription on the first joint-stock company in the early 1930s to the creation of the largest stock market in the Middle East in the 1990s, the role of the Saudi investors has been significant. To be sure, macroeconomics considerations explain the development of the demand for equities and the participation of companies in the market. The massive growth of the Saudi economy in the early 1970s proved vital to the transformation of the equity market. The significant growth in national economy led to higher salaries and savings, which provided a natural basis for the growth of the sector.\(^{19}\) Share trading, in particular, was attractive because of its potential for a higher rate of return for investors, particularly when deposit interest was not attractive to most investors for religious or other reasons.\(^{20}\) Indeed, the early establishment of the informal market in Saudi Arabia was necessary to meet the already developing demand from individuals to trade shares. The Executive Rules 1984 further established the stock market within the network of commercial banks, and empowered SAMA as the regulator for the stock market.\(^{21}\)

In the meantime, the Executive Rules, which restricted brokerage activities to

\(^{19}\) See R. Wilson, *The Economies of the Middle East*, Macmillan Press Ltd, London, 1979, p. 44.


\(^{21}\) The Executive Rules To Regulate Share Dealings Through Commercial Banks, The General Banking Control Department, Riyadh, 1984.
commercial banks, had the effect of eliminating informal brokers from the market, reducing the liquidity of the market.\textsuperscript{22} Further, the Executive Rules restricted trading in the market to Saudi government institutions, licensed firms and individuals only.\textsuperscript{23} The upshot of this conservative policy has led to highly limited participation, consisting mostly of a few government-backed institutions, 11 banks, and individual investors. (See Table 5.1).

<table>
<thead>
<tr>
<th>Type of holder</th>
<th>Market Capitalisation</th>
<th>Shares outstanding</th>
</tr>
</thead>
<tbody>
<tr>
<td>Individuals</td>
<td>51%</td>
<td>48%</td>
</tr>
<tr>
<td>Government</td>
<td>33%</td>
<td>40%</td>
</tr>
<tr>
<td>Banks</td>
<td>9%</td>
<td>5%</td>
</tr>
<tr>
<td>Others</td>
<td>7%</td>
<td>7%</td>
</tr>
</tbody>
</table>

Source: SSRC

2.1 The government

The Saudi government plays a crucial role in the national economy. Typically, the government provides funding for many of the projects initiated by the private sector. The Saudi stock market also enjoys the support and funding of the government. In fact, the Saudi government is the largest shareholder in the Saudi stock market today.\textsuperscript{24} The involvement of the government was thought necessary in the early stages so as to encourage the establishment of new business and projects and to

\textsuperscript{22} H. Azzam, \textit{The Emerging Arab Capital Markets: Investment Opportunities in Relatively Underplayed Markets}, p. 156.

\textsuperscript{23} The Executive Rules 1984, Art. 1, state that the duty of buying and selling shares is restricted to Saudi banks, which are licensed to do so. The banks perform the role of mediator on behalf of clients (directly) and no share dealings can take place without their mediation.

\textsuperscript{24} See 'Development of GCC Financial Markets', in Bakheet Annual Stock Market Review, p. 4.
guarantee the success of some of the larger projects, especially in the industrial sector.\textsuperscript{25} Given the relatively underdeveloped state of the private sectors, the government sought to establish an organised stock market in order to stimulate economic growth. Upon the establishment of the Saudi market, more than half the market capitalisation was attributable to the government.\textsuperscript{26}

Today, the government still owns more than 40\% of the total shares of companies listed on the Saudi stock market. Most of its shares are concentrated in the industrial and electricity sectors. For example, 70\% of the Saudi Basic Industries Corporation (SABIC) is controlled by the government. To appreciate the size of the government’s involvement in the market, SABIC is presently the largest listed company in the Saudi stock market, with SR 47 billion market capitalisation representing more than 20\% of total market capitalisation.\textsuperscript{27} Although SABIC was initially wholly state-owned, the government floated a 30\% block in 1984.\textsuperscript{28} Given the extent of privatisation, it is no surprise that the government also controls the main petroleum-supplying corporations in the Kingdom.\textsuperscript{29} The other major government


\textsuperscript{27} Saudi Share Registration Company, Annual Report, Riyadh, 1992, pp. 40-41. SABIC was established in 1976 to add value to the Kingdom’s hydrocarbon reserves development, petrochemicals, fertiliser, and other industries. Today, SABIC is the third largest producer in the world of chemicals, petrochemicals and plastics, and accounts for 5\% of the global output. Since its establishment, SABIC has undertaken the majority of downstream activities in the petrochemical industry either directly or in joint ventures with third parties. Downstream activities include ethanol, ethylene, MTBE, fertilisers, industrial chemicals, iron and steel.

\textsuperscript{28} SABIC has 19 subsidiaries and four sister companies, some of them large listed companies, such as the Saudi Arabian Fertilisers CO “ Safco” (41\%), Sadaf (50\%), Kemya (50\%), Gulf Petrochemical Industries Co. (33\%), and Aluminium Bahrain (20\%). See SSRC Annual Report, 1992.

holding is in the electricity corporation; the government owns more than 70% of the total shares issued in this sector.\textsuperscript{30} However, the Kingdom is planning a comprehensive reorganisation of the power sector, leading to the elimination of four regional Saudi Consolidated Electricity companies, and the increase of private sector participation in future utilities for power generation and distribution.\textsuperscript{31} In addition to its holding in the industrial sector, the government controls more than 40% of the services sector.

The Saudi government is a major investor in many of the listed companies on the Saudi exchange. Typically, the government will invest directly or through its own funds.\textsuperscript{32} In this regard, the General Investment Fund (GIF), the General Organisation for Social Insurance (GOSI), the Pension Fund (PF), and the Public Investment Fund (PIF) are the main quasi-governmental investment vehicles involved in the stock market. Whilst the market could benefit from the government and its institutions providing the market with more liquidity, these institutions tend to acquire securities and maintain a long-hold position, which deprives the market from increased liquidity.\textsuperscript{33} For example, GOSI has a very large asset portfolio, but tends to pursue a

\textsuperscript{30} There are nine electricity corporations listed in the Saudi stock market. However, they are among the less-traded companies in the market. Although the stake held by the government is the main reason, the large dividend paid (guarantee of 7%) has encouraged other shareholders to hold on to their shares as well. See SSRC Annual Report, 1995, pp. 126-132.


\textsuperscript{33} For example, the Chilean pension reform and rising investment needs of such funds, the instruments thereby created, and the competitive set-up of the privately managed pension funds made the financial market deeper, more liquid, and more competitive. See R. Holzmann, 'Pension Reform, Financial Market Development, and Economic Growth: Preliminary Evidence from Chile', International Monetary Fund, Staff Papers, Vol. 44, No. 2, June 1997, pp. 156-161.
hold strategy and hardly ever sells in the market. Apart from the institutional funds, the government’s market role is also passive, meaning that its investments are linked to indexes. Given its preference for diversification and the general characteristics of the market, it is unlikely that the government-controlled funds will be inclined to undertake to become more active investors in the market.

### 2.2 Banks

Commercial banks have traditionally dominated the financial sectors of developing countries. The dominance of debt finance arose chiefly because of microeconomics and regulatory policies that did not foster an economic environment in which the private sector was encouraged to play an active role in the economy. Atje & Jovanovic wrote that “We have found a large effect of stock markets on subsequent development. We have failed to find a similar effect of bank lending. That this differential effect should exist is, in itself, surprising. But if it is true, then it is even more surprising that more countries are not developing their stock markets as quickly as they can as a means of speeding up their economic development.”

Since 1984, the reliance on banks and debt finance has curtailed the development of the Saudi stock market. Perhaps due to the near-monopoly control

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34 GOSI alone invested more than SR 19 billion in 46 different companies listed in the Saudi stock market. Most of this investment (46%) was concentrated in banking and real-estate companies, 28% in industrial companies. See SAMA 34th Annual Report, Riyadh, 1998, pp. 125-132.


36 Ibid.

exercised by the banks over the financial system, the government policymakers
granted local banks a monopoly over the brokerage activities in the market. Despite
their role as intermediaries for the system, banks ironically were not allowed to take
positions as investors in the market until 1990.\footnote{Executive Rules 1984, Art. 1, state that banks are forbidden from buying and selling shares on their
own behalf except with the Ministerial Committee’s permission.} The government’s policy restricting
brokerage activities to only banks, and excluding market-maker dealers, and
institutional investors from brokerage activities, was designed by the government
planners to bring stability to the share market. In an interview, Osama Faqih,
Minister of Commerce and Member of the Ministerial Committee, noted that:

"The policy drawn by the government upon the establishment of the
stock market was to serve three main issues: the financial soundness
and prudential suppression of intermediaries; the efficiency and
security of secondary market trading and clearance and settlement
systems; and the soundness and attractiveness of companies offered
on the primary market." \footnote{See interview with Mr. Osama Faqih, Saudi Minister of Commerce and Member of the Ministerial
Committee, Riyadh, 28 July 1997.}

Yet, despite the public policy objective underlying the legislation, it has
become apparent that banks alone cannot provide the market with innovation,
liquidity and long-term stability.\footnote{See generally M. Hellwig, ‘Banking, Financial Intermediation and Corporate Finance’, in A.
Giovanni & C. Mayer (eds.), \textit{European Financial Integration}, Cambridge, Cambridge University
Press, 1993, pp. 31-63.} Even though SAMA has allowed licensed banks to
take positions in the market and trade directly for their own account, there has been
little change in the market liquidity. Indeed, banks hold directly only 3\% of shares
outstanding, which is a very disappointing ratio given their liquidity and monopoly role as intermediaries in the market.41

2.2.1 Mutual funds

In the 1990s, the advantages of securities ownership through the purchase of packaged investment has turned millions of households into holders of financial assets, and has poured trillions of dollars into the market.42 Such vehicles provide professional management for investment, which enables investors to benefit through the ownership of the underlying securities, plus the potential to reduce risk through diversification that would be difficult to achieve on their own.43 There are several types of institutions that perform a pooling function for savers. Aside from traditional financial products offered by banks (short-term and demand deposits), there are several types of pooled funds available from a variety of institutions.44 A mutual fund is a general investment type of institution that pools the investment funds of hundreds of investors, thereby enabling the investors both to diversify and to buy the investment expertise of the fund’s managers.45 Such a fund is typically structured as

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41 Instructions to CTUs 1990, Art. 7, provide that a bank, through its CTU, may be authorised as a dealer by SAMA to buy on behalf of the bank. However, the CTU must obtain approval from SAMA to act as a dealer in particular securities.


44 By the end of 1997, the total mutual assets in the United States had reached $3.9 trillion in more than 4,000 funds, with over half that amount in stock mutual funds. The $2 trillion in stock funds in May 1997 was double the amount dedicated to these funds just two years earlier. Bond funds posted $925 billion in assets, and money market fund assets also topped $1 trillion. See R. Teweles & E. Bradley, The Stock Market, pp. 418-419.

a corporation whose business is the re-investment of the money of its shareholders. The fund’s shares are purchased for a price by savers who wish to participate in the fund. The fund re-invests the capital used by the savers to purchase the shares.\(^{46}\)

In response to the liquidity issue, SAMA authorised the establishment of open-ended mutual funds for investment in Saudi listed companies in 1992.\(^{47}\) An open-ended mutual fund is a joint investment account offering investors access to a specific financial market which is open for unit purchases at any time. These funds are a highly flexible form of investment, since investors can select the fund that matches their preferences for risk and reward.\(^{48}\) SAMA authorised banks to offer mutual fund investment in Saudi listed companies. The government’s decision to restrict mutual funds investment to banks is best viewed as a continuance of its earlier policy allowing only banks to provide investment services to clients, which began with the launch of the first, domestic open-ended fund in 1979 – the National Commercial Bank’s Short-term Dollar Fund.\(^{49}\)

The decision to allow commercial banks to launch mutual funds for local shares in the first half of 1992 was necessary to close the gap in the market created

\^46\text{In theory, then, the fund is owned by the shareholders, who govern it through an elected Board of Directors. As a result of this structure, the investment risk is borne by savers. While this is advantageous to the fund itself, it must also offer the shareholders some protection through diversification of investment. See, for example, U.S. Investment Company Act 1940, Section 5b-1, 15 U.S.C., section 80a-15.}

\^47\text{See ‘Rules and Procedures for the Establishment and Regulation of Saudi Royal Mutual Funds’, Securities Control Department, SAMA, 1992.}

\^48\text{R. Teweles & E. Bradley, \textit{The Stock Market}, pp. 415-416. Teweles noted that as investors purchase mutual fund shares, the fund’s transfer agent issues new shares at net asset value, plus a sales charge (if any). When shares are tendered for redemption, the transfer agent cancels those shares and pays their net asset value in cash to the shareholder. Thus, if investors buy more shares than they redeem, the number of shares outstanding rises. Conversely, if redemption exceed purchases, the number of outstanding shares contracts.}

by the marked absence of institutional participation in the market. Initially, these funds attracted more investors to the market, particularly small investors. The funds provided investors with new, less risky access to the stock market. Risk is controlled through portfolio diversification and by professional managers who have the high-powered incentives necessary to enhance performance in the market. Corresponding with the introduction of the funds, it was hoped that they would bring more stabilisation to the market prices. Yet, during the first two years of operation, the funds failed to achieve their launch projections. Shortly thereafter, the funds experienced a sharp decline in the market price, which has persisted for the past three years. (See Table 5.2)

Table 5.2  **Saudi mutual funds performance (1994-1998)**

<table>
<thead>
<tr>
<th>Fund</th>
<th>1994 CHANGE %</th>
<th>1995 CHANGE %</th>
<th>1996 CHANGE %</th>
<th>1997 CHANGE %</th>
<th>1998 CHANGE %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Riyadh Equity 1</td>
<td>-9.49</td>
<td>12.7</td>
<td>20.1</td>
<td>27.3</td>
<td>-17.1</td>
</tr>
<tr>
<td>Al-Musahim</td>
<td>-21.02</td>
<td>12.8</td>
<td>19.3</td>
<td>29.8</td>
<td>-21.2</td>
</tr>
<tr>
<td>NCB Equity</td>
<td>-29.42</td>
<td>5.6</td>
<td>13.5</td>
<td>24.4</td>
<td>-19.8</td>
</tr>
<tr>
<td>BSF Istithmar</td>
<td>-27.65</td>
<td>3.1</td>
<td>2.3</td>
<td>29.6</td>
<td>-23.5</td>
</tr>
<tr>
<td>Al-Arabi Equity</td>
<td>-19.47</td>
<td>12.9</td>
<td>14.8</td>
<td>22.2</td>
<td>-6.2</td>
</tr>
<tr>
<td>SABB Equity 1</td>
<td>-33.03</td>
<td>8.6</td>
<td>14.7</td>
<td>34.1</td>
<td>-17.3</td>
</tr>
<tr>
<td>SABB Equity 2</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
<td>-22.8</td>
</tr>
<tr>
<td>Arabi Equity 2</td>
<td>-10.50</td>
<td>8.7</td>
<td>23.6</td>
<td>11.6</td>
<td>-3.7</td>
</tr>
<tr>
<td>Arabic Equity</td>
<td>-18.27</td>
<td>-1.1</td>
<td>4.1</td>
<td>11.7</td>
<td>-27.2</td>
</tr>
<tr>
<td>SHB Murabaha</td>
<td>NA</td>
<td>NA</td>
<td>14.8</td>
<td>17.7</td>
<td>-13.5</td>
</tr>
<tr>
<td>Riyadh Equity 2</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
<td>19.2</td>
<td>-13.7</td>
</tr>
</tbody>
</table>

Source: SAMA

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50 Since 1979 the Saudi banks have launched more than 100 funds offering investors a variety of options for their investment. However, only ten of the total funds are investing in the local stock market.
Currently there are 11 mutual funds operating with total assets of approximately SR 500 million under the management of eight banks and the supervision of SAMA.\footnote{Rules and Procedures for Establishment of Saudi Mutual Funds 1992, Art 1., state that in order for a bank to obtain a licence to establish a mutual fund, SAMA must approve the Terms and Conditions, Prospectus and Management and staff authorised to operate the Fund.} There are approximately 3,500 members participating in these funds. These funds were launched by banks that specialise in the local stock market, but are considered small in comparison with other mutual funds that have been launched by the same banks. Although the funds that are active in Saudi stock market have made good returns in recent years, the total assets traded in the local market represents only 3.27% of the total assets of the total funds managed by banks. Furthermore, the number of people investing in local funds represents only 7.7% of the total number of investors that are involved in all the funds introduced by banks.\footnote{The Saudi Mutual Funds Annual Report, the Banking Control Department, SAMA, 1997, pp. 3-4.} Despite the fact that banks and their mutual funds are the only official institutional investors that are regulated and licensed by the market authorities to operate and provide services in the market, their participation to date has been exceptionally poor and has not contributed to the potential liquidity or expertise that could be brought to the market.

One of the most important issues that emerges when talking about bank participation in the Saudi stock market is the potential for conflict of interest to arise. This issue is particularly important when considering the monopoly position of banks in the market.\footnote{See 'Case Study: the Saudi Stock Market', Bakheet Financial Advisors, Riyadh, 1998, p. 5.} There were several factors that influenced policymakers in only authorising banks to introduce mutual funds investment. In terms of market
capitalisation, banks represent the largest sector in the domestic stock market, and
the largest sector in the market in terms of most active trading. In addition to these
features, commercial banks are the main lenders to the Saudi listed companies as
well as the exchange investors. Accordingly, their position in the market provides
them with unique access to privileged financial and business information, which is
not available for the rest of market participants. So, for example, their access to
priority information may place them in a better position than other market investors,
especially if they are going to trade for their account. In this respect, Basher Bakheet,
the General Director of Bakheet Financial Advisors, noted that:

"I think there is a clear conflict of interest for banks operating as the
only brokers on the one hand and as traders on the other. Banks have
access to most important information about trading activities, who is
trading and other information which is not available to other investors.
It is sometimes difficult to determine when banks are trading directly for
their own account or for their mutual funds. Finally, banks play a
crucial role in the market as the biggest creditor to market participants.
Given all the roles that banks have, there seems to be clear proof that
there is a conflict of interest for banks in the market."

The segregation of the banks from trading for their own account is designed to limit
the manipulation of their own shares. More importantly, the segregation of orders, in
terms of time, also provides for a transparent mechanism to control insider trading by
banks. Despite the latter controls, banks have been able to successfully piggyback

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54 Currently, there are 11 listed banks on the Saudi stock exchange. These banks represent 39% of the
total market capitalisation, making it the biggest sector in the domestic stock market. Furthermore,
bank shares are the most traded shares among all other sectors. SR 30 billion worth of shares were
traded in the banking sector, representing 47% of total market turnover.
55 Interview with Basher Bakheet, the General Director of Bakheet Financial Advisors, Riyadh, 12
December 1997.
56 Instructions to CTUs 1990, Art. 7-1, regulate the conflicts of interest that might appear when banks
trade for their own account. Art. 7 provides that the CTU shall enter all orders to the system in their
or bunch trades to their own advantage. Whether an electronic trading system is immune from such manipulation is an empirical question, and cannot be addressed in this thesis.

The introduction of mutual funds by banks, as a new alternative for savings, was intended to provide an instrument for investors that offered a range of maturates and risk profiles. The initial take-up of these funds appeared promising, but expansion has been subsequently limited by under-performance of funds and certain significant losses occurring across funds in a recent down-market. In order to encourage more transparency in the trading of mutual funds, the Kingdom’s policymakers, through SAMA’s SCD, should be encouraged to introduce new rules that could inhibit unfair practices. More specifically, SAMA should publish detailed rules prohibiting the fraud, manipulation and insider trading in securities traded by mutual funds managers. At the same time, the importance of attracting more investors requires that SAMA tightly regulate commission of mutual funds, while phasing in non-bank participation in the market in order to stimulate competition in price and quality services.

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58 Al-Jeffery, Investment in the Saudi Stock Market, p. 16.
2.3 Individual investors

The exclusion of institutional investors in the Saudi market led the market to be dominated by individuals. As we have seen, the Kingdom’s policy, through the Executive Rules 1984, has been to limit brokerage activities and other investment activities to the banking system. Presently, individual investors account for more than 90% of the transactions in the market, with the residual being accounted for by the institutional investors. The dominance of individual investors of the Saudi stock market can be seen also in the shareholders’ ratio. Recent statistics reveal that 48% of the market’s outstanding shares are held by 1.67 million individual shareholders in the Kingdom, approximately 12% of the adult population. Although the percentage of the individual shareholders indicates a relatively high rate in comparison to the total population, the number of shareholders who are frequent traders is very modest. It appears that most of the shareholders are concentrated in the primary market, with very few participating in secondary market trading.

There are many reasons for the sharp decline of individual investors’ activity in the secondary market. First, the Kingdom’s old policy of insisting that shares should be offered at only par value, guaranteeing subscribers a quick return just after the end of the subscription, naturally depressed the market. Furthermore, trading in the primary market does not demand the same cost, experience and effort required for trading in the secondary market, and most individuals dispose of their share

\[\text{\footnotesize \cite{M. Gorman, 'The Efficiency of the Saudi Arabian Equity Market', unpublished paper, Securities Control Department, SAMA, 1997, p. 2.}}\]

\[\text{\footnotesize \cite{Ibid., p. 3.}}\]

\[\text{\footnotesize \cite{Ibid., p. 16.}}\]
immediately after subscription. Finally, many of the wealthy individual investors pursue a buy-and-hold strategy in blue chip companies, which has resulted in the concentration of a majority of shares in a few hands.\(^{63}\) It should be pointed out that the domination of the Saudi market by individual investors representing the interests of institutional investors, could further depress the market. Also, many studies show that markets dominated by individuals show less trading volume and less liquidity than those dominated by institutional investors.\(^{64}\) Finally, individual investors, in general, fail to take into account the market fundamentals while they are trading, which tends to reduce market stability and efficiency.\(^{65}\) Accordingly, there is a need to increase the level of institutional investor involvement in order to increase liquidity and stability in the Saudi market.

### 2.4 Institutional investors

In this day and age, the benefit that any stock market can obtain from increasing the number of institutional investors in the market cannot be ignored.\(^{66}\) Large asset portfolios and professional management allow institutional investors to provide the

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\(^{63}\) Al-Dukhiel, ‘Saudi Stock Market Between Government Control and the Monopoly of the Few’, p. 10. In his study of the concentration of share ownership applied to four banks in the Saudi market from 1981-1986, the author observes that the number of shareholders dropped sharply between 60% (highest) and 33% (lowest).


\(^{66}\) Szewczyk, Tsetsekos, & Varma, ‘Institutional Ownership and the Liquidity of Common Stock Offerings’, *27 Financial Review* 211, 1992, pp. 211-214. The authors state that institutional investors have a positive effect on stock market activities. First, because institutional investors have great resources they typically trade more frequently than individuals, which increases the liquidity of the market. Secondly, because of their large investment, institutional investors have greater incentives to monitor the activities of companies than individuals. Finally, because of their economy of scale and
market with the liquidity and stability it needs. However, the Saudi policymakers have not made efforts to encourage the participation of such institutions in the Saudi market. Instead, the stock market rules prohibit anyone except licensed banks from providing any service related to the stock market. At the same time, the Rules do not authorise the issuance of licences to any persons or institutions to act as dealers or fund managers outside the banking sector. Moreover, the rules do not allow any person or institution to act as a market maker. In other words, the exclusion of a significant group of investors who could provide stability and liquidity for the market has, to be sure, had an impact on the nature of trading and the liquidity of the market. For example, models by Grossman and Miller (1988) and by Glosten (1989) show that market makers can enhance liquidity when trading volume is low or when adverse selection problems are large. The policymakers' early trade-off, favouring stability at the expense of liquidity, must now be modified in light of new economic conditions in order to increase market depth and financial market performance.

Professional expertise, institutional investors acquire low-cost and higher-quality information than those acquired by individuals.


68 Executive Rules 1984, Art. 1, state that the buying and selling of shares is restricted to Saudi banks which are licensed to do so. The banks perform the role of mediator on behalf of clients (directly) and no share dealings can take place without their mediation.


The restriction created more problems than it was intended to eliminate. First, prohibiting trading by institutions has deprived the market from much liquidity and stimulus to further developing the structure of the market. Studies have shown that markets dominated by individuals are more speculative, less efficient and less liquid than those dominated by institutional investors.\textsuperscript{71} In contrast, institutional investors offer professional management, diversification and liquidity to investors.\textsuperscript{72} These institutions usually offer better information capabilities, to which individual investors would not otherwise have access. Further, they offer a wide variety of investment vehicles which individuals might not have otherwise learned about. Finally, institutional investors are usually able to take advantage of economies of scale, which are usually out of the normal investors' reach. Consequently, allowing institutional investment, which is more efficient than individual investment, may mark a turning point in the evolution of the market.\textsuperscript{73}

In the past five years, the Saudi market has witnessed the appearance of new investment firms outside the banking sector. Whilst the stock market rules prohibit any person from taking a position in the market as dealer, broker or market maker unless he is a licensed bank, a number of unauthorised non-banks are engaged in securities market activities.\textsuperscript{74} Although there is no precise account of the private agencies that are operating in the securities market as brokers, dealers and advisors,

\textsuperscript{73} D. Silver, \textit{The Securities Regulatory Environment and Growth of Institutional Investors: A Preliminary Overview}, Boston University, 1993, pp. 8-9.
their numbers are not insignificant. This means that a large portion of the market today is operating without regulatory supervision, hence exposing investors to a certain level of legal risk. In an interview, Suleman Al-Mohameed, Assistant Director of the Department of Companies at the Ministry of Commerce, noted that:

“A common strategy to avoid the government’s prohibition is when financial intermediaries open investment advisory offices. In this context, the Ministry of Commerce will grant a licence to serve as a general financial and investment advisor. It is estimated that over the last five years, most of these offices have provided securities market services in the Saudi stock market operations, whether as advisors or direct investors”.75

Many of these offices have been established by expert bankers and professional investment managers, which has allowed them to play a major role in the market by providing the market with detailed monthly reports analysing the performance of the Saudi market.76 Those offices are often directly involved in widespread stock market activities, either through the publication of in-depth analyses of the Saudi stock market, giving advice to market investors, or through acting as an advisor for large investors’ portfolios. Because these activities are not authorised by SAMA, investors and foreign residents are unprotected against fraud, incompetence, manipulation and other unprofessional conduct.

Another common type of unlicensed agencies that are involved in the stock market is constituted by the funds established by large companies. The government’s policy prompted companies with large asset portfolios to establish their own funds

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75 Interview with Mr Suleman Al-Mohameed, Assistant Director of the Companies Department, Ministry of Commerce, Riyadh, 3 November 1997.

76 See Consulting Centre For Finance and Investment, Bakheet Financial Advisors, and Al-Zughaibi & Al Kabbani Co.
within the investment department of the parent company.\textsuperscript{77} Furthermore, over the past five years, the market has witnessed the intervention of some of the largest companies who are licensed by the Ministry of Commerce in the market. These investment companies tend to operate across markets, involving real estate, industrial and other commercial projects. Some of these companies have clearly begun to concentrate their operations in the lock-stock market.\textsuperscript{78} Typically, these firms offer highly reputable services and products. The rate of returns in many of these companies is high in comparison with domestic financial services sectors. In this respect, Fahad Al-Mobarak, General Manager of RANA Investment Company, noted that:

"RANA Investment Company is the first company to be licensed by the Ministry of Commerce as a limited liability company to provide services in the stock market such as private placement opportunities, evaluation and review of investments, domestic and international investment, asset allocation, management advisory, mergers and acquisitions management, project screening, evaluation of feasibility studies and banks and government debt financing."\textsuperscript{79}

The fact that non-banks are engaged in offering widespread securities activities without regulation points to the rationale of their involvement in the market. If handled prudently, allowing the entry of domestic, incorporated non-bank intermediaries to all areas of the market could bring substantial benefits to the market and the Kingdom's economy. By introducing a number of new financial products,

\textsuperscript{77} See the Investment of National Cooperative Company for Insurance, Dollah Group, Zamil Group, and Olayan Investment Co.

\textsuperscript{78} RANA Investment Company, established as a limited liability company, has 37 shareholders that are prominent Saudi businessmen with varied backgrounds and interests in banking, finance and other industries. Most of its shareholders and clients are members in boards of directors in major banks and large corporations in the Gulf and worldwide.

\textsuperscript{79} See interview with Fahad Al-Mobarak, General Manager of RANA Investment Company, Riyadh, 2 October 1997.
non-bank intermediaries will create a full range of securities services and products for investors. These instruments would increase liquidity in the market. The introduction of new products would naturally need to be done in a fashion consistent with the securities law. Exposing the scope of the market activities could lead to more competition between providers of financial services, leading to better products and lower prices for investors. It is anticipated that non-banks might also create new markets for their products, leading many new investors into it.

Developing greater diversity in the market may require changes in the legal and regulatory structure of the Kingdom's securities market. This could be achieved by SAMA licensing specific activities in the market, i.e., underwriting, investment management, trading on behalf of others, trading as a principal, financial advising and other activities. SAMA itself could offer explicit guidelines on the regulations that apply to the licensing, operation, and prudential supervision of non-banks.

It may be that opening the securities market to foreign institutional investors could bring further efficiency gains by introducing a new layer of competition to the market. Foreign institutional investors have considerable experience in most areas of the market and could provide valuable experience for investors and the government, particularly in the area of asset disposals and privatisation. Whilst there are a number of high-quality (but unappreciated) domestic intermediaries, the decision to license foreign firms could be an important signal to investors that the market is moving in a new, international direction. When considering the issue of introducing foreign intermediaries, SAMA should publish guidelines regarding the licensing of foreign
intermediaries, as well as establishing regulations that apply to cooperation between SAMA and the authorities in foreign jurisdictions.

### 2.5 Foreign investors

The world financial markets have witnessed in recent years a phenomenon in emerging markets, where international capital flows have been marked by a sharp expansion in net and gross capital flows and a substantial increase in the participation of foreign investors and foreign financial institutions in the financial markets of several developing countries.\(^8^0\) Emerging markets are usually understood as "rapidly growing markets" or "stock markets in newly industrialised countries."\(^8^1\) The worldwide acceptance of the internationalisation, integration and liberalisation of the capital markets idea has contributed effectively to the inflow of capital to the developing countries.\(^8^2\) The attraction of the emerging markets mainly derives from the outstanding return performance registered by many of these markets in recent years, which have helped the markets in many developing countries to expand rapidly.\(^8^3\) Net international equity flows to emerging markets rose from $3.3 billion

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in 1986 to $61 billion in 1993.\textsuperscript{84} As a result, the combined capitalisation of traded equities on the 38 emerging stock markets has risen from less than $100 billion at the end of 1983 to over $2 trillion at the end of 1994.\textsuperscript{85}

The process of the development of the Saudi stock market and its integration with international capital markets is less advanced than other emerging markets.\textsuperscript{86} Although there are more than 350 joint-venture projects involving foreign investment in the Kingdom, the role of foreign investors is restricted to participation that does not exceed 40% of the capital of the company.\textsuperscript{87} Presently, foreign investors own 9% of the stock market capitalisation through their shares in listed companies. However, they are not allowed to trade in the stock market.\textsuperscript{88} The Saudi authorities were pursuing a conservative policy when it restricted foreign participation in the stock market.\textsuperscript{89} Restricting foreign investors from purchasing Saudi equity shares has deprived the market of numerous important benefits that have been enjoyed by other emerging markets in recent years.\textsuperscript{90} As Ross Levine noted: “Consider the impact of one particular policy lever: liberalising controls on international capital flows.

\textsuperscript{84} M. Keppler & M. Lechner, Emerging Markets, Research, Strategies and Benchmarks, pp. 19-23.
\textsuperscript{87} Capital Investment Act, issued under Royal Decree No. M/4, dated 2/2/1399.
\textsuperscript{88} Executive Rules 1984, Art. 8.
\textsuperscript{89} According to a survey conducted by the Riyadh Chamber of Commerce, most Arabic stock market rules allow foreigners to invest directly in their market, except Saudi Arabia and Kuwait, who still resist foreign direct investment. See ‘The Rules Governing Foreign Participation in the Saudi Stock Market In Comparison with other Arabic Markets’, a study conducted by the Chamber of Commerce Securities Committee, Riyadh, July 1997, pp. 17-21.
Liberalisation may involve easing restrictions on capital inflows or reducing impediments to repatriating dividends or capital. In either case, reducing barriers to cross-border capital flows can affect the functioning of emerging stock markets. First, by enhancing the integration of emerging markets into world capital markets, thereby bringing the prices of domestic securities into line with those elsewhere, and second, by forcing domestic firms seeking foreign investment to upgrade their information disclosure policy and accounting systems. Moreover, the entry of more foreign investors into emerging markets may lead to pressure to upgrade trading systems to support more trading, and to the introduction of a greater variety of financial instruments.  

Until recently, trading in the Saudi stock market was totally restricted to Saudi nationals, authorised funds and, on a limited basis, to Gulf Cooperation Council nationals. The Kingdom’s policymakers believed that individuals were not ready to compete with foreign investors, who may have benefited at the expenses of incompetent Saudi investors. This concern led the government to limit the influence of foreign investment within the Saudi stock market.

However, foreign investment raises the level of capital, gives higher rates of return and increases efficiency. For these reasons, policymakers have recently taken steps towards the liberalisation of the stock market. First, the restriction of GCC
citizens' participation in the Saudi stock market has been reconsidered. A decision was issued by the Council of Ministers, which approved the resolution of the GCC's 15th meeting in 1997 regarding GCC citizens' rights to own shares of public corporations in GCC countries and to trade shares. The new rules permit GCC citizens to establish, or participate in the establishment of, new companies, and to subscribe for, own, and trade shares of existing public companies that conduct economic activities allowable for GCC participants, based on the GCC Supreme Council Resolutions and the provisions of the GCC economic agreement. Moreover, GCC individuals are now allowed to own and trade the shares of GCC joint-stock companies, based on the rules applicable where the company is established.

The Saudi Council of Ministers' decision permits GCC citizens not only to trade shares of companies jointly established, but also allows them to trade shares of other listed companies. Despite these changes, the Kingdom still maintains a certain limitation in their participation. First, GCC citizens are restricted from trading in the shares of insurance companies, money exchangers and banks. This means they are only allowed to trade in 62 of the 74 listed companies in the Saudi stock market.

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95 The Council of Ministers decision No. 16, dated 20/1/1418, Ministry of Commerce Reference No. 222/427/9572, dated 5/2/1418.

96 SAMA circular 1671, issued on 4 January 1998, implemented the Council of Ministers Resolution No. 16, dated 26/5/1997. The Resolution and subsequent circular permit GCC citizens and 100% owned GCC corporations to purchase up to 25% of equity issued by Saudi Arabian joint-stock companies.

97 Trading by GCC Citizens Rules, Ministry of Commerce, Reference No. 222/427/9572, dated 5/2/1418, Art. 3.
Second, the permission for GCC citizens to trade shares is subject to ownership limitation.98

The second step towards liberalisation involves opening up stock market investment to foreigners. Typically, the Kingdom allows foreign investors to establish a business in Saudi Arabia if they operate through a joint-venture firm. The Ministry of Industry and Electricity, through the application of the Foreign Capital Investment Act, is the body in charge of licensing all foreign direct investment in the Kingdom.99 The foreign Capital Investment Act established the requirements and criteria that foreign applicants should comply with.100

Until recently, the restrictions on foreign investment in Saudi Arabia limited the world’s portfolio investor community from participating in the equity market. Limiting market participation to Saudi persons and firms deprived the national economy of $17 billion transferred to foreign individuals by the six million foreigners employed in the Kingdom.101 The new policy opening the market to foreign investment through the country fund will provide foreign investors with unrestricted access to securities quoted on the Saudi stock market.102 The launch of the Saudi Arabian (closed-end) Investment Fund (SAIF), incorporated in Guernsey as

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98 Trading by GCC Citizens Rules, Art 2. The Rules state that GCC citizens are allowed to trade in the companies, the majority of whose shares (51%) should remain in the control of Saudi shareholders.


98 Ministry of Industry and Electricity is responsible for licensing foreign investment, with the exception of mineral concessions, which are handled by the Ministry of Petroleum and Mineral Resources, and banks, which are handled by the Ministry of Finance and National Economy.


limited liability company by the Saudi American Bank, was established in 1997 to
invest all its assets in securities issued by companies and governmental agencies
listed in the Saudi stock market through the fund.\textsuperscript{103} The SAIF’s aim upon its
successful launch was to attract $250 million to the fund. Since its inception, the
fund has attracted considerable assets and is now the largest closed-ended single-
country offshore fund launched in recent years.\textsuperscript{104} Today, SAIF shares are traded on
the London Stock Exchange, providing foreign investors with the opportunity to
achieve long-term capital appreciation through a diversified portfolio, principally of
equity securities traded on the Saudi stock market, but also including debt
instruments issued by Saudi governmental agencies and other listed companies.

These relatively recent efforts to offer non-Saudi investors their first
opportunity to participate in the market, albeit indirectly, contributes significantly to
creating favourable market conditions.\textsuperscript{105} The Kingdom’s liberalisation efforts lag
behind other regional markets in this regard. The smaller, but more liquid, markets in
the region have taken more steps to attract foreign investment to their markets.\textsuperscript{106}
This leaves the Saudi market at a competitive disadvantage in relation to these

\textsuperscript{103} See ‘The Consent of the Saudi Arabian Monetary Agency for the establishment of the Saudi
Arabian Investment Fund’, SAMA Circular No. MA 1274, dated 3/12/1413, pursuant to Ministerial
Decision No. 3/2052, dated 24/7/1413.

\textsuperscript{104} The SAIF Fund is a collective investment scheme established by a contract between the SAIF
Limited Company and Saudi American Bank on the basis that the only investor in the SAIF Fund is
the Company. The establishment of SAIF, approved by SAMA, is as a Saudi Arabian investment fund
to be managed by the Investment Department of Saudi American banks, and to operate in accordance
with the fund’s regulations and rules set forth.

\textsuperscript{105} See R. Levine, ‘Stock Markets: A Spur to Economic Growth’, p. 10. Levine maintains that the
removal of barriers to foreign investment can improve the market operation of domestic capital
markets. The role of stock market liquidity significantly increased in 12 out of 14 counties that
liberalised controls on international capital flows.
markets. Other markets in the region, such as the Amman Stock Exchange, foreign investors like Jordanian citizens, trade directly without any restrictions. In looking to the next area of development, the task for the Kingdom’s policymakers is to attract foreign investors by allowing them more direct access to the trading, clearing and settlement system of the market. Given the efficiency and completeness of the market’s infrastructure, combined with certain regulatory changes, the Saudi market can offer large foreign investors a highly competitive situation for trading securities.

3. Summary

This chapter focused on the supply-side character of the Saudi stock market. The introduction provided a survey of the benefits of institutional shareholding and explored strategies to promote liquidity in the market. In the first section, we surveyed the range of investors presently involved in the market. This analysis revealed that the Saudi situation is unique in terms of the type of players participating in the market. Whilst there are no official market makers or dealers in the market, the large institutional investors and mutual funds participate through a range of largely passive trading strategies. It was also noted that foreign investors are not allowed to invest directly in the stock market. A critical element of the Saudi market is that it is thinly traded. This weakness, perceived by SAMA, has led to foreigners being

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allowed to invest indirectly through country funds. It is unlikely that such funds will create more liquidity. The stock market rules restrict the participation in the market to the government, banks and individual investors. Although the Saudi market capitalisation is relatively large, it is concentrated in a small number of companies. The Saudi stock market’s annual trading volume and daily average trading is very low in comparison to other emerging markets. The net impact of the exclusion of financial intermediaries from the market has been to limit liquidity that could be supplied by these groups. It was suggested that further liberalisation of foreign investment, along with change in stock market rules permitting non-bank participation in the market, could significantly contribute to the completeness, liquidity and ultimately efficiency of the market.
Chapter 6
Trading in the Saudi Stock Market

1. Introduction

It is generally acknowledged that efficiently functioning securities markets can promote economic growth. Research by financial economists reveals a positive and significant correlation between stock market development and long-term economic growth. The outcome of this research suggests that a well-functioning stock market in terms of size, liquidity and integration with world capital markets can enhance the growth of saving, efficient allocation of investment resources, and better utilisation of existing resources. Crucial to the realisation of an efficient, liquid and deep stock market is the existence of an effective market infrastructure. Recent empirical work suggests that the provision of a structure for financial intermediaries and investors for transacting securities markets, complemented by formal regulations, promotes greater efficiency gains that can be realised across sectors.

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This chapter provides an introduction to the Kingdom’s securities market structure. The main aim is to review the composite elements of the market, examining the trading system, the role of brokers, liquidity and clearing and settlement. In particular, the Electronic Securities Information System (ESIS) and the clearance, settlement and registration system based on the Saudi Share Registration Company (SSRC) are critically evaluated in relation to the needs of the securities market. It is argued that the advantages of this electronic network include (1) economic benefits emanating from a trading system based on a widely distributed computer network, (2) an order-driven market that ensures immediate execution, adding to liquidity in the market, and (3) a highly efficient clearance and settlement system.

Commentators generally agree that the Kingdom possesses several competitive advantages related to the provision of a trading system that accounts for the liquidity and depth of its securities market. Yet the Kingdom’s competitive advantages on the operation side is unlikely to form a basis for competitive advantage in the long run, since other jurisdictions can also easily develop these systems; in fact, Kuwait and UAE have established a modern operational infrastructure which delivers similar benefits to private sector users. By itself, technical improvement in the operation and management of the existing trading system alone may not be enough to secure a competitive advantage.

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6 The Kuwaiti Stock Exchange operates a very sophisticated electronic trading system that was designed and developed in Kuwait with the assistance of outside consultants. UAE has also recently announced the installation of an electronic trading system similar to ESIS. See ‘Establishment of UAE stock market’, Al-Hayat Gazette, 24 July 1999, p. 12.
advantage for the Kingdom’s equity market. Certainly, reforms in the market’s architecture, including the introduction of an alternative trading system, may increase liquidity. Moreover, innovation in securities design, which could be stimulated by the introduction of financial intermediaries, is needed to further enforce the competitive position of the market. According to this view, the Kingdom could actively use its proficiency in trading, clearance and settlement to increase its competitive position while responding to the demand for the introduction of new instruments and intermediaries. If successfully managed, this could supply the market with greater stability, increase liquidity and stimulate increased participation by large investors.

This chapter proceeds as follows. Section 2 describes the main characteristics of the Kingdom’s trading system, noting that its restriction on foreign investors trading in the market limits its evolution. It then describes the role of market makers in the market. The discussion goes on to market capitalisation, trading volume and liquidity, and the number of new firms listed in the market. Section 3 provides a description of the ESIS. It also evaluates the advantages of trading through the system. Our discussion then analyses the advantage of the system of dematerialising shares for the efficient transfer of

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8. See A. Al-Dukhiel, ‘The development of the Saudi stock market’, in *Gulf Financial Markets*, Gulf International Bank, Bahrain, January 1988, p. 59. Al-Dukhiel writes that the regulatory environment for trading has to be further developed. Regulations need to be developed to deal with issues such as insider trading and the concentration of holdings. See in this regard, H. Azzam, *The Emerging Arab Capital Markets: Investment Opportunities in Relatively Underplayed Markets*, Kegan Paul International, London, 1997, p. 155. Azzam states that the Saudi share-trading system, unlike that in most other countries, currently does not allow market makers, which would provide two desired characteristics: marketability and liquidity. In order for market making to be effective, it is important to have a sufficient amount of government regulation. Initially, Saudi banks that are operating under the present system could be given the market-making role. Gradually, as the market becomes larger, it will be possible to shift the market-making activities to separate entities such as brokerage firms, which are specialised in such activities.
ownership and clearance. It also argues that, because of these systems, the settlement period exceeds the G30's recommendations on settlement, enhancing the market's competitive advantage. Section 4 highlights the other forms of regulations and taxation in share trading. Finally, the chapter examines the commission rate charged by banks for trading securities. The commissions, unusually high in comparison with other similarly placed markets, suggest that there is inadequate competition in the retail sector for the trading of shares. The introduction of financial intermediaries could stimulate further competition in the market, prompting more efficient pricing and perhaps, ultimately, the introduction of a competitive trading system.

2. The Saudi Stock Exchange

Stock exchanges exist for an economic reason, namely to allow investors to allocate risk, to assist investors to raise capital for their enterprises and to facilitate both short-and long-term investors to achieve returns on their investments. The type of market structure and the role of intermediaries in price discovery, liquidity and price stabilisation increase their importance in the efficient functioning of any stock market. To be sure, there are many market structures worldwide that offer distinct trading processes and clearing systems. Yet these structures are not solely the result of the Kingdom's business planning but also represent the respective values of the market's actors.

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To some extent, the government's priorities and values are reflected in its regulatory arrangements, its commitment to supply credible legal rules, and expertise in regulation and monitoring. In many respects, the Saudi trading system also reflects the undercurrents in the market.

Using broad definitions of organised securities exchanges, one may refer to the Saudi securities market as an over-the-counter market (OTC). However, the creation of trading rooms (CTUs), which are spread throughout the Kingdom and provide investors with excellent market access, enabling them to view real-time trading data and interact actively with each other and the bank staff, along with the computerised trading system, has blurred the classification of the Saudi exchange.

In designing the stock exchange trading, the government, drawing its inspiration from European sources, chose to develop an order-driven market. Policy-makers in the government, having opted for the order-driven approach, decided to design electronic share trading through a system of refunded computers. In order to bring together traders, the government, through the Executive Rules 1984, delegated to banks the function of acting as stock brokers. The Saudi Government believed that a bank-based system of brokers would be most practicable to achieve financial stability. To this end, the

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12 Secondary markets have been divided into two broad classes: the organised securities exchanges and over-the-counter markets. In general terms, a trade either occurs on an exchange floor or it does not. Those trades that do not take place on an exchange are said to be OTC. See R. Teweles & E. Bradley, *The Stock Market*, John Wiley & Sons, Inc. New York, 7th Edition, 1998, pp. 4-5.


14 "The Executive Rules To Regulate Share Dealing Through Commercial Banks' 1984, Art. 1, state that the duty of buying and selling shares are restricted to Saudi banks which are licensed to do so. The banks perform the role of mediator on behalf of clients (directly) and no share dealings can take place without their mediation.

Executive Rules require that banks supply a central trading unit at their corporate headquarters in Riyadh City. In terms of licensing, banks were already licensed and supervised by the Banking Control Law and Companies Act, and operated as stock brokers under the authority of SAMA, one of the most organised agencies within the Kingdom. It is worth pointing out that the Saudi banks were already providing for their customers various other financial services, including share trading. Justifying the establishment of the Saudi stock market within the banking system, Mansoor Al-Mayman, Deputy Minister of Finance and Member of the Supervisory Committee, said:

"Because there are more than 1000 bank branches across the Kingdom, it was thought the banks were in the best position to provide this service to all citizens, even if they are in remote locations. Most importantly, building the stock exchange within the banking system would provide the market with better settlement and clearing systems. It was rightly assumed that situating the stock market within the banking system would provide the market with the best and less risky settlement. I think that we have been successful in preventing our market from collapsing or other financial shakings which neighbouring markets are familiar with."

By restricting trading in the market through banks only, the Saudi authorities thought that they could reduce the risk of settlement failure, which was one of the main reasons behind the collapse of the Kuwaiti market. Therefore, the Executive Rules restricted all the transactions in the market to cash settlement and prohibited banks from accepting any credit deals or transactions
based on forward cheques. Yet the government’s decision to locate the Saudi exchange within the banking system was perceived as insufficient to protect investors and the financial system from market failures or collapse of the exchange. As president of a non-bank company, Al-Dukhiel suggested:

"It is better for the stock market growth and development to be distinct from the banking system. Share trading activity is different from banking activity, therefore they should be managed by an independent commission unconnected with banks. I call for allowing non-bank companies to act as brokers, dealers, and market makers instead of limiting this role to banks."\(^{20}\)

In this regard, policymakers went further by restricting the brokerage role to only the 11 licensed banks. The Executive Rules granted local banks a virtual monopoly over all brokerage activities. It was determined that only banks could perform the role of mediator on behalf of their clients directly, and share trading should not take place without their mediation.\(^{21}\) The government’s decision to limit brokerage activities to banks inevitably restricted the development of intermediaries within the financial system.

It is well known that financial intermediaries are essential for reducing market imperfections and improving the allocation of assets within the financial system. Typically, intermediaries will (1) facilitate transfers, (2) supply liquidity, (3) monitor loans and other contracts, and (4) manage portfolios.\(^{22}\) The Saudi banking sector, because of the relative underdevelopment of the financial system, has provided the risk sharing and intermediation activities for the market.

\(^{19}\) Executive Rules 1984, Art I.
\(^{20}\) See interview with Abdul Aziz Al-Dukhiel, former deputy of the Ministry of Finance and President of the Consulting Centre for Finance and Investment, Riyadh, 12 December 1997.
\(^{21}\) Executive Rules 1984, Art. 1, state that the banks perform the role of mediator on behalf of clients (directly) and no share dealings can take place without their mediation.
As with other bank-oriented systems, in the early stages of the economic development, bank-based intermediation may have been a relatively efficient way to provide direct financing for firms and loans to consumers. In the early stages, banks improve the economic welfare of the economy. However, with the introduction of a stock market, there are different financial intermediaries, besides banks, which can offer more competitive packaging on the sale of securities and other financial products. Naturally, the monopoly position of banks may be threatened by the competition brought about by financial integration.

As we have seen, the dominance of the Saudi banking system was reinforced by the government's decision to limit the entry of other financial intermediaries into the market. We also noted that the extended network of branches across the Kingdom operates, in effect, as a barrier to entry. Yet, the Kingdom's banking sector, which tends to provide largely retail banking and commercial loans, suffers from under-development in corporate finance and the market for securities. It is worth emphasising that allowing financial intermediaries to supply certain financial services (share trading, mutual funds, etc.), would provide investors with a greater range of financial services and help eliminate inefficient service, without injecting any new risk into the financial system. Nevertheless, there are some non-bank intermediaries that are providing securities or other financial products without the authorisation of SAMA.

\[\text{23} \quad \text{Ibid.}\]
\[\text{26} \quad \text{Azzam, } \textit{The Emerging Arab Capital Markets: Investment Opportunities in Relatively Underplayed Markets}, \textit{pp. 154-155. Azzam notes that a large proportion of trading takes place}\]
Khalid Al-Bassam, Investment Sales and Marketing Department Manager of Al Bank Al Saudi Al Fransi, said that:

"I think that the market might operate better if the government would allow other private institutions to operate in the market as brokers besides banks. This will increase the competition in the market and will result in better services to market participants."27

In practice, there is an unacceptable level of trading in securities for which no obligation exists on the part of non-banks to make guarantees about the risk or completeness of the terms or conditions related to the purchase of such securities. The upshot is that non-bank distribution of securities may be conducted on less than the best terms. Hence investors may end up, unless they engage in proper due diligence and take reasonable precautions, being left without a remedy for recovery of losses related to unsavoury market practices of non-banks.

2.1 Market brokers

As we have seen, brokers and dealers provide a crucial liquidity function for markets.28 Interestingly, Saudi stock market rules limit brokerage activities to only those commercial banks that are licensed to operate in the Kingdom. Today, there are 10 banks conducting brokerage activities in the Saudi market: Riyadh Bank, Bank Al-Jazirah, Saudi Investment Bank, Saudi Hollandi Bank, Al-Bank directly between buyers and sellers outside ESIS. This loophole has allowed informal brokers to continue to operate in the market despite an official ban.

27 Interview with Khalid Al-Bassam, Investment Sales and Marketing Department Manager of Al Bank Al Saudi Al Fransi, Riyadh, 29 July 1997.

28 R. Schwartz, Reshaping the Equity Markets, Business One, Irwin, Illinois, 1993, pp. 136-141. Schwartz argues that dealers provide immediacy in the sense that they enable buyers and sellers to meet each other in time and space. The quotes that dealers post on the market further help to stabilise prices and to keep prices in tune with the market's underlying demand propensities. Furthermore, OTC dealers and exchange specialists enforce various trading rules that bring order and fairness to the market.

Unlike jurisdictions where banking and securities regulators are separated, the Kingdom regulates securities operations of banks within the unified structure of SAMA. Given the Kingdom's system of bank intermediation, it makes perfect sense for SAMA, in competition with the Ministry of Commerce through the Companies Act, to regulate banks' activities in the market. For the Kingdom, there are no additional securities regulations that are required once the basic banking licence has been granted. In practice, banks only need to be licensed under SAMA's Banking Control regulations and the Executive Rules to operate as a broker in the Saudi stock market.  

There are no special rules that govern the licensing of commercial banks to act as brokers. Ironically, there have been banks that have not been inclined to provide stock market service for their customers, and found themselves forced by the government to do so. It is crucial to note that the absence of clear rules to govern the licensing of brokers has tended to deprive the market of the great services that might be offered by non-bank agencies.

In fact, there is a compelling need to enact additional securities rules to cover the licensing requirements and qualifications for banks in order to ascertain which Saudi institutions are capable of carrying out these securities functions in a satisfactory manner. In securities markets, it is not enough for a bank to only satisfy prudential rules, it must also, when undertaking to become

29 Banking Control Law, Issued By The Royal Decree No. M/5 on 22.2.1386 (11.6.1966), Saudi Arabia Monetary Agency, Banking Control Department, Riyadh, Saudi Arabia.

involved in investments, brokering and advising on investments, ensure authorisation in the form of a licensing regime. In answer to a question concerning bank securities services, Khalid Al-Gadeai, Manager of Equity Services for Local Shares in the Saudi British Bank, noted that:

"The Kingdom's experience shows that few banks (four) are active in supplying securities services and most others are struggling with supplying these services. I believe that the market is in need of large investment institutions who can trade for investors and who do not want to trade directly. This will increase the competition with banks and will provide investors with better services. At the same time, it will increase market liquidity."

It is important to point out that there are a number of problems with this approach to supplying financial services. Given that banks can incur liability when investors buy services, the decision to rely on banking regulations to govern the conduct of banks is problematic. The Executive Rules do not require any qualification, entry requirements or any other management requirements of banks other than the provisions that apply to banks under the Banking Control Law. Certainly, the trading instructions of the Electronic Securities Information System (ESIS) to CTUs do supply mandatory rules concerning qualification (see Section 2.3.3) and business practices. However, these provisions, which were designed and implemented by SAMA, are not sufficiently comprehensive to

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31 E. Greene, D. Braverman & J. Schneck, 'Concepts of Regulation - The U.S. Model', The Future for the Global Securities Market, Oditah, Clarendon Press, Oxford, pp. 167-168. The authors state that because of the importance of brokers-dealers to the market, regulation of their activities was another major element of the regulatory reform after the 1929 stock market crash. Key areas where more rigorous standards were introduced included capital adequacy requirements, limits on the amount of credit that can be extended for the purchase of securities and supervisory and record-keeping requirements. To ensure that US investors benefit from these protections, it is a requirement of the US regulatory system that only brokers-dealers who are registered with the SEC, and therefore subject to their regulations, can deal with US investors.

32 Interview with Khalid Al-Gadeai, Manager of Equity Services for Local Shares in the Saudi British Bank, 28 November 1997.

33 Instructions to Central Trading Units, General Banking Control Department, Riyadh, 1994.
regulate all trading activities of banks, and efforts to extend the provisions, with an emphasis on imposing higher qualification standards, must be considered if effective securities regulation is to develop in the Kingdom.

The absence of regulation has meant, for example, that banks have not been forced to distinguish between their role as a bank and stock broker. Moreover, banks tend to discriminate in favour of their large clients. Basher Bakheet, General Manager of Bakheet Financial Advisor, expressed the view that:

"Saudi banks place low priority on their brokerage activities in the market (and see it) as secondary. The government policy that excludes non-banks from providing brokerage services, along with the relatively low level of superiority of banks, is responsible for the relatively low quality of performance by these institutions."

In practice, many unregulated non-banks have more qualified personnel and are more professional in their approach than most local banks in this respect. Whilst the government’s limitation of brokerage activities has stifled the competition, there is a growing demand by investors for deregulation of the sector. The high level of consumer dissatisfaction should lead in the near future to the introduction of a more efficient and responsive system. Clearly, legal and regulatory changes are required to provide the Kingdom with a more comprehensive basis for regulating banks with respect to their securities market activities. Securities regulation is underdeveloped in the Kingdom and the

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34 Interview with Mr Basher Bakheet, General Manager of Bakheet Financial Advisors, Riyadh, 12 December 1997.

35 See the Consulting Centre for Finance and Investment, Bakheet Financial Advisors, RANA Investment Company, and Zughaibi and Kabbani Co.

government should be encouraged to promulgate new regulation concerning the brokerage, dealing and managing of investments by banks.

2.2 Market capitalisation

The market capitalisation ratio is very important, since analysts frequently use the ratio as a measure of the stock market size.\textsuperscript{37} Over the period 1985-1996, the total capitalisation of the Saudi market rose by a factor of 156% from SR 67 billion to almost SR 172 billion, representing more than 40% of the total capitalisation of all Arabic stock markets.\textsuperscript{38} The market capitalisation rose sharply to reach SR 222.7 billion in 1997. On 31 December 1998, Saudi equity prices dropped by 28%, bringing the capitalisation of the market to SR 160 billion, as shown in Figure 6.1.

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{figure6_1.png}
\caption{Saudi Stock Market Capitalization}
\end{figure}


In comparison with other emerging markets, the rise of the Saudi stock market capitalisation is considered modest. The emerging markets recorded an average rise in the period of 1985-1996 from $172 billion to $1,929 billion.\textsuperscript{39} Although the current total market capitalisation of the Saudi market represents more than 40\% of the total Arabic market capitalisation, the Saudi stock capitalisation is below the average of those of other emerging markets. At $45 billion, it ranks 13\textsuperscript{th} out of 33 other emerging markets.\textsuperscript{40} (See Table 6.1 below)

Table 6.1

<table>
<thead>
<tr>
<th>Category</th>
<th>Saudi Arabia</th>
<th>Emerging markets (IFCG, average for 33 exchanges)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market capitalisation</td>
<td>US$ 45 billion, rank 13\textsuperscript{th}</td>
<td>US$ 53 billion</td>
</tr>
<tr>
<td>Annual market turnover</td>
<td>US$ 14 billion, rank 15\textsuperscript{th}</td>
<td>US$ 60 billion</td>
</tr>
<tr>
<td>Turnover/capitalisation</td>
<td>20%, rank 20\textsuperscript{th}</td>
<td>112%</td>
</tr>
<tr>
<td>Number of listed companies</td>
<td>74 companies, rank 30\textsuperscript{th}</td>
<td>518 companies</td>
</tr>
<tr>
<td>Average company size</td>
<td>US$ 608 million, rank 2\textsuperscript{nd}</td>
<td>US$ 103 million</td>
</tr>
</tbody>
</table>

Source: BFA & IFC

The current market capitalisation is 33\% of the Saudi GDP. The size of the Saudi equity market compared to GDP is extremely modest in comparison to other emerging markets and, in fact, does not represent the size or growth potential of the Saudi economy, which is one of the strongest in the emerging

\textsuperscript{40} Bakheet Financial Advisors, Annual Report 1998.
markets. The modest level of market capitalisation is mainly due to the limited initial public offering activity (IPO) in the market and the restrictions to direct foreign participation, which are slowly being eased.

2.3 Number of listed companies

At the end of 1998, there were 74 listed companies in the Saudi stock market. The market is segmented into six sectors, as shown in Figure 6.2. The number of listed companies in the Saudi market is by all means very modest. Only 13 companies went public during the past 10 years (see Figure 6.3). In comparison to other emerging markets, the number of the companies listed in the Saudi market is far below the emerging markets average of 350 listed companies. The low number of listed companies make the Saudi market rank 30th among other emerging markets in terms of the number of listed companies.

Figure 6.2

Breakdown of the Saudi stock market by sectors

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43 The Saudi listed companies rank second among the other emerging markets in terms of average size of listed companies. Hence, the relatively large market capitalisation is concentrated in a small number of companies. In fact, the ten largest listed companies account for approximately 64% of the total market capitalisation.
There are many reasons for the dearth of IPO activity in the market. First, the Government used to provide free financing for most of the products that reduce the incentives for going public.\textsuperscript{44} Second, and most importantly, the disclosure requirements under the Companies Act, as previously noted in chapter 4, are not sufficiently market-based to provide for mandated information that will inform investors about the price characteristics of the stock. Successful securities markets must counter the problem of adverse selection, i.e., the problem in which high-quality issuers leave the market because they cannot obtain fair value for their shares, while low-quality issuers remain.\textsuperscript{45}

Successful markets have developed a number of institutions to counter the adverse selection problems. They include securities laws which are backed by severe sanctions for false or misleading disclosure, securities regulators with the staff, skill and budgets to pursue fraudulent players in the market, accounting rules that limit the opportunity for an issuer to fudge its financial results, an

\begin{figure}
\centering
\includegraphics[width=\textwidth]{new_issues_graph.png}
\caption{New issues (SR Million)}
\end{figure}

Source: Ministry of Commerce


accounting profession with the skill and expertise to expose instances of attempted fraud and investment bankers whose reputations depend on not selling fraudulent or overpriced securities to investors. These institutions reduce the emergence of fraud and the extent of adverse selection. As a result, they attract honest issuers into the securities market and drive out dishonest issuers. Moreover, as the average level of disclosure increases, investors will place greater faith in disclosure, and will pay more for securities. This will lead to more high-quality issuers entering the market.

2.4 Trading volume and liquidity

Trading volume and turnover ratio are important factors in any stock market because they measure the market liquidity. Market investors, particularly institutional investors, are concerned by the level of market liquidity, which may influence the level of investment they wish to make in the market. The term liquidity is generally used to refer to the ability to easily buy and sell securities without disruptive price changes, making investment less risky and facilitating more profitable, longer-term investments. Hence, in order for the market to be attractive, the annual trading volume and turnover ratio must reach a level that is

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47 The liquidity of the market can be measured in terms of the turnover ratio; the value of shares traded as percentage of market capitalisation.


acceptable to a wide range of investors. The higher this is, the more attractive the market will be.\(^{50}\)

The total-value-traded ratio measures the organised trading of equities as a share of national output, and should therefore positively reflect liquidity on an economy-wide basis.\(^{51}\) Over the period past 15 years, the annual trading volume in the Saudi market rose from SR 759,972,525 to SR 51,509,159,079 in 1998. The market annual value of shares traded is about $14 billion, which is 77% less than other comparable emerging markets.\(^{52}\) During 1998, 295 million shares changed hands for a traded value of SR 51.5 billion, about 20% of the total market capitalisation. Table 6.1 shows that the Kingdom's stock market turnover ratio (value of shares traded as percentage of the market capitalisation) is low compared to that of other emerging markets, where the turnover ratio average of 112%.\(^{53}\)

There is no doubt that the Saudi market, due to the slow increase in annual trading volume, lags behind other markets in providing sufficient liquidity for institutional investors. Typically, institutional investors will be unwilling to place large orders unless there is enough liquidity to limit their exposure to adverse market changes.\(^{54}\) Does the Saudi market have efficient liquidity to supply large institutional investors? While the daily trading volume exceeded the $100 million mark in nine of the emerging market, the daily trading volume in the Saudi

\(^{50}\) Ibid.

\(^{51}\) Ibid., p. 295.


\(^{53}\) R. Feldman & M. Kumar, ‘Emerging Equity Markets: Growth, Benefits, and Policy Concerns’, p. 184. Feldman & Kumar note that the value of shares traded soared from less than $10 billion in 1983 to more than $340 billion in 1993 in Taiwan (China), for example, and increased by about twenty times in Argentina, Hong Kong, the Republic of Korea, Mexico, and Thailand.

\(^{54}\) S. Figlewski, *Hedging With Financial Futures for Institutional Investors*, p. 49.
market has not exceeded $45 million.\textsuperscript{55} In the major industrial nations, the turnover ratio varied from 85\% in the U.S.A to 134\% in France. Among the emerging markets, the turnover ratios range from 10\% in South Sahara markets to 226\% in Turkey.\textsuperscript{56} However, a reasonable turnover ratio falls between 40\% and 80\%, which shows the market is sustainable active.\textsuperscript{57} The figures shown above indicate that the Saudi market has insufficient depth and suffers from shallowness and thinness.

Typically, order-driven markets such as the Saudi stock exchange (ESIS), which involve no dealer intermediation, provide less liquidity than dealers markets.\textsuperscript{58} Numerous empirical studies point to the fact that liquidity effects provided by market makers which lessen the volatility in the market are due to reduction in ask/buy spread.\textsuperscript{59}

Order-driven markets rely on the flow of buy and sell orders from investors through the agency of a broker to create market liquidity and market depth, which depend on the random arrival of orders from traders and speculators.\textsuperscript{60} The most serious concern is whether the Saudi stock exchange has the capability to handle large transactions through an order-driven system and provide the market with the needed liquidity. Studies reveal that if order flow is uneven in order-driven markets, the market may become one-sided or

\textsuperscript{55} See M. El-Erian, & M. Kumar, 'Emerging Equity Markets in Middle Eastern Countries', World Bank conference, 1995, pp. 20-29.
\textsuperscript{57} M. Keppeler & M. Lecher, Emerging Markets, Research, Strategies and Benchmarks, pp. 22-23.
\textsuperscript{58} R. Schwartz, 'Equity Trading II: Integration, Fragmentation and the Quality of Markets', in Benn Steil (ed.) The European Equity Markets, The State of the Union and an Agenda for the Millennium, the Royal Institute of International Affairs, London, 1996, p. 69.
\textsuperscript{60} Dattels, 'The Microstructure of Government Securities', pp. 7-9
unbalanced.\textsuperscript{61} In dealer markets, market makers or specialists quote both buy and sell prices for securities and trade on their own account, which helps to ensure that there always a quoted market for the shares.\textsuperscript{62} The lack of institutional investors, together with market makers relying solely on driven-order, increases the risk of the execution price of large-size trades. For example, the Bundesbank in Germany, on behalf of the government, participates in the market on eight regional exchanges; buying and selling from time-to-time, as appropriate, to reduce price volatility and provide continuity and session (call action).\textsuperscript{63} In the Saudi market, this problem can be seen in the increasing use of face-to-face trade outside the market to execute the large transactions.

Order-driven markets, in response to challenges posed by broker-oriented markets, have introduced reforms (in terms of lower cost and better execution) which in the medium term, especially across Europe, led to a rise in liquidity.\textsuperscript{64} The increases were due to lower transaction costs for small traders, and the movement of large institutional investors to deal in these markets.\textsuperscript{65} This suggests that the absence of liquidity in the Saudi stock market is not at all surprising, since the absence of brokers from the market makes it less liquid than it would otherwise be. The Kingdom obviously has good reasons, for efficiency’s sake, to continue with its electronic, order-driven market, but in order to increase liquidity levels, it may wish to introduce reforms that stimulate competition in lower

\textsuperscript{61} Ibid., p. 37.  
\textsuperscript{63} Dattels, ‘The Microstructure of Government Securities’, p. 34.  
\textsuperscript{64} R. Schwartz, Reshaping the Equity Markets, p. 24.  
\textsuperscript{65} Ibid.
transaction costs for traders, and to make it less difficult for foreign institutional investors to trade in listed securities.

3. The Electronic Securities Information System (ESIS)

There are a variety of securities trading systems in the world today, which cannot be separated from the pricing function and the market role in the allocation of investment.66 Following the international trend toward electronic trading, the Kingdom opted for an order-driven electronic trading system.67 The Electronic Securities Information System (ESIS), which is owned and operated by SAMA, was introduced in 1990. The legal and technical infrastructure was designed and implemented by SAMA. The regulations that govern share trading through ESIS were set forth in the Instructions to Central Trading Units. The instructions for all CTUs and authorised bank branches are mandatory.68

In taking advantage of the state-of-the-art technology represented in ESIS, the Saudi Government has developed the way of trading most suitable for social and geographical needs. The order-driven based electronic system has many advantages. First, the Kingdom’s order-driven trading, in contrast to a periodic market characterised by trading intervals where buying and selling orders are

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67 C. Chapman, How the Stock Markets Work, 6th edition, Century Business, 1997, pp. 38-42. The author shows that most of the major stock markets today are no longer trading on a floor. For example, the US New York stock exchange is a floor auction with electronic order routing, and US NASDAQ is an electronic quote-driven system, plus limit orders, Japan has a floor auction and electronic order book, Britain has a mixed electronic order book and quote-driven system, Germany has a mixed floor auction and electronic order book, and France has an electronic order book.
68 Instructions to CTUs, Securities Control Department, SAMA, 1990. The Instructions have been reviewed and amended by SAMA to fit every new release in the ESIS system.
posted sequentially, offers greater efficiency for small traders.\textsuperscript{69} Government policymakers selected a continuous trading market format where trading takes place continuously through the trading period and buy and sell orders are posted for all securities contemporaneously. Accordingly, continuous trading execution permits more trading than periodic markets. Second, an order-driven market provides continuous price discovery, because it ensures the speed of price information into the market. By supplying investors with contemporaneous information on prices, transactions and market conditions, it is more likely that prices will clear at the optimal price.\textsuperscript{70} Third, an order-driven market may offer investors trading at lower cost. Evidence from European order-driven markets reveals that greater quality about order flows leads to greater post-trade transparency in the market.\textsuperscript{71} For this reason, the Kingdom's decision to invest in an order-driven market, despite liquidity concerns, was a reasonable and informed policy choice.

ESIS was developed to provide an integrated electronic trading, information, settlement and clearing system. Using central computers within SAMA and terminal workstations within the banks, a high-speed telecommunications network now links the system, offering security, fault tolerance, data integrity and a friendly user interface with fast response times.\textsuperscript{72}


\textsuperscript{72} ESIS began by linking up the 11 banks' CTUs to the main computer at SAMA through what is called ESIS PC, which enables market investors to trade in one single market. However, the ESIS PC service was limited only to Riyadh City. To close this gap, SAMA introduced what is called ESIS Line, linking up more than 80% of bank branches nation-wide to the CTUs. However, the ESIS Line service is not linked directly to the central computer at SAMA, hence its service shows the prices and quantities of the market operation 2-5 minutes later than ESIS PC. Furthermore,
ESIS was introduced with five main aims in mind. First, as noted above, ESIS provides the market with transparency through instantaneous dissemination of the bids/offers, executed quantities and prices to all market participants. Information terminals are available in more than 400 branches domestically and abroad. In fact, ESIS has enhanced transparency in the market by allowing the entire population to trade in the same market and see all the trading data and the whole process live through the computer network linked to bank branches. Second, ESIS increases market fairness by providing equal access to the market for all market participants. ESIS was designed to match the placed order and bid offer with the best available offer and bid prices. In the execution of orders, the system first gives priority to prices and then to the time the order is placed in the system. Third, ESIS tends to narrow price spreads by providing the market with buy and sell orders priced around market averages and previous results. Finally, ESIS may lead to increased market efficiency by enabling order entry, execution, settlement and transfer of ownership to take place within a very short period of time. The speed and accuracy of settlement far exceeds those specified in international guidelines.

"ESIS has increased the market liquidity and transparency. With instantaneous dissemination of bids/offers, executed quantities and prices to all market participants, and with information terminals being available in over 400 branches, I think the current trading system is transparent. Furthermore, by providing market participants with a short trading cycle, tends to increase market liquidity: by gathering all

ESIS Line branches cannot enter ESIS directly and place orders; these branches have to send orders by fax or telephone to the CTUs in Riyadh in order for them to be executed. In order to solve this problem, SAMA introduced what is called ESIS Net in 1992. ESIS Net links some branches to the main computer at SAMA, which enables them to provide the same services as ESIS PC, however, the ESIS Net service is still limited to some branches in Riyadh City and has not been expanded to the other cities in the Kingdom.


trading in one system nation-wide, the system can serve more investors all around the country, attracting more investors.\textsuperscript{75}

Although ESIS has enhanced the efficiency of the Saudi stock market since its inception in 1990, there are naturally certain limitations regarding its operation. With regard to equal execution of orders, order-driven markets typically will not treat large orders differently. Yet, it would appear that the execution costs for large traders are less than for small traders, as Nasser Al-Twaijri, Manager Brokerage & Custody Services for Local Shares, Arab National Bank, explains:

"Banks will tend to offer lower commission and may get better bid/ask quotes for large trades, given the importance of these clients to our business. We cannot deny that the size of the client and his business with the bank definitely have great impact on the level of commission and service when purchasing shares."\textsuperscript{76}

Second, the effect of large traders may have an adverse effect on prices in the market, leading to higher trading costs for small investors.\textsuperscript{77} Third, whilst ESIS is a remarkable piece of technology, the system is not presently employed for the entire market. Indeed, only a few branches across the Kingdom are positioned to execute customer orders directly through ESIS. Most of the cities within the Kingdom cannot place their order directly in ESIS, because the ESIS Net service, which links branches directly to the main computer at SAMA, is limited to a few major cities.\textsuperscript{78} As a result, traders located in other cities must fax or phone with CTU to ensure the placement and execution of any order. For example, certain banks have linked ESIS Line to only a few of their branches and

\textsuperscript{75} Interview with Maurice Gorman, SCD Advisor, Riyadh, 7 August 1997.
\textsuperscript{76} Interview with Mr. Nasser Al-Twaijri, Manager Brokerage & Custody Services for Local Shares, Arab National Bank, Riyadh, 5 September 1997.
\textsuperscript{78} Al-Jeffery, \textit{Investment in the Saudi Stock Market}, p. 40.
the link to ESIS Net is restricted to the major branches in Riyadh City.⁷⁹ In this regard, Mr. Bandar Al-Muhareb Central Trading Unit Manager and Investment Group in Saudi Holland Bank expressed the view that:

"I think that ESIS has limitations affecting investors ability of trading. The current trading system does not allow investors to buy and sell on the same day. Furthermore, the system is concentrated in Riyadh City, which favours investors in Riyadh, whereas investors in other cities have slower access and are often faced with technical mistakes, resulting in some investors' dissatisfaction with the system"⁸⁰

Clearly, the ESIS system has great potential for increasing market liquidity and trading volume through linking the system directly to market participants' personal computers. Yet, the service presently fails to reach a significant number of members in the Kingdom.

It is important to point out that Saudi law did not intend to limit trade only through ESIS. Article 19-b of the Executive Rules allows face-to-face transactions to be conducted directly through the company registrar without passing through ESIS.⁸¹ In answer to a question concerning Article 19-b and off-ESIS transactions, Basher Bakheet, General Manager of Bakheet Financial Advisors, explained:

"Whilst conducting this process has facilitated large traders with better liquidity and a reduction of execution risk, it correspondingly has limited market transparency by depriving the other investors from obtaining immediate information about the size and price of transactions conducted outside the market. One implication of this approach is that numerous informal stock brokers, who specialise in block trades, have been able to acquire

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⁷⁹ Although SAMA financed the ESIS system and monitors its development, SAMA has required banks to finance the links of ESIS Line and ESIS Net to their branches. Because most banks find it too costly to link all their branches, this limits the service to just a few branches in the major cities.

⁸⁰ Interview with Mr. Bandar Al-Muhareb Central Trading Unit Manager and Investment Group in Saudi Holland Bank, Riyadh, 11 December, 1997.

large amounts of securities outside the market, rather than buying it directly through ESIS.”

But are such off-ESIS transactions the only way to provide the conditions for institutional investors to achieve competitive trades in a market characterised by thinness and volatility?

The problem with off-ESIS trading is that the growth of those arrangements, which are purchased at better bid/ask spreads, provides better return to unofficial brokers who arrange these transactions, while providing lower execution costs overall to large investors. Perhaps the diversion to off-ESIS trading would not be problematic were the order flows smaller. The point is that unless there is a rule ensuring that investors obtain the 'best execution price' for their orders, it is likely that the divergence between ESIS and off-ESIS orders will persist, to the detriment of many small- and medium-size investors. We might wish to look to Omani stock market rules that mandate that listed companies’ shares can be traded only by licensed brokers, prohibiting any share transaction outside the exchange unless it is expressly permitted by the exchange management.83

82 Interview with Mr. Basher Bakheet, General Manager of Bakheet Financial Advisors. Riyadh, 12 December 1997. Mr. Bakheet went on to say that: ‘most large traders prefer to go through the informal traders to collect large amount of shares rather than doing so through ESIS for the following reasons. First, these brokers can guarantee the delivery of the amount needed within an agreed time which banks cannot do. Second, they can provide large traders with the best prices by collecting the amount of shares needed directly from other traders without going through ESIS, which could have a great deal of impact on the share prices. Finally, due to the fact that most of these brokers are working for themselves, they can provide large traders with a very flexible and much lower charge of commission.’

3.2 Trading procedures

ESIS provides Saudi nationals with one single floorless electronic matching system linking up the 11 banks licensed to act as stockbrokers to the system’s central computing unit, located at and supervised by SAMA. As noted earlier, ESIS is a continuous trading market where trading takes place throughout the trading period and buy and sell orders are posted for all securities contemporaneously. The ESIS system is designed to match the placed bid and offer orders with the best available offer and bid prices, according to the time they come in. Although the ESIS system is available to banks from 08:30am to 08:00pm Saturday through Thursday every day, the actual trading time only lasts three and a half hours divided between periods in the morning and evening.84

3.2.1 The morning trading period

The morning trading period lasts from 10:15am to 12:00 noon. During the first 15 minutes, all firm bids and offers in the market participate in a collective opening process.85 This process ensures that all potential traders from existing bids and offers in the market are executed at the start of the trading period. Out of this collective execution process, bids and offers are executed at the equilibrium price. This price is calculated to be the best one possible in order to process the maximum number of shares available in the market at the start of the opening period.

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84 Besides the trading period, the ESIS system goes through other different periods during the day. For example, the order maintenance and report printing in the morning lasts from 7:30 to 10:15. During this period, only trading takes place, but brokers can add and maintain order bids and offers and prints of daily reports and Ishaaraat. The same happens after the end of the morning period and before the start of the evening period.

85 The Instructions to CTUs 1990, Art. 2.2.2, Version 7.0, January 1994.
period. Al-Rashed, the Manager of the SCD noted that:

"Because we do not have official market makers or specialists to decide the opening prices for each share, we rely on the opening period to decide daily share prices. However, if there is no bid and offer in some shares in the opening period, the prices of listed shares will be decided as the last prices that share was executed." 87

The priority of execution of bids and offers during the opening execution process is the best price and time, given a particular price. 88 Firm bids and offers that were not executed in the opening period remain in the market for the trading period. The morning trading period starts as soon as the opening period ends and continues until 12:00 noon. During the morning trading period, the system automatically matches and executes firm bids against the best firm offers available in the system, provided these offers' prices are equal to or lower than bid prices. It also automatically matches and executes firm offers against the best firm bids available in the system, provided these offers' prices are equal to or higher than offer prices. 89

3.2.2 The evening trading period

The evening trading period lasts from 16:15pm to 18:30pm, using the same process followed in the morning period. The first 15 minutes constitute the opening period, followed by the evening trading period, which continues until

86 Ibid.
87 See interview with Mr. Al-Rashed, Manager of the Securities Control Department, Riyadh, 17 August 1997.
88 Instructions to CTUs 1990, Art. 2.2.2, Version 7.0, Art. 2, 1994, provide that the priority of execution of bids and offers during the opening execution process is:
   - Price: Best price (highest bid and lowest offer)
   - Time: Given a particular price, bid/offers with the earliest release date and time have a higher priority.
89 Ibid.
18:30. As soon as the evening trading period ends, the post-trading period continues until 19:30. During the first half-hour of this period, brokers are routed to settlement, and trading statistics are compiled and printed. No orders, bids or offers can be added or maintained during this period. During the last half-hour of this period, no trading takes place, but brokers can add and maintain order bids and offers and print daily reports. From the end of this period until the start of the morning trading period the following day, no user has access to the system.

3.2.3 ESIS trading cycle

A transaction through ESIS must go through a number of different steps in order to be completed, as is shown in Figure 6.4 below. First, buying and selling clients approach designated branches to place their buy and sell orders. The Instructions to CTUs have adopted the most common kinds of orders, such as Market Orders, Limit Orders and Stop Orders, which traders and brokers must use when executing their orders. These orders represent the agreement between the bank and their clients to execute specific business transactions. The system automatically validates the availability of the share and client details. Banks must also ensure that all documents supporting an order are correct and that there are no restrictions on the order. To enter an investor's order, his personal data must be either already present in the system or clearly provided with the order form. Investors that have not yet been registered in the system may be temporarily

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90 Instructions to CTUs 1990, Art, 2.2.6, Version 7.0, 1994.
91 Instructions to CTUs 1990, Art, 2.2.7, Version 7.0, 1994.
92 Instructions to CTUs 1990, Art, 2.2.8, Version 7.0, 1994.
93 Instructions to CTUs 1990, Art, 2.5.5, Version 7.0, 1994.
94 Ibid. Art 2.5 states that orders must be entered in the system as valid for 1 to 12 days. The system rejects all orders after the trading session on the last day of their validity period. Further,
added by the CTUs until they are confirmed by the SSRC. Banks must distinguish the identity of buyers and sellers and ensure that they are entitled to buy or sell the shares.\(^95\)

Second, after orders are placed at the designated branches, such orders are passed electronically to the Central Trading Unit’s (CTU) dealing room at each bank. Orders received update the CTU electronic order book.\(^96\) The electronic order book provides CTUs with an effective way of managing and tracking their orders. Although these orders are stored in the central computer system, they are only accessible by the CTU who has entered the orders and SAMA’s Surveillance Division. Only CTU brokers working in the dealing room can generate bids and offers from the orders. These bids and offers are then placed in the electronic market and displayed to all market participants.\(^97\)

Third, once the order is placed in the electronic market, the computer system will attempt to match the placed bid/offer with the best available bid/offer according to price, and then time priority. Sellers and buyers can change or cancel the placed order as long as the order is still outstanding, i.e., not expired or fully executed.\(^98\) During the opening and trading periods, the system attempts to execute all existing firm bids and offers. Traded bids/offers are executed at their limit price or at a better price. A potential of a bid and an offer by the same CTU

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95 To ensure valid identity of selling and buying investors, ESIS supports the Central Investors Database, which contains the information on individual sellers and buyers necessary to trading, settlement, share transfer and share registration.
97 Instructions to CTUs 1990, Art. 6, Version 7.0, 1994. Art. 6 states that branches should advise investors on the latest trading prices of the shares they are interested in. Where available, ESIS Line or ESIS PC should be used, otherwise the current Daily Price list should be made available.
is delayed by 15 minutes if there are no bids and offers from other CTUs at a
similar or better price.\textsuperscript{99} A firm bid or offer can be partially executed. Unmatched
bids and offers are kept in the electronic market until they are either matched by
the system of taken out of the market by the CTU brokers on request of the
client.\textsuperscript{100}

Fourth, trades are generated from matched bids and offers, and reported
electronically to the settlement system.\textsuperscript{101} The settlement system keeps track of all
trades to be settled. Settlement of book-based positions (evidenced by receipt of

\textsuperscript{99} If, within a cross delay, another CTU enters a counter-bid or counter-offer, in whole or in part at
a better price, the system shall immediately execute the just released bid/offer with its counterpart
in the cross delay.

\textsuperscript{100} Instructions to CTUs 1990, Art. 7, Version 7.0, 1994.

\textsuperscript{101} See the Electronic Securities Information System report, Securities Control Department,
ownership called an ‘Ishaaraat’) occurs in the evening of the Trade date (T) with payments being moved through the central bank accounts on the morning of T+1 certificate-based trades. Settlement of trades with certificates requires one extra day. For certificate-based trades, the transfer system generates transfer instructions in the form of reports for each security, listing the individual buyers and sellers. These reports are sent to the company registrar. The registrar cancels the certificate and updates the corresponding number of shares in the nominee central share account of the Saudi Share Registration Company (SSRC).

Finally, all banks are required to hold clearing accounts with SAMA. After settlement, net money clearance takes place with net transfer between the banks’ accounts. Settlement, clearing reports and Ishaaraat are electronically delivered back to the originating CTU or branch. Banks can integrate this information directly into their own systems, thus allowing support of custodial services and crediting of client accounts. The banks/branches either credit the client’s bank account or pay the client directly.

3.3 ESIS clearing and settlement

In this section, the Kingdom’s clearance and settlement system are examined. Clearance and Settlement systems which are effective are thought to enhance the liquidity of a market. Because of this, settlement and clearance were given the highest priority by the government in the establishment of these organisations.

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104 Ibid.
105 Ibid.
We have seen that this priority emerged from the belief that failure in clearance and settlement was the reason for the collapse of other stock markets in the region. Problems of clearance, settlement and transfer of ownership were serious problems that had troubled the Saudi market in the past.\footnote{Banafe, Saudi Arabia Financial Markets, pp. 178-179. The author states that, for example, the transfer of ownership of traded shares was the mission of the issuing company itself. Trading was limited to only the share’s certificates. The problem was that the process of transfer of ownership and registration would often take several weeks to be completed. Typically, there were faults in the delivery of money, and the certificates often led to sustained losses for investors.}

In light of this, the Saudi Shares Registration Company (SSRC) was established in 1984 in order to ameliorate these problems.\footnote{Saudi Share Registration Company Bylaw. SSRC is a limited liability partnership formed jointly by the 11 Saudi commercial banks with a capital of SR 11 million.} The SSRC was organised by the commercial banks to provide central registration facilities for joint-stock companies, and to settle and clear all equity transactions. We have noted earlier that it was only after 1989, when SAMA introduced the Automated Clearing and Settlement System, that the clearing and settlement problem was resolved to investors’ satisfaction. Initially, the SSRC’s first operations were very weak. The company recorded losses in the first eight years and relied on SAMA’s financial support to continue operating. Since 1994, the SSRC has shown great improvement in its operation and has moved into the black, recording net profits from the levy of 10\% on the bank’s securities trading commissions.\footnote{SSRC Annual Report, SAMA, Riyadh, 1997.}

The SSRC is authorised pursuant to the Instructions to CTUs, and is under the supervision of SAMA to prepare instructions to Company Registrars to effect the share transfer and registration required by trades settled in ESIS.\footnote{Instructions to CTUs 1990, Art. 3, Version 7.0, 1994.} This process is carried out by the Central Share Accounts Division of the SSRC through electronic linkage with the settlement process. The Central Share
Account maintains share accounts on behalf of investors. For each investor an account is automatically established. The shares held in the account are referred to as being 'dematerialised'. Investors receive notification of ownership in the form of an Ishaar. The SSRC is authorised to establish and maintain facilities for issue and transfer of negotiable share documents called Ishaaraat on behalf of companies listed for trading through ESIS. ESIS automatically validates availability of the shares held in the Central Share Account on order entry. As a result, holding shares in the Central Share Account is the safest option for investors. In fact, the receipt of ownership (Ishaar) is used as the mode of settlement in more than 95% of transactions in the Saudi market. The transfer of ownership is delivered automatically by computer book-entry. It should be noted that certificates may be obtained by investors wishing to have documentation through withdrawals from the central accounts and the issue of a certificate by the company registrar.

The details of all matched trades are passed to the Clearing Division within the SSRC in the evening of the Trade date (T). The seller's position in the sold share is cancelled and a new position created for the buyer's Central Share Account. The old Ishaar will be cancelled. On the morning of T-1, the new Ishaar for the buyer is printed at the branch of the bank where the client entered

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110 Ibid.
111 The Ishaar is supported by an entry in the Ishaar Register of SSRC for an equivalent number of shares. It confers on the holder beneficial ownership of the shares represented by the Ishaar, and of all dividends, rights and other distributions and any other privileges arising from the shares. In addition, Ishaar is recognised in sold and bought transactions in the Nominee Account and is valid as a negotiable document through the ESIS trading system.
112 Using Ishaar as the ownership document provides investors with faster settlement and transfer of ownership. Furthermore, if the physical Ishaar is lost or damaged, the investors' holdings are safe. Replacement Ishaaraat can normally be issued within 24 hours.
113 Instructions to CTUs 1990, Art. 3.11, Version 7.0, 1994.
their order, coinciding with the delivery of the new Ishaar on the morning of T+1. Settlement of trades with certificates require one extra day. Payments are made using net debits or credits between the banks’ accounts at SAMA (central bank funds). Banks then debit or credit their clients’ accounts. The clearing of trades is completed instantaneously in ESIS, the electronic trading system. This sophisticated trading and clearing/settlement system provides the CTUs of banks with electronic feedback of their trading activities. All aspects of the clearing and settlement process are supervised by SAMA.

The Kingdom’s securities clearing and settlement environment is much admired, since it integrates a number of services in one continuous process. During the last decade, SAMA, along with the SSRC, have developed their own modern clearing and settlement system, which meets or exceeds all major international standards. The short settlement period (T or T+1), the use of central bank funds and the fact that all brokers are large banks provide for a virtually risk-free settlement environment. In contrast, most regional markets have found it difficult to meet the international standards in clearance and settlement. For example, the survey shows that nine of the Middle Eastern stock markets could not cope with the T+3 clearance and settlement standards, combined with a high risk in their settlement environment. The advanced technology used by the Saudi market has placed it far ahead of other clearing and settlement systems in standards set forth by the Group of Thirty.

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118 Ibid.
119 Ibid. The Middle East Survey indicates that where settlement occurs later than 3 days in countries such as Tunis, Lebanon and Amman, Saudi Arabia is clearly the leader in clearing and
A Group of Thirty survey shows that the Saudi market's current clearance and settlement system works as follows:

(a) comparison occurs on the same day as the trade;

(b) trades are settled by secure book-entry transfer of securities against debit or credit entries on an account held by the intermediaries with SAMA for this purpose;

(c) settlement occurs on T+1.\(^{120}\)

Despite the advanced level of integration of the Kingdom's clearing and settlement system, there are certain limitations that still inhibit its efficiency. First, the SSRC does not provide central registration facilities for all listed companies. Al-Qahtani, Assistant Manager of the SSRC noted that:

"Whilst delegating the responsibility of all registration and shareholders affairs to the SSRC is cheaper and easier for most companies, there are only 25 of the listed companies presently working with the SSRC in this regard. The remainder of listed companies are managing their own registration through their own shareholders affair departments." \(^{121}\)

Because the computerised trading system was designed for trading by Saudi citizens, it has been observed that the Saudi electronic trading system with its short settlement period (T+1) could create difficulties for foreign investors...
who must have monies transferred to Saudi Arabia in T+1.\textsuperscript{122} Clearly, the achievement of settlement in one day gives the Kingdom significant competitive benefits relative to other settlement systems. It is worth noting that the movement towards greater international participation in the Saudi market would naturally put pressure on the policymakers towards the international settlement of T+3, given that cross-border investors would be hard pressed otherwise.

4. Taxation and Commission on Securities

The costs of trading include explicit costs (the bid-ask spread, order handling charges, commissions, taxes, etc.) and implicit costs (such as adverse price movements) which have an important influence on the efficiency of the market.\textsuperscript{123} It has been argued that when trading costs are high, investors will trade less, as trading would reduce portfolio returns. In turn, lower trading volume may reduce the efficiency of determining true price value in the market.\textsuperscript{124} It follows that investors are more likely to engage in trading when there are lower transaction costs and better incentives (e.g., competitive tax treatment).\textsuperscript{125}

4.1 Taxation

A hidden, indirect cost is taxation.\textsuperscript{126} Whilst the Kingdom does not tax personal income, it does apply two types of taxes, one for Saudis and one for non-Saudis.

\textsuperscript{122} ‘Middle East Clearing & Settlement Survey’, The International Finance Corporation and the Arab Monetary Fund, January 1997.

\textsuperscript{123} Dattels, ‘The Microstructure of Government Securities’, pp. 4-5.


First, Saudi Arabia has a religious tax, known as Zakat, which applies to Saudi individuals, wholly owned Saudi companies and Saudi shareholdings in joint-stock companies. The Zakat tax is calculated at 2.5% of the net worth, less the net value, of fixed assets after depreciation. Although Zakat tax applies on a voluntary basis to individuals, Saudi companies are liable to taxation at the rate of 2.5% of capital employed that is not invested in fixed assets and long-term investment, adjusted by net results for the year. A company which has both Saudi and non-Saudi shareholders is required to pay the Zakat tax on the Saudi shareholdings.

The second type of tax applied under the Saudi law is the income tax on non-Saudi individuals and companies. Any income derived from business conducted by persons in the Kingdom who are not citizens of Saudi Arabia is subject to tax on income from capital investment. Individuals are required to pay tax from the net proceeds or products acquired from any business in which the taxpayer has invested movable or immovable capital, buying and selling goods of all kinds and descriptions, products from the land, exchange money, and renting or leasing any means of transport, machinery or equipment.

Non-Saudi individuals are currently subject to taxation as follows: 5% on the first SR 16,000, 10% on the next SR 20,000, 20% on the next SR 40,000 and 30% on profits in excess of SR 60,000. Companies which have both Saudi and non-Saudi shareholders are required to pay income tax at the applicable marginal

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127 Zakat is an Islamic principle which levies on capital and earnings therefrom; all proceeds, profits and gains from business, industry or personal work; and property or monetary acquisitions of whatever kind of description, including commercial and financial transactions and dividends, livestock, and crops.
128 The Zakat and Income Tax Law, Issued under Royal Decree, No. 8634, 1951.
129 GCC citizens are treated under the Saudi law as Saudi citizens in respect of taxation treatment.
130 Saudi Tax law issued under Royal Decree No. 17.2.28.576. Dated 14/13/1376.
tax rate for corporations on the portion of its earnings which is attributed to non-Saudi shareholders.\textsuperscript{131} The current corporate tax rates are as the follow: 25\% on the first SR 100,000, 35\% on the next SR 400,000, 40\% on the next SR 500,000 and 45\% on profits in excess of SR 1,000,000. As corporate income tax is paid at company level, Saudi and non-Saudi individuals are remitted to shareholders without further deductions of tax.\textsuperscript{132}

Although Saudi citizens are enjoying the low tax regimes, foreign investors found it difficult to cope with the rate, which led the government to grant foreign capital the same concessions enjoyed by national capital under the National Industries Encouragement Act 1962.\textsuperscript{133} Industrial or agricultural projects with foreign capital are exempted from income and corporate taxes for ten years, and other projects for five years, from the start of production, provided that the project retains a Saudi Arabian equity participation of not less than 25\% during the period of exemption.\textsuperscript{134} For example, the high tax rate on foreign investment threatened the launch of the SAIF, as the first foreign investors fund in the Saudi stock market, which led the Ministry of Finance and National Economy to confirm that the SAIF Fund is not subject to Saudi taxation.\textsuperscript{135} Saudi taxation policy does not seem to be competitive with other taxation rules in the region at

\begin{itemize}
\item \textsuperscript{131} Non-Saudi companies’ operations taking place both inside and outside the Kingdom are subject to tax income related to their business in the Kingdom.
\item \textsuperscript{132} Saudi Tax Law, 1956, Art. 10.
\item \textsuperscript{133} See M. Al-Saleh, ‘A Study of the Foreign Investment Regulation in the Kingdom of Saudi Arabia: Law and Policy’, thesis submitted to the University of Warwick School of Law for the degree of Doctor of Philosophy, 1994, pp. 136-147.
\item \textsuperscript{134} The Foreign Capital Investment Act Issued under Royal Decree No. M/4, 2/2/1399.
\item \textsuperscript{135} See ‘The Consent of the Saudi Arabian Monetary Agency for the establishment of the Saudi Arabian Investment Fund’, SAMA Circular No. MA 1274, dated 3/12/1413, pursuant to Ministerial Decision No. 3/2052, dated 24/7/1413.
\end{itemize}
As can be seen from the above indication, the Saudi tax policy is very hard on foreign investors and it is increasing the cost of foreign participation in the Saudi stock market. The Saudi tax policy therefore would make the market unattractive to foreign investors. Obviously, there is a true need for Saudi authorities to reconsider the tax rate with the main goal of making it more suitable and attractive for foreign investment.

4.2 Commission

The other cost of the Saudi stock market is the transaction commissions. SAMA has set forth a maximum brokerage commission charged by banks based on the value of shares traded. The current brokerage fee is 0.5% for up to SR 10,000; 0.25% for SR 10,001 to 100,000; 0.15% for SR 100,001 to 500,000; and 0.1% for amounts of SR 500,001 and higher. There is a minimum commission of SR 25 on any transaction. Payment of commission is divided equally between buyer and seller. This rate is relatively expensive compared to other markets in the region and lends further support to the view that the Saudi stock market is not cheap. Moreover, banks are charging a high commission on each transaction has a negative impact on incentives which attract new investors to the market. Basher Bakheet, the General Manager of Bakheet Financial Advisors, took the view that:

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139 M. El-Erian, 'Middle East Financial Markets : Potential for Development and Internationalisation', The Middle East Executive Report, June 1994. The study shows that most of the Arabic markets have lower costing rates than those in the Saudi market.
"In fact, banks have used the commission on share transactions as incentives to attract more clients to the banks by linking the discount of the commission to the size of the client, which itself make the cost of transaction more expensive for the small investors than the large investors."  

Initially, the introduction of a high commission was needed to encourage banks to provide the services and invest in the training and technology required. Yet the persistence of high commissions, relative to other markets, suggests that the monopoly enjoyed by banks on the provision of services is a partial reason for the static quality of service for investors, as well as high prices.

5. Summary

In this chapter we have examined the main aspects of the Kingdom’s market micro-structure. The development of the Kingdom’s electronic trading platform and clearing system has, due to their effectiveness for investors, signalled a major shift toward the creation of a world-class market. More specifically, the reliance on advanced technology has been crucial to the Kingdom’s ability to meet and surpass the G-30 international benchmarks in trading execution and settlement. Yet, to enhance the liquidity level in the market, the existing infrastructure must be supplemented. In the long run, the most pressing issue in reform will be the development of a securities regime that allows for the introduction of non-bank intermediaries to function in the market.

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140 Interview with Basher Bakheet, General Manager of Bakheet Financial Advisors, 12 December 1997.
Chapter 7

The Saudi Disclosure Regime

1. Introduction

This chapter provides a unified approach to disclosure of information to investors in the Saudi market. It is now widely appreciated that disclosure of information is one of the key principles for the effective operation of stock markets. Requirements to disclose specific financial information and business facts and events (with the exception of confidential information) now dominate the system of disclosure in Europe and the US. The obligation of firms to disclose information is triggered by specific events, first through registration and subsequently through periodic reporting, which form the foundation of the mechanics of disclosure. Whilst the level and nature of information disclosed varies across regimes, the task of disclosure is to provide a feasible and reliable means to inform investors about information and events which could affect their expectations about investments in a firm’s securities. The aggregate cost of disclosure will vary depending on the registration system and, among other things, the difficulty in meeting the demands of the regulators.

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The disclosure duty in Saudi Arabia can be seen to emerge from three different sources in the Kingdom’s regulatory regime. The first involves registration. Issuers, whether issuing anew or announcing a new development, are required to file a public report with the Ministry of Commerce. \(^6\) It is this category of disclosure requirements, most of which is administrative, which ensures that firms make adequate information available to the market so as not to mislead investors. Second, the Companies Act requires publicly listed companies to file annual reports. \(^7\) The Executive Rules require also that firms submit quarterly reports. \(^8\) Finally, the Disclosure Rules 1997 require listed companies to carry out disclosure on a continuous basis. \(^9\)

The aim of this chapter is to assess the pattern of the disclosure rules in Saudi Arabia. Until recently there was very little concern about this issue. \(^10\) This may have simply been due to the fact that firms were not obliged, in order to avoid misleading investors, to release accurate statements about the state of the firm’s functions and events. \(^11\) Unlike the US, which has developed a painstaking regime of continuous disclosure under the Securities Exchange Act of 1934, requiring firms to file comprehensive sets of periodic reports to the Securities and Exchange Commission (SEC), the Saudi regime has, like most developing

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\(^6\) Companies Act 1965, Art. 52 & 64; See also, ‘The Guidelines for the Conversion of Companies to Joint Stock Companies’ issued by the Ministry of Commerce, Circular 495, dated 25/3/1418-29/7/1997, Art. 2.4.

\(^7\) Companies Act 1965, Art. 123.

\(^8\) The Executive Rules To Regulate Share Dealing In Company Shares Through Commercial Banks, SAMA Circular to all banks, General Banking Control Department, Saudi Arabia, December 1984, Art. 19.


countries, only recently acknowledged the importance of imposing a disclosure duty on the management of firms.\textsuperscript{12} This chapter will, therefore, examine the current system of disclosure in Saudi Arabia, assessing whether they are adequate for their intended purpose. We shall question whether, in light of the limitations of the current approach, a new set of rules is necessary to facilitate the release of information needed by investors.

Corporations typically generate significant amounts of information that investors seeking trading profits wish to acquire. Managers are prepared to disclose some of it voluntarily to satisfy investors but, naturally, not all of it.\textsuperscript{13} However, international experience teaches us that, unless it is mandatory, hardly any disclosure is given, especially by smaller companies that tend not to attract institutional investors.\textsuperscript{14} Disclosure rules establish a general obligation for publicly traded firms to disclose information pursuant to specific statutes, rules, regulations, schedules and items.\textsuperscript{15}

Disclosure refers to the “deliberate public release of financial information, whether voluntary or required, numbers, words, formal or informal, any time during the year”.\textsuperscript{16} More generally, disclosure can be understood in terms of the publication of any economic or corporate information relating to a business

\textsuperscript{12} While it may sometimes seem that the US requires too much disclosure, it would appear that most other countries require too little and have too much room in their accounting rules for fudging. See H. Scott & P. Wellons, \textit{International Finance: Transactions, Policy, and Regulation}, Westbury, New York, 1995, pp. 300-311.
\textsuperscript{14} Coffee, ‘Market Failure and The Economic Case for a Mandatory Disclosure System’, pp. 739-743.
enterprise, quantitative or otherwise, which facilitates the making of economic
decisions.\textsuperscript{17} Despite the seeming simplicity of the concept, few issues in today's
securities market are more contentious than the debate surrounding disclosure.
Does the mechanism of disclosure of company information provide the investor
with the material information needed for trading? Can publicly traded firms
afford to comply with a general disclosure rule that requires continuous periodic
reporting of sensitive information? How can exchanges and regulations guarantee
that the required disclosure is adequate? Is mandated disclosure an achievable
goal, or is it an amorphous concept like market efficiency? These issues represent
some of the problems surrounding disclosure and the difficulties of generating a
coherent and credible vision of what the practice should entail.\textsuperscript{18}

This chapter is organised as follows; in Section 2 we consider the
theoretical aspects of disclosure, with particular attention given to the economic
aspects of enhanced information flow to the market. Section 3 considers the Saudi
approach to disclosure by reviewing the obligations of firms to provide financial
information, such as annual reports, in specific time frames as well as the
obligation to disclose information triggered by events, such as a firm listing its
shares in the Saudi stock exchange. In Section 4 we examine the impact of the
new Disclosure Rules on the practice of company disclosure. The chapter's last

\textsuperscript{17} S. Choi, 'Financial Disclosure and Entry to the European Capital Market', \textit{Journal of
Accounting Research}, Vol. 11, No. 2, Autumn 1973, pp. 159-175.

\textsuperscript{18} Mandatory Disclosure has been subject to a long debate. A number of commentators have
suggested that mandatory disclosure is not necessary. See, for example, G. Stigler, 'Public
Regulation of the Securities Markets', \textit{Journal of Business} 37, 1964, p. 117; G. Benston,
'Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange', \textit{American
does not benefit investors. However, others have argued that mandatory disclosure is necessary to
overcome 'market failure' associated with the private production of securities information. See,
for example, I. Friend & R. Westerfield, 'Required Disclosure and the Stock Market: Comment',
\textit{American Economic Review}, Vol. 65, No. 3, June 1975; Coffee, 'Market Failure and The
section provides an analysis of disclosure requirements on firms' managers of tender offers, and the need to establish provisions that encourage the flow of accurate information to investors and the market.

2. Theoretical Perspective on Disclosure

The importance of disclosure is best understood in the context of the role and meaning of information in the economic market. The basic question is: what role does information play in a competitive market? Information plays a vital role in share prices, and subsequently underlines the importance of providing investors with as much material information as possible. Securities regulation in the US and other jurisdictions, by its focus on disclosure, has contributed to raising such questions and issues as fairness, social welfare, investors' protection, and market efficiency. Many commentators have argued that the essential purpose of all securities regulation is to ensure that markets operate freely and fairly. Proponents, such as Brudney, argued that market participants should have equal access to information regarding companies that are publicly traded. Upon entering a market they are assumed to receive equal treatment and equal access to information relevant to the shares they wish to trade. These commentators insist

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20 See S. Grossman, *The Informational Role of Prices*, The MIT Press, London, 1989. Grossman states that it is a common theme in most discussions of the competitive price system that prices convey information. He added "Hayek (1945, p. 527) wrote, 'We must look at the prices system as ... a mechanism for communicating information if we want to understand its real function.... The most significant fact about this system is the economy of knowledge with which it operates, or how little the individual participants need to know in order to be able to take the right action'".


that the unfairness is not just a question of merely possessing more information or not. It is often the case that certain investors will possess more information than others.\textsuperscript{23} In this regard, unfairness is thought to arise when material information is available to some investors lawfully, when it cannot, lawfully, be acquired by others.\textsuperscript{24}

One of the crucial aims of securities regulation worldwide is the protection of investors. Many countries have used investors' protection as the basis for requiring full disclosure.\textsuperscript{25} Investors may lack resources to request the information of issuers and analyse it effectively. By regulating the market through disclosure requirements, securities regulators provide the mechanics of making information available to investors regarding a particular security.\textsuperscript{26} Additionally, securities regulation may play a role in forcing companies to provide information truthfully to investors, since without truthful disclosure investors may be unable to distinguish between fraudulent and honourable companies.\textsuperscript{27} In this regard, the truly uninformed investors who are not able to distinguish between the two types of companies will inevitably choose to disregard all stock in the market. The result is that quality issuers will be significantly deterred from issuing securities and may choose to leave the market. The problem of adverse selection by issuers, in which high-quality companies cannot obtain fair market value for their

\textsuperscript{23} Ibid., p. 346.
\textsuperscript{24} Opponents of the fairness argument suggest that investors can overcome the less informed investors' problem by relying on information from intermediaries regarding their potential investment or by investing with different types of intermediaries to invest for them. See, for example, W.H. Beaver, 'Future Disclosure Requirements May Give Greater Recognition to the Professional Community', \textit{Journal of Accounting Research} 44, January 1978.
\textsuperscript{26} Coffee, 'Market Failure and the Economic Case for a Mandatory Disclosure System', pp. 740-743.
\textsuperscript{27} Easterbrook & Fischel, 'Mandatory Disclosure and the Protection of Investors', pp. 677-678.
securities while low-quality companies continue to operate in the market, presents investors with a ‘lemon’s problem’. 28

Some commentators have argued that the adverse selection problem can be successfully addressed by introducing institutions that foster full disclosure. 29 It is often argued that rules that prompt full (or nearly full) disclosure will increase the informational efficiency of the stock market through the enhancement of investors learning the best price, and thereby reducing the concealment of such information. 30 At the same time, as the quality of information increases, investors will come to have greater confidence in the disclosure statements of companies and will therefore pay a higher price for their securities. 31 At the very least, therefore, higher-quality issuers will be attracted to the market, since they will be able to distinguish themselves successfully from low-quality issuers. Investors will benefit as long as it is clear that low-quality issuers can be mostly kept out of the market. 32

Yet, increased regulation may not lead to an increase in investor welfare. To be sure, compliance costs in the United States are not trivial. 33

30 J. Coffee, ‘Market Failure and The Economic Case for a Mandatory Disclosure System’, p. 751. Coffee states that the strongest arguments for a mandatory disclosure system may be efficiency-based. Empirical data strongly suggests that adoption of a mandatory disclosure system reduces price dispersion, thereby enhancing allocative efficiency of our capital markets.
31 Informational efficiency is defined as the degree to which stock prices reflect information that is available about performance of the companies. According to the academic literature, the Efficient Market Hypothesis (EMH) is subdivided into weak-form efficiency, semi-strong-form efficiency and strong-form efficiency. See S. Keane, Stock market Efficiency, Theory, Evidence and Implications, Philip Allan Publishers Ltd., Oxford, 1982.
33 L. Loss & J. Seligman, Fundamentals of Securities Regulation, Little, Brown & Co., Boston, 1988, p. 39. The authors state that the average cost for a company’s offering documents to comply with disclosure requirements is between 1.5% to 2% of the proceeds.
regulation in the US introduced a number of stringent controls to counter the problem of adverse selection, supported by monetary sanctions for false or misleading disclosure. These are enforced by a regulatory body (the SEC), which has a large staff and budget to pursue firms that dishonestly disclose information. At the same time, the accounting requirements make it less likely that a publicly traded company will be able to deceive or confuse professionals, and accounting rules make it less possible for fraud or extreme embellishment to occur in company reports. Thus, even naive investors may, with the information provided to them through disclosure, be in a position to make informed judgements when making a choice about investing in the market.

As noted above, the compliance can be very expensive. Due diligence investigation is costly too. Yet, without these investigations, the adverse selection costs will increase. It may be that a cost benefit analysis is required to determine when regulatory controls become excessive. This implies, at the least, that if the costs of compliance exceed the benefits to investors, making it (too) costly to invest, then the regulation should be relaxed so as not to impose higher costs on them. This approach provides protection to investors, while recognising that

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34 L. Lowenstein, 'Financial Transparency and Corporate Governance: You Manage What Your Measure', p. 1353. Lowenstein writes that at the SEC, there are 120 accountants just within CorpFin – one half of its review staff – reading annual reports and other filings. They are an integral part of what Linda Quinn, until recently director of the Division of Enforcement, liked to call the Commission's “active oversight” function. Why wait, she argued, until losses have been suffered? Why let misrepresentations and errors fester until only the Division of Enforcement can act? Those 120 accountants in CorpFin, who have no counterpart elsewhere, monitor routine filings and are likely to be the first to see emerging issues. The division then compiles a list of 'hot issues', so that by a speech here and a discussion there, the staff can alert the business community as to what is to be expected.


37 Coffee, 'Market Failure and the Economic Case for a Mandatory Disclosure System'. Coffee argues that a mandatory disclosure system reduces the costs incurred by market professionals.
increased regulation does not necessarily lead to the most efficient outcome for investors.

There are a number of different disclosure regimes. Investors may gravitate to those securities regimes that provide them with regulations that offer accurate information that can be relied upon when determining the value of a security. To function well, lawmakers will design rules that foster clarity and efficiency in the provision of information to investors.

Against this background, we turn to the analysis of the Saudi disclosure regime, concentrating on the rules and procedures for the release of company information to the market.

3. The Saudi Disclosure Regime

The analysis of the previous section suggests that an information asymmetry between investors and the market is best reduced by a system of truthful disclosure, where investors can become reasonably informed about the value of a firm's securities. In this section we begin by looking at the Saudi disclosure regime, which can be found in the Companies Act 1965, governing public offerings and incorporations, the Executive Rules 1984, and the Disclosure Rules 1997.

We first turn to the disclosure requirements inaugurated initially in the Companies Act 1965. Since its enactment, the Companies Act has played a major role in fostering disclosure and providing investors with essential important information about companies in general, and joint-stock companies in particular.

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Since then, all types of companies have been required to comply with the Companies Act’s rules in order to register and operate within the Saudi jurisdiction. As noted previously, the Act delegates regulatory agency responsibility to the Ministry of Commerce, which has exclusive power over the establishment of joint-stock companies, and the issuance of securities by publicly traded companies. The Companies Act provides the disclosure requirements for joint-stock companies in two stages. In Saudi Arabia, the Companies Act was largely enacted in order to acquire information about companies when making registrations. The Act requires public companies to file annual reports; the idea is that Saudi companies have a duty in this context to supply material information about their functions and events that may affect the financial performance of the firm.

3.1 The registration statement

A duty to disclose arises when a Saudi firm files a registration statement with the Ministry of Commerce. In this category of disclosure, the firm must supply information prior to being granted the authorisation to incorporate under Saudi law. A company filing with the DoC at the Ministry of Commerce provides investors with their first chance to examine certain financial facts about the applicant. The application for registration requires that the company state its main purpose and function, its structure, the manner of subscription for the company’s

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39 Although the Companies Act set up the first disclosure requirements in 1965, the accounting profession and practices were not founded until 1971. See A. Shinawi & W. F. Crum, W.F. ‘The Emergence of Professional Accounting Education and Research’, International Journal of Accounting Education and Research, 6, 1971.

40 Companies Act 1965, Art. 52, prohibits the incorporation of any companies that are not authorised and approved by the Ministry of Commerce.
capital, the number of shares reserved by the founders for themselves, as well as the amount subscribed by each founder. The company must also submit a copy of the company’s memorandum of association and bylaws, which must be signed by the incorporators and other founders.

A second category of disclosure occurs under the Companies Act when a firm files a prospectus prior to the initial public listing of shares. If a company wishes to offer its shares to the public, it is required to disclose certain information in its prospectus. The prospectus requires that firms disclose the following information:

- The company’s name, objective, and head office;
- The amount of paid-in capital; the classes of stock, their value, number, the amount offered for public subscription, the amount subscribed for by the founders, and the restrictions imposed on the negotiability of shares;
- The particulars concerning contributions in kind and the rights attached thereto;
- The special privileges granted to the founders or others;
- The method of distribution of profits;
- The estimated amount of the company’s preliminary expenses;
- The dates set for opening and closing the subscription and the places and terms thereof;

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41 Companies Act 1965, Art. 52-3.
42 Since the application statement, forms filed to the Ministry of Commerce are the starting point for the establishment of such companies, the Department of Companies has the right to reject the application or to call for more information to be disclosed or alterations to be made. If the application is initially accepted, all its information is open to public search.
43 Although the law in most jurisdictions defined the term 'prospectus', the Saudi Companies Act did not and referred to it as 'an invitation for subscription'.
44 Companies Act 1965, Art. 55.
The method for the allotment of shares to subscribers, if the number of shares subscribed for exceeds the number offered for subscription;

- The date of issue of the Royal Decree authorising the incorporation of the company and the number of the Official Gazette in which it was published.45

The goal of the Saudi prospectus disclosure requirement is that the market receives sufficient information about the new company issuing shares, so that a decision to invest in shares can be made with a reasonable amount of confidence. The Companies Act, in order to ensure compliance with its disclosure requirements, created joint liability for founders of disclosures that contain untrue or misleading statements or important omissions.46 The Act provides for both criminal and civil liabilities for any violation of these rules. Yet, while the publicly stated objective to protect the capital market is reasonable, and certainly consistent with regimes in other jurisdictions, a well-functioning market requires that action be taken against parties that fail to observe these standards. In this regard, the history of the Ministry of Commerce in enforcing violations suggests that the disclosure obligation is not a serious requirement.47

As previously noted, the disclosure requirements under the Companies Act are not sufficiently market-based as to provide for the kind of information required to inform investors about the price characteristics of the stock. In the US

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45 Companies Act 1965, Art. 55-3
46 Companies Act 1965, Art. 55-4, states that the founders shall be jointly responsible for the correctness of the particulars contained in the prospectus, and for setting forth in it all the particulars referred to in the third paragraph of Art. 55.
47 Companies Act 1965, Art. 229, provides that any founder, manager or director who invites public subscription for shares of stock or bonds in contravention to the provision of the Companies Act regulations, or anyone who knowingly signs or distributes such documents, shall be liable for imprisonment for a period of not less than three months and not more than one year and/or a fine of not less than five thousand and not more than twenty thousand Saudi Riyal. Despite the existence of such penalties, few cases have been brought in this context yet. See interview with Soleman Al-Mohemmeed, Department of Companies, Ministry of Commerce, Riyadh, 3 November 1997.
regime of mandatory disclosure, the promoters of IPO companies are responsible for supplying information on valuations, free cash flow, earning projections, potential risks and contingencies, and significant amounts of other information that enables investors to make informed decisions regarding the company's share price and its future movements.\textsuperscript{48} In contrast, the Kingdom's disclosure regime in respect to IPOs is based on a merit approach, whereby the Ministry of Commerce, by its authority under the regulation for companies, has the responsibility to review a company's filings for incorporation, or conversion to joint-stock status.\textsuperscript{49} The criteria regarding conversion and offerings are designed to allow the Ministry of Commerce considerable discretion in its review of the proposed primary issue, which includes analysis of management, issuers' assets and material facts related to appraisal. Like the early 'Blue Sky' laws in the United States, which also mandated 'merit review', the Ministry of Commerce evaluates offerings by reference to whether the sale of securities would harm the interest of investors or not.\textsuperscript{50} In this regard, the Kingdom's model of new issue regulation evaluates the application on the basis of whether the sale is conducted on fair grounds and whether the price of the issue offered is fair.\textsuperscript{51} Unsurprisingly, the so-called merits system of disclosure was rejected early on by the legislative draftsmen of the US Securities Act as being too crude, in favour of a pure disclosure regime,


\textsuperscript{49} 'The Guidelines for Conversion to Joint Stock Companies', issued by the Ministry of Commerce, Circular 495, dated 25/3/1418-29/7/1997, established rules for submission of applications to the Ministry of Commerce in respect of the conversion to joint-stock companies.


\textsuperscript{51} Unlike most mature markets, where the offering price is usually suggested by underwriters on the basis of market conditions at the offering date, the Ministry of Commerce, through the General Department, will state the initial offering price after reviewing the company's documents.
which relies on well-accepted business principles.\textsuperscript{52} Based on this analysis, the Ministry of Commerce’s approach to the evaluation of companies’ offerings suffers from a range of problems. In absence of a regime that makes this role a priority for them, the Kingdom’s model must be viewed as largely incomplete. It is ill-equipped to assist investors in accurately evaluating risks and returns concerning new issues, both in terms of supplying information about the capital structure, accounts and earnings, and of mandating that the promoter has a fiduciary duty to the investors by providing them with specialised information concerning the profitability of the new issue.

In practice, the Ministry of Commerce requires that each company applying for conversion to a joint-stock company must have reached a certain, significant profitability and size in the years preceding the application.\textsuperscript{53} These conservative standards and strict requirements restrict many potentially high-growth companies from going public. The argument advanced should not be construed as a suggestion that the Ministry of Commerce should allow just any company to go public, but rather that the Kingdom’s requirements must be updated and revised so as to narrow the information gap between issuer and market investors.

\textsuperscript{52} Mahoey, ‘Mandatory Disclosure as a Solution to Agency Problems’, 43, p. 1076.

\textsuperscript{53} See ‘Guidelines for Conversion to Joint Stock Companies’, No. 495, dated 25/3/1418, Ministry of Commerce. The Guidelines state that a company wishing to convert to a joint-stock company must have been established for at least 10 years, have net assets and shareholders’ equity of no less than SR 75 million and a return on equity of no less than 10\% in each of the preceding five years. In addition, a feasibility study must confirm that the return will not be less than 10\% in each of the five years following conversion.
3.2 The annual reports

The duty to update information is also required under the Companies Act. The duty to update is based on the idea that investors, in order to stay informed of the financial health of the company, require continuous and accurate information about the firm's assets and liabilities. In this regard, the Act requires that chairman and directors supply updated information by filing an annual report. Besides the initial prospectus and other registration documents, a company's annual report and accounts normally provide more information about the firm's finances than any other document it publishes. Typically, the annual report informs the company's shareholders and potential buyers about the company's financial condition, results of its operations, capital resources, income and dividends, and provides an estimation of its future earnings potential.

Saudi law is no different in this respect. To better enable investors to assess the quality of the initial disclosure, the Companies Act requires that a company file annual reports. Under the Act, the Board of Directors of any joint-stock company is required every year, at least 60 days prior to the date set for the Annual General Meeting, to prepare a balance sheet, a profit-and-loss statement, a report on the company's operations and financial position, and a statement of the method by which it proposes to distribute net profits. The report must be signed by the chairman of the Board of Directors, and copies placed at the disposal of the shareholders and head offices of the company at least 25 days prior to the date set.

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55 Companies Act 1965, Art. 123, states that at the end of every financial year, the Board of Directors shall make an inventory of the value of the company's assets and liabilities as of that date and prepare a balance sheet of the company, a profit-and-loss statement and a report on its operations and financial position for the expired financial year, setting out the proposed method for the allocation of net profits.
for the General Meeting. In order to make the information available to investors, the chairman of the Board of Directors must publish, in one of the local newspapers, the company’s balance sheet, its profit-and-loss statement, a comprehensive summary of the Board of Directors’ report, and the full text of the auditor’s report. The firm must also dispatch a copy of each of these documents to the DoC at least 25 days prior to the date set for the General Meeting.56 At the end of every financial year, companies must also take an inventory of the value of the company’s assets and liabilities as of that date and prepare a balance sheet, a profit-and-loss statement, a report on its operations and financial position for the past financial year, and an outline of the proposed method for the allocation of net profits. The Board must deposit the documents with the auditor at least 55 days prior to the date set for the General Meeting.57

In addition to the annual report, the company’s auditor is required to submit a report to the annual general shareholders’ meeting. The report provides shareholders with information regarding any potential violation of the Companies Act or of the company’s bylaws that have been discovered, and the extent to which, in the opinion of the auditor, the company’s accounts are in conformity with generally accepted accounting standards.58 In addition, the auditor’s report must be read at the General Meeting. The General Meeting may not approve the Board of Directors’ report without hearing the auditor’s report. Although the disclosure requirements of the Companies Act are not as stringent with disclosure

56 Companies Act 1965, Art. 98.
57 Although many jurisdictions have paid considerable attention to disclosure through proxy statements (a document signed by a shareholder of a corporation authorising a designated person to vote his shares of stock at a specified shareholders meeting, which must be filed with the securities holder), the Saudi Companies Act failed to provide ample rules governing this area, leaving the organisation of proxy and other matter relating to voting to the company’s bylaws.
58 Companies Act 1965, Art. 132.
obligations as requirements in many other jurisdictions, a great number of Saudi joint-stock companies have nevertheless found it very difficult to comply with these rules. In this regard, Radi Haddad, Manager of the Investment Services Dept., Riyadh Bank, reported in an interview:

"Despite the less than restrictive annual disclosure requirements, only certain large companies and banks have published sufficiently comprehensive reports. These firms are motivated either by concern for their international reputation or a desire to satisfy the interests of their foreign shareholders. In contrast, domestically controlled companies have fewer pressures to report accurately to investors."

Recent empirical research reveals that the level of financial disclosure provided in Saudi corporate annual reports is very poor. In a study by Al-Mulhem, for example, none of the Saudi corporations that he examined complied fully with the mandatory information rules. Al-Mulhem states that "the study indicated that none of the 40 corporations investigated comply fully with mandatory requirements. Even those companies that disclose the most, still fail to meet a considerable number of mandatory regulations." For this and other reasons, the Ministry of Commerce has been prompted to develop new ways of strengthening the disclosure requirements, requiring all joint-stock companies to follow a standard set forth by the Saudi Organisation for Certified Public Accountants.

60 Interview with Mr. Radi Haddad, Manager of the Investment Services Dept., Riyadh Bank, Riyadh, 13 December 1997. Mr. Haddad went on to say: "... with the exception of SABIC and large banks, most listed companies do not comply with the regulations of time or quality of disclosure set forth by the Ministry of Commerce."
62 Ibid. Al-Mulhem states that the results of these studies provides the regulatory authorities in the Kingdom with firm evidence that Saudi corporations are not fully complying with the mandatory rules. Overall disclosure indexes vary between companies, ranging from 38% to 76%.
63 Saudi Organisation for Certified Public Accountants, issued by Royal Decree No. M/12, dated 13/5/1412, under the jurisdiction of the Ministry of Commerce.
In 1997, the Saudi Organisation for Certified Public Accountants issued what is called the General Presentation and Disclosure Standard, which sets forth the general presentation and disclosure requirements of financial statements, including consolidated and development-stage company financial statements.\(^{64}\) The General Presentation and Disclosure Standard prescribes the treatment for accounting changes and contingencies. More specifically, it prescribes requirements with respect to the disclosure of the identity of the reporting entity, the nature of its business, characteristics of its financial statements, its accounting policies, and reporting of changes, contingencies, commitments and events.\(^{65}\) The Ministry of Commerce responded quickly by adopting the General Presentation and Disclosure Standard and applied it to all financial statements of business enterprises, regardless of the legal form of the reporting entity or the nature of its business activities.\(^{66}\) Whilst the standard proposed is a good mechanism to prompt better disclosure levels, many of the joint-stock companies could not comply with it, because they found the rules either too difficult to comply with, or because they felt the rules did not fit their interests. In this respect, Yousef El-Mobarak, Secretary General of SOCPA, noted that:

"The adoption of the standard was to provide people with better information. However, some companies have not complied with the standards for different reasons. For example, banks that have adopted their own accounting and disclosure requirements which suit the nature of their own business do not want to change."

\(^{64}\) Ibid.
\(^{66}\) See Ministry of Commerce Circular to all joint-stock companies, No. 222/400/4783, dated 2/9/1415.
\(^{67}\) See interview with Mr. Yousef El-Mobarak, Secretary General of SOCPA, Riyadh, 27 August 1997. See also SAMA circular to all banks, No. M.A/382, dated 22/7/1415.
Unfortunately, the Ministry of Commerce's adoption of the General Presentation and Disclosure Standard, does not improve reporting standards for investors and shows little influence on whether the company actually satisfies the disclosure obligation. In order to ensure complete and proper disclosure, the Ministry of Commerce will certainly have to introduce other requirements.

4. The Stock Market Disclosure Rules

Stock exchanges in most countries require all companies which wish their securities to be traded on the stock exchange to publish more initial information than was required by the prospectus requirements of the Companies Acts. As in most jurisdictions, in Saudi Arabia there are stock market rules that mandate disclosure. The stock market disclosure rules are governed by the Executive Rules, Instructions to Central Trading Units, and the Disclosure Rules. The stock market rules were designed to supplement disclosure requirements set forth by the Companies Act, which were perceived as insufficient to satisfy the information requirements of market investors. We now turn to the analysis of the listing requirements.

4.1 The stock market listing requirements

Listing requirements are major features of the main stock markets today. Stock exchanges usually require companies seeking listing to enter into a listing
agreement with the exchange, under which, for the privilege of listing, the company agrees to publicise more information on a continuous basis, over and above the limited annual reports and accounts required by law. Whatever the motives for seeking listing, an issuer today must meet the stricter disclosure and financial reporting requirements required by stock markets worldwide. Clearly, listing requirements play a larger role than merely acquiring more information from companies. First, they serve the primary purpose of any stock exchange, which is to foster public confidence in the market: namely, they ensure that each applicant for listing is of at least a minimum size, has sufficient history and provides adequate information in the prospectus to form a reliable basis for a market evaluation, that all issuers are marketed on a fair and open basis, with public participation when appropriate, and that the company treats investors with proper consideration at all times, even when they represent a minority. Second, and most importantly, listing requirements enhance the power of the market rules and their enforcement. Any company obtaining listing on the stock exchange is deemed to have accepted the rules and supervision of the stock market authorities. This underscores the necessity for them to be one of the essential requirements, not only in the mature market but also in most of the emerging


Ibid., p. 1429.


Ibid.

See Reed, 'The Stock Exchange Listing Agreements as a Vehicle for Corporate Governance', p. 1444.
market as well. This is particularly true for the Middle East markets, especially the relatively closed market of Saudi Arabia.\footnote{See M. El-Erian, ‘Middle East Financial Markets: Potential for Development and Internationalization’, \textit{Middle East Executive Report}, June 1994.}

Although listing requirements typically provide market participants with a mass of detailed information and better control over those companies who seek to go public, neither the Executive Rules nor the Disclosure Rules have any listing requirements. Companies granted a licence to operate as a joint-stock company from the Ministry of Commerce are automatically qualified for listing. According to the Companies Act, issuers are allowed to float shares as soon as the subscribers receive the share warrants and register the transfer with the company.\footnote{Companies Act 1965, Art. 102, states that registered shares shall be transferred by means of an entry in the stockholders' register kept by the company, containing (1) stockholders' names, nationalities, residence addresses and occupations, (2) serial numbers of the shares held by them, and (3) the amounts paid up on such shares. An annotation shall be made on the share warrants to the effect that such an entry was made. A transfer of title to any registered share shall be effective as far as the company or third parties are concerned only from the date of its entry in the said register. Shares to bearer are transferable by mere delivery.} This central omission in the Saudi disclosure regime is allegedly justified by the view that if joint-stock companies are required to comply with the listing requirement, issuers would also be obliged to provide disclosure in accordance with the Ministry of Commerce's prospectus requirement. While listing requirements are viewed as necessary in most jurisdictions because they provide investors with the relevant financial information immediately, the stock market regulatory body apparently also holds the view that listing requirements, as applied to joint-stock companies, could be an unnecessary duplication.\footnote{See for example S. Malaikah, 'Saudi Arabia & Kuwait: A Study of Stock Market Behaviour and its Policy Implications', dissertation submitted to Michigan State University for the degree of Doctor of Philosophy, 1990, pp. 17-19.}

Presently, the disclosure regime of Saudi Arabia has no specific listing
requirements for publicly traded companies. Listing rules are designed to provide information about events that would materially affect the price or value of the company’s securities. Firms are required to release this information as soon as the company becomes aware of the information.

It is submitted that the Ministerial Committee should enact new listing requirements, or amend the Disclosure Rules 1997, which require that publicly traded companies comply with a set of Saudi exchange disclosure rules. The Ministerial Committee could formulate a set of rules, starting with the general mandate that joint-stock companies be required to immediately make available any relevant material or information that a reasonable investor would expect to affect the value of their share price. This rule would not apply to particular information. It might further provide that the Ministry of Commerce, or SAMA, be given the discretion to ensure that disclosure requirements are translated into rules that ensure fair information to the market generally. This proposed amendment is consistent with the Ministerial Committee’s modern trend of requiring firms to also report continuously. In this regard, while the Saudi disclosure regime is bereft of listing rules, it mandates that firms provide periodic and continuous reporting as set forth in the Disclosure Rules, Article 2. Hence, the Ministerial Committee can be expected to supplement the regime by offering a compliance structure that enhances the delivery of important financial information to the market.
4.2 The stock market periodic reports

As we have argued, the Executive Rules do not oblige firms to comply with any listing requirements. The Executive Rules do, however, provide for quarterly periodic reports. In addition to the annual financial reporting requirement, the Executive Rules seek to provide investors with more information, by requiring each company to publish quarterly information of its financial position and its operating activities. The report must be published in two daily papers within a two-month period from the end of the quarter. Companies that do not comply with the disclosure requirements will be held liable, usually by being suspended from share trading in the market, or with punishments available pursuant to the Companies Act. Our interviews with SAMA officials revealed that, despite the penalties available under the Act, few, if any, companies have been held liable for disclosure non-compliance.

The quarterly report is required to contain the company’s balance sheet, profit-and-loss statement, summary of the Board of Directors’ report and the full report of the company’s auditor. Unsurprisingly, it is only large companies and banks, as with the annual report, who have been able to comply with the quarterly disclosure requirement. It is even less satisfactory that the publication of the financial figures about some companies did not offer a truly clear idea about the financial position of these companies, since ‘bad’ news is almost never

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77 ‘Executive Rules to Regulate Share Dealing in Company Shares through Local Banks’, SAMA circular to all banks, General Banking Control Department, Saudi Arabia, December 1984, Art. 19.
78 Executive Rules 1984, Art. 19-d.
79 Interview with Al-Rashed, Manger of the Securities Control Department, Riyadh, 17 August 1997.
80 It is clear that banks comply with the quarterly report because they are directly supervised and regulated by SAMA, under which the SCD falls. However, other joint-stock companies continue
Until recently, the release of information was a serious problem in the Saudi market. Many companies try to hide bad news from investors and only publish reports concerning predictions of the future success of their operations. Radi Haddad, Assistant Senior Manager of Investment Services Department of Riyadh Banks, took the view that:

"The Saudi disclosure regime is not satisfactory at all. Indeed, I think that the disclosure regime is the most serious problem threatening the market. I believe that the timing and type of information published by most listed companies has not helped investors in making their investment decisions. Not only does the delay of publications fail to meet the required standard, but also the type of information. Furthermore, due to the lack of listing requirements as well as other reporting requirements, there is little to be gained from the disclosure regime."

There are several explanations of the perceived failure of firms to comply with quarterly reporting requirements. It may be that the cost of hiring good accountants is too high for small firms. Yet, beyond a cost explanation, it must be assumed that since the Ministry of Commerce does not appear to punish violators, firms have little compulsion, unless they have foreign investors or shareholders, to accurately report the information to the market.

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81 See, for example, Mobarrad Annual Report and financial statements 1993-1994, Riyadh Gazette, Vol. 10319, 24 September 1996. The company published misleading information in its annual report and financial statement. See also Bakheet Financial Advisors' Annual Report 1998, P4, which states that Riyadh Bank has consistently refused, for reasons yet to be made public, to publish many of its quarterly statements for the past few years.

82 Interview with Radi Haddad, Assistant Senior Manager of Investment Services Department of Riyadh Bank, Riyadh, 13 December 1997.

5. The Disclosure Rules

In response to the demand for more investor protection, Saudi Arabia enacted the Disclosure Rules in 1997 to strengthen the market’s disclosure regime. In effect, the new rules amount to a continuous disclosure requirement. They require, through Article 2(a), that any information, decisions or major events which may affect share prices directly or indirectly must be announced immediately to the SCD of SAMA for dissemination via ESIS, and to the mass media. As we have seen, such a requirement was necessary, because the Executive Rules did not contain listing rules for publicly traded companies or government enforcement of such rules. The passage of the Disclosure Rules coincided with major personnel changes at the ministries, including the appointment of a new Minister of Commerce and a new Minister of Finance and National Economy. In this regard, the new rules can be seen as an attempt to pursue policy objectives that promote value for investors by favouring disclosure.

This requirement imposes liability upon the Chairman or Managing Director. The Ministerial Committee takes the position that if important information related to the company is generally available, it is either the Chairman or the Managing Director who will possess it due to their positions. With respect to disclosure responsibilities it may therefore be said that a company is liable to disclose any information a person would reasonably expect a director

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86 A new Council of Ministers was appointed in 1995 as the beginning of a new strategy for economic development that would shift the national economy from one that relied heavily on the government to one that was led by the private sector. Therefore, the new Council of Ministers includes new ministers in charge of trade and finance who are highly educated and well-versed in development economics.
or chief officer to have come into possession of in the course of the performance of their duties.\footnote{Disclosure Rules 1997, Art. 2.}

The Rules also provide that a listed company must disclose such information through the mass media and to the SCD. The SCD provides that its staff is responsible for processing the material information confidentially.\footnote{Disclosure Rules 1997, Art. 2-a.}

Presumably, the SCD was selected to operate the continuous disclosure system, because businesses wanted to have a party with which they could negotiate, for example, about which information must be disclosed.

In contrast, the US continuous disclosure regime has been criticised for failing to consider the importance of issuer concerns arising from the value of information in competitive markets.\footnote{E. Kitch, 'The Theory and Practice of Continuous Disclosure', \textit{Brooklyn Law Review}, 1995, pp. 763-770.} The concern, no doubt, is that a rule requiring disclosure of all material information, does not consider that firms may need to keep some information secret. To stem concerns of the loss of business confidence and litigation, the SEC published a series of announcements to accommodate the business community's concerns.\footnote{See, e.g., Exchange Act Release No. 16, 384, 18 SEC Doc het (CCH) 1053, 1070, 29 November 1979, conceding secrecy in the control of a Schedule 14D-9 filing; See also Schedule 14D-9, Item 7(a) instructions, 17C. F.R. & 240, 14d-1, 1998.} Turning more specifically to the obligations of the Saudi disclosure system, the new rules require firms to announce 'any major events or information'. The continuous disclosure requirement is unusually broad, lacking any concern for sensitive information. The extraordinary breadth, however, is revealing. Commentators argue that an exchange that does not specifically enforce its rules can afford to be imprecise
and overly broad in their language, because there is no prospect of effective enforcement.91

Despite its extraordinary breadth, the Disclosure Rules provide a list of major events that a listed company would be expected to disclose. Article 2-a requires disclosure in the case of the following non-inclusive circumstances:

- Any important information which would help shareholders and investors to understand the company’s statutes or about major developments concerning activities of the company which may lead to major changes in its assets, liabilities or financial situation;
- Recommendations concerning cash dividends;
- Recommendations concerning the company’s increase or decrease of capital;
- Recommendations concerning the distribution of stock dividends through capitalisation;
- Merger or take-over situations; both companies involved must make an announcement;
- Any sudden losses suffered by the company that may affect share prices;
- Sale of any part of the company’s assets that would materially affect the company’s profit or loss;
- New contracts which may materially affect the company’s profitability or share prices, and;
- Any change in ownership which would affect the management or policy of the company.92

Certainly, the list of major events seems to provide a framework for satisfying the continuous reporting requirement. While the disclosure rules are specific to major cash dividends, losses and other corporate events, it must be assumed that the rules also cover conflict-of-interest transactions and other similar acts. The Disclosure Rules attempt to address the problem of rumours or unusual market activities by requiring that both companies involved in merger situations make statements about a pending merger or take-over situation.

The Disclosure Rules 1997 require, for the first time, disclosure of information relating to take-overs and changes in corporate control. If management has knowledge of developments that could result in abnormally heavy trading and price fluctuation due to mergers or take-over talks, it is obliged to disclose this. In such a situation, regulators fear that rumours about a potential transaction could start, and accordingly require a company to make a public release of it in order to prevent any unfairness or abuse of the information. Al-Routea, a trader, expressed that view that:

"I think that the important information is not available for the rest of the market participants. Valuable information is only available to those who are close to listed companies and other

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93 The Saudi approach towards disclosure requirements might be reformulated to include relevant information. Such a standard was adopted by New Zealand in 1993, when it revised the Companies Act, and the New Zealand Stock Exchange amended its listing rules immediately thereafter. For example, New Zealand List Rule 10.1.1 obliges the release of all relevant information to the Exchange, which means that the issuer (in contrast to equity and security holders) immediately ceases to attach great value to the confidentiality of the information. It shall no longer be a sufficient reason to withhold relevant information if release of it may adversely affect the market price of any of the issuer's quoted securities, or its abilities to attract and retain debt financing on favourable firms.

94 Pursuant to Art. 2 of the Disclosure Rules, we expect management of some of the listed companies to announce other new developments, such as those concerning changes in the companies' managers or auditors, or the establishment of competitive companies.


96 Interview with Abdulaziz Al-Dukhiel, President of the Consulting Centre for Finance and Investment, Riyadh, 12 December 1997, Al-Dukhiel states that one of the major factors slowing down IPO's growth is the lack of rules governing take-overs and mergers. Families and owners of private companies that are going public may lead to hostile take-overs.
sources of such information, whereas other market participants have no access to such information whatsoever, which might explain the sudden movements of some shares without the announcement of new information.'

The Disclosure Rules also require that anticipated changes in ownership be reported, although, in Article 2’s present wording, it is broad in scope. Accordingly, the Rules could be revised by first requiring the owner, if triggered by material probable acquisition, to disclose its change in holdings, enabling the market authorities to control any sudden and unwelcome take-over and acquisition by outsiders. The Rules could also be supplemented by specifying the percentage of control that has to shift in order to be considered a change in ownership and, therefore, constituting a major event. Given the sensitive nature of information, firms should give a clear and precise set of disclosure rules to ensure effective compliance. It is submitted that the existing disclosure rules concerning tender offers require a comprehensive policy review and revision. There are no specific information requirements on acquiring companies or persons making a bid for shares of a company.

To address this problem, securities regulations will typically include security market law provisions relating to the methods by which a substantial shareholding in a publicly traded company may be obtained, and the disclosure requirements that are triggered when a substantial holding is reached.

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97 Interview with Mr. Ahmad Al-Routea an active trader in the Saudi stock market, Riyadh, 3 December 1997.
98 In the UK, all dealings by directors have to be reported to the Stock Exchange within five days of the dealing. This information is published, in full detail, in the Stock Exchange Weekly Intelligence. Unsurprisingly, dealing by directors has become a popular source of information for investors. See G.A. O’Connor, ‘Guide to Stockpicking. Director’s Dealings’, Gillian O’Connor, London, 1996, pp. 61-63.
99 In the US, A substantial holding is defined as more than 5% of a class of stock of a public company. See, e.g., Dan River v. Unitex, 624 F.2d 1216 (4th Cir.1980).
In the US, for example, Rule 13(d) "requires any person or group who acquires, directly or indirectly, beneficial ownership of more than 5% of any class of equity securities of an issuer must disclose such acquisition by filling the information required on Schedule 13D within 10 days of such acquisition." This provision, along with certain SEC rules, requires that a person acquiring this proportion of a company's shares must immediately disclose their holdings and make further filings each time holdings are increased or decreased. The purpose of this regime is to alert existing investors, in the face of tender offers, that a new major participant exists.

Usually take-over rules require the bidder to disclose to the securities market regulator specific information relating to the offer, particularly financial conditions of the acquiring company, plans for the target company (e.g., disposals) and any agreements. The purpose of the disclosure requirements is to give investors an opportunity to become informed about significant changes for the company and plans for any changes which may affect their interests. Arguably, the introduction of supplemental rules to the Disclosure Act would add considerably to the quality of investor protection in the Kingdom.

Returning to the Disclosure Rules, Article 2-b requires that the Board of Directors, managers and executive employees must not make statements or comments or offer information, unless such announcements truly reflect the

100 15 U.S.C. § 78m (d).
101 The principal source of the take-over regulations is the Williams Act 1968. Williams Act added several new provisions to the 1934 Act. Those directly applicable to take-over bids are §§ 13(d) and (e) and §§ 14(d) and (e).
current state of affairs of the company. This provision is intended to place company directors and officers under pressure to tell the truth in any statement or comment they may make about the company's situation. The law imposes liability for the announcement of any untrue statements or omission of any important information about the company. The prohibition was necessary to restrain the directors of some companies from providing the market with untrue or misleading information for the purpose of increasing the prices of the company's shares, or to satisfy company shareholders in the General Meeting.

The duty to disclose information that is not misleading is, in essence, an anti-fraud rule. There are no official anti-fraud rules in Kingdom's market regulations. Accordingly, there is very little incentive for companies to inform investors credibly about their plans. This lacuna can be addressed by adopting a provision that requires firms' managers to make truthful statements in connection with tender offers. This is based on the idea that managers should be obliged to give investors (and the market) fundamentally accurate statements about their plans and they should be held liable for any misstatements. This suggestion would build on the basic disclosure regime to increase efficiency and effectiveness, and would enhance the aims of the Kingdom in developing rules that encourage the provision of information to the market. In this regard, the Securities Control Department of SAMA would be in a position to require a firm to supplement its statement with specific documentation or non-material public


information to show that the firm's statements are not misleading. Undoubtedly, the new Disclosure Rules enacted by the Ministerial Committee articulate a continuous disclosure obligation that supplements the Companies Act and the stock market rules. Yet, the unusually broad definition of the disclosure requirement is a cause for concern, since no regime can afford to require firms to be subject to rules that do not allow businesses to keep some information confidential. In this regard, an articulation that this applies to the disclosure of relevant information provides a more appropriate standard, acknowledging justified circumstances of withholding information.

6. Summary

This chapter has examined the pattern of the disclosure rules in Saudi Arabia, questioning whether the new rules enforce positive disclosure obligations on the management of firms. In the first section of the chapter, we considered the theoretical aspects of disclosure, with particular attention given to the economic aspects of enhanced information flow to the market. We then examined the Saudi approach to disclosure by reviewing the obligations of listed companies to disclose information to stock market investors. In this regard, we examined the specific disclosure rules contained in the Companies Act, the Executive Rules, and the Disclosure Rules. We found that the reporting requirements set forth in the Companies Act and the Executive Rules provide the basis for the release of essential information about companies to the market. Special attention

105 For example, the US context provides investors with confidence by supplying information necessary to make a statement not misleading. See Rule 105-5(6), 17 C.F.R. & 240, 106-5(b), 1998.
was given to registration requirements, particularly for new companies, and their adequacy in informing investors of new information, developments and possible investment risks. The analysis of annual reports indicated that the requirements are sufficiently comprehensive as to provide investors with accurate financial statements of the company in question.

Subsequently, the importance of listing requirements as a major step towards adequate disclosure was discussed. Our analysis revealed that Saudi law does not mandate any listing requirements. It was recommended that the Kingdom introduce listing rules in conformity with the worldwide trend. The last part of the chapter analysed the Disclosure Rules 1997, which were adopted to strengthen the flow of information to the market. We have seen that the Disclosure Rules impose liabilities upon corporate managers to announce any new major event likely to have impact on share prices of the company. This chapter has shown that the Kingdom's continuous disclosure requirement is rather broad and lacks concern for sensitive information or information likely to have an effect on share prices of listed companies. Suggestions have subsequently been made to encourage more effective disclosure.
Chapter 8

Insider Trading

1. Introduction

This chapter analyses the problem of insider trading, identifies an agenda for research and legal reform in Saudi Arabia, and compares the US and European approaches to the regulation of insider trading. This chapter draws some lessons from the main legal and economic models dealing with the enforcement of illegal trading. It is now widely accepted that trading by an individual, on the basis of non-public material information in securities of a corporation of which he is an insider, violates the securities laws in many countries. Corporate insiders are no longer allowed, under many legal theories, to utilise insider information that they receive by virtue of their position to gain personal profit at the expense of their trading partners. Until recently, insider trading was often considered a problem related to the US markets.¹ This may have been due to the fact that the battle against insider trading has a very long history there, dating back to the nineteenth century, when the fiduciary issue was first raised.² Unlike the US, which has long been committed to the prohibition of insider trading, many European and most developing countries, have permitted it.³ These states have only recently recognised the shortcomings of their own established practices, and have


³ Until 1986, the United Kingdom and France were the only countries in Europe who had regulations against insider trading. Other European countries have enacted legislation against insider trading more recently.
developed specific procedures designed to strengthen the reputations of their respective capital markets.⁴

A number of factors are responsible for the worldwide proliferation of insider trading regulation. Many discussions of the phenomenon point to the globalisation of securities markets, which purportedly has created the situation whereby securities laws, including insider trading, have increasingly become a matter of informational concern.⁵ In this view, there are strong domestic and international pressures on regulators to pursue national regulatory policy, which enhances and sustains the globalisation and integration of capital markets. Indeed, the impact of internationally driven changes in the capital markets led the European Community to adopt the Inside-Dealing Directive.⁶ Interestingly, the introduction of the Directive forced the few countries that had failed to pass legislation prohibiting insider trading to enact regulations to make such trading illegal. For example, Germany adopted legislation in 1994, making insider trading a crime for the first time in German history.⁷

In many developing countries, the law against insider trading has tended to converge with US and EC approaches. Yet, there has been reluctance on the part of national regulators within certain jurisdictions to inaugurate new legal

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⁷ Prior to implementation of the Directive, insider trading in Germany was governed by the Voluntary Insider Trading Guidelines. The Guidelines were voluntary, and adhered to by contract. Therefore, they do not have the force of law and it is doubtful that they rise to the level of customary usage of the industry, which might create obligations under the Civil Code. See, G. Thoma & J. Berck, 'Insider Trading in Germany', in Gaillard (ed.), Insider Trading, the Laws of Europe, the United States and Japan, pp. 79-80. For the developments of German insider trading, see D. Standen, 'Insider Trading Reforms Sweep Across Germany: Bracing for the Cold Winds of Change', in Harvard International Law Journal, Vol. 36, No. 1, Winter 1995, pp. 177-178, and
prohibitions. Their reluctance to alter the rules of the game is due perhaps to the
distributional implications of insider trading legislation. Indeed, Saudi Arabia
was, until 1997, quite successful in resisting the international pressures to enact
specific regulations prohibiting insider trading.

The Disclosure Rules 1997 impose liability upon any person who trades
on the basis of non-public information. The absence of a norm and legal rules
against insider trading suggested that there were strong domestic pressures in
favour of the status quo. In this regard, Saudi directors were permitted (without
restriction) to trade the securities of companies in which they were managers
without violating the law. In answer to a question concerning the level of insider
trading in the Saudi stock market, Abdul Aziz Al-Dukhiel, President of the
Consulting Centre for Finance and Investment, expressed the view that:

"While it is difficult to provide a precise measure of the level of
insider trading in the Saudi stock market, I think that with the
current standard of disclosure, trading based on inside
information is the only way to win in the market. And if this
practice is illegal, it would appear that illegal practices take place
on a large scale. I call for the current regulation to be developed
in order to stop trading based on inside information."

Despite the presence and depth of large-scale insider trading, there have been
growing pressures, mostly from large institutions, to introduce much-needed
reforms in the regulation of the stock market. In its efforts to respond to the

1989.
8 Companies Act 1965, Art. 73, prohibits corporate insiders and corporate auditors from releasing
inside information to anyone outside the General Meeting of the company; however, the law did
not prohibit them from trading based on such information themselves.
2222/221/9/3340, dated 8/11/1417, Art. 4.
10 See interview Abdul Aziz Al-Dukhiel, President of the Consulting Centre for Finance and
Investment, Riyadh, 12 December 1997.
11 SAMA was relatively aware of the side-effect of the abuse of inside information by banks and
their employees, which led to the including of insider trading provisions in the new enactment
demand that the Kingdom’s stock market operate fairly and freely, the Ministerial Committee enacted the 1997 Disclosure Rules.\(^{12}\) As was the case in Germany, it was the first time the government directly addressed the problem of insider trading in Saudi legislation.\(^{13}\) Unfortunately, the new provisions were drafted in an overly technical and restrictive manner. Based on this legislative construction, it appears that the Kingdom’s commitment to pursue this line of reform may not be fully credible.\(^{14}\) Undoubtedly, the issue of commitment is affected by the institutional arrangements for administering regulatory policy. The government could introduce mechanisms that make commitment more likely. One proposal for introducing good regulatory policy might be the introduction of a new structural arrangement. For example, the creation of an enforcement agency charged with regulating fraud and taking actions to curb investors’ incentives to act in an opportunistic way could enhance fairness and efficiency in the market. This goal could be furthered by the enforcement agency introducing a surveillance system that is supported by punitive penalties for insider trading.

The issue of commitment and opportunistic behaviour is certainly a key issue for Saudi Arabia, since presently there are no criminal or civil remedies for insider trading.\(^{15}\) Generating incentives for efficient regulation, therefore, requires

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\(^{13}\) See Standen, ‘Insider Trading Reforms Sweep Across Germany; Bracing for the Cold Winds of Change’, pp. 177-178.

\(^{14}\) See, H. Azzam, The Emerging Arab Capital Markets: Investment Opportunities in Relatively Underplayed Markets, Kegan Paul International, London, 1997, p. 156. Azzam states that insider trading is illegal in Saudi Arabia, just as in the United States. However, the enforcement mechanism in Saudi Arabia is poor. The penalty for such trading is not specified in regulations. In practice, an offender usually receives a warning for a violation and is asked not to do it again.

\(^{15}\) Ministerial Committee Disclosure Rules, Ministry of Commerce Circular Reference No. 2222/221/9/3340, dated 8/11/1417. Art. 5, which is devoted to punishment of violations, has not set forth the available sanctions. In particular, Art. 5 states that the creation of an unfair market
political entrepreneurs and politicians to actively counter the actions of interest
groups, who profit from the current lax enforcement policy. To the extent that
barring insiders from trading has distributive consequences, we can expect private
interest groups to mount political action directed at policymakers. Naturally, the
incentive for the Kingdom’s policy makers to take legislative action stems in part
from the possibility that the policy outcome will result in a more effective
regulatory environment, lowering the transaction costs of securities trading in the
market.

It is, of course, difficult to quantify the reduction of additional trading
costs due to stepped-up regulation against insiders. Recent micro-economic
research shows that the failure to enforce regulations can have adverse
consequences on trading mechanisms. Market friction due to the presence of
informed trading has the effect of increasing the costs for small, uninformed
traders.\footnote{N. Seyhun, \textit{Investment Intelligence From Insider Trading}, Massachusetts Institute of
investors feel that the stock market is stacked against them, they will choose to invest their funds
elsewhere, such as in savings accounts or government bonds. This will decrease the liquidity of
the stock market and thereby increase the cost of raising new funds for firms.} Hence, the average expected trading costs tend to be lower in more
New World Order in International Finance}, London, MacMillan, 1997, pp. 53-54.} The efficiency effect of more transparency and the
presence of a norm against insider trading could result generally in greater
liquidity, which will improve the terms of trade for the majority of traders.
Operational and informational efficiency considerations reinforce the priority for
regulatory reform of the capital market in order to enhance liquidity. Clearly, the
case for regulatory reform in the Saudi stock market is based on the benefits that
can be derived from enhanced liquidity and limiting the costs of the terms of trade. 18

This chapter studies insider trading both at the theoretical level and at the level of legal doctrine. It outlines economic discussions of insider trading, which I will address in this thesis. In this chapter, I attempt to analyse what might be done to introduce legal reforms to strengthen the performance of the national regulator in Saudi Arabia. The prohibition of insider trading has been subject to a considerable amount of discussion during the past two decades. Section 2 discusses theories of insider trading, concentrating on efficiency and fairness approaches. Section 3 examines the Saudi approach to insider trading and new rules adopted to deter the practice. Particular attention will be given to the analysis of the definition of the terms ‘insiders’ (primary v. secondary), ‘tippees’ and ‘outsiders’.

2. Theoretical Perspective on Insider Trading

Insider trading is a worldwide phenomenon. In fact, most jurisdictions have by now enacted regulations prohibiting insider trading. 19 The term ‘insider trading’ generally refers to stock transactions made by officers, directors or large shareholders of the firm in question. 20 Trading by insiders in securities on the basis of unpublished price-sensitive information has been regulated under different legal theories. This section examines the fiduciary, efficiency, fairness

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and liquidity theories, respectively, theories which have been offered as the bases for prohibiting insider trading.

2.1 Fiduciary duty and insider trading

The theory of fiduciary duty is one of the oldest theories offered as a basis for the prohibition of insider trading.\(^{21}\) Although insider trading has been described as one of the most serious offences occurring in financial markets today, arguments about the morality of corporate insiders trading based on non-public price-sensitive information was not questioned publicly until 1909.\(^{22}\) At that time, many American courts had used the fiduciary duty to establish a special relationship between directors, the corporation and its shareholders, whereby directors owe fiduciary duties to their corporation and the shareholders thereof.\(^{23}\)

The introduction of fiduciary duty as a basis for the prohibition of insider trading was first developed in the US under the common law.\(^{24}\) Some states adopted what is usually described as the 'majority rule'. Under this rule, directors and offices had no affirmative obligation to disclose the information used as basis for the transaction as long as the corporation suffered no damage.\(^{25}\) The majority rule established that corporate insiders owe a fiduciary duty only to the corporation, and not to the shareholders.\(^{26}\) Directors could be involved in selling


\(^{22}\) At that time, many American courts had ruled for the first time on some cases that raised the issue of the fiduciary duty as a reason for prohibiting insiders from using information which they receive by their positions to gain personal profits. See, for example, *Oliver v. Oliver*, 118 Ga 362, 45 S.E. 232 (1903) and *Strong v. Repide*, 213 U.S. 419, 431(1909).


\(^{25}\) Ibid., pp. 768-769.

\(^{26}\) Ibid.
and buying shares of the corporation that they manage, without the obligation to
disclose any information. Under the minority rule, the courts simply asserted that
directors and officers were a fiduciary or trustee to existing shareholders.\textsuperscript{27}

Even after the enactment of the securities laws in the US, the reliance on
the fiduciary duty doctrine continued to be the central legal basis for the
prohibition of insider trading.\textsuperscript{28} Indeed, the early interpretation of Section 10b and
Rule 10(b)-5 by federal courts established a 'disclose or abstain' requirement with
respect to trading on the basis of non-public price-sensitive information.\textsuperscript{29} The
'disclose or abstain' rule required that insiders who are in a fiduciary relationship
to the other party in a transaction either disclose the material information or
abstain from making the transaction.\textsuperscript{30}

The duty of insiders to disclose or abstain was first found in \textit{Matter of
Cady Roberts & Co.}\textsuperscript{31} In this case, the Supreme Court determined that anyone
who was involved in trading for his own account in the securities of a
corporation, and who has "access, directly or indirectly, to information intended
to be available only for a corporate purpose and not for the personal benefit of
anyone", may not take advantage of such information knowing it is unavailable to
those with whom he is dealing.\textsuperscript{32} In the landmark decision of the Texas

\begin{itemize}
\item \textsuperscript{27} Ibid. Under the minority rules, corporate insiders were required to make full disclosure of all
relevant facts before dealing with their beneficiary.
\item \textsuperscript{28} J. McLaughin, & M. Macfarlane, 'Insider Trading in the United States of America', in
Emmanuel Gaillard (ed.), \textit{Insider Trading, the Laws of Europe, the United States and Japan}, pp.
289-293.
\item \textsuperscript{29} 15 U.S.C. § 78j (b).
\item \textsuperscript{30} Yet ironically, insiders normally forgo following the rule since disclosure of the information
will breach fiduciary duty to the corporation and, by disclosing, they will lose the advantage over
their trading partners. See H. Hazen, \textit{The Law of Securities Regulation}, 3rd edition, West
\item \textsuperscript{31} \textit{Cady Roberts & Co.}, 40 S.E.C. 907 (1961).
\item \textsuperscript{32} This case is one of special importance in the US's administration of the Federal Securities Act.
It involved a director who leaked impending news about a dividend cut to his broker, who then
sold shares for discretionary accounts (including that of his wife) upon an exchange.
\end{itemize}
Gulf, the court applied the catchall disclose or abstain rule, which required anyone possessing material, non-public information to either disclose the information or abstain from trading.

Generally, the language of Section 10(b) and Rule 10b-5 does not provide clear guidelines for deciding which activities are fraudulent and who should be the relevant target for such inquiry. More importantly, courts have not interpreted the broad language of the initial regulatory framework uniformly. Courts still disagree about the proper grounds for the obligation under Rule 10b-5. Contemporary developments in insider-trading law derive principally from the Supreme Court’s holding in Chiarella v. United States, and Dirks v. SEC. In the much-cited Chiarella v. United States, the Supreme Court held that a trader violates Rule 10b-5 only if he fails to disclose material information prior to the consummation of a transaction when he is under duty to do so. The duty to disclose or abstain arises only from a fiduciary duty or other similar relation of trust and confidence between the parties of the transaction.

The Supreme Court defined the relationship between breach of fiduciary duty and tipper-tippee liability in Dirks v. SEC. There, the Supreme Court held that a defendant who traded on the basis of material non-public information received from an insider only violates Rule 10b-5 if the insider has breached his

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34 This case involved an insider who bought 9,100 shares after the company discovered minerals before the discovery was announced. See R. Jennings & J. Jennings Jr., Securities Regulations, Cases and Materials, 7th edition, The Foundation Press, Westbury, New York. 1992, p. 1005.
36 Ibid., p. 127.
or her fiduciary duty by disclosing the information for personal gain, and the
recipient knows, or should know, of the breach.\textsuperscript{40} The court went on to observe
that in the absence of personal gain, there was no breach of duty to the
shareholders. Since the tippee’s duty is derivative of the tipper’s duty, there can
be no liability for the tippee if there has been no breach of duty by the insider.\textsuperscript{41}
Dirks established an additional means by which erstwhile outsiders become
fiduciary of a corporation’s shareholders.\textsuperscript{42} The effect of this theory is to ‘clothe’
an outsider with temporary insider status when the outsider obtains access to
confidential information. As a result, the temporary insider acquires a correlative
fiduciary duty to the corporation’s shareholders.\textsuperscript{43}

The narrow focus on specific fiduciary duties shown in cases like
Chiarella and Dirks limited the number of fiduciary relationships that produce
obligations to disclose.\textsuperscript{44} While the Supreme Court’s narrow application of the
specific fiduciary theory seems to restrict what will count as insider trading, the
Second, Third, Seventh and Ninth Circuit have adopted the ‘misappropriation
theory’, which covers wider situations.\textsuperscript{45} Under the misappropriation theory, a
person violates Rule 10(b)-5 when he or she misappropriates material non-public
information in breach of a fiduciary duty or a similar relationship of trust and
confidence, and use that information in a securities transaction.\textsuperscript{46} The courts have

\textsuperscript{40} The \textit{Dirks} court found the printer of a financial firm who traded based on information regarding
tender offers left at the printer, not to have a sufficiently close relationship of trust and confidence
with the tendered companies and their shareholders to be found liable. Mere possession of non-
public information is thus insufficient to create a duty to disclose or abstain; also that trade on
non-public information is not, in itself, enough to incur liability under Rule 10b-5.

\textsuperscript{41} Jennings & Jennings Jr., \textit{Securities Regulations, Cases and Materials}, 29, p. 1006.

\textsuperscript{42} See L. Soderquist, \textit{Securities Regulation}, 3\textsuperscript{rd} edition, Foundation Press, Westbury, New York,

\textsuperscript{43} Scheppele, ‘It’s Just not Right: The Ethics of Insider Trading’, p. 136.

\textsuperscript{44} Ibid., p. 140.

\textsuperscript{45} Soderquist, \textit{Securities Regulation}, pp. 491-492.
recently relied upon the theory of misappropriation as interpreting and justifying Rule 10(b)-5. Under this theory of liability, a duty to disclose or abstain is imposed on any person who has misappropriated or stolen inside information. However, the theory has been applied only in the context of employment relationships.47

The case of Carpenter v. United States48 addressed the theory of misappropriation inconclusively.49 While the Second Circuit upheld the conviction of the defendant, the Supreme Court was equally divided on the 10(b)-5 claim in this case and affirmed the Second Circuit's majority without an opinion concerning the misappropriation theory.50 A number of federal courts have immediately applied the theory of misappropriation in other cases, too: Materia v. SEC51, where a copyholder breached the duty to his printing company; United States v. Newman52, where an investment banker breached duty to his firm; and United States v. Willis53, which denied a motion to dismiss indictment of a psychiatrist who traded on the basis of information obtained from a patient as breach of duty arising from a relationship of trust and confidence.54

Unlike the traditional fiduciary duty theory, misappropriation theory not only examines whether a fiduciary relationship exists, but also whether a

47 Ibid.
48 Carpenter v. United States, 484 US 19 (1987). In this case the court was asked whether Wall Street Journal’s R. Foster Winans, who used information that he collected to write his financial column for personal gain, was guilty or not.
49 Ibid.
50 Ibid.
51 Materia v. SEC, 745 F.2d 197 (2nd Cir. 1984), cert. denied, 471 US 1053.
53 United States v. Willis, 737 F. Supp. 269 (S.D.NY 1990)
relationship of trust and confidence exists.\textsuperscript{55} Although the misappropriation theory widens the scope of the law as it applies to some insider-trading cases, it has been argued that the prohibition of insider trading based on fiduciary duty is inadequate. First, the theory fails to acknowledge the equitable rules about fraud that have long been in use in the US. Second, the theory fails to acknowledge the more complicated and anonymous relationships that now characterise corporate America.\textsuperscript{56}

\subsection*{2.1.1 The limits of the fiduciary approach to insider trading}

Turning to the Saudi Companies Act for a moment, directors and employees are considered to be trustees of the shareholders.\textsuperscript{57} In this view, it is assumed that they should work for the best interest of their beneficiaries and not for themselves. The law provides that they must disclose any personal benefits they gain by virtue of their position to their beneficiaries, otherwise, it will be deemed to be a breach of their fiduciary duty.\textsuperscript{58} In this regard, corporate insiders are under the obligation to work for the best interests of the company and its shareholders. Hence, it is a breach of their duties as fiduciary to use information that belongs to another for their own gain.\textsuperscript{59} Under Saudi law, shareholders are granted the right to institute a case of action for liability against directors for wrongful acts that will lead to a personal prejudice, and thus a disadvantage on the part of the

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\textsuperscript{56} Scheppele, 'It's Just not Right: The Ethics of Insider Trading', p. 173.
\textsuperscript{57} See S. Al-Bogomi, 'Joint-stock Companies in the Saudi Arabian law', \textit{Comparative Study with the Islamic Law}, Umm Al-Qura University, Makkah, 1986, p. 425.
\textsuperscript{58} Ibid., pp. 430-433.
\textsuperscript{59} Companies Act 1965, Art. 69, prohibits directors from using their position for personal gain, except with an authorisation from the regular General Meeting. Directors must declare to the
The crucial question for Saudi law is whether the fiduciary duty approach should be the basis for the prohibition of insider trading. Although the fiduciary duty concept provides important reasons for the prohibition of insider trading, it fails to provide a coherent theoretical rationale for the proscription and should be viewed only as a partial element in a more general theory. It is clear that prohibiting insider trading on the basis of the concept of fiduciary duty narrows the scope of the law by limiting the application of insider trading to those who have a fiduciary relationship to the corporation and its shareholders. The aim of insider trading regulations is to deter the trading on the basis of non-public price-sensitive information by all traders and not only by certain persons. The question here is whether there is trading based on inside information, not whether the trader has a fiduciary duty or not.

Unfortunately, we cannot assume that there will be the same room for interpretation in all jurisdictions. In the case of Saudi Arabia, as previously discussed in Chapter 3, the role of commercial tribunals is limited to the application of the existing rules, while judges have very limited interpretative power to apply the law in such a way that it can be developed in new and unanticipated directions. We may assume that this restriction with respect to directions judges may take also restricts the potential benefits of a fiduciary approach to deter insider trading.

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60 Companies Act 1965, Art. 78, states: "every shareholder shall have the right to institute the action in liability against directors on behalf of the company if the wrongful act committed by them is of a nature to cause him personal prejudice."

61 Scheppele, "It's Just not Right: The Ethics of Insider Trading", p. 125.

62 Cases related to trade and financial activities in the Kingdom are governed by legislative enactment, and their disputes must be brought in front of commercial courts where judges are found to follow them strictly. See K. Al-Tawil, "The Settlement of Commercial Disputes Through Arbitration in Saudi Arabia", L.L.M dissertation, Exeter University, 1992.
In other words, courts with restricted power will apply the regulations only to insiders who are in a fiduciary relationship. The problem is that courts are restricted from applying insider-trading provisions to the ‘tippee’, who is trading with the use of information obtained from insiders. The main purpose of enacting insider-trading regulations is to stop anyone from misusing inside information, not just the insiders. In this regard, the fiduciary duty approach is inadequate in that it is easily avoided.

This section has shown that insider-trading legislation should avoid an approach that may limit the scope of the prohibition, whether it is based on the fiduciary duty or the theory of misappropriation. Insider trading legislation should be based on a theory which makes the prohibition reach every person who might trade on the basis of unpublished, price-sensitive information, whether this person is connected with the corporation or not.

2.2 The efficiency approach

This sub-section critically analyses the efficiency approach to the regulations of insider trading. Today, the benefits that societies gain from efficient capital markets are well known. It has been argued that greater information efficiency increases stock prices and encourages real investments. As referred to in much academic literature, an efficient capital market is a market in which all available

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64 Ibid.
66 Seyhun, Investment Intelligence From Insider Trading, p. 349, states that “Greater information efficiency increases stock prices by leading to better investment decisions. For instance, prices provide useful signals for capital issuance, managerial compensation, and business expansion and
information is fully reflected in the prices of securities. Commentators have suggested that, based on the efficient capital market hypothesis (EMH), a perfectly efficient capital market will exist if the prices of securities traded on the market reflect all information, whether public or private, at all times. The market efficiency model has been offered as a basis for regulating insider trading. Proponents of insider trading regulations have argued that insider trading affects securities markets' efficiency.

The early arguments of Professor Henry Manne, in favour of insider trading, have attracted considerable attention. Manne argued in defence of insider trading by suggesting that legitimising insider trading would be an efficient method to compensate managers for their efforts. Allowing managers to trade based on inside information offers incentives for them to be more creative and innovative. In this regard, insider trading will encourage insiders to work harder for the corporation and its shareholders' interests. Moreover, he argued that permitting insider trading enhances market efficiency by providing the market with necessary information and helping the share prices to be more

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67 Commentators have distinguished between informational efficiency and allocative efficiency. The first implies that securities prices react immediately to the release of new information, whereas allocative efficiency implies that the market allocates resources to their most efficient or productive uses. See Stout, 'The Unimportance of Being Efficient: An Analysis of Stock Market Pricing and Securities Regulation', in Michigan Law Review, Vol. 87, 1988, p. 613.

68 Conventionally, Fama has subdivided the EMH into three distinct versions: 'weak' - the information contained in the past sequence of prices of a security is fully reflected in the current market price; 'semi-strong' - all public information is fully reflected in a security's current market price; and 'strong' - all information, whether public or private, is fully reflected in a security's current price. See F. Fama, 'Efficient Capital Markets: A Review of Theory &Empirical Works', Journal of Finance, Vol. 23, 1970, pp. 383-417.


71 Ibid., pp. 131-145.
accurate. It was suggested that when insiders use information that is not available to the public, their trading in a corporation’s shares will move the prices of such shares in the right direction. As a result, the market will be informed of the inside information that has been used by insiders.73

Yet, allowing insiders to trade on the basis of inside information as appropriate compensation for their services fails to recognise many points. First, if corporate managers perceive that they have not received adequate compensation, they can sell their services to competitive corporations and receive better compensation.74 Secondly, allowing insiders to use inside information to make profit gives managers the right to make profit from bad news as well as from good news. We can assume that this will create the problem of a moral hazard.75 That is, we can assume there would be a natural conflict between a shareholder’s interest in higher stock prices and insiders’ interest in creating volatile stock prices. In this view, managers, in order to make greater profit, might be tempted to delay the publication of news, good or bad.76 Moreover, managers could seek to manipulate corporate press or oral communications with the press in order to accentuate stock price volatility.77

It would appear that there are more effective incentive reward systems than insider trading. For example, shareholders can write an incentive contract that, subject to performance conditions, offers management a percentage of the

72 Ibid.
74 Loss & Selgiman, Fundamentals of Securities Regulation, p. 766.
77 Ibid.
firm's profits. There are other reasons for rejecting Manne's proposal. For example, this policy would effectively permit unproductive insiders to have the same opportunity as productive insiders to trade based on inside information. Also, the insider will have an incentive to play with the time and accuracy of the information disseminated. Finally, corporate insiders will have an incentive to engage in higher-risk investments, producing wider stock price fluctuations in order to create more opportunities for trading profits.

The argument that insider trading enhances market efficiency by providing the market with necessary information, consequently giving the market signals to move in the right direction, can be criticised on a number of empirical grounds as well. First, many studies have indicated that insider trading does not have a significant impact on market prices. Usually, insiders trade in quantities that are too small to affect market prices and also camouflage their activities, making observation difficult. In the case of information related to the assets or expected performance of the corporation, the sooner it is known, the more accurately it is appraised, the more immediately it induces a purchase or a sale, and the more precisely will the market price of securities correspond to the value of the enterprise.

The market will function efficiently if savings are allocated to enterprises that are more profitable and diverted from enterprises which are less profitable.

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79 Ibid.
80 Ibid.
81 Ibid.
83 Ibid., pp. 766-767.
85 Ibid.
Hence, the market is likely to be more efficient if insider trading is prohibited. Information flows to the market as it is produced, rather than as it is manipulated by inside traders.\textsuperscript{86} It has been observed that information is the heart of the stock market. Thus, information about a company which portends a promising future, should result in an increase in the prices of shares. Conversely, information about the value of companies indicating that these companies have a less promising future will result in decline of the value of their shares.\textsuperscript{87} Changes in share prices should therefore be based on timing and accuracy of the release of the new information, and not on signals or rumours. The market tends to become more efficient as more insiders are restricted from trading.\textsuperscript{88}

On the other hand, it might be argued that insiders who trade while in possession of inside information will not damage market efficiency, because market participants will typically buy without knowing the bad news, and sell without knowing the good news.\textsuperscript{89} Yet, again it can be argued that insider trading will result in inaccurate share prices, which affects the manner in which resources are allocated and hence reduce investors’ welfare generally by reducing the size of the aggregate corporate income stream.\textsuperscript{90} Inaccurate share prices damage economic sufficiency in at least three ways. First, inaccurate share prices reduce the likelihood that resources will be allocated to the most productive projects, which will result in depriving the most promising projects from receiving the necessary funds.\textsuperscript{91} Second, inaccurate share prices will widen the bid-ask spread,

\textsuperscript{86} Bagby, The Evolving Controversy Over Insider Trading, pp. 581-582.
\textsuperscript{88} Ibid.
\textsuperscript{91} Ibid.
leading to even greater volatility because the share price has further to go in its movement toward actual value. Finally, the inaccuracy of the share prices on the market will undermine the market for corporate control. Less accurate prices make investment in the acquisition of a target riskier.

Although many commentators have argued that insider trading is beneficial from an economic point of view, these arguments fail to recognise many difficulties. First, as we have noted above, the market will be efficient if, in general, share prices reflect the information available in the market, rather than rumours or signals. In the case of outsider trading, the uninformed party will pay higher prices than they would if bad news had been disclosed, and they will sell at a lower price than if good news had been disclosed. In both cases, outsider investors will suffer loss because the share prices are lower or higher than the actual value. This sub-section has shown that the market will suffer from inaccurate share prices, which will damage market efficiency, because funds will go to the less promising projects, leaving the most attractive projects without enough funds.

### 2.3 Fairness arguments

Since we can assume that the efficiency approach, which was outlined in the above sub-section, is not fully convincing to justify insider trading as a means of

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92 Ibid.
93 Ibid.
94 Although Manne was the first to argue in favour of insider trading, there are other authors who have shared the same view. See, for example, Carney and Bhide.
95 Suter, The Regulation of Insider Dealing in Britain, p. 31.
enhancing market efficiency, we now turn to consider a competing approach, the 'fairness perspective'.

One of the most common arguments lodged against insider trading is that it is 'unfair'.\(^96\) Before the promulgation of the Insider Trading Sanction Act of 1984, the House Committee on Energy and Commerce wrote "The abuse of informational advantages, which other investors cannot hope to overcome through their own efforts, is unfair and inconsistent with the public's legitimate expectation of an honest and fair securities markets where all participants play by the same rules."\(^97\)

For over two decades, legal commentators have argued that insider trading is not fair.\(^98\) Typically we hear that all market participants should have equal access to information about the companies issuing the shares. In this view, it is assumed that investors, upon entering the market, should receive equal treatment and equal access to information relevant to the securities they wish to purchase or sell.\(^99\)

The sole reason that insiders have access to confidential information is due to the fact that they conduct the company's business. When directors and officers acquire inside information, they do so in the interest of the corporation and its shareholders.\(^100\) The unfairness arises when an insider takes advantages of such information, knowing that it is unavailable to other shareholders.\(^101\) Also,

\(^{96}\) Loss & Seligman, *Fundamentals of Securities Regulation*, pp. 760-761.
\(^{97}\) Ibid.
\(^{98}\) See, for example, Barry, 'The Economics of Outside Information and Rule 10b-', in *129 University of Pennsylvania Law Review* 1307, 1981, pp. 1323-1328.
\(^{100}\) Brudney, 'Insiders, Outsiders, and Informational Advantages under the Federal Securities Laws', p. 344.
\(^{101}\) Suter, *The Regulation of Insider Dealing in Britain*, p. 39.
unfairness can arise when acquiring inside information lawfully if other investors cannot obtain the same information.\(^\text{102}\) The unfairness is not in the fact of possessing more information – some outsiders may possess more information than others by reason of their diligence or zeal – but in that it is an advantage that cannot be competed away, since it depends upon a lawful privilege to which an outsider cannot have access.\(^\text{103}\) It is typically argued that insiders have acquired inside information as an agent or fiduciaries of the shareholders. On the fairness story, proponents insist that the latter are equally entitled to the information or, at any rate, are not to be disadvantaged by lack of that information in dealing with their agents.\(^\text{104}\)

Despite the fact that fairness is one of the most traditional rationales as to why insider trading is undesirable, it has been argued that the fairness concept is a fuzzy idea that needs to be clarified with the pure logic of economic theory.\(^\text{105}\) More specifically, it is argued that if the existence of insider trading is known, outsiders will not be disadvantaged because the prices they pay will reflect the risk of insider trading. Additionally, fairness theory cannot support a condemnation of all such transactions.\(^\text{106}\) According to the fairness approach, the first party in the transaction must be an insider of the corporation from which the information is derived, and the other party must be either an existing shareholder or a person who becomes a shareholder by reason of trade.\(^\text{107}\) Accordingly, a trade in a corporation’s shares by an outsider who received such information by

\(^{102}\) Ibid., p. 40.
\(^{104}\) Ibid., p. 344.
\(^{107}\) Ibid., p. 268.
accident is not covered. Clearly, then, it has been shown above that there are severe limitations to the fairness approach to insider trading.

2.4 Market liquidity

In this section, we consider a new line of theory developed by micro-economists over the past decade. We have seen that the efficiency perspective cannot support deregulatory policies, since permitting insider trading is not an effective mechanism to introduce information into the market. The theory of imperfect securities markets supports the view that insider trading, because it has distributional consequences, increases the problems of less liquidity and higher transaction costs, unless regulators design policies to counter the opportunistic taking of profits by insiders.

Micro-economists studying securities markets have demonstrated that under certain conditions the trading by individuals on the basis of superior information can reduce market liquidity. Generally, "liquidity in a market relies on market makers and other speculators. Without their presence, markets quickly die. Yet, too many losses caused by trading with insiders could force market makers to widen the spreads between their offer and bid prices on all securities to compensate for the loss of margins. In this view, wider spreads and the

108 Ibid.
111 Ibid.
perception that the market is rigged in favour of insiders may in themselves deter speculators and long-term investors from using the market, which reduces the market liquidity by narrowing market participants.112

In support of this view, there are many studies that find a positive relation between insider trading and bid-ask spread.113 These studies show that specialists and other market makers systematically profit from trading with liquidity traders, but they systematically lose from trading with informed traders.114 Specialists and other market makers are assumed to trade with at least two different types of traders; those trading based on inside information and liquidity traders.115 Specialists and other market makers establish their maximising spread by balancing the expected total revenues from liquidity traders and the expected total losses from informed trading.116 Monopolistic dealers will establish a wider bid-ask spread than perfectly competitive dealers will. To avoid losing from trading with insiders, dealers will always set a higher ask price and lower bid price than what they believe true market prices to be.117 In any event, it appears that other investors besides informed traders and market makers always lose out in the stock market, whether they trade with an insider or a dealer. The insight here is that if they trade with an insider, they sell or buy without knowing the good or the bad news and consequently suffer losses. On the other hand, in the case of trading


114 Ibid.


116 Ibid., p. 1468.

117 Ibid.
with dealers, they lose as well, since the dealer will widen the bid-ask spread just in case he is dealing with an insider. 118

Within this theory, it is clear that insider trading and other market manipulation may impact the liquidity in a market. Market participants will exit from the market if they believe that the market is unfair and not everyone is playing by the same rules. 119 The consequence of a decrease in the number of market participants could, in the worst case, result in a run on the market. More specifically, while investors will generally accept a certain level of market and transaction risk, they will refuse to invest in markets where the winning percentage is close to zero. 120 Unless regulators seek to curtail the manipulation of bid-ask spreads, no-one will trade in the stock market. It is thought that in markets where insider trading has a large effect on prices, market liquidity will be negatively impacted. This has certainly been the case in the German and Saudi Arabian markets.

In sum, restricting insider trading will increase market liquidity by enhancing market participants' confidence. Furthermore, market efficiency will be positively increased by forcing insiders to disclose private information before trading.

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118 Ibid.

119 Seyhun, *Investment Intelligence from Insider Trading*, p. 30. Seyhun argues that a clear winner from insider-trading regulations is the small, transient investor. Looking at the history of how insider-trading laws have been enacted also supports this view. He went on to say that small investors and the securities industry that caters to them want liquidity, which is valuable because it allows diversification and easy exit for small investors. From the securities industry’s perspective, liquidity generates large trading volumes and higher commission fees. Given that insider trading penalises liquidity traders, it is not surprising that insider-trading restrictions have increased simultaneously with the importance of small traders.
3. Insider Trading in the Saudi Securities Law

Prior to 1997 there were no specific regulations prohibiting insider trading in Saudi Arabia. Yet the lack of insider trading regulation in the past did not mean that insider trading did not take place in the market. Indeed, there was little interest in eliminating the misuse of the non-public, price-sensitive information. In this regard, Mansoor Al-Mayman, Deputy of Minister of Finance and National Economy, Member of the Supervisory Committee, explained that:

"The policy of the government, at the establishment of the Saudi market, was rather to encourage as much trading as possible and only later to introduce, step-by-step, more rules to the market." 

The Disclosure Rules 1997 were the first instance in which the country directly addressed the issue of insider trading. There had been earlier attempts to reduce insiders from misusing or appropriating material, inside information. These early attempts, through Articles 72 and 133 of the Companies Act, using a different theory, tried to limit the dissemination of confidential information concerning companies by directors or corporate insiders. This approach failed to stem the tide of insider trading, because there was no prohibition concerning

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120 Copeland & Galai, 'Information Effects of the Bid-Ask Spread', p. 1468.

121 See Alaam Al-Eqtisad, 'The Saudi Stock Market', in proceedings of conference held in Riyadh, November 1994, pp. 59-59. This conference showed that there has been high demand from different institutions and investors for reforms in the anti-fraud provisions in general and insider trading in particular.

122 See interview with Mr. Mansoor Al-Mayman, Deputy Minister of Finance and National Economy, member of the Supervisory Committee, Riyadh, 21 November 1997.

123 Companies Act 1965, Art. 72, states that directors may not disclose to third parties, or to shareholders outside the General Meeting, any of the company's secrets as may have come to their knowledge by reason of their directorship; otherwise, they must be removed and held liable for damages. Art. 133 puts the same restrictions on the company's auditor. However, the Companies Act rules are inappropriate as a means to limit insider trading since they were promulgated to regulate the behaviour of directors and auditors, but not including their trading as such. First, the Act limited the prohibition to directors and auditors and left other persons who may have access to inside information outside the prohibition. Second, the Act prohibits directors or auditors from passing confidential information on to other shareholders or third parties prior to the announcement of such information in the General Meeting.
the use of confidential information in the context of trading in the market for securities.

The second attempt to regulate insider trading occurred with the passage of the Instructions to the Central Trading Units.\textsuperscript{124} The Instructions to CTUs include a prohibition of insider trading that is highly restrictive and applies only to bank employees whose jobs are related to buying and selling shares.\textsuperscript{125} Given its restrictive scope, it is difficult to rely on the Instructions to CTUs to prohibit insiders from using non-public, price-sensitive information for personal benefit.\textsuperscript{126} Al-Souage, an investor, expressed the view that:

\begin{quote}
\textit{I believe that the market rules to stop trading based on inside information are unsatisfactory. Whether the problem has to do with the rules themselves or with their enforcement, I think insider trading is big problem in the market and so far I have never heard of any case in which action has been taken. I think that the shortage of valued information forces people to rely on inside information, as a result of which it may be hard to stop such practices now.} \textsuperscript{127}
\end{quote}

After these early attempts at reform, the long-awaited insider-trading provisions were finally introduced in 1997. The Kingdom's passage of new legislation followed in the wake of the worldwide trend to deter insider trading.\textsuperscript{128} The provisions against insider trading are designed to create confidence in the market. But while many other jurisdictions have supplied strong bases for the

\begin{footnotesize}
\begin{enumerate}
\item The Electronic Securities Information System Instructions to Central Trading Units. SAMA, Securities Control Department, 1990.
\item Instructions to CTUs 1990, Art. 8.
\item The language of the insider-trading rules in the instructions are identical to those sections in the Companies Act. In both pieces of legislation the prohibitions on insider trading are narrow and limited to certain persons. For example, Article 8 of the instructions states that it shall be restricted to any employee whose jobs involves selling and buying securities from using information obtained at work for person gain.
\item Interview with Sami Al-Souage an active investor in the Saudi stock market, Riyadh, 12 December 1997.
\item The Ministerial Committee Disclosure Rules, Ministry of Commerce Circular, Reference No. 2222/221/9/3340, dated 8/1/1/1417.
\end{enumerate}
\end{footnotesize}
prohibition of trading, the Saudi authorities declined to offer reasons for the prohibition of insider trading. Rather, the Ministerial Committee elected to rely on the public interest, i.e., general welfare, as the reason for the prohibition of insider trading. The rules concerning insider trading are contained in Article 4 of the Ministerial Committee Disclosure Rules enacted in 1997. The term ‘insider trading’ is not defined in the Saudi Disclosure Rules. Article 4-a of the Disclosure Rules 1997 provides that “any person shall not trade based on inside information, information which is not published and freely available to the public, whether this information is received either directly or indirectly.

3.1 Inside information

Article 4 of the Disclosure Rules defined inside information as information that is not published and freely available to the public. This language of Article 4, which limits trading on the basis of non-public information, provides no criteria for determining which information is not yet public and freely available. The failure to provide criteria is significant. Yet, it may be assumed that the definition amounts to information that will be disseminated in such a way that it is made available to investors generally. In the case of the Saudi market, it could be argued that information will be considered public if it has been announced to the SCD of SAMA, or if it has been published so that it is readily

129 Ibid.


available to investors in the market through, for instance, the release of the company’s accounts.132 It is therefore very important to have a clear and precise definition of non-public information in order to determine under which circumstances it is permissible for investors to employ market information when investing in securities.133

It is clear that since the concept of public information is crucial to the definition of insider trading, a more detailed and careful approach is needed. In this regard, one of the better definitions of when information has been made public is provided by the UK Criminal Justice Act.134 The CJA sets forth criteria to determine when inside information will be deemed to have been made public. These rules go a long way in clarifying the essential considerations involved in determining when information is public.135 Because information tends to influence securities markets, access to information is a crucial economic and policy consideration for regulation. Disclosure rules require, but often prohibit, the publication of different types of financial information. Unlike the US disclosure rules, which focus almost exclusively on stock transactions, the rules of Saudi Arabia require the disclosure of corporate information.

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132 This assumption is based on Art. 2-a of the Disclosure Rules, which require publicly-traded companies to announce any important information to the Securities Control Department and to the mass media.

133 See Alcock, ‘Insider Dealing – How Did We Get Here?’, pp. 70-71.

134 Criminal Justice Act 1993, Part V, S 58(2), S 58(3).

135 Art. S 58 of the CJA states that information is made public if:

a) it is published in accordance with the rules of a regulated market for the purpose of informing investors and their professional advisers;

b) it is contained in records which by virtue of any enactment are open to inspection by the public;

c) it can be readily acquired by those likely to deal in any securities;

d) it is derived from information which has been made public.

Also information may be treated as made public even though:

a) it can be acquired only by persons exercising diligence or experience;

b) it is communicated to a section of the public and not to the public at large;

c) it can be acquired only by observation;

d) it is communicated only on payment of a fee; or
specifically, Article 2 stipulates that a company is required to disclose any
corporate information that may have an effect on share prices, directly or
indirectly. Rules represent an indirect way to curb abuse of securities, especially
when it is difficult to limit insider-trading abuse. Hence, the option of publishing
(or a prohibition to publish) information is required of regulations that would
limit insider trading. Returning to the question of what constitutes inside
information, it can be seen that the scope of the definition under Article 4 is
especially wide, since it is difficult to ascertain what information will be deemed
to be inside information, and therefore not permitted to be used when trading in
securities. The question concerns whether the regulation was meant to prohibit
the use of any information that is not public, whether it affects the share price or
not. It may be argued that the main goal of rules restricting the use of inside
information is to limit the misuse of the knowledge that will have an effect on
stock market prices.

As with most other insider-trading regimes in Europe and the US, the
information that is subject to the prohibition is the information that may have an
effect on the share prices, which is what the Saudi legislators also intended to
regulate when propounding the Disclosure Rules 1997. To be sure, information
might be non-public but may have no effect on share prices. Yet, it is clear that
the Disclosure Act was implemented solely to prohibit the misuse of information
that could have an impact on share prices and therefore offer advantages to
informed traders over uninformed traders in the market.\textsuperscript{139} The Saudi Insider Trading regulation applies to all types of information, whether it was received directly or indirectly. Any information that has not yet been made public will be deemed to be inside information, whether this information was obtained directly by insiders such as directors or officers or whether it was obtained indirectly by outsiders such as friends or family relations.\textsuperscript{140}

In general, insiders are not prohibited from trading in securities. They are even permitted to trade in the securities of firms in which they are employed as managers.\textsuperscript{141} Efforts to restrict insiders from trading are only made in Saudi Arabia to try to restrict them from trading based on material non-public, price-sensitive information. Unlike the Saudi insider trading provision, most jurisdictions have included another essential condition in order to determine whether the information falls within the concept of inside information. For example, US case law defines the term ‘inside information’ as material, non-public information.\textsuperscript{142} Non-public information is defined as information which has not been disclosed in reports filed to the SEC or the Exchange, or has not been published in press releases. There, the test of materiality depends on the ability of reasonable investors to become accurately informed.\textsuperscript{143} So, for example, the Supreme Court in \textit{TSC Industries v. Northway}, found that ‘an omitted fact is material if there is a substantial likelihood that a reasonable shareholder would

\textsuperscript{139} Scheppele, 'It's Just not Right: The Ethics of Insider Trading', p. 145.
\textsuperscript{140} Disclosure Rules 1997, Art. 4-a.
\textsuperscript{141} Soderquist, \textit{Securities Regulation}, p. 420.
\textsuperscript{142} In the US, the term ‘inside information’ has nowhere been defined by statute of regulation; it has been defined by case law.
consider it important in deciding how to vote'. \(^{144}\) In this view, the court would not require proof that the shareholder’s behaviour would be different if the omitted fact was disclosed. \(^{145}\) Hence, US courts have defined non-public material information as the information that is not available to the public, which a reasonable, prudent person would take into account when making investment decisions. \(^{146}\) Whilst it may appear that the American definition of the concept ‘inside information’ is unusually broad in that it employs the test of the ‘reasonable investor’, the approach nevertheless supplies insiders and other investors with some leeway to decide the type of inside information that they are not allowed to base trade on. \(^{147}\) That is not the case in Saudi law, where the regulation requires the information to be ‘non-public’ in order for the information to be inside information or not, ignoring the question of whether the information will affect share prices or not.

In contrast to the US approach, the European Directive on insider dealing and the UK insider dealing rules have chosen to enact specific definitions of inside information. \(^{148}\) Both statutes require that the information have an effect on the price of the securities for it to constitute inside information. The European Directive on insider dealing defines inside information as the information which is (1) of a precise nature, (2) related to one or several issuers of transferable securities or to one of the several transferable securities, (3) has not been made

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\(^{145}\) Ibid.


public and (4) is likely to have a significant effect on the price of the securities it concerns if made public.\textsuperscript{149} In this regard, the EC and UK definitions of inside information have gone one step further than the US by supplying insiders and other investors with a more precise and clear definition. More specifically, the European approach set forth three conditions that must be satisfied in order for information to fall within the scope of inside information.\textsuperscript{150} Besides requiring the information to be non-public, EC and UK legislators have stated that the information is to be of a precise nature, and that the information is likely to have a significant effect on the share prices. Requiring information to be of a precise nature is very important to give the insiders and any others a clearer, better idea of how to distinguish rumours or speculation from hard facts.\textsuperscript{151}

In addition to the requirement that information be precise and non-public, the EC Directive and UK statutes also require the information to be likely to have a significant effect on the price of the shares. And this element, as we have seen earlier in our discussion of the US approach, is what was missing in the Saudi definition of inside information. Requiring that information have a likely impact on the price of the shares is essential, since it is clear that not all the information known to the public can be considered inside information, otherwise managers and other directors would be prevented from trading at all when they have any non-public information.\textsuperscript{152} Hence, the main point of prohibiting insider trading is

\textsuperscript{149} E. Gaillard, \textit{Insider Trading, the Laws of Europe, the United States and Japan}, pp. 6-9.


\textsuperscript{151} Ibid. The author states that in UK Insider Dealing Act 1985, we used the word ‘specific’ or ‘precise’ where in the directive they only use the word ‘precise’. It was clearly the UK Government’s view that the word ‘specific’ is somewhat ‘wider’ than the word ‘precise’.

to prevent insiders from trading based on non-public, price-sensitive information. If we return to the Disclosure Rules 1997, it is submitted that, in order to be more precise about the concept of insider information, the Ministerial Committee would be advised to amend the definition in Article 4 so as to include the important characteristic of price-sensitivity as an essential feature of inside information.153

3.2 Insiders

Prior to the enactment of the Disclosure Rules 1997, the Companies Act and Instructions to CTUs included certain rules which might have touched upon the problem of insider trading. However, these rules are unlikely to assist the regulators, since there are no criteria defining insiders. For example, the Instructions to CTUs set out the categories of who is exactly prohibited from trading based on inside information. The Instructions prohibit any trader or mediator from trading based on inside information that they received while doing their jobs.154 The Instructions also prohibit a trader from trading while in possession of inside information, which obviously limits this rule to only traders and no-one else.155 Although the sophisticated role played by banks in the Saudi market makes it very important to stop bank employees from abusing inside information, it was also very important to try to stop other persons from doing this as well. As we have seen earlier, the Instruction's rules referring to insiders

154 Instructions to CTUs 1990, Art. 11-2, prohibit any trader from carrying out any securities transaction on behalf of his CTU or on behalf of a third party, based on non-public information.
155 The Instructions define 'trader' as any employee who is working for the CTUs. Traders or mediators play a very important role in the Saudi stock market by being the only persons who are
are excessively narrow in scope, limiting the prohibition to bank employees who work for CTUs. The sensitive role played by banks in the Saudi market makes it necessary to prevent bank employees from strategically using the confidential information that they have received during the course of their employment. However, it is, of course, also essential to restrict other persons who, just as much as CTU employees, might be in a position to profit from information obtained in the course of their employment.\(^{156}\) The CTU’s rules are too narrow when it comes to defining insiders, allowing other persons who have greater access to inside information, such as corporate directors, officers, large shareholders and other employees to remain out of reach of the definition purview of the Act.

The Saudi Disclosure Rules 1997 may have gone further in overcoming the excessively narrow definition of an insider under the Instructions to CTUs. The Disclosure Rules prohibit any person from trading based on inside information, whether the information is received directly or indirectly.\(^{157}\) Yet, the Rules do not expressly define the concept of insider. Rather it is assumed that an insider is any person who is in possession of non-public, inside information on the basis of which they can trade before such information becomes public. Thus, unlike certain European countries’ insider-trading regimes, which distinguish between different types of insiders, Saudi-law does not allow for a precise definition. Saudi law implicitly defines insiders either by proximity to insider information or by virtue of their employment or profession.

\(^{156}\) Instructions to CTUs 1990, Art. 8.2.

\(^{157}\) Disclosure Rules 1997, Art. 4-a.
3.2.1 Primary insiders

As noted earlier, the Disclosure Rules 1997 prohibit any person from trading based on inside information, whether the information is received directly or indirectly. The first category of insiders therefore includes individuals who receive non-public information directly. Arguably, the main reason behind the prohibition of insider trading is to prevent the misuse of inside information and, therefore, it is clear that the main target group of the regulation is the group of individuals who have an employment relationship with a corporation whose shares are being traded, such as corporate directors, officers and executive employees. Although Article 4 does not distinguish between insiders, given the broad texture of the rules, it must be assumed that by virtue of their positions in a company, directors, officers and executive employees are the main targets. This reasoning is supported by Article 3 of the Disclosure Rules which expressly prohibits directors, officers and executive employees from trade in short swing (daily, weekly), which means they are not allowed to trade 10 days before or one day after the announcement of any major events. This provision is crucial, since it is intended to cover internal insiders, i.e., any person who acquires information in the exercise of his duties as an employee or officer of the company. It suffices to say that while Article 3 gives a precise definition of an insider, we can infer that Article 4 includes not only internal insiders, but also any

158 Article 3 of the Disclosure Rules states that the Board of Directors, managers and executive employees are prohibited from trading the shares of their company in the short term (daily or weekly) for speculative purposes or to mislead the market, and they should also not deal or trade before the company announces any major events likely to affect the prices of the share or buy or sell for one day following any such announcement. They are also prohibited from buying, selling or transferring ownership in the 10 days preceding the announcement of quarterly financial statements.
insiders who, despite their function, come into contact with, or have access to, confidential information.

Thus, besides directors, officers and other executive employees of a joint-stock company, the law implicitly also covers large blockholders or major shareholders. The presumption is that controlling shareholders, by virtue of their equity ownership or their position on the board of directors, have access to all confidential information. In addition to directors, officers and major shareholders, the insider regulation is assumed to extend to cover all persons who obtain the information directly, such as professional advisers, lawyers, accountants, counsellors, analysts, stock exchange employees, banks and anyone else who can get the information directly by virtue of his job.

### 3.2.2 Secondary insiders

As noted, the main purpose of regulating insider trading is to limit the abuse of inside information by any person, whether the possession of the information was directly by virtue of his job or indirectly. To this end, the Disclosure Rules prohibit any person who possesses inside information from trading on the basis of it before the information goes public. It is clear, therefore, that Saudi law must also cover all secondary insiders who might obtain inside information from primary insiders. Although the Disclosure Rules in the insider trading provision did not expressly prohibit primary insiders from passing inside information to third parties, the rules went on to prohibit any person who is in possession of inside information from trading in securities. It can be argued that the Disclosure

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Act extends to encompass secondary insiders' (or so-called 'tippees'), who obtain information indirectly and insiders who obtain their information directly during the exercise of their employment, profession or duty. A tippee is anyone who obtains inside information from someone who he knows is an insider, or whose source is such an insider.\footnote{Alcock, 'Insider Dealing – How Did We Get Here?', p. 70.}

Hence, it is clear that Saudi insider trading regulations intend, as do those of most other countries, to prohibit primary insiders, who are in a position to receive inside information directly, and secondary insiders, who might receive it indirectly, from passing such information to outsiders, who, at the same time, are themselves prohibited from trading based on inside information. It should be pointed out that the Saudi insider regulations, despite this analysis, failed to include a requirement prohibiting or holding liable tippees for trading based on inside information. An ammunition of the statute shows that there is complete disregard for the different types of insiders and the potential liabilities that could be imposed. It must consequently be argued that for the Saudi Disclosure Rules to introduce compelling reasons for penalties and punishment, it is recommended that a distinction between the various categories of insiders be made, so as to facilitate the development of a perspective on penalties based on a sufficiently exercised concept of the clarity and motive of their actions.

4. Summary

This chapter has examined the system of Saudi insider-trading regulation. Section 2 was devoted to the theoretical aspects of insider trading, with particular
attention given to efficiency and liquidity. The section showed that the traditional fiduciary duty theory fails to provide a coherent theoretical rationale for the proscription and should be viewed only as a partial element in a more general theory. We also saw that market efficiency will be enhanced by prohibiting insider trading and it was shown that permitting insider trading would provide inaccurate share prices that would damage market efficiency. It was also suggested that fairness is an elusive concept that needs to be clarified with the pure logic of economic theory, which led us to consider the new line of micro-economists who have shown that trading by individuals on the basis of superior information can reduce market liquidity. Finally, it was shown that the restriction of insider trading may increase market liquidity by enhancing the confidence of market participants.

In Section 3 we examined the adequacy of the Saudi insider-trading regulations elaborated on in the Disclosure Rules 1997. Our analysis revealed that the Saudi approach to the definition of inside information contained in the Act is broad and lacks a concern for price-sensitive information. Furthermore, it was observed that the Saudi approach fails to distinguish for a precise definition of an insider. By relying on an especially wide definition of insider, it will be difficult for the Kingdom’s regulators to implement rules for enforcement, let alone for penalties, against the diverse categories of insiders. These limitations in the drafting of the Disclosure Rules point the way for between different types of insiders. In this regard, the Disclosure Rules do not allow reform of the insider-trading rules. In this regard, amendments to the rules, based on clear and concise definitions of insiders, confidential market information and trading violations, will lead to more robust enforcement measures.
Chapter 9

Enforcement of Stock Market Rules

1. Introduction

This chapter will attempt to offer an account of securities market enforcement in the Kingdom. The policy objectives behind securities regulation are to protect investors, foster confidence in the integrity of the stock market, and promote capital market efficiency.1 Securities markets appear to be less attractive if there are no rules to prevent fraud, manipulation and other dishonest practices.2 The enactment of the rules, however, may not alone be sufficient to prevent fraud and foster public confidence. In order to actually be able to protect market participants, it is essential that regulations be enforceable.3 Commentators such as Ayres and Braithwaite have argued that enforcement of securities regulation appears to be stronger if the designated agency responsible for regulating the securities market is supported by strong and various sanctions.4 It has been suggested that regulators are better able to cultivate compliance when they can

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2 M. Pagano, 'The Flotation of Companies on the Stock Market: A coordination failure model', in European Economic Review, Vol. 37, 1993, p. 1102. Pagano argues that stock markets in Continental Europe are less attractive to ordinary investors because regulators are less resolute in repressing insider trading and protection of minority shareholders is weaker.


resort to a hierarchy of sanctions and are able, if necessary, to invoke strong legal measures.\(^5\)

The Kingdom’s enforcement programme has tended to concentrate on several areas, including violations by regulated firms, such as market manipulation and disclosure violations. The regulated firms have adopted the compliance system established by SAMA. In this regard, the Kingdom has been slow in introducing rules that are more comprehensive in coverage, although new initiatives have been introduced over the past two years. For example, SAMA promulgated new rules devoted to enforcing insider trading, fraud and investment fraud in the financial industry.\(^6\) Through the expansion of its enforcement programme, the Kingdom is both responding to old problems and to new market conditions that have generated complex issues, requiring new enforcement strategies to deal with unforeseen market circumstances.\(^7\)

In the Saudi context, a programme of enforcement is necessary to create an environment that increases the efficiency of the market and provides deterrents to securities law violations. The Kingdom’s enforcement regime takes a relatively narrow approach to market regulation.\(^8\) This agency-centered approach allows


\(^7\) See for example S. Malaikah, ‘Saudi Arabia & Kuwait: A Study of Stock Market Behaviour and its Policy Implications’, dissertation submitted to Michigan State University for the degree of Doctor of Philosophy, 1990, p. 19. Malaikah wrote that apart from suspending share trading, no other penalties are specified, and suspension of trading has never been enforced on non-complying companies. As a result, although a few firms have complied with the disclosure requirements in the Executive Rules, the majority has not.

market participants to obtain experience of modern market practices within the relatively narrow and protected confines of close government scrutiny. The question now is whether the government is prepared to introduce a new system of enforcement requiring significant industry co-regulation in order to detect, investigate and prosecute securities fraud.

Correspondingly, the Kingdom could, in close cooperation with SAMA’s SCD, effectively develop a system of securities regulation and enforcement, that places more emphasis on firms’ internal control and compliance. Ideally, the SCD, as the department responsible for enforcing the stock market rules, could be supported by a new Securities Act that would authorize a greater range of flexibility in sanctions and penalties for securities violations.

It is common for stock markets to undertake a degree of responsibility for self-regulation, under the ultimate authority, control and supervision of an independent regulatory agency within the government.9 Over the past decade, there has been a development in advanced and developing counties towards a higher degree of independence and self-regulatory control. There has been a similar development towards the creation of independent, specialist government authorities in the securities market (e.g., the United Kingdom).10 This approach has long been the model for securities regulation in the US, with the SEC charged

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9 See J. Suter, *The Regulation of Insider Dealing in Britain*, Butterworths, London, 1989, p. 65. Suter states that the term ‘self-regulation’ is defined in terms of the statutory functions performed. An SRO is a body (whether a corporate body or an unincorporated association) which regulates the carrying on of investment business of any kind by enforcing rules which are binding on persons carrying on business of that kind, either because they are members of that body or because they are otherwise subject to its control.

with the independent regulation of market participants.\textsuperscript{11} It is argued that the private sector is well placed to take on more responsibility for its own conduct within the market, given the changed role of investors and institutions within the market.\textsuperscript{12}

A starting point for implementing more effective compliance could be the introduction of a new, independent division of SAMA to carry out an enforcement programme. This division could be dedicated to articulating a set of strategies that will oblige regulated firms to comply with the rules, or be subject to a range of sanctions and enforcement actions. Reform-minded policymakers have yet to bring about the substantive changes necessary in the legal infrastructure to create the basis for an enforcement regime that is suited to the modern securities market practices. It could be expected that such a new agency, if properly supported by funds and personnel, and able to impose a range of civil penalties as part of the Kingdom's enforcement regime, could increase market efficiency considerably. In this respect, in an interview, Fahad Al-Mobarak, General Manager of RANA Investment Company, noted that:

"I think that the market will be much better off with an independent regulatory and supervisory body which has only one mission, i.e., the stock market. Having an independent regulatory and supervisory body will increase the quality of the rules and the quality of supervision, and will help in developing the market. I believe it is time for the Saudi market to have an independent organization to take care of the market like most of other countries in the world."


\textsuperscript{12} While banks are required under Article 8.3 of the Instructions to CTUs to adopt in-house rules to prevent any employee or any holder of office in the organisation from using information obtained at work for personal gain, our interviews with banks employees reveal that most banks still do not have such rules.

\textsuperscript{13} Interview, Fahad Al-Mobarak, General Manager of RANA Investment Company, Riyadh, 2 October 1997.
In light of this background, the main task of this chapter is to evaluate the current enforcement regime, determining its effectiveness in ensuring compliance with the stock market rules and in protecting market investors. Section 2 analyses the liabilities of regulated firms under the stock market rules. The first part of this section is devoted to liabilities under the CTUs. The second part discusses the disclosure and antifraud rules that impose liabilities upon market investors under the Disclosure Rules. Section 3 offers an analysis of the various enforcement techniques, looking closely at the supervisory authorities’ roles, their investigative powers, their ability to prosecute those who violate regulations, and penalties for violations.

2. Liability under Stock Market Rules

As a starting point for considering the Kingdom’s enforcement regime, it is appropriate to review how the programme has changed over the past decade and a half. During the 1980s, the Kingdom passed the Executive Rules to formalize the stock market and to design trading and supervision structures. The Executive Rules promised to usher in a new era in securities market regulation in the Kingdom. It authorized the buying and selling of shares through banks, and a system of rules and regulations concerning the organization of banking mediators, with an emphasis on the procedures for buying and selling shares and restrictions on the purchase of

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14 Executive Rules to Regulated Share Trading in Company Shares through Commercial Banks, Circular No. 123219/m/a276, December 1984, the General Banking Control Department, SAMA.
shares. The provisions promulgated under the Executive Rules also created the SCD to provide the necessary monitoring of banks’ central units that deal in shares.\textsuperscript{15} The purpose of the SCD is to restrict unsafe practices in the market. The Rules tend to focus on reducing market risk, seeing this as being the greatest threat to investors. For example, Article 1 forbids banks to act in shares for their own account, and Article 7 forbids investors to work with credit or IOUs when dealing in shares.\textsuperscript{16} Whilst the Executive Rules aim primarily to limit market risk and to develop administrative procedures for supervising share dealings, no reference is made to any principles or rules proscribing fraud, manipulation or insider trading. This lacuna is especially remarkable given the persistence of such practices in the earlier, informal market.

Besides purely technical trading issues concerning the buying and selling of shares, the Saudi market regulators developed no significant legal basis for enforcement of trading violations.\textsuperscript{17} The principal reason that a strong enforcement regime was not developed is due to the government’s priority to establish factors and conditions necessary to promote the development of the financial market, rather than directly regulate participation in the market.\textsuperscript{18} The Executive Rules succeeded in establishing the conditions for the formal trading market. The Kingdom’s policymakers had assumed that by excluding financial intermediates from the market, there would be little securities fraud. Such reasoning is highly problematic since the absence of an effective disclosure

\textsuperscript{15} Executive Rules 1984, Art. 2-f.
\textsuperscript{16} Executive Rules 1984; Art. 7 states that it is forbidden to deal in shares on credit and that banks are not allowed to accept payment for shares in the form of post-dated cheques or any other post-dated instructions; banks are responsible for any violation of this prohibition.
regime, which is necessary to limit financial fraud and insider trading, makes it extremely easy for market actors and firms to pursue illegal strategies. In an interview, Nasser Al-Salem, an investor, noted that:

"The Saudi market, just as many other markets, has some illegal practices. I believe that the lack of adequate supervision is the main reason behind some of the illegal activities. It can also be observed that some shares suddenly go up sharply and then drop again in a short time with no reasonable explanation."\(^{19}\)

The more recent initiatives of the Kingdom's policymakers, especially the Instructions to CTUs, are designed to overcome the regulation shortcomings by providing rules that impose penalties on dealers that either make false markets or engage in insider trading.\(^{20}\) We now turn to an analysis of these new provisions.

### 2.1 Liability under the Instructions to CTUs

The Instructions to Central Trading Units were promulgated by SAMA to provide guidance for the CTUs in the execution of transactions through the electronic trading system ESIS.\(^{21}\) Introduced in1990 for the internal use of banks, the instructions set forth the procedures that CTU employees are required to follow when executing orders through ESIS.\(^{22}\) The new rules immediately filled the regulatory gap and became the primary regulations governing the daily operation of the stock market. The rules apply only to CTUs, linked branches, and their

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\(^{18}\) See interview Mr. Mansoor Al-Mayman, Deputy Minister of Finance and National Economy, member of the Supervisory Committee, Riyadh, 21 November 1997.

\(^{19}\) Interview with Nasser Al-Salem, an active trader in the Saudi stock market, Riyadh, 22 October 1997.

\(^{20}\) See interview with Abdul Aziz Al-Dukhiel. Al-Dukhiel states that there were cases of insider trading against which SAMA was ill-prepared to bring adequate measures, hence the new rules were targeted to close that gap in market regulation.

\(^{21}\) Instructions to CTUs, Securities Control Department, SAMA, Riyadh, 1990.

\(^{22}\) Instructions to CTUs 1990, Art. 1.
employees. The applicability of the Instructions to bank employees can only be found in Article 8 of the Instructions, which states that any trading violation committed by a bank employee as a result of not following the trading instructions shall be recorded.\textsuperscript{23} Any violation of Article 8 can result in their suspension.\textsuperscript{24} The aim of this measure is to dissuade bank employees, who may wish to take advantage of their position by trading in advance of the market, from doing so. Interestingly, there are no requirements that serious offenders be required to relinquish their profits or be subject to civil liability for wrongful actions.\textsuperscript{25} Ultimately, the detection and enforcement of these violations will require significant formative support by compliance officers, as well as the willingness of bank executives to institute in-house measures that will help thwart such violations.

2.1.1 False market

A major concern of the policymakers is to prevent intentional interference in the market forces of supply and demand. SAMA's SCD engages in surveillance to ensure the integrity of trading on the stock market. An attempt to distort these forces through scheme, artifice or design constitutes market manipulation. Manipulation can be attempted in a number of forms, but will involve an attempt to artificially raise or lower the price of a market security. SAMA's commitment

\textsuperscript{23} Instructions to CTUs 1990, Art. 8.
\textsuperscript{24} Instructions to CTUs 1990; Article 8 states that trading violations committed by traders as a result of not following the trading instructions shall be recorded. Violations can lead to charges against the concerned traders or their CTU, and can result in their suspension.
to limit fraud and manipulation is reflected in Article 8.1 of the Instructions to CTUs.\textsuperscript{26} This provision prohibits any employee from helping to make a false market, by which is meant being involved in collusion between a buyer and seller so as to create a false movement in certain shares that is deceptive to market participants. Employees are prohibited from making a trade that does not result in a beneficial change of ownership of the shares.\textsuperscript{27} Given the crucial role bank employees play in the running of market operations, policymakers believed it essential to establish rules to prevent them from abusing their privileged position. So far, there has been very little progress made by SAMA in restricting manipulation by investors.\textsuperscript{28} Abuses may, for instance, occur when employees trade through nominee accounts, collusively driving up the price of a stock, and later dumping it, which causes harm to investors. Clearly more attention to the regulation of false statements and stock manipulation by bank employees is necessary to change the image of a stock market that is highly manipulated.\textsuperscript{29}

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\textsuperscript{26} Instructions to CTUs 1990, Art. 8.

\textsuperscript{27} Instructions to CTUs 1990; Art. 8.1 states that it shall be contrary to the Instructions to make a false market in a security, by which is meant collusion between a buyer and a seller contrived so as to create a movement in security price which is not justified by the earnings or prospects of a company.

\textsuperscript{28} H. Azzam, \textit{The Emerging Arab Capital Markets: Investment Opportunities in Relatively Underplayed Markets}, Kegan Paul International, London, 1997, p. 156. Azzam provides that for the price of a stock market to be determined fairly, it is important that no price manipulation be allowed. Current regulations of the Saudi stock market prohibit price manipulation. However, unlike other countries where the monitoring and enforcement mechanisms are quite effective, mechanisms to monitor unusual price fluctuations and enforce offences are lacking in the Saudi stock market.

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2.1.2 Bank's inside information

The new regulations include the specification of violations by regulated banks, including the use of inside information. More specifically, Article 8.2 makes it illegal for a CTU or other connected branch to carry out, on behalf of themselves or third parties, any share transactions based on internal or confidential information concerning the affairs of a listed company prior to the arranged time for publication of that information by the company.\(^{30}\) The central role that bank employees play in the handling of the transactions, and their consequent access to inside information, provide ample scope for insider trading. The concern that employees will obtain information through their employment relationship is at the heart of the regulations. Given the importance of employees' position in the market, it is reasonable that the government is concerned about designing measures which help prevent violations. However, SAMA's insider trading enforcement programme has just recently been launched and, until now, charges have never been brought against bank employees allegedly involved in insider dealing.\(^{31}\) In order to sustain and secure compliance, the legislation could perhaps be amended to include a range of sanctions (e.g. dismissal, fines, etc.). The Kingdom might also enact strong measures that compel banks to undertake significant efforts themselves to detect and limit insider trading. This would not only be likely to yield positive results for the banking industry, it would also limit the need for SAMA to intervene in the internal organisational affairs of banks in its efforts to regulate their employees' trading practices.


\(^{30}\) Instructions to CTUs 1990, Art. 8.2.
2.2 Liability under the disclosure rules

As noted earlier, the aim of the Executive Rules 1984 was mainly to organize trading and to structure the market place. Accordingly, the regulations did not provide for the prohibition of illegal trading practices or other violations that might occur in the market.\textsuperscript{32} The Ministerial Committee, after reviewing reports of the Supervisory Committee warning of the serious consequences for the market due to insider trading, fraud and other violations, enacted the Disclosure Rules 1997 to supplement the Executive Rules.\textsuperscript{33} The Disclosure Rules were designed to limit the occurrence of fraud and other market violations that might affect the interests of investors in the market; they address suspension of trading, the publishing of false information, insider trading, and short-swing trading. They also impose liability upon those who violate the rules. We now turn to an examination of the issues addressed under the Disclosure Rules provisions.

2.2.1 Suspension of trading

The Disclosure Rules prohibit companies from manipulating the market through voluntary suspension of trading in their company’s shares. Article 1 of the Disclosure Rules imposes liability upon any company and its directors for illegal suspension of trading in their securities for self-serving reasons (e.g., in connection with an upcoming Annual General Meeting, dividend payment, etc.)\textsuperscript{34}

\textsuperscript{31} Azzam, The Emerging Arab Capital Markets: Investment Opportunities in Relatively Underplayed Markets, p. 156.
\textsuperscript{33} Ministerial Committee Disclosure Rules, Minister of Commerce Circular Reference No. 2222/221/9/3340, dated 8/11/1417, 1997.
\textsuperscript{34} Disclosure Rules 1997, Art. 1.
Of course, under exceptional circumstances and for good reasons companies are permitted to suspend share trading, but only with the express prior approval of the Ministry of Commerce. The enactment of this rule will hopefully stem earlier abuse by company insiders through manipulation of their shares and fraudulent behaviour as investors. It is likely that the rules will need to be amended and strengthened with penalties in order to provide compelling reasons for company directors to follow the mandate.

2.2.2 Disclosure

Until recently, the Kingdom operated the stock market without a disclosure regime. The absence of such a regime led to serious consequences for investors and other market participants. Accordingly, the Ministerial Committee enacted legislation designed to stimulate the flow of information to market participants. The purpose of disclosure is to limit asymmetrical information in the market, protecting investors from manipulation and other adverse market activities. It is intended to close information gaps in the market. The Disclosure Rules impose liability on those in certain functions in companies that fail to satisfy the terms of disclosure. More specifically, Article 2-a requires the chairman or managing director to announce any major events and information which may affect share

35 Disclosure Rules 1997; Article 1 states that companies cannot suspend trading of securities for administrative reasons, such as Annual General Meetings or dividend payments. Companies can in exceptional circumstances, and after coordinating with the Ministry of Commerce, suspend the trading of securities for one week.
36 See Al-Badrah, 'Calling for the Termination of ESIS and the Establishment of Traditional Floor', p. 13.
prices indirectly or directly. Company directors are obliged to announce any company news that will affect share prices without delay.\textsuperscript{38}

Furthermore, Article 2-b makes it unlawful for the Board of Directors, managers and other executive employees to make statements or comments or offer information, unless the statements or the information truly reflect the current state of affairs of the company.\textsuperscript{39} The Kingdom's policymakers recognize that any statement or omission by a company may have consequences for investors. The main purpose of the provision, therefore, is to prevent a company's management from deceiving the market by making untrue statements of material fact or omitting to state an important material fact. The legislation will perhaps be updated eventually to include more intensive coverage of market fraud perpetrated by companies. In that case, the courts may be required to provide legal grounds for limiting the extent of the fraud in the market.\textsuperscript{40}

\subsection*{2.2.3 Short-swing trading}

The Disclosure Rules also protect market participants by prohibiting the Board of Directors, managers and executive employees from trading shares in their company in the short term for speculative purposes.\textsuperscript{41} Managers are also restricted from trading in the company's shares prior to the announcement of any major events likely to affect the price of the shares, or buying and selling one day following any such announcement.

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\textsuperscript{38} Disclosure Rules 1997; Art 2-a states that the chairman or managing director must announce any major events, information or decisions which may affect share prices indirectly or directly to the SCD of SAMA for dissemination via ESIS and the mass media.
\textsuperscript{39} Disclosure Rules 1997, Art 2-b.
\textsuperscript{40} See Chapter 3, pp. 14-17 for more details about the commercial court system in the Kingdom.
\textsuperscript{41} Disclosure Rules 1997; Article 3-a prohibits the Board of Directors, managers and executive employees from short-term trading (daily or weekly) of their company’s shares for speculative purposes, trading these shares to mislead the market, dealing or trading shares before the company announces any major events likely to affect the price of the shares, or buying and selling one day following any such announcement.
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event likely to affect the price of shares. Art. 3-b states that it is unlawful for the board of directors, managers and executive employees to buy, sell or transfer ownership in the 10 days preceding the announcement of quarterly financial statement. While the enactment of a provision to limit short-swing trading signals the new trend to curb manipulation by corporate insiders, it is unlikely to be enforced by SAMA, due to the limited power and penalties available to the organisation to tackle this market violation.

2.2.4 Insider trading

In Chapter 8 we noted that the Ministerial Committee enacted insider-trading rules to limit the misuse of non-public material information by insiders. Article 4-a of the Disclosure Rules applies to the sale or purchase of shares made by any person who possesses material information that is not available to the public. The law imposes liability upon those with access to insider information, such as the company's Board of Directors, managers and executive employees. The rules also impose liability upon those who are not directly connected to the company, but have the potential to trade based on inside information, such as outsiders and tippees.

The SCD, which is responsible for surveillance and enforcement of insider trading regulations, operates under very difficult conditions, due to limited resources and conflicts with other agencies about prosecutable activities.

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44 The Disclosure Rules 1997, Art. 4-a, state that no one may deal on inside information that is not published and freely available to the public, whether this information is received directly or
Accordingly, no actions have been announced to date against any alleged insider, and our fieldwork revealed that few warnings have been issued for alleged cases involving misappropriation of price-sensitive information which was used in trading of securities.\(^{45}\) Clearly, the creation of an independent enforcement body is crucial for effective enforcement.

3. Enforcement Mechanisms of the SCD

It has been argued that no regulatory system can be effective in protecting investors without a strong and efficient system of discipline and enforcement.\(^{46}\) This section examines the surveillance capabilities and procedures of the SCD. We turn initially to the question of the investigations of violations by the SCD.

3.1 Investigations

As noted in Chapter 4, The Executive Rules empower SAMA as the body delegated with the task of regulating the stock market’s functioning. Given the role of banks in the market, it was reasonable for the Executive Rules to establish the Securities Control Department as a division of the Banking Control Department within SAMA.\(^{47}\) The function of the SCD is to supervise the daily indirectly. In this regard, the Disclosure Rules do not distinguish between insiders and outsiders in the prohibition of the use of non-public information.

\(^{45}\) For example, Azzam states that while insider trading is illegal in Saudi Arabia, violators of the insider trading rules usually just receive a warning from the market authorities, admonishing that it not happen again.


\(^{47}\) The Executive Rules 1984, Art. 2-f, state that to be able to complete the daily supervisory role, the banking control department at SAMA has to establish a permanent control division which will be called the Securities Control department.
trading in the market. The SCD, through the Instructions to CTUs, is mandated to supervise banks and their employees when conducting securities transactions through ESIS.49

As noted earlier, neither the Executive Rules nor the Instructions to CTUs provide the SCD with any power over listed companies, since joint-stock companies remain under the direct supervision of the Ministry of Commerce. Whilst SAMA is the main agency responsible for stock market operation, its regulatory role is uncertain and limited by its legislative mandate.50 It is likely that regulation of non-banks and other financial companies will need to be consolidated under a single agency so that effective enforcement can be made possible. When promulgating the Disclosure Rules in 1997, the Kingdom's policymakers failed to limit the uncertainty of stock market supervision and re-allocate responsibility. Instead of clarifying the situation further, the Kingdom's policymakers suggested that the SCD cooperate with the DoC at the Ministry of Commerce to ensure compliance with the Disclosure Rules.51 None of the stock market regulations mentioned how the stock market supervisory authorities

48 According to Art. 2-f of the Executive Rules, the SCD shall perform the following functions: define the hours of dealing in the stock market; analyse the daily dealings which are returned from the bank's Central Units; supervise the appointment of employees in the Trading Units of Banks; receive the complaints of participants; fashion solutions; undertake administrative procedures; advertise the prices of shares in the local papers; convey to banks and companies the instructions issued by the Ministerial Committee and the Supervisory Committee about share dealing; issue informative publications and notes on share dealings; and provide the necessary secretarial work for the Supervisory Committee.

49 Instructions to CTUs 1990, Art. 2 (4) (3).

50 As argued earlier in Chapter 4, pp. 26-27, regulatory competencies in the Kingdom are divided between SAMA and the Ministry of Commerce. In this regard, SAMA's power over the secondary market is still limited by the law mainly to the operations through ESIS. Market activities related to listed companies are still under the jurisdiction of the Ministry of Commerce.

51 For example, Article 1 of the Disclosure Rules requires companies that want to suspend trading of their securities to acquire prior approval from the Ministry of Commerce. This task should actually have been given to the SCD, because it is responsible for the secondary market, and not the Ministry of Commerce. Furthermore, the Disclosure Rules clearly expressed the policymakers' intention to invite the Ministry of Commerce to share SAMA's responsibilities in Article 5, which
would handle enforcement of the rules under complex circumstances. It is worth pointing out that whenever there appears to be a violation of stock market rules, questions emerge as to which agency has the responsibility of investigation and enforcement. Until this conflict over regulatory ‘turf’ is resolved, the difficulties and high cost of coordination will limit the effectiveness of the Kingdom’s enforcement efforts. In this regard, Abdul Aziz Al-Dukhiel, President of the Consulting Centre for Finance and Investment said that:

"I think that the market rules failed to provide the market with the protection needed. The rules are not clear and not effective to increase the flow of information to the market or to stop insider trading. The rules are too weak to force large investors to abstain from manipulating the market or at least require them to report their ownership."

In order to assess the present level of enforcement in the Kingdom’s securities market, it may be useful to examine supervision and enforcement mechanisms of mature markets, as well as those of other emerging markets. Consider, for example, the United States’ Securities and Exchange Commission (SEC) which is the most well-known body for monitoring the securities industry in the world. The SEC was created on 1 June 1934 by Section 4-a of the Securities Exchange Act of 1934. Supported by more than 2,000 employees, the SEC supervises the US securities market. The Organisation is divided into four

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52 Interview with Abdul Aziz Al-Dukhiel, President of the Consulting Centre for Finance and Investment, Riyadh, 12 December 1997.
54 The SEC is an independent agency in the executive branch of the Federal government, which was created by the Exchange Act for the administration of both the Securities Acts. It consists of five Commissioners appointed by the President, with the advice and consent of the Senate, for five-year terms; a maximum of three commissioners may be members of the same political party. See L. Loss, & J. Seligman, *Fundamentals of Securities Regulation*, Little, Brown and Company, Boston, 1995, p. 50.
divisions, Corporation Finance, Enforcement, Investment Management and Market Regulation.55

No law can be effective without someone to enforce it. The SEC is the federal agency empowered to enforce federal securities laws. In the event of suspected violations of the federal securities law, the SEC has full responsibility and power to investigate.56 It has the authority to take disciplinary action against brokers, dealers, investment advisers and investment companies, as well as against the self-regulatory organisations.57 SEC investigations are conducted by the Enforcement Division. Although investigations usually start informally, the division may request the SEC council to authorise a formal investigation, pursuant to which the SEC has broad remedial powers.58 After the Enforcement Division has conducted its investigation, its report may recommend that the SEC initiate disciplinary proceedings, bring the case before the courts, or drop the case.59 Recently, the SEC delegated some of its supervisory powers to self-regulatory organisations. These self-regulatory bodies, such as the North American Securities Administrators Association and individual investment houses, are supposed to monitor the markets on an in-depth, daily basis and report

58 Ibid.
59 Historically, the SEC was limited in its powers of enforcement. The enforcement division had the power to investigate violations pursuant to which it could issue formal orders of investigation and subpoena the production of documents and witnesses. Its ability to seek and/or impose sanctions, however, was restricted. It had statutory authority to censure violators of the securities laws and to revoke broker-dealer's registration. The sweeping legislation of the last decade, examined in detail in subsequent sections, has served to radically increase the remedies available to the SEC. McLaughlin & Macfarlane, 'Insider Trading in the United States of America', pp. 300-301.
to the SEC if there is any evidence of fraud or other violations. The SEC oversees the markets on a broader, national scale. The SEC may negotiate and impose civil sanctions, ranging from injunctions to fines. The SEC has to bring charges and initiate criminal actions, which it must then refer to the Department of Justice. Until recently, criminal prosecutions under the securities laws were rare and available sanctions of minimal deterrent value. Such criminal actions were more commonly brought under the provisions of the mail and wire fraud statutes.

There are two ways in which the SEC can detect violations of the securities laws. First, a member of the public or another government body may notify the SEC that they have detected violations. Second, the SEC has its own monitoring system. For example, the SEC has developed what is called the 'Stock Watch' program; a computerised system that tracks market activities, looking for abnormalities in stock trading patterns by analysing dozens of characteristics, such as daily trading volume, daily price, identities of buyers and sellers and their past, personal trading history. The Self-Regulation Organisation's (SRO) rules and regulations impose the obligation on member firms to supervise their own operations for violations. Therefore, both the

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61 Ibid.
62 McLaughlin & M. Macfarlane, 'Insider Trading in the United States of America', in Emmanuel Guillard (ed.), Insider Trading, the Laws of Europe, the United States and Japan, p. 301.
63 The Commission’s general investigation powers derive from Section 19 of the Securities Act and Section 21 of the Exchange Act, which give the Commission broad powers to conduct investigations into possible statutory violations. L. Soderquist, Securities Regulation, 3rd edition, Foundation Press, Westbury, New York, 1994, p. 577.
American Stock Exchange and the Pacific Stock Exchange required members to institute supervisory procedures to assure compliance with applicable securities laws and regulations.\footnote{65}

In the United Kingdom, the operation of financial institutions is prescribed by the Securities and Investment Board (SIB), the regulatory structure that was established under the terms of the Financial Services Act 1986.\footnote{66} The FSA states that any investment business conducted has to be authorised by, and placed under the supervision of, the SIB.\footnote{67} The SIB is a private company funded by the authorised firms and received no public finance.\footnote{68} Under the FSA Act 1986, SIB may, whenever it appears there is reason to do so, embark upon an investigation into any aspect of the affairs of a person that are relevant to investment business which he is, was, or appears to be, carrying on.\footnote{69} The SIB is empowered to call before it anyone necessary to answer questions, provide information or produce documents relevant to the investigation.\footnote{70} The investigative powers of the SIB are also supplemented by its authority to call for information from any authorised person, SRO, Recognised Professional Body (RPB) or Recognised Investment Exchange (RIE).\footnote{71}


\footnote{67} Section 105 of the Financial Services Act 1986.

\footnote{68} Black, Rules and Regulators, 1997, p. 67.

\footnote{69} Section 105(1) of the Financial Services Act 1986.

\footnote{70} Section 105(3) of the Financial Services Act 1986.

Until recently, the self-regulatory authorities played a prominent role in increasing the adequacy of the securities regulations. The regulatory framework introduced by the FSA 1986, containing self-regulation as an essential and pervading element, gave back to the revamped self-regulation bodies the primary responsibility for policing their members. Under the FSA, SIB has the power to delegate its regulatory responsibilities to a number of authorised agencies, namely the Self-Regulatory Organisations (SROs). The investigative and surveillance role of SROs in the stock market cannot be ignored. All SRO rule books contain regulations providing for investigation whenever it appears that a member of the SRO is not a fit and proper person, that there may have been a contravention of the rules, or that an investigation is desirable for the protection of investors. The stock exchange plays a crucial role in the application of the securities regulations. The Exchange’s Surveillance department is in charge of identifying any suspected cases of trade rule violations and, if necessary, brings charges itself. In the case of suspicious circumstances, the Exchange will notify the Department of Trade and Industry (DTI), which can investigate to establish whether there is a prima facie case, while inspectors can require a suspect to produce documents, appear before them, and give statements under oath that can later be used in court.

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73 At present there are a number of relevant SROs, including the Association of Futures Brokers and Dealers (AFBD), the Financial Intermediaries and Brokers Regulatory Association (FIMBRA), the Investment Management Regulatory Organisation (IMRO), the Life Assurance and Unit Trust Regulatory Association (LAUTRO), and the Securities Association (TSA).

74 Suter, The Regulation of Insider Dealing in Britain, p. 65.

75 Gaillard, in Insider Trading, the Laws of Europe, the United States and Japan, p. 191.


77 Ibid.
Recent concern with the level and value of enforcement in the market has led to the introduction of a single market regulator for the functioning of services.\(^7\)\(^8\)

Improving securities regulation through effective enforcement is an important step for the orderly development of capital markets in developing countries.\(^7\)\(^9\) The introduction of an effective enforcement environment, limiting the instances of fraud, insider trading and manipulation, is of paramount importance for liberalising and near-liberalising countries in the Middle East region. A prime example of a jurisdiction that has moved to the forefront in the area of regulatory regimes is Oman, a country with a small, but quickly developing capital market.\(^8\)\(^0\) Given the proximity of the Omani market to the Kingdom, its potential influence on investors in the region, and the similarities between the Omani and Saudi markets, it is very useful to look at recent reforms undertaken by their government. The success of these reforms may assist the Kingdom’s policymakers in developing their own new strategy to deal with supervision and enforcement issues. It is worth pointing out that the Omani stock market is one of the newest in the area, but is considered one of the most well-regulated and advanced markets in the Arab region.\(^8\)\(^1\) The Omani Muscat Securities Market Law (1988) is a piece of legislation that covers all the aspects related to the stock exchange and its operations. In terms of supervision and enforcement, the Muscat Securities Market Law describes in detail the internal and external supervision and enforcement mechanisms in the market. It creates

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\(^8\)\(^1\) Ibid.
the Muscat Securities Market Management as the regulatory and supervisory body for the Omani stock markets.\textsuperscript{82} The Minister of Commerce & Industry is responsible for appointing the General Director of the Securities Market, who is the main person in charge of executing the policy, regulations and decisions set forth by the Market Management.\textsuperscript{83} As head of the executive department of the market, the General Director is responsible for implementing policy that supports employees, consultants and professionals to carry out their tasks.\textsuperscript{84}

In regard to supervision and enforcement, the Securities Markets Law delegates full power to the Securities Market Management and its supervisory body to conduct any investigation or surveillance necessary to ensure the safe and sound operation of the market.\textsuperscript{85} In this regard, the securities regulator is entitled to conduct any investigations into violations, or suspected violations, of the securities law at any time deemed necessary.\textsuperscript{86} The regulator is entitled to demand that any necessary persons provide the management with information, explanations or documents needed. The General Director, as the representative of the Market Management and as the head of the Executive Department, has the right to appoint a commission made up of market employees to conduct a formal investigation and report to the management.\textsuperscript{87} This commission is also entitled to request any documentation or information, and to call anyone before it for testimony it deems necessary.\textsuperscript{88} The Market Management has the right to

\textsuperscript{82} Muscat Securities Market Law was enacted under Royal Decree No. 88/53, 1988. Article 23 states that the Securities Market Management is the main body in charge of regulating and supervising the affairs of the market.

\textsuperscript{83} Muscat Securities Market Law, Art. 25.

\textsuperscript{84} Muscat Securities Market Law, Art. 28.

\textsuperscript{85} Muscat Securities Market Law, Art. 52-b.

\textsuperscript{86} Muscat Securities Market Law, Art. 52-a.

\textsuperscript{87} Muscat Securities Market Law, Art. 52.

\textsuperscript{88} Muscat Securities Market Law, Art. 52-b.
prosecute those who violate the law and can bring legal action against them for violations of the securities law before the Market Settlement Commission or the Omani Commercial Court. 

These initiatives and market reforms have led to an environment in which investors have more confidence in the transparency of the market. The rules for market operations and enforcement have led to a well-regulated market, where violations are quickly and clearly penalised, sanctioned by the Muscat Regulatory and Supervisory Body. A single securities regulator – responsible for an enforcement programme, directed by highly professional officials and supported by adequate resources and legal measures – has coalesced into a base for an efficient market structure, offering foreign investors a secure environment in which to invest assets.

3.2 Sanctions

There is a wide range of sanctions available to the Ministry of Commerce under the Saudi Companies Act. Saudi regulations provide for civil, administrative and criminal sanctions for violation and non-compliance with the Act. Although these elements are in place under the Act, when a sanction or an order is required, enforcement usually comes down to administrative sanctions under other stock

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89 Muscat Securities Market Law. Art. 43-a, 43-b, 43-c.
90 Companies Act 1965, Articles 76, 77, 78, 229 and 230.
91 Companies Act 1965; Article 78 states that every stockholder shall have the right to institute the action of liability against directors on behalf of the company if the wrongful act committed by them is of a nature to cause personal prejudice. However, stockholders may institute such action only if the company’s right to institute is still valid and after notifying the company of their intention to do so. If stockholders institute such action, they shall be compensated only to the extent of the prejudice caused to them. Article 229 provides for imprisonment for a period of no
market rules. In this regard, the SCD has limited authority under the secondary market rules and related legislation. The enforcement options included in the Executive rules and Instructions to CTUs allow only for cancellation of the transaction, or suspension of traders. There is a potential danger with the latter penalty, since it is limited to bank employees and the linked CTUs and branches. It is conceivable that while employees may face proceedings, some investors or listed companies who have engaged in the same transaction, will be able to avoid penalty. The Ministerial Committee, recognising this problem, passed the Disclosure Rules in 1997, which imposes liability upon any person or firm that violates rules for disclosure, short-swing trading, insider trading, and other fraud on investors. Creating a wide range of regulations can, and indeed must, entail an enforcement strategy, otherwise the rules will not be complied with. In this respect, a problematic feature of the disclosure rules is the absence of specific penalties to be applied in case of violations. Although the Disclosure Rules are an improvement over the Executive Rules or the Instructions to CTU, since they are not backed by penalties other than suspension or cancellation, they still

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93 Instructions to CTUs 1990; Art. 2.4, version 7.0, 1994.
94 Instructions to CTUs 1990; Art. 2.10, version 7.0, 1994, states that transactions may be cancelled at the discretion of SAMA for regulatory reasons, which include the following:
- The certificate representing the shares was invalid for any reason.
- The seller did not have the right to transfer the shares or did not own them.
- The buyer did not have the right to buy the shares.
- The transaction was a serious infringement of trading regulations
- The transaction of the share was not valid at the time of trading.
- The transaction was intended to create a false market.
- The transaction concerned inside trading.
- Or for any other reason which, in the view of SAMA, justifies cancellation of the transaction.
fail to provide specific penalty provisions for violations other than noting that 'violators will be punished'. It is this uncertainty, and the lack of civil and criminal sanctions, that has led to difficulties in detecting, investigating and prosecuting securities fraud.

In contrast, most countries have adopted different kinds of sanctions in order to deter violations of the securities rules. For example, in the US, there are sanctions for fraud and other violations which fall into three primary categories; civil sanctions, administrative remedies and criminal sanctions available through prosecution brought by the Justice Department, as well as remedies available to private litigants in civil actions. More specifically, section 21(d) of the Exchange Act empowers the commission to take legal action seeking an injunction against any person who 'is engaged or is about to engage' in a securities law violation. Courts have held that injunctive relief is available under this provision upon establishing a past violation and such circumstances that indicate there is a reasonable likelihood of future violation. The Exchange Act also provides the SEC with power to issue temporary and permanent cease-

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96 Ministerial Committee Disclosure Rules; Art. 5 states that the creation of an unfair market and/or persons acting on inside information, is prohibited. Violations will be punished according to the regulations within the Kingdom.

97 In general, criminal prosecutions are those brought by agencies of the State and usually punished by imprisonment or fines paid to the State. On the other hand, civil action is a private action brought by someone who claims that he has suffered loss because of the improper action of someone else. See, for example, Mann, 'Punitive Civil Sanctions: The Middle Ground Between Criminal and Civil Law', in Yale Law Journal, Vol. 101, 1795, 1992.

98 15 U.S.C § 78u(d).

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The Enforcement Act significantly expanded the SEC's power to impose sanctions in administrative proceedings further, by authorising it to impose civil monetary penalties of up to $500,000 and/or to order surrender of profits against persons found to be violating, or about to violate, securities law. Moreover, the Enforcement Act additionally empowers the SEC to apply to the courts for an order to prohibit any person who is found to have violated section 10(b) of the Exchange Act, and/or any of the rules and regulations promulgated thereunder, from serving as a director or officer of a company registered under the Act.

Over the past decade, the SEC's powers to impose civil sanctions have been dramatically increased. Seeking additional remedies to further deter insider trading, the US Congress passed the Insider Trading Sanctions Act of 1984 (ITSA) and Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA), while adding new sections 20A and 21A to the 1934 Act.

Section 21A of the Exchange Act permits the SEC to seek civil penalties, both on inside traders and on persons who control inside traders. The penalty for insider trading is at the discretion of the court, but may be as high as three times the profit gained, or loss avoided, as a result of the inside trading, except in

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100 15 U.S.C § 78u-3. A cease-and-desist order is an administrative remedy that orders a person to refrain from engaging in further violations. See McLaughlin and Macfarlane, 'Insider Trading in the United States of America', p. 306.
101 Exchange Act § 21B (a), (b), (e), 15 U.S.C 78u-2(a), (b), (e).
102 15 U.S.C § 77t(e).
103 Soderquist, Securities Regulation, p. 246.
104 15 U.S.C § 78u-1.
106 15 U.S.C § 77t(e).
the case people with controlling function, whose penalties can be as high as $1 million, regardless of the profit gained or loss avoided.\textsuperscript{107}

In addition to civil sanctions, Section 32 of the Exchange Act renders any person who ‘wilfully violates’ any provision of the federal securities laws and regulations subject to criminal penalties.\textsuperscript{108} In particular, Section 32(a) of the Exchange Act states that any person who wilfully violates any provision of this title, or any rule or regulation thereunder the violation of which is made unlawful or the observance of which is required under the terms of this title, or any person who wilfully and knowingly makes, or causes to be made, any statement in any application, report, or document required to be filed under this title or any rule or regulation thereunder............., which statement was false or misleading with respect to any material fact, shall upon conviction be fined up to $1,000,000, or imprisoned up to 10 years, or both. However, if the person is a person other than a natural person, a fine not exceeding $2,500,000 may be imposed; but no person shall be subject to imprisonment under this section for such violations.\textsuperscript{109}

In the UK, civil liabilities are limited to the general law obligations (e.g., claims for breach of contract, breach of fiduciary duty, or tort). The common law provides that any person who has suffered loss due to the improper action of

\textsuperscript{107} Under § 21A of the Securities Exchange Act 1934, the SEC may impose a civil penalty of up to three times the trading profit, or losses avoided, upon finding that a defendant violated Rule 10b5, Rules 14e-3, or any other provisions or rules under the Exchange Act that prohibit insider trading. Profit or loss is defined as the difference between the purchase or sale price, and the value of the security at a reasonable period after public dissemination of non-public information.

\textsuperscript{108} 15 U.S.C § 78ff (a).

\textsuperscript{109} Prior to the enactment of the ITSA and ITSFEA, the maximum criminal fine was $10,000 and the period of imprisonment was limited to five years. Section 32a was amended by ITSA to increase the maximum criminal fine to $100,000. Congress further amended section 32a under the ITSFEA in 1988 to increase the maximum fine for individuals to $1,000,000 and for institutions for $2,500,000. See McLaughlin & Macfarlane, ‘Insider Trading in the United States of America’, pp. 311-312.
someone else, has the right to take legal action to cover the damages. As the securities markets supervisor, SIB has the power to impose a wide range of sanctions. In the event of any breach of SIB regulations, SIB can withdraw or suspend authorisation to trade, make a disqualification direction, and decree that a person may no longer be employed in the authorised investment business. The FSA also provides that the SIB has the power to publicly reprimand an authorised person and empowers the SIB to prohibit an authorised person from further dealing with assets, even if those assets are outside the United Kingdom. The FSA gives the SIB the authority to require that an authorised person transfer assets to a trustee and to prescribe that an authorised person maintain sufficient assets in the jurisdiction in order that all liabilities may be met. The SIB’s power to bring civil action on behalf of investors does not prejudice the right of investors to sue on their own behalf.

Criminal penalties can also be imposed upon those who violate the UK securities law. The criminal provisions of the FSA Act define certain existing offences, ranging from technical or regulatory offences to serious crimes of commercial fraud. However, the application of an offence may differ according to whether or not the person concerned is an authorised person. Any person found guilty of a criminal offence as stipulated by the FSA faces a penalty of imprisonment up to a maximum of seven years, and/or a fine of up to the

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113 See Section 60 of the Financial Services Act 1986.
116 Ibid.
117 Ibid.
118 Ibid.
statutory maximum of summary convictions.\textsuperscript{119} In the case of insider trading offences, a convicted person will be punished according to the CJA1993.\textsuperscript{120} The CJA provides that an individual who is convicted after a summary trial of insider dealing, is liable to a fine not exceeding the statutory maximum, a term of imprisonment not exceeding six months, or both. In the case of conviction on indictment, there is no maximum limit on the fine and the term of imprisonment may be up to seven years.\textsuperscript{121} It is worth pointing out that the criminalization of insider trading has not led to successful enforcement.\textsuperscript{122} For the most part in the UK, Crown prosecutors have been unable to present a compelling enough combination of evidence so as to persuade judges that criminal guilt is involved. Accordingly, some legal commentators question the wisdom of allocating scarce resources to prosecute such complex and difficult criminal charges and have instead recommended that the Crown seek exclusively civil penalties against those committing securities fraud.\textsuperscript{123}

If we look again to the enforcement regimes of developing markets, we see that, for example, Muscat Securities Market law provides administrative, civil and criminal sanctions to be imposed upon those who violate the securities law. First, the Omani securities law empowers the stock market management through

\footnotesize{\textsuperscript{119} See Section 47 of the Financial Services Act 1986.}
\footnotesize{\textsuperscript{120} The Criminal Justice Act 1993.}
\footnotesize{\textsuperscript{121} The Criminal Justice Act 1993, Section 61.}
\footnotesize{\textsuperscript{122} See, for example, J. Coffee, 'Paradigms Lost: The Blurring of Criminal and Civil Law Models and What can be Done about It', in \textit{Yale Law Journal}, Vol. 10, 1992, p. 1875.}
\footnotesize{\textsuperscript{123} The criminalization of securities violations raises a number of issues. First, prosecution of securities fraud must be defined with sufficient clarity to give defendants sufficient awareness of the illegality of their charges. Secondly, prosecutors should avoid initiating actions on purely technical reporting requirements. The conduct to be prosecuted should entail criminal liability, which must be shown to differ from practices that only give rise to civil liability. Critics of criminal prosecution for securities regulation violations observe that prosecutors have failed in many cases to define fraud with sufficient clarity, and prosecuted conduct concerning which observers could seriously question whether criminal liability was called for. See, Rider, \textit{Guide to Financial Services Regulation}, pp. 4410-416.}
the Muscat Securities Market Settlement Commission to impose administrative sanctions upon any persons who violate the securities law. The sanctions range from a warning to the cancellation of membership from the stock market. In addition to administrative sanctions, Omani law gives any person the right to bring legal action against someone before the Commission for the Settlement of Commercial Disputes, in order to claim compensation losses caused by the improper action of that other person. Finally, the Omani stock market law imposes criminal sanctions upon those who violate the stock market rules. First, the law provides that any person who trades based on non-public material information, or who attempts to affect investors' decisions by spreading rumours, will be subject to a minimum of three months' imprisonment and/or a fine of up to OR 5,000. Second, the law provides that any person who knowingly engages in any act or course of conduct which creates a false or misleading impression of the market will be subjected to imprisonment for not less than one month and/or a fine of maximally OR 3,000.

As the above suggests, the strategy of regulating a trading market requires significant enforcement. A regulator must have a range of sanctions and remedies available in order to introduce motivation for compliance. Unlike what is practised in the Kingdom, most advanced markets and some developing countries have an effective primary regulator of the stock market that plays a central, controlling role in measuring compliance, and enforcing stock market standards. The Kingdom possesses fewer statutory devices for ensuring compliance. Whilst

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SAMA has the powers to regulate the secondary market, there are insufficient resources for investigation and enforcement. The enforcement problem is highlighted further by the narrow realm of remedies (i.e., administration) available to SAMA.\textsuperscript{129}

4. Summary

This chapter has focused on the effectiveness of the Saudi stock market rules and their enforcement by SAMA. The primary purpose of the stock market rules is to limit or prevent fraudulent practices, and to foster public confidence in the stock market through improvement of the stock market disclosure regime and strong antifraud provisions. Still, the existing range of rules is not sufficient to guarantee the protection of market investors’ interests. In order to ensure market investors’ protection, the Kingdom needs to promulgate new rules and ensure their compliance. The harm that fraud and manipulation can do to the market emphasises the importance of preventing such offences by providing appropriate supervision and investigation, action and enforcement, deterrents and sanctions.

The present structure of enforcement within the Kingdom is not optimal. The development of the modern market microstructure means that SAMA has exclusive regulatory power over the trading activities of banks in the stock market. The regulatory mandate of SAMA, however, is limited, since only banks

\textsuperscript{128} Muscat Securities Market Law 1988, Art. 54.

\textsuperscript{129} It is worth pointing out that the now-dominant regulation of disclosure for the listing of companies on the exchange, which is designed to regulate fraud, is not technically employed at present by the Ministry of Commerce. Amendments to the Companies Act, requiring mandating disclosure upon listing, could support further the regulations of securities against fraud in the Kingdom.
of listed companies and other non-bank investors in the market fall under the supervision of the secondary market regulator. The Ministry of Commerce regulates the primary market activities and other joint-stock companies activities, which is consistent with the early design and development of the market. We have seen that this hybrid regulatory structure has created some confusion with respect to the stock market supervision. We have argued that neither supervisory branch is able to regulate properly due to truncated powers and unclear arrangements. The upshot is that the adequacy of supervision and investigation of securities fraud is questionable. Presently, there is a perception that only banks are obliged to obey SCD orders, while other listed companies are only obliged to obey the rules promulgated by the Department of Companies under the jurisdiction of the Ministry of Commerce.

Improved supervision of market rules could be assisted by the creation of a single market regulator with full power over all listed companies. This change in policy would converge with international fraud regulations, as witnessed in the case of the United Kingdom. Such a structure would naturally require more resources and further changes in legislation (e.g., the introduction of a Securities Act) so as to establish its position as the main regulator for the market. Effective market enforcement requires that the Kingdom take legal action against persons who violate securities fraud rules or engage in insider trading. The present weak enforcement structure, in which there is no mention of litigation or procedures for bringing legal actions against violators, leads to uncertainty about the Kingdom's commitment to securities regulations. The fact that the stock market rules do not contain any civil or criminal sanctions weaken the possibility of enforcement.
Because the only penalty for violations is the suspension of CTUs, employees and/or transactions, it is unlikely that violators have sufficient deterrence to avoid engaging in potentially distorting or illegal activities. This chapter has, by examining the practices and procedures of other markets, provided a basis for the policymakers in the Kingdom to consider changes to its stock market legal structure and enforcement regime. The prospect of further market growth in the financial services sector depends crucially on change being made to the regulatory system. We have seen that efficient market microstructures must be supported by rules that promote transparency. Anti-fraud rules and regulation of insider trading and manipulation are necessary for the Kingdom's modern market infrastructure.
Chapter 10

Conclusion and Suggested Reforms

1. Introduction

In the aftermath of the recent finance-driven trouble in East Asia and elsewhere,¹ and the scandals concerning minority investors’ exposure to unfair self-dealing and other transactions in England and continental Europe, many commentators have called for legal and institutional reforms that could strengthen the minority shareholders.²

Recent research on securities markets has found that, despite differences in capital market development and ownership patterns³, the development of minority investors’ rights and their reliance on external finance appears to correlate with the strength of a country’s capital market. This work emphasises the centrality of laws that provide investors with good information about the value of a company and protect investors from the self-dealing transactions of the company’s insiders.⁴ There is evidence that, to the extent that a country undertakes to initiate legal and institutional reforms along these dimensions, a country can expect to enhance the development of its stock

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market. As a consequence, because so much evidence is emerging about the benefits of legal standards for strong stock markets, countries world-wide are attempting to overcome the weaknesses of their existing regimes by developing supporting institutions and an enforcement system designed to counter insider trading, manipulation, self-dealing and other abuses. Given the empirical relationship between stock market development and a legal regime that supports transparency and investor protection, this chapter explains why the level of market development in the Kingdom is unlikely to be stimulated without the introduction of specific legal and institutional reforms. The main aim of the chapter, therefore, is to argue that there is an array of legal reforms, discussed in Chapters 4-9, which are needed to significantly increase the current level of stock market development in the Kingdom.

When studying the regulation of institutions that regulate the listing and selling of shares on a stock exchange in countries like Saudi Arabia, one must take into account the fact that the system of legal rules and remedies there is fundamentally different from that in common law nations and most other major western nations. In particular, common law legal systems tend to outperform civil law in providing investor protection and structures that promote a liquid stock market and international integration. Quite unlike the Saudi legal regime, the legal regimes in common law countries have developed quite effective mechanisms for dealing


7 See, LaPorta et al., 'Corporate Ownership Around the World', 54 J. Fin. 471, 475, 1999.
with the agency problems that confront investors in securities markets.\(^9\) Despite differences in legal tradition, the Kingdom’s performance in protecting investors and providing high disclosure rules more closely resembles the practices in civil law systems than the common law approach.\(^10\) The Saudi market is characterised by a relatively low number of publicly listed companies, a reasonably liquid market and few initial public offerings. Until recently, the market has been closed to foreign investors, except via closed-end mutual funds. As in many other concentrated systems of shareholding, a large portion of the listed companies on the Saudi exchange are not susceptible to hostile take-overs or interventions by institutional investors. Deficiencies and gaps in Saudi law tend to inadequately protect investors from exposure to self-dealing transactions. And if we focus on enforcement, it becomes clear that private investors have few remedies against firms who may confiscate their assets. In recent years, the Kingdom has taken steps to develop rules for insider trading, disclosure of financial information, and general issues which constitute a move toward developing a regulatory framework that operates to increase the level of transparency.

This thesis has paid considerable attention to the laws and institutions needed to support greater monitoring and liquidity. The analysis presented here suggests that a strong stock market requires not only well-designed securities laws (and a strong deterrence environment), but also the involvement of financial intermediaries to


reduce agency costs and supply much-needed liquidity. In many countries, financial
intermediaries, with special reputational assets, often play a crucial role in
information disclosure by providing investors with credible information about
companies and their future performance possibilities. Furthermore, they exert a
strong presence in the market by limiting securities fraud, since in most cases
intermediaries put their own reputation on the line when they vouch for the
disclosure quality of their clients' statements to the market and government
regulators. It was argued in Chapter 6 that, as long as financial intermediaries are
legally excluded from the Kingdom's stock market, valuable aspects of a modern
securities practice will be absent from the market (i.e., meaningful listings standards,
high levels of disclosure, meaningful ratings, etc.).

Although the thesis has paid particular attention to the legal environment,
Chapters 2 and 3 also provided considerable insight into the historical development
of the market and the environment in which market actors operate. It is worth
pointing out that this is the first legal thesis which addresses not only the Kingdom's
'law on the books' but, in sharp contrast to earlier works in the field, explains how
the regulatory mechanisms actually function in practice. In line with recent research
on comparative corporate governance and securities law, the focus on the
performance of the legal rules and institutions themselves is based on detailed field
work and interviews, containing a number of original aspects. This new emphasis on

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11 B.S. Black, 'The Legal and Institutional Preconditions for Strong Stock Markets: The Non-triviality
of Securities Law', pp. 4-8.
12 See, generally, J.A. McCahery et al., Convergence and Diversity in Corporate Governance Regimes
legal rules for securities markets provides a fruitful basis for discussing the possibilities for developing more efficient practices. From this perspective, this thesis focused on the adequacy of disclosure and market transparency standards, rules on insider trading, take-overs and self-dealing transactions.

This chapter will proceed through two stages. Part II focuses on main elements of the Saudi regulatory regime in order to reveal some of the deficiencies in the practices and to assess some of the new reforms designed to address the system's shortcomings. Part III will then focus on a series of suggested policy reforms, emerging from the detailed review of the Saudi regime. This section explains why the adoption of credible disclosure rules, insider trading and anti-fraud rules, and the movement toward the establishment of a securities regulator may create the necessary basis for the establishment of a strong securities market in the Kingdom.

2. Conclusion

Successful securities markets tend to develop a set of rules and institutions that foster investor knowledge and confidence in the market. Chapter 1 was devoted mainly to explaining the importance of capital markets for economic growth in the Kingdom. There are a number of pressures contributing to the demand for a strong stock market in the Kingdom. Creating a strong capital market is viewed as especially important because it can facilitate economic growth by providing a more efficient way for companies to raise capital. It is notable that the family-controlled firms, with few exceptions, constitute a significant segment of the business community in Saudi Arabia. These firms, controlled through extensive cross-ownership and holding
structures, tend to have good government contacts that are crucial for their long-term performance. Yet many of these companies do not have access to the Saudi capital markets, due to inadequate disclosure and the absence of intermediaries to give detailed information to investors, and must rely on internal financing or bank loans. Thus, a large section of the Saudi business community is not only forced to suffer higher costs but will remain uncompetitive with respect to foreign firms. To address this problem, it is submitted that rapid changes are required to create a well-functioning public stock market that can give more companies access to external capital, which may help them grow faster. It is suggested that changes in financing patterns for small and medium-sized companies will force them to select more concentrated lines of business, allowing them to make more profit in the long run. To improve the funding of companies is only one reason why the government is undertaking reforms. Viewed in an international context, the prospect of WTO membership, which becomes effective in 2003, binds the Kingdom to confirm the link between a fully effective membership and the liberalisation of the country's financial system. For this reason, there is general agreement that the government will have an incentive to proactively develop the regulations required for membership and to ensure adequate disclosure of information. Whilst it is expected that the rules of the game will be changed to bring them in line with broad international practice before entering into the WTO, it is anticipated that increasing foreign participation in the market will rapidly force changes in capital market practice and regulatory posture within the Kingdom.\textsuperscript{13}

\textsuperscript{13} A similar process is taking place in the United Arab Emirates, see Financial Times, Tuesday 21
Chapter 2 was devoted mainly to examining the main aspects of the genesis and evolution of the Kingdom’s stock market. We saw that the market expanded rapidly over the past three decades. The level of stock market development is measured typically by the size of the market, market liquidity, market concentration, market volatility, institutional development and integration in the world capital markets.\textsuperscript{14} Stock market development had been relatively slow until the late 1980s due to the absence of large institutional investor participation and reliable disclosure rules to encourage investment and trading in the market. The emergence of domestic institutional investors, which brought growth in terms of demand for assets, has been a vital factor in increasing the size and improving the liquidity of the market. The growth in the market has indeed been significant. For example, between 1985 and 1998, the number of transactions, volume and value of trading increased more than 32-fold. Market capitalisation has increased by more than 160\%, making the Saudi market by far the largest market in the region. Despite the relative success of the Saudi market, it is acknowledged that this level of development, while notable, is modest in comparison with other emerging markets in developing countries.\textsuperscript{15} In this regard, the absence of foreign investors and integration within the world capital markets suggest that the Saudi market is significantly underdeveloped. It is important that the government facilitate the adoption of specific policies to allow more direct foreign participation and ownership, rather than hindering or restricting the types of

December 1999, Supplement, p. 3.


\textsuperscript{15} Ibid., pp. 305-307.
investments and investors permitted to operate in the market. In the longer run, the adoption of such measures should enhance greater market liquidity, while limiting damaging volatility.

Chapter 3 provided a framework for understanding the regulatory design of the stock market rules. The analysis explains why a number of diverse regulatory processes and institutions are employed to govern the Kingdom’s capital market. Whilst there is extensive variation in the structure and organisation of the Kingdom’s regulatory regime, most rules are designed invariably to regulate the activities of the market players, rather than the actual stock market. On the whole, this approach tends to limit flexibility and innovation. In addition to rules that focus on participants rather than instruments, the regulatory system is not yet unified under the authority of a regulatory agency which has the mandate to delineate the substance of its regulatory mandate. Problems with gaps in regulatory authority and the lack of detailed procedures to regulate securities markets operations undermine any attempt to establish a credible regulatory system. The evidence presented for the Kingdom is that recent reforms have attempted to force implementation of credible rules that provided the required safeguards for investment and growth in a system that can change along with the changes in the market’s activities.\(^{16}\)

Chapter 4 assessed the Kingdom’s existing regulatory arrangements for the primary and secondary markets. The Kingdom was found to have a hybrid arrangement, with the primary market being regulated by the Ministry of Commerce, and SAMA monitoring the secondary market. With respect to the performance of

regulatory institutions, it was found that the fact that the government was able to coordinate policy and determine the context of agency regulation was, until recently, largely due to the supervision and management of the agencies' day-to-day decisions carried out by Ministerial and Supervisory Committees. However, serious problems are emerging with respect to the institutional division of labour. It is submitted that the Kingdom's hybrid system, while effective in an earlier stage of the market evolution, may no longer be sustainable in closely controlling the market's complex and evolving structure. In the long run, the government may need to amend its regulatory framework in order to achieve its economic objectives.

Chapter 5 was devoted to examining the supply-side character of the Saudi stock market. The chapter demonstrated the benefits, both directly and indirectly, of institutional shareholding. The level of institutional intervention to change or alter under-performing management structures in Saudi Arabia was found to be very low.\textsuperscript{17} This reflects the fact that while there may have been increased institutional ownership, most of the major institutions, such as funds, pensions and closed-end investment vehicles, play no direct role in the monitoring of companies. Indeed, most of the institutions employ fund-management firms or have their in-house managers pursue investment strategies that are commonly employed by external fund managers. Given the fact that most of the largest funds are dedicated to managing their long-term investments in shareholdings, it was argued that this behaviour of these managers actually leads to low levels in the rate of turnover of shares. In this

\textsuperscript{17} For an account of the growth of institutional shareholding and an analysis of the effect of their interventions in the UK and Australia, see G.P. Stapledon, \textit{Institutional Shareholders and Corporate Governance}, Oxford, Clarendon Press, 1996, esp. Chapter 2.
regard, the Saudi approach to a longer-term strategy would appear to approach the style of investment in bank-based systems, such as those in Germany and Japan.\footnote{Ibid., pp. 210-211.}

Undoubtedly, the long-term orientation of Saudi institutional investors stems from the bank-oriented structure of the market, which means that the funds and institutions tend to be fairly homogenous. Whilst this type of market has the effect of creating stability, this may be a two-edged sword, because the very fact that institutions do not often engage in the sell-side of the market may lead to low turnover and very little in the way of IPO activity. This insight was supported by the second observation that, while Saudi market capitalisation is relatively large, it is concentrated in a small number of companies. It would appear that, given the low annual trading volumes and daily average, which are unlikely to increase without the stepped-up involvement of both domestic and foreign intermediaries in institutional fund management. Furthermore, domestic underwriting services and positive regulatory changes are needed.

Chapter 6 examined the main aspects of the Kingdom’s market infrastructure. In this chapter we saw that the development of the Kingdom’s electronic trading platform and clearing system signalled a major shift toward the creation of a world-class market. More specifically, the reliance on advanced technology has been crucial to the Kingdom’s ability to meet and surpass the G-30 international benchmarks in trading execution and settlement. This chapter also argued that the Kingdom’s Executive Rules, which restrict operation of the Kingdom’s share trading to the main eleven banks within the system, may have been a good thing as a way of developing
the infrastructure. However, it was concluded that, in the light of the high trading fees and the innovations that usually accompany greater competition (e.g., Internet trading), if anything, the Executive Rules should be amended to allow financial intermediaries to participate in the area of supplying venues for share trading. The benefits from increased competition could be enormous. There is even evidence that, by allowing financial intermediaries to participate in stock exchange trading, such firms may acquire strong incentives, as in the United States, to create their own automated trading systems.19

Chapter 7 evaluated the pattern of the disclosure in Saudi Arabia, questioning whether the regime enforced a positive disclosure obligation on management. The basis of the reporting requirement is set forth in the Companies Act and the Executive Rules, which mandate the release of essential information about companies in the market. Special attention was given to registration requirements, particularly for new companies, and whether these offer an adequate basis to inform investors of the investment risks. It was shown that reporting requirements for annual reports are not sufficiently comprehensive so as to provide investors with accurate financial statements of the company in question. The disclosure system, which has no mandatory listing requirements, was revealed to be of a rather low quality. It was argued that successful securities markets tend to provide investors with extensive financial disclosure, good listing rules, liability rules that ensure that companies meet

the minimum quality standards, and sophisticated intermediaries who ensure honest disclosure. It was suggested that in order to give investors reasonable assurances about the quality of a firm's shares, the Kingdom could introduce listing rules, supplemented by enforcement rules, and involve financial intermediaries in the disclosure process. Hence, extensive disclosure rules can, if adopted and enforced, reinforce the position of minority investors who have developed few protections to counter false or misleading disclosures.

In Chapter 8 the regulations with respect to insider trading were examined. In a country such as Saudi Arabia, with a recent history of stock market organisation, there is a relatively underdeveloped culture of securities enforcement. Indeed, enforcement depends on strong institutions with strong backing from the market and political decision-makers. It was found in Chapter 8 that the Saudi approach to regulation of insider trading was constrained by a rather broad and imprecise definition of inside information as contained in the Disclosure Rules 1997. Moreover, the rules lack sufficient useful analytical features, such a way of distinguishing between different types of insiders, thus reducing the probability of successful enforcement. The rules against insider trading (Disclosure Rules) could be amended so as to provide for a precise definition of an insider.

Chapter 9 focused on the effectiveness of the Kingdom's enforcement regime, which is controlled by SAMA. It was contended that the regulatory mandate

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of SAMA is unnecessarily truncated because it only covers the activities of banks. It was argued that the absence of a securities law and regulatory body that monitors the activities of market participants is a substantial barrier to successful market enforcement. It was argued that the Kingdom's hybrid regulatory structure, which creates substantial barriers to enforcement, is responsible for the inadequate system of stock market supervision. For example, it was not surprising that, given the limited capacity of the regulatory body, we found that certain unlicensed domestic intermediaries do not come under the purview of the regulator. A large part of the problem of enforcement comes down to the fact that there seems to be little in the way of civil or criminal sanctions. Indeed, because there is no clear penalty for violators, it is unlikely that violators will be sufficiently deterred from engaging in activities which distort prices or divert monies from investors. As in the earlier chapters, it was argued that the Kingdom must alter the regulatory mandate of SAMA so as to provide a more effective enforcement vehicle.

Taking the above chapters together, it was concluded that, despite its technical rate of growth, the Saudi stock market has played a relatively unimportant role in the development of the Kingdom's economy. One of the keys to a successful economy is the role of the stock market. Not surprisingly, it was discovered that the Saudi stock market is not as competitive as other regional markets. The absence of major market players within the financial system has meant that the Saudi market is less well developed. It would appear that the lack of competition in the market, due to the absence of domestic and foreign intermediaries, has led to acute financial problems, because the lack of competition in the market has resulted in higher prices
and a lower level of liquidity. At the same time, it was argued that there are serious regulatory problems associated with the governance of the market due to there being different types of laws and regulators with overlapping areas of competence. The combination of fragmented regulations and a hybrid regulatory structure are not sufficient to guarantee the protection of the market investors. Yet it would appear that pressures are emerging (both domestically and internationally) that might prompt the Kingdom to take the steps necessary to transform effectively its nascent system of supervision into a securities and corporate governance regime that can support further development of the stock market.

3. Recommended Reforms

As we have seen, the Kingdom has established the basis for a world-class securities market. The development of the Kingdom’s electronic trading platform and clearing system has, due to their effectiveness for investors, signalled a major shift towards the creation of a securities market which is fully capable of contributing to the Kingdom’s economic growth. However, the existing advanced technology may not be enough to create a successful securities market. In order to create a successful securities market, the Kingdom’s policymakers must counter the problem of adverse selection, i.e., the problem that high-quality issuers leave the market because they cannot obtain fair value for their shares, while low-quality issuers remain. Successful markets have developed a number of institutions to counter adverse selection problems. They include (1) securities laws that are backed up by severe sanctions for false or misleading disclosure and a securities regulator with the staff, equipment and
budgets to pursue fraudulent players in the market, (2) accounting rules that limit the opportunities for issuers to fudge their financial results; (3) an accounting profession with the skills and expertise to expose instances of attempted fraud; and (4) investment bankers whose reputations depend on not selling fraudulent or overpriced securities to investors. Such institutions reduce the emergence of fraud and the extent of adverse selection. As a result, they attract honest issuers into the securities market and drive out dishonest issuers. Moreover, as the average level of disclosure increases, investors will have greater faith in disclosure, and will pay more for securities. This will lead to more high-quality issuers entering the market. But the participation of accountants, investment bankers, securities lawyers and venture capitalists is costly.

It is clear that there is ample reason to believe that improvement in the regulatory regime will enhance the Kingdom’s stock market activities. We have developed some recommendations that we think are necessary for the Saudi policymakers to undertake in order to create the conditions for a successful securities market.

3.1 One securities market law

The governance of the market with different types of laws might be suited to the market and goals of its regulators in the past. However, the protection of market investors and the potential role that the market could play in the Saudi economy necessitate the enactment of a single set of coherent and consistent securities regulations that address all market matters, while avoiding gaps in the regulation.
Adoption of a single, comprehensive stock market law could, in the first instance, provide a short-term solution for the current problems facing the Kingdom's regulators.

3.1.1 Disclosure regime

International experience tells us that unless disclosure is mandatory, it tends to be avoided, especially by smaller companies, which do not normally attract institutional investors. While it may appear that the US requires too much disclosure (although this is unclear), it seems that other countries require too little and have much too much room in their accounting rules for fudging. As a consequence, securities markets suffer. This is certainly the case for the Saudi market. In this regard, it is recommended that the Kingdom adopt a new Stock Market Law that mandates listing rules, requiring that publicly traded companies comply with a series of Saudi exchange disclosure rules. Under the new Law, listed companies would be required to provide sufficient and comprehensive annual and quarterly reports so as to provide investors with accurate statements of the company in question.

The central task for securities regulation is to ensure that trading prices are promptly published, so that each investor knows the prices that others have paid for publicly traded securities. This gives investors confidence that they are not paying a higher price for the securities he is buying. Transparency gives investors additional protection against asymmetric information. The extra protection translates into higher securities prices, and reinforces the virtuous cycles initiated by good disclosure rules, where high prices attract more high-quality investors into the market. For our
purposes, the Stock Market Law should be formulated so as to create a series of rules, starting with the general mandate that joint-stock companies shall be required to make immediately available any relevant, material information that a reasonable investor would expect to affect the value of the share price of the securities of relevant entities.

The Kingdom's extant disclosure regime is broad and lacks concern for demanding sensitive information or information which most likely will have an effect on share prices of listed companies. Good accounting rules that inform investors of a company's past performance and restrict a firm's ability to choose among different accounting techniques should be introduced. Besides writing serious accounting rules, the disclosure regimes must be supplemented with at least some liability rules to ensure that companies make honest disclosures. Also, the disclosure system should be amended to require full and fair reporting of financial information in a number of change of control contexts. An important part of such reforms is to introduce a far-ranging financial disclosure obligation for investors or the board of a company when they have increased their holdings in the shares of the company. This rule could be supplemented by stating what percentage will be considered a change in the ownership and therefore constitutes a major event. Given the sensitive nature of information, firms should be subject to a clear and precise set of disclosure rules, to ensure effective compliance. It is submitted that the existing disclosure rules concerning tender offers require a comprehensive policy review and the introduction of new rules. This is because there is no attempt to place specific information
requirements on the company or person acquiring or making a bid for the shares of the company.

The current insider trading provision relies on a particularly broad definition of inside information and insider, which will cause difficulties for the Kingdom's regulators when implementing rules for enforcement. In this regard, the new Stock Market Law should provide new provisions based on clear and concise definitions of inside information and insider.

3.1.2 Anti-fraud provision

The single most important job for a securities regulator is chasing off would-be crooks. The key element here is that there are clear anti-fraud provisions and a specialised agency with the will and ability to pursue sophisticated fraud (insider trading, etc.). Certainly, the existence of a wide range of rules is not sufficient to guarantee the protection of investors' interests. Naturally, the harm that can be caused to the market by fraud and manipulation underscores the importance of controlling the offences by providing appropriate suppression and investigation measures, action and enforcement, deterrence, and a range of sanctions.

In order to ensure that market investors are protected, the government should consider amending its securities regulation system so as to provide investors with a comprehensive and coherent set of anti-fraud rules, insider trading regulations and penalties for non-compliance, including criminal sanctions. The new amendments should include litigation rules and administrative procedures for bringing actions
against violators. Such changes are likely to lead to greater certainty about the Kingdom's commitment to securities regulations.

3.2 An independent agency

In an attempt to ameliorate the gaps in its regulations and limit the weakness of the current agency structure, it is essential that the Kingdom's policymakers introduce new legislation, creating a single and independent agency. In many jurisdictions, policymakers have found it more effective to create an independent agency with administrative and regulatory responsibility for the securities markets. If supported with sufficient funding and resources, an independent agency could bring the greatest benefit to the Kingdom's securities market by effectively modernising the rule-making process (with changes being subjected to greater industry-wide comment and discussion). It is anticipated that a single agency will avoid jurisdictional disputes which have caused agencies to increase their jurisdictional authority without modernising the rules in light of changes in the market.

The new agency obviously must have jurisdiction over all primary and secondary securities markets as well as over all over-the-counter and alternative trading markets. It seems reasonable to expect that such an agency should have exclusive power over the disclosure regime which will mandate that all listed companies are obliged to comply with the disclosure requirements set forth by the new agency. All listed companies would then be required to comply with new agency rules and criteria regarding proxy solicitations, mergers and take-over bids. Finally, the new agency will be responsible for setting forth comprehensive, substantive
regulations to license the market of securities firms and the securities business and for providing a system for the registration and overseeing of investment advisors.

An independent stock market regulatory and supervisory body, with as its main and full responsibility the regulation and supervision of the stock market, including the responsibility of the IPOs, is perhaps the only reasonable policy option which could eliminate most of the market’s problems and offer coherence in market regulation. In general, then, the idea of unification in this area should be especially welcome and important for the following reasons. Creating a unified agency structure may tend to build a process of regulatory decision-making that responds to changes in the market, while limiting politicians from intervening in the policymaking process. The Ministerial and Supervisory Committees would be in the position to control and monitor the performance of the agency by reliance on notification procedures. This supervisory role could be supplemented by a set of procedural rules that place constraints on the decision-making of the agency, allowing the Ministerial and Supervisory Committees the opportunity to intervene in the bureaucratic decision-making process. Furthermore, the Committees could create procedural rules for the agency that causes the agency’s administrators to produce policy decisions that can be reviewed ex post by the Ministerial Committee.

It is submitted that a modest redesign of the existing agencies, their structures and procedures, if implemented effectively, might offer the Kingdom’s policymakers a regulatory structure that is at once responsive to changes in the interests of the market, while at the same time creating rules that can benefit the interests of investors. Moreover, a redesigned agency structure would enable the Kingdom to
create a mechanism for creating an effective regulatory apparatus to achieve its regulatory goals for the market, while enabling Ministers to have greater control over the decisions generated by the agency.

3.3 Trading

Over the past fifteen years, the Kingdom has developed a very sophisticated electronic trading platform and clearing system which has been crucial to the Kingdom’s ability to meet and surpass the G-30 international benchmarks for trading, execution and settlement. Yet, by itself, technical improvement of the operation and management of the existing trading system alone may not be enough to secure a competitive advantage for the Kingdom’s equity market. The restrictive policy adopted by the government has resulted in only a few listed companies in the market and a low trading volume and liquidity level in comparison to other emerging stock markets. A modern stock market must provide the means for investors to have access to the most efficient modern trading systems. The government should allow for the introduction of vigorous price competition and remove barriers to innovate technologically in order to provide the best possible trading system.

3.3.1 Primary market

In the light of the newly emerging market conditions, it can be seen that the Ministry of Commerce’s conservative approach to new issues is one of the main factors restricting market growth. In this regard, the newly promulgated Stock Market Law could eliminate the imperfections in the system by introducing a legal framework for
new offerings, based on the concept of regulation by disclosure rather than on the merit review approach. The benefits from such a change in approach include lower costs, since the regulator is concerned only with determining the price of the issue and whether the information disclosed is relevant to assessing the security on offer. The upshot is that the move to a new disclosure-based regime means that the new agency must ensure that all valuations and financial valuations made in the offering are soundly based and fully explained. This scheme relies on the promoters and financial intermediaries to ensure that the disclosures made are fair and sound, and penalties and other incentives should ensure that the parties take all the necessary actions to ensure compliance. Our approach will fundamentally shift the basic traditional conservative role of the responsibility of the private sector and its intermediaries.

3.3.2 Secondary market

Clearly, a number of legal and regulatory changes are required to provide the Kingdom with a deep, broad and liquid stock market. Securities regulation is underdeveloped in the Kingdom and the government should be encouraged to promulgate new regulation concerning brokerage, dealing and the management of investments by banks. Certainly, reforms in the market architecture, including the introduction of an alternative trading system, are necessary in order to enhance liquidity. The benefits of innovation in securities design could be stimulated by the introduction of financial intermediaries whose presence is needed to further enhance the competitive position of the stock market. It is important to remember that
financial intermediaries are essential for reducing market imperfections and improving the allocation of assets within the financial system. The Kingdom would benefit from introducing new types of intermediaries who will facilitate transfers, supply liquidity, monitor loans and manage portfolios. It is suggested that further liberalisation of foreign non-bank participation in the market could contribute significantly to the completeness, liquidity and ultimately the efficiency of the market.

In sum, therefore, introducing reform measures will result ultimately in lower costs for issuing securities. Moreover, if rules on foreign investment in the stock market were to be relaxed, the introduction of powerful changes in the securities regime could serve to attract more investors to the Kingdom. But without these changes, most firms will invest in only a few of the biggest firms. For most investors, the information asymmetry costs are simply too large. Sensible government officials, particularly if they are intent on privatising some of their state-owned enterprises, will lower the regulatory barriers to stimulate investment in the stock market. Another attraction of this approach to reform is that it should encourage large domestic investors (many of whom are active in foreign markets) to become more active in the equity market. The overriding attraction of this package of reforms is that, by imposing rigorous disclosure, listing standards and transparency requirements, the market will succeed in meeting investor confidence, which will in turn lead to further market development creating a strong, well-developed and efficient securities market in Saudi Arabia.
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Materia v. SEC, 745 F. 2d 197 (2d Cir. 1984), cert. denied, 471 U.S.1053.


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Appendix A

Executive Rules to Regulate Dealings in Company’s Shares Through Local Banks

Art.1. The duty of buying and selling shares of joint stock Saudi companies are restricted to Saudi banks which are licensed to do so. The banks perform the role of mediator on behalf of clients (directly) and no share dealings can take place without their mediation. The banks are forbidden from buying and selling shares on their own behalf except with Ministerial Committee permission.

Art.2. A permanent committee is formed to supervise share dealings (which will be called the Supervisory Committee) which is made up of representatives of the Ministry of Finance and National Economy, the Ministry of Commerce and SAMA, and has the following functions:

a. Supervise share dealings and ensure that the regulations and instructions from the Ministerial Committee are carried out.

b. Review rules and regulations relating to the organisation of share dealings, with the purpose of developing and increasing their effectiveness. (In this situation) it has the right to request all financial information relating to dealings from commercial banks or companies. The commercial banks and the companies are obliged to provide all the information that the Committee requests about share dealings.

c. The Committee has the right to stop dealings in shares of a company or to put a maximum limit on dealing in its shares if the general welfare so requires, on a temporary basis that does not exceed on week. For anything more than one week, the Committee has to obtain the permission of the Ministerial Committee. Also the Committee has the right to stop any dealings in the market altogether after obtaining the Ministerial Committee’s approval.

d. The committee holds at least a monthly meeting and a meeting can be called at the request of any member. The meeting takes place in the offices of SAMA, with all the members present; the Committee’s resolutions are issued if approval of 2/3 of the members is obtained.
e. The Committee has to present a quarterly report on its activities to the Ministerial Committee and needs the approval of the Ministerial Committee for any changes in the executive regulations for share dealings.

f. To be able to compete the daily supervisory role the Banking Control Department at SAMA has to establish a permanent Control Division which will be called the ‘Shares Control Division’. This Division specialises in the following functions (duties):

- Defining the working hours for dealings in shares at the Central Unit.
- Analysing daily dealings which are returned from the Banks’ Central Unit.
- Supervising the appointment of employees in the dealing units of Banks.
- Registering the complaints of participants, and providing solutions and undertaking (orderly) procedures.
- Advertising the prices of shares in the local papers and conveying to the Banks and the companies the instructions issued by the Ministerial Committee or the Supervisory Committee about share dealings.
- Issuing informative publications and notes on share dealings for the general welfare.
- Providing the necessary secretarial work for the Supervisory Committee.

Art.3. Each Bank designates a separate Central Unit, which will deal in shares at its head office if it is situated in Riyadh City or in one of its operative branches in Riyadh City; the Central Unit would receive requests from Branches and complete the share dealings with other Banks. Operating in it will be one or more Mediators, which the Bank will appoint after ensuring the following conditions are satisfied:

a. The Mediator should be a Saudi Arabian.

b. He has to be of good standing and has not had any legal charges against him.

c. He is suitably educated and has had enough training in share dealings before taking on the job. The Bank has to obtain the approval of the
Shares Control Division at SAMA for all those nominated to work as Mediators; this Division also has the right to request the change of Mediator whenever the general welfare so requires.

Art.4. All the employees concerned with share dealings are under the direct supervision of the general management of the Bank, the general management is responsible for all their actions and behaviour.

Art.5. The Mediator who works in the dealing unit has to ensure that all the documents and information relating to the share dealings have been completed and that there are no restrictions on dealing in the shares on offer, also that the sale does not have any conditions which are against the regulatory rules for share dealings.

Art.6. The individuals who act as Mediators are forbidden to deal in shares for their own account or for the account of relatives of the first degree.

Art.7. It is forbidden to deal in shares on credit and the banks are not allowed to accept payment for the value of shares bought in the form of post-dated cheques on or any other post-dated instruction. The Bank is responsible for any violation thereof.

Art.8. Share dealings are restricted to shares of Saudi joint-stock companies which are owned fully by natural or naturalised Saudis, also to shares of Saudi joint-stock companies which have foreign share capital providing that the dealings in the shares do not result in the transfer of their ownership to foreigners.

Art.18. The shares of a joint-stock company are not to be dealt in before the Minister of Commerce issues a decree for its establishment; never the less, temporary share certificates issued after the formation of the company can be dealt in. The transactions are not recognised as valid vis-a-vis the company or vis-a-vis third parties except from the date of registration in the shareholders registry according to Article 102 of the Companies Regulations.

Art.19. To compete the share dealing procedures, the joint-stock companies have to comply with the following:

a. Speed in completing the formalities of registering and transferring the share certificates and ensuring that preparing the registry and issuing of the certificates does not exceed two months from the date of the ministerial decree for forming the company.
To increase a company's share capital, a period of not more than two months from the date of subscription should have elapsed before issuing its certificates and allocating the shares to the subscribers.

b. Not completing the registration procedures and transferring of share ownership unless the Band is a Mediator if it is proven to the company that it was a direct transaction between the buyer and the seller without Mediators, and without use of drafts made in favour of other people. The company has to present daily a report to the Shares Control Division at SAMA about the transfer of the share ownership.

c. Not registering more than one sale of the same shares at the same time.

d. Publishing quarterly information on the financial position of the company and its operating activities in two daily papers within a two month period from the end of the quarter. The punishments mentioned in the Company Regulations will be carried out on whoever does not comply with this. The Ministerial Committee has the right to stop dealings in the shares of Companies in default.
INTRODUCTION

1.1 ABOUT THE INSTRUCTIONS

These Instructions are set out by the SUPERVISORY COMMITTEE FOR SHARE TRADING and shall govern the trading of securities in ESIS.

The Saudi Arabian Monetary Agency shall review and update these instructions as deemed necessary.

Banks and their affiliated CTUs and authorized Bank Branches must strictly follow these Trading Instructions and their updates.

1.2 THE TECHNOLOGY

CTUs are responsible for ensuring that their traders receive adequate training and are supervised when using the ESIS system.

Each CTU is fully responsible for controlling access to its Trading Workstations and other computer facilities.

2.10 CANCELLATION OF TRADING TRANSACTIONS

Transactions may be cancelled at the discretion of SAMA for regulatory reasons, which include the following:

The certificate representing the shares was invalid for any reason.
The seller did not have right to transfer the shares or did not own them.
The buyer does not have the right to buy the shares.
The transaction was a serious infringement of trading regulations. A transaction in the share was not valid at the time of trading. The transaction was intended to create a false market. The transaction was insider trading. Or for any other reason which in the view of SAMA justifies cancellation of the transaction.

If, due to genuine error, a transaction has been reported which does not represent the investor’s instructions, the selling and buying CTUs may jointly apply, before settlement, to SAMA for cancellation of the transaction.

Such cancellation is totally at the discretion of SAMA.

2.11 BUYING IN OF SHARES

2.11.1 If a CTU fails to make good on delivery on Settlement Due Day, the CTU is notified through the Unsettled Trades Report. The CTU must follow up on unsettled trades as follows.

The CTU must, as soon as possible, rectify the failure to deliver. Five days after the due settlement day are allowed for the CTU to deliver the delayed securities by normal settlement procedure. A charge may be made against the CTU for each day’s delay.

If the CTU has not made good delivery by the 5th day, the CTU is notified that it has defaulted. The original transaction is cancelled and is replaced by a buy-in transaction as set out in Trading Instruction 8.1

The buy-in transaction is then settled normally between the original buyer and the new seller. If the buy-in is unsuccessful on the first day, it shall be continued, at the percentage increase of price each day according to a published scale to be agreed between SAMA and the Banks.

2.11.2 The financial liabilities of the defaulting seller are:

If the shares are bought-in at higher price than the original transaction, the original seller pays the difference to the original buyer.
If the shares are bought-in at lower price than the original transaction, the original buyer pays the difference to SSRC.

In all cases of buying-in, the defaulting CTU pays the SSRC one half percent of the value of the defaulted transaction.

All charges arising from buying-in are paid by the CTU and not the investor.

2.12 SELLING OUT OF SHARES

In the event of a buyer proving ineligible to take up the shares purchased, SAMA may, at its discretion sell out the shares. The procedure for this and the financial liabilities incurred are the reverse of the transactions set out for buying-in.

2.13 DIVIDEND STRIPPING

No share should be sold with any past unclaimed dividends attached or with dividend value in the share price. Such past dividends shall, before sale, be stripped from the certificate (or ishaar if required) by the following procedure:

The seller signs an authority, in a form approved by SAMA, enabling the selling CTU to claim the dividend for payment to him.

The selling CTU sends this form with the certificate (if required) to the paying bank.

The paying banks cancel-stamp the coupon (if required) and transmits the dividend money and the certificate to the seller’s CTU.

2.14 DIVIDEND CLAIMS

Entitlement to a current dividend or benefit is determined by whether the trade takes place on the dates for ‘with’ and ‘without’ trading, as set out in Trading Instructions Sections 8.2 and 8.3.

The final instructions to the Registrar to register buyers eligible for the dividend or benefit are those prepared on the Settlement Day for the last
day of trading 'with' the dividend or benefit.

If, due to late delivery, a 'with' transaction is not settled on the scheduled Settlement Due Day, and cannot be registered before the register is closed, the buying CTU claims the dividend from the selling CTU, which claims it from the selling investor.

Ishaaraat issued from 'without' trades carry a message that the buyer is not entitled to the current dividend or benefit.

2.15 BANK CUSTODIAN HOLDING OF INVESTOR SECURITIES

To permit immediate response to investor orders and other efficient customer service, CTUs may act as custodians of their investors' physical securities, under arrangements agreed between the investor and the Bank whereby:

The Bank holds the investor's securities, (i.e., ishaaraat or certificates, in safe-custody). The Bank maintains a record of shares held in safe custody for investors.

The securities remain in the name of the investor lodging them for safekeeping until they are sold.

The shares held by the Bank in safe-custody for the investor are not used in any interest other than that of the investor on the investor's instructions.

All trades in Saudi shares originating from the Bank Custodian must continue to go through the ESIS market.

The Nominee function on the Companies' registers is held by SSRC operating on behalf of all the Banks.

Shares held in safe custody by the Custodian are to be deposited, where possible, into ESIS as retained ishaaraat to take full advantage of the automated transfer facilities.

The Custodian Bank, in addition to sending the investor a confirmation note of all trades executed for him and statements of money account, sends to the investor regular statement of the securities held for him in safe-custody.
7  **BIDS & OFFERS / EXECUTION**

7.1 **GENERATING BIDS AND OFFERS**

- Bids are generated from buy orders and offers are generated from sell orders in preparation for trading and execution.

- A generated bid or offer cannot exceed their order’s available quantity.

- Bids / offers must be within their orders price step, quantity and price limit.

- Bids/offers can be generated as Firm or on Hold.

7.2 **ON HOLD BIDS/OFFERS**

- Bids/offers put on Hold are out of the market thus invisible to other CTUs and cannot be executed.

- Price fluctuation limits do not apply to on Hold bids/offers.

- Suspension of a security, CTU or Trader does not affect associated on Hold bids/offers.

7.3 **FIRMS BIDS/OFFERS**

- Firm bids/offers are in the market and are liable to be executed at any given time during the Opening and Trading period.

- Firm bids/offers can be fully or partially executed within their orders’ price limit.

- Suspension of a security or a CTU results in placing all its associated bids/offers on Hold.

7.4 **BID/OFFER ADJUSTMENTS**

- The following will be enforced against order adjustment:

  Quantity
An outstanding (Firm and On Hold) bid/offer’s number of shares can be reduced at any time. This shall automatically increment the available quantity of the order in question.

An outstanding (Firm and On Hold) bid/offer’s number of shares can be increased as long as the bid/offer’s share increase does not exceed the order’s available quantity. This increase shall automatically deduct the increased number of shares from the available quantity of the order in question.

Changing a Firm bid or offer’s quantity shall result in giving the bid/offer a new date and time stamp (i.e. it loses its time priority).

Price

An outstanding (Firm and on Hold) bid’s price can be decreased at any time. The bid’s price can be increased up to its buy order’s limit price.

An outstanding (Firm and on Hold) offer’s price can be increased at any time. The offer’s price can be decreased down to its sell order’s price.

Changing a Firm bid or offer’s price shall result in giving the bid/offer a new date and time stamp (i.e. it loses its time priority).

Hold/Release Changing

A firm bid/offer can be returned to on Hold at any time.

Releasing an on Hold bid or offer to firm is only accepted for active securities and from an active trader.

7.5 BID/OFFER CANCELLATION

- Outstanding (Firm and on Hold) bids and offers can be cancelled at any time.

- The cancellation of a bid/offer shall automatically increment the available number of shares of the order in question. The increase equals the number of shares of the cancelled bid/offer.

7.6 BID/OFFER EXECUTION

- During the Opening and Trading periods, the system attempts to execute all
existing firm bids and offers. Traded bids/offers are executed at their limit price or at a better price.

- In its attempt to execute all firm bids/offers in the market, the system shall prioritize according to the following criteria:

  Price: Best price (highest bid and lowest offer)

  Time: Within the same price, bids/offers with the earliest release date and time have priority.

- A firm bid or offer can be partially executed. The balance (number of shares not executed) is then automatically placed in a new bid/offer with the same price limit as the original bid/offer. This newly created bid or offer will have the same execution priority as the original bid or offer.

7.7 INACTIVE SECURITIES EXECUTION

- Each potential execution of a bid and an offer of an inactive security shall be delayed by one trading day. On the following trading day the delayed bid and offer shall be executed against the best offers/bids in the market.

7.8 CROSS EXECUTION

- A potential execution of a bid and an offer of the same CTU is to be delayed by 15 minutes if there are no bids and offers from other CTUs at a similar or better price.

- If within a cross delay another CTU enters a counter-bid or counter-offer, in whole or in part at better price, the system shall immediately execute the just released bid/offer with its counterpart in the cross delay.

8 SPECIAL INSTRUCTIONS

8.1 BUYING IN AND SELLING OUT TRANSACTIONS

- When SAMA decides shares should be bought-in to make good a defaulted delivery, (or should be sold out to make good a defaulted purchase) it shall on opening of trading the following day inform CTUs that a buying-in (or selling out) is taking place. The buy-in (or sell out) trade shall be handled as a put-through between the original buyer and seller.
- The conditions of these transactions and the liabilities arising are set out in the Settlement Instructions.

8.2 DIVIDEND ENTITLEMENT

- Shares purchased through ESIS shall in general carry entitlements to dividends paid after the purchase.

- To clarify dividend entitlement in purchases close to the date when the registrar of the company closes his books for payment, listed companies shall notify SAMA in writing of the date on which they intend to close their registers for payment of dividend or distribution of any other benefit, as soon as such date is decided by each company.

- Company registrars shall agree with SAMA a period prior to and up to books close date, during which the buyer shall not be entitled to receive the dividend or benefit. The first day of this period shall be the ‘without dividend date’.

- From this date until books close date, shares shall be traded, in ESIS, without dividend. All trades executed in ESIS during this period shall be ‘without-dividend’.

- The ‘without-dividend’ date of each listed share shall be published and communicated to CTUs.

8.3 BENEFITS ENTITLEMENT

Listed companies making an issue of rights, or of bonus shares, or making a subdivision or consolidation of shares, or making any other arrangement which affects the form or value of a traded share, shall notify SAMA well in advance and not later than when the papers for the relevant General Meeting are sent out. In these situations the company shall

arrange with SAMA the trading schedule for such share situations, similar to that required for dividends in Instruction 8.2.

agree with SAMA in the case of a rights issue, the treatment of the lapsed rights.

agree with SAMA, in the case of a new form of shares, the date on which
trading in the new form shall start and the date on which trading in the old form shall cease.

If the market requires that a security must be dealt, at the same time, with two conditions applying, the system will trade the conditioned shares separately.

9 VIOLATIONS

Trading violations committed by traders as a result of not following the Trading Instructions shall be recorded. These violations can be taken against the concerned traders or their CTU and may result in their suspension.

9.1 FALSE MARKETS

- It shall be contrary to these instructions to make a false market in a security, by which is meant collusion between a buyer and seller contrived so as to create a movement in security price which is not justified by the earnings or prospects of a company.

- It shall be contrary to these Instructions to knowingly make a trade through the central system which results in no change of beneficial ownership of the securities.

9.2 INSIDER INFORMATION

- It shall be contrary to these Instructions for a trader to carry out, on behalf of his CTU or on behalf of any person, any securities transaction based on internal or confidential information concerning the affairs of a listed company prior to the normal or arranged time for publication of that information by that company.

9.3 SECURITIES INDUSTRY PERSONNEL

- It shall be the responsibility of the employing Banks to ensure that in-house rules are written and imposed which prevent any employee or any holder of office in the organization from using information obtained at work for personal gain in the share market.
Appendix C

The Guidelines for Conversion to Joint Stock Companies
Ministry of Commerce Reference Number 495
Date 25/3/1418 H (29/7/1997)

(First) Introduction:

The guidelines for conversion to joint stock companies provide the basis for regulating the conversion of commercial companies to joint stock ones. The conversion process, which will involve the provision of information to owners and investors, will benefit the converted company specially and the national economy generally. These guidelines aim to clarify the rules governing the conversion process including conditions required to be met and in particular the information to be disclosed by a company applying for conversion; also to specify the relationships and responsibilities of all parties involved in the conversion process.

It is anticipated that these guidelines will accomplish the following:

1. Provide the necessary information to the present owners and potential investors on which to base their decisions.
2. Clarify the conversion procedures.
3. Specify the information and figures that must be disclosed.
4. Specify the relationships and responsibilities of all parties involved in the conversion process.

(Second) Conditions for Conversion:

1. A company applying for conversion must have reached significant profitability and size in the year preceding the application for conversion; nevertheless, the company’s net assets and shareholders’ equity should not be less than SR 75m on the date of conversion.

2. Return on equity should not be less than 10% in each of the preceding five years. Furthermore, the feasibility study must confirm that the return will not be less than 10% in each of the next five years following conversion.

3. A company applying for conversion should have been in existence for at least 10 years.

4. A company applying for conversion with public offering must offer not less than 51% of the issued shares.
5. A company applying for conversion should have in place a proper management capable of managing the company efficiently and effectively. Also, it should have effective internal controls to protect its assets. The company should have the capability to compete in the market.

(Third) Conversion Procedures:

1. Applying for Conversion

1.1. A qualifying company wanting to convert to a joint stock company should apply to the Department of Companies (DoC) at the Ministry of Commerce; the application should contain:

1.1.1. Company's name, address and year of formation.
1.1.2. Management's salaries, bonuses and any other benefits allocated to any of them (including retirement and any other privileges).
1.1.3. Description of any significant shareholding by the Management in other companies related to the company.
1.1.4. Summary of the selected financial figures of each of the preceding five years. This should, as a minimum, include sales, profits, working capital, total assets and long term debts.
1.1.5. Description of any legal proceedings or major law suits filed against the company that have not been totally resolved.
1.1.6. Explanation of the risks that potential investors, in the company, should be aware of (this includes any low performance in the past, significant competition, etc.).
1.1.7. Management plans for the use of the proceeds of the issue (if any).
1.1.8. Methodology of arriving at the proposed share price of the converted company including the different assumptions used to arrive at that price. A description of the capital structure of the company post conversion: i.e. whether it is to be limited to existing shareholders and to the existing paid in capital or any other structure. In the event of a public offering, details must be provided of the proposed capital, i.e. of the part allocated to the present shareholders and that which would be offered to the public, if any.
1.1.9. List of shares owned by the management or other related people in the company and their shareholdings in the new company as a result of the exchange. Any significant changes in shareholdings during the five years preceding the application, must be disclosed.
1.1.10. Description of underwriting arrangement, if not totally subscribed, and the name(s) of the underwriter(s), number of shares underwritten by each of the underwriters and the fees for each, if any.
1.2. The following documents shall be attached to the application:

1.2.1. A copy of the company’s Memorandum of Association and amendments.
1.2.2. A letter confirming the approval of the company’s owners to convert.
1.2.3. Audited financial statements for the preceding five years.
1.2.4. Auditor’s report for a limited review of the applying company’s financial statements for the period starting the last published financial statements to the date of the application. The auditor’s opinion should state that the financial statement, reviewed represent, to his knowledge, the fair position of the company.
1.2.5. A feasibility study for the company’s objectives, prepared by an office licensed to operate in the Kingdom (presumably licensed by the MoC) to include the office’s valuation of the converted company, financial projections for the new company covering and the valuation methodology. This should be conducted according to common standards. The study should also include a comprehensive summary of the information and data included in the company’s application.

2. Reviewing the Application:

2.1. The DoC shall review the application and may request any additional information to enable it to complete its review. The DoC shall ascertain compliance with conditions stated in (Second) and the completion of required information stated in (1.1 of Third) above.
2.2. According to the results of the application’s preliminary review, the DoC shall indicate whether it approves, in principle, accepting the application or filing (rejecting) it. The DoC’s decision, in all cases must be justified; the result of the review shall be submitted to the Minister of Commerce for authorization.
2.3. If preliminary acceptance for conversion is granted, the DoC shall request the company to submit the following documents;

2.3.1. Owners’ resolution approving the conversion according to the company’s Articles and bylaws.
2.3.2. Proposed Company’s bylaws according to the standards stated in the Ministerial Directive No. 583 dated 1/5/1385 and its amendments; the bylaws must include provisions relating to:

One) The appointment of an auditor for the first year, and of the first company board for a period of no more than three years.
Two) Converting the existing owners' shares to common shares and restricting their tradability for two financial years from the date of approval of the conversion.

Three) Setting a voting limit for the general meetings whereby no shareholders shall have votes representing more than (5 to 20% according to the company's position at the time of conversion). This shall be applied to all General Meeting resolutions according to article (34) of on the standard bylaws in the Ministerial Directive No. 583 dated 1/5/1385 and Article (107) of the Companies Regulations.

2.4. In situations of converting a company and increasing its capital through public subscription or maintaining its capital and offering part of the capital for public subscription, the DoC shall appoint one (or more) expert(s) with the objective of ascertaining the valuation of the converting company and specifying the fair share price of the proposed joint stock in accordance with the provisions of Articles (60 & 61) of the Companies Regulations according to common accounting standards applicable. As for the situation where the company converts while maintaining the same shareholders and capital or increase the capital through closed subscription, the DoC may evaluate (or consider) this situation according to feasibility study only; in either case the converting company shall pay for all the expense incurred in employing the third party expert.

(Fourth) Permission to Convert:

If it becomes clear to the Ministry of Commerce that the requirements above have been met and the economic benefits of the company's conversion have been demonstrated, the Ministry shall conduct the necessary steps to convert the company to a joint stock one through a Ministerial Directive issued according to Companies Regulations. The Prospectus should contain a comprehensive summary of information and figures contained in the original conversion application; all investors shall have the right to examine the applicati
Appendix D

Ministerial Committee Disclosure Rules
Minister of Commerce Circular Reference Number 2222/221/9/3340
Date 8/11/1417

We wish to inform you that the Ministerial Committee established by Royal Decree Number 1230/8 11/07/1403 to supervise share trading in the Kingdom has met on 17/09/1417 and has decided the following rules:

1. **Suspension of Trading**

   Companies cannot suspend trading of securities for administrative reasons, for example, Annual General Meetings or dividend payments. Companies can in exceptional circumstances and after coordinating with Ministry of Commerce, suspend the trading of securities for 1 week.

2. **Disclosure**

   The Ministerial Committee has developed the share market and to continue the gradual development with the principles of and requirements for disclosure and after reviewing the Supervisory Committee reports regarding disclosure, we approve the following:

   a) The Chairman or Managing Director should announce any major events and information which may affect share prices indirectly or directly, or if the company has reached a decision which may affect the share price, the company must announce immediately to the Share Control Department of SAMA for dissemination via ESIS and to the mass media details of the announcement. Examples of major events which may affect share prices are as follows:

   - any important information which would help shareholders and investors to understand the companies status or major developments in the activities of the company which may lead to major changes in the assets or liabilities of the company or the financial situation of the company;
   - recommendation concerning cash dividends,
   - recommendation concerning the increase or the decrease of the capital of the company
- recommendation concerning the distribution of stock dividends through capitalisation;
- merger or take-over situations, both companies involved must make announcements;
- any sudden losses experienced by the company, which may affect the share price of the company;

Clause 2. a) contd.

- sale of any part of the companies assets which would materially affect the companies profit or loss;
- new contracts which may materially affect the companies profitability or the share price of the company; and
- any change in ownership which would affect the management or policy of the company.

b) The Board of Directors, Managers and Executive Employees must not make statements or comments or offer information unless the statement or the information truly reflects the current state of affairs of the company.

3. Trading Rules for the Board of Directors, Managers and Executive Employees

a) The Board of Directors, Managers and Executive Employees should not trade the shares of their company in the short term (daily or weekly) for speculative purposes and should not trade these shares to mislead the market and they should not deal or trade before the company announces any major events likely to affect the price of the shares and should not buy or sell, 1 day following any announcement.

b) The Board of Directors, Managers and Executive Employees cannot buy or sell or transfer ownership during the 10 days preceding the announcement of quarterly financial statements.

4. Trading Rules for Investors

a) Any person should not deal on inside information, information which is not published and freely available to the public, whether this information is received either indirectly or directly.
b) It is prohibited to manipulate or the create false markets or any action which would likely mislead the market into thinking there is activity. It is also prohibited to publish false information.

5. **General**

The creation of an unfair market and/or persons acting on inside information, information which is not freely available to the public, is prohibited. Any violation will be punishable according to the regulations within the Kingdom.

The Companies Department of the Ministry of Commerce and the Share Control Department of SAMA will follow up these rules with companies
Appendix E
Trading by GCC Citizens Rules
Circular to All Companies
Ministry of Commerce Reference Number 222/427/9/572
Date 5/2/1418

We would like to inform you of the issuance of the Council of Ministers decision number 16 dated 20/1/1418 which approves the resolution of the GCC 15th meeting (Bahrain) regarding GCC citizens right to own shares of public corporations in GCC countries and trade shares in accordance with the amended rules attached to the decision.

And it desired by the Minister of Commerce that all related parties know these rules which are addressed below and which were attached with the Council of Ministers Decision.

1. **Definitions**

   **Corporation or public company**: a company which has the nationality of one of the GCC countries and is established according to the companies regulations for that country and it’s capital is divided into negotiable shares of equal value for trading.

   **GCC Individuals**: natural persons who have the nationality of one of the GCC countries and juristic persons where the majority of it’s (the juristic person) capital is owned by GCC citizens or GCC Governments and has the nationality of one of the GCC countries.

2. It is permitted for GCC citizens to establish new public companies and to participate in the establishment of and to subscribe for, and own and trade, the shares of existing public companies which conduct economic activities allowable for GCC participation, based on the GCC Supreme Council Resolutions and the provisions of the GCC economic agreement, and also it is allowed for them (GCC individuals) to own and trade the shares of GCC joint companies, accordingly the rules applicable are the rules where the company was established, each country where the company is established may establish a limit that the majority (51%) should be the citizens of that country.

3. With the exception of insurance companies, money exchangers and banks, it is allowed for GCC individuals to establish new public
companies and participate in the establishment and subscribe in it and own and trade the shares of the existing public companies which conduct business in other economic activities and this should not exceed 25% of the capital of these companies, accordingly to the rules applicable where the company was established.

4. The procedures [rules] for the establishment and trading of shares will be governed by the rules of the country where the company was established (and the nationality).

5. a. The shares which are owned by the GCC individuals have the same voting rights as do the shareholders of the company where the company was established

b. representation on the Board of Directors of individuals other than individuals representing the country of establishment should not exceed the percentage warranted by the ownership of shares. [For example, if there are 20 Directors and GCC owned 25% of issued shares only 4 GCC Directors can be appointed (GCC in this instance refers to the other 5 countries not including the country of establishment)]

c. It is permitted for each GCC country to set out a condition that the Board of Directors must be formed by GCC citizens natural or a representative of juristic persons.

6. These rules will not affect any previous benefits or rights which may be have been issued in the GCC in the past

7. These rules will be enacted after 3 months from the date of the Supreme Council decision.

8. These rules will be reviewed after three years from the date of enactment in order to develop and enhance the rules if required.