SHAREHOLDER SPRING IN THE MIDDLE EAST?

The Arab Spring has now gone through a few seasons and has no end in sight as the conflict in Syria rages on and the situation in Tunisia, Yemen and Lebanon remains fragile. While much has been said about the thirst of the Arab people for change, not much - and certainly not enough - has been said about the economic roots of the events we are witnessing. And yet, underlying the debate we are seeing unfold is the profound questioning of the role of the state and business elites in the generation and distribution of wealth. State-owned enterprises, private local or foreign companies, have often been subject to criticism that their strategy ignores the socio-economic context in which they operate.

Corporations are therefore party to the ongoing debate on the future of the Middle East. Taken as a whole, over 1400 companies are listed today on regional stock exchanges and already, a number of Gulf-based enterprises such as SABIC, Al Rajhi Bank and Qatar National Bank feature in the Financial Times' Global 500 list, highlighting that some regional champions are emerging on a global scale. Listed companies are important because they are the public face of the region's corporate world. They are also central because regional stock markets are making enormous efforts to attract listings by setting up special listing tiers for SMEs and seeking foreign listings, while at the same time introducing measures to promote greater liquidity.

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

Recent developments in most MENA stock markets, with the exception of Saudi Arabia, Iraq and Tunisia, are not particularly encouraging. Most MENA markets have experienced difficulties in keeping the IPO pipeline active and stock market valuations up and are hence considering more structural changes such as privatisation, demutualisation or restructuring of regulatory responsibilities between the exchange and the securities regulator. Borsa Istanbul has recently been corporatised, the Casablanca Stock Exchange is in the process of demutualising and Tadawul - while remaining largely closed to foreign investors - has allowed foreign companies to cross-list on it. The impact of these changes might not be immediately felt but they are by no means minor.

In addition to these structural changes, multiple fundamental trends would support the view that recent lackluster performance of most Arab exchanges might be a hiccup rather than a long term trend. McKinsey estimates that MENA households hold $2.7 trillion USD of assets, of which only 14% are invested in fixed income and 18% in equities, demonstrating large potential for further development of capital markets, especially as pension, mutual fund and insurance sectors grow. This is happening against a backdrop of a growing proportion of global assets flowing to emerging markets, of which MENA listed companies could capture a greater proportion, especially in light of some the recent upgrade of Qatar and UAE by the MSCI.

And yet, all these seemingly positive trends do not for the moment add up to create vibrant MENA capital markets. Ownership structures and corporate governance have much to do with that. Taking away the controlled stakes, the free float of MENA listed companies tends to be low and dominated by retail investors. In Saudi Arabia, the largest MENA market, retail investors account for an estimated 85% of the market turnover. This market structure obviously raises the question of incentives for companies to adopt good governance practices. In other words, what kind of corporate governance and in whose interest?

The question of incentives for corporations to adopt better governance practices requires us to revisit a good old economic concept: the equilibrium. Equilibrium, market economic theory tells us, can only be achieved when supply and demand meet. When we look at the demand side of the corporate governance equation, we see the regulators, generally standing alone. The tougher regulatory stance by regulators is being taken in the name of public interest and shareholder protection, especially of minority shareholders who face a greater risk of abuse. But where exactly are the shareholders and what do they want?

Much debate has surrounded this question all over the world and it continues to be incredulously repeated as the grave governance failures brought to the fore by the global financial crisis are uncovered and analysed. As a result, the presumed role of institutional shareholders as those expected to possess the resources to engage with individual companies is being seriously reconsidered. Whether institutional investors face the right incentives to act as the guardians at the gate has been placed squarely on the table as a key question for further debate.

While placing all hope in the hands of institutional or retail investors may not be realistic, stimulating companies' interest in better corporate governance singularly via regulatory pressure does not appear as a feasible way forward either. Market expectations do need to play a role. If shares of sub-optimally governed companies were actually trading at a discount, and if large investors voted with their feet when they detected governance abuses, the "corporate governance equilibrium" in the region might become more than just a mirage, and regulators might have less headache chasing companies back to compliance.

As it stands today, corporate governance is viewed by most companies in the region, including listed ones, from a purely regulatory compliance angle. The use of the expression "corporate governance compliance" is no coincidence. To some extent, it reflects the fact that regulators in the region are "growing teeth". To be sure, the region has seen very few enforcement cases, beyond penalties issued as a result of late or inadequate disclosure. Exceptions to this rule include Egypt and to some extent Kuwait, where a large number of companies have been de-listed in the past few years.

Some high profile enforcement cases such as Damas in the UAE, where the regulator ordered the controlling shareholders to repay the sums embezzled from the company, highlight that appetite for enforcement is growing. While the $700,000 USD penalty imposed on the brothers in March 2010 was a first tough stance taken by the DFSA, it was relatively "soft" by international standards, especially considering that the application of most of this penalty was suspended. The governance breaches that this penalty intended to address were serious. The controlling shareholders used the accounts and goods of Damas as their personal assets, despite the fact that the holding company under which it operated was listed.

The Saudi CMA is perhaps the most rigorous in the region in publishing their enforcement actions against listed companies, which in 2011 exceeded 300 cases, most of them related to corporate governance breaches, particularly the failure to disclose market-sensitive information. Other regulators, some of which recently established (e.g. Lebanon, Kuwait), are only now starting to experiment with their enforcement powers and soon will be making steps down the same road as they establish the relevant departments and expertise. But is regulatory forbearance enough to motivate companies to implement deep-seated governance changes?

The stick without the carrot approach can only go so far – incentives are needed for companies to look at governance beyond compliance. And yet, the fact remains that MENA investors have been largely passive, beyond injecting and withdrawing funds in capital markets in response to geopolitical developments. Individual investors can technically lodge complaints with regulators, however their power to affect governance is generally insufficient in controlled companies. In many cases, they might simply be tempted to "bet" on the success of a controlling shareholder based on family reputation or proximity to the elites.

This leaves sovereign wealth funds and a few private players which have large enough exposures to capital markets in the region to act as the agents of change. The Saudi Kingdom Holding alone is estimated to administer over $25 billion USD of assets, a significant part of them invested in the region. Sovereign wealth funds are estimated to have large stakes in over 130 GCC listed companies. The state itself is a direct shareholder in 32 of the largest 100 largest listed companies in the region, which account for 45% of total market capitalisation of Arab exchanges. And yet, the impact of these sovereign and private investors on governance and transparency is largely unknown since they are not required to disclose their voting record or their voting policy.

Family offices and other large private investors maybe making some governance advances behind the scenes, but little evidence of this is available. The dialogue between these investors and companies in which they invest appears to be placid and generally centered around disclosure-related items. Governance of state-owned listed companies is evolving but greater credit can be given to the effect of their listing than to engaged ownership. This is happening against the backdrop of some improvements in the investor relations function in MENA-based companies, which is getting established as a key corporate function in most listed firms.

A fundamental challenge to effective investor activism in the region is that it has no platform and therefore no coherent voice. Greater shareholder collaboration is necessary to address this vacuum, so that better corporate governance is not seen as a distant objective promoted by the regulators. Large investors in MENA, whether local or foreign, could draw inspiration from models of institutional investor co-ordination existing in the Netherlands (Eumedion), Australia (ACSI) or Switzerland (Ethos) that spread monitoring and engagement costs and amplify investor voice.

Today, it is virtually unheard of for an AGM of a MENA company to vote against management remuneration or to reject a board candidate. It is equally rare for investors to use exit as their voice. As the complacency before the outbreak of the global financial crisis has aptly demonstrated, this is not necessarily an indication of the house being in order but more likely a sign that nobody is home to do anything about it. Greater shareholder activism and collaboration is necessary to promote the culture of good governance and it is in the interest of actual and potential investors in MENA markets, both local and foreign.

A recent initiative of the OECD, the MENA Investor Council, is meant to facilitate such dialogue thereby promoting the emergence of shareholder spring in Arab countries. The Council, comprised of representatives of large family, sovereign and institutional investors with exposure to Arab capital markets will serve as a platform for discussion of obstacles to sustainable portfolio investment in the region. Currently being established, the Council is a membership-driven initiative aimed at allowing investors to discuss their concerns regarding the quality of Arab capital markets and governance regulations; to conduct research on emerging challenges related to the efficient operation of MENA markets; to engage with regulators and stock exchanges on issues of priority to the sound development of local capital markets; and eventually to engage with individual companies on practices seen as detrimental for the future attractiveness of MENA markets.