

The Legal and Regulatory Framework for Corporate Governance in The Kingdom of Bahrain

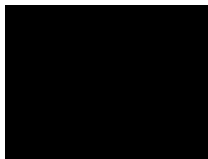
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Corporate governance has become a major issue for businesses in an increasingly global economy. To remain competitive in a global economy, attract capital, ensure sustainability and combat corruption, companies need to put in place good governance institutions. As noted by Jim Wolfensohn, former president of the World Bank “The governance of the corporation is now as important to the world economy as the government of countries”.

At its most basic level corporate governance is the body of “rules of the game” by which companies are managed internally and supervised by boards of directors in order to protect the interests of the shareholders and other stakeholders who have a vested interest in a company. In family-owned enterprises and small and medium sized enterprises (SMEs) these principles still apply and should be adopted to enhance efficiency, minimize conflict, and ensure the transition of ownership from parent to heir.

The Organization for Economic Co-operation and Development (OECD) has developed and endorsed a set of principles on corporate governance - the *Principles of Corporate Governance* in 1999 (revised in 2004). The OECD principles are used as a benchmark by the national governments of member States, the private sector, and various international organizations including the World Bank and the International Monetary Fund. The OECD Principles focus on the corporate governance problems arising from the separation of ownership of a company from its control and in particular focus on six areas:

1. Ensuring the basis for an effective corporate governance framework;
2. The rights of shareholders;
3. The equitable treatment of shareholders;
4. The role of stakeholders;
5. Disclosure and transparency; and
6. The responsibilities of the board.

This paper uses the OECD Principles as its key reference to corporate governance principles.

In addition to the internal governance of companies, there are critical external mechanisms that help complete the corporate governance framework. Broadly speaking, both the private side and regulatory side make up what can be called the institutional framework within which corporate governance is implemented. Just as this institutional framework affects corporate governance mechanisms and corporate governance enforcement, it is at the same time influenced by corporate governance.

Building on this foundation are a variety of public and private institutions that define corporate governance practice and enforce its implementation. Stock exchanges, through their listing requirements, and securities markets, with regulators and

enforcement actions, form the front line of external control. These institutions also guarantee property rights through providing share owners an efficient exit mechanism from ownership which is an important element in attracting investment.

As it has become evident over the last decade, internal company practices are inseparable from the environment within which these companies operate. In some emerging markets, these external institutions may be weak or missing altogether. Addressing these institutional deficiencies along with internal company practices is crucial to the success of corporate governance reforms.

In response to the need to address corporate governance in the Kingdom of Bahrain, the National Committee on Corporate Governance was created under the auspices of the Ministry of Industry and Commerce and the Central Bank of Bahrain to bring Bahrain into compliance with international best practice and to facilitate business and economic development. The National Committee includes key stakeholders from the public and private sector and has developed a Code of Corporate Governance. It is anticipated that the Code will be issued by the Ministry of Industry and Commerce in late 2009.

This paper considers the legal, regulatory and judicial framework affecting corporate governance in the Kingdom of Bahrain. The paper also highlights some priorities and makes possible recommendations for legal reform.

The laws considered in this Paper are the following:

- Decree No. (64) of 2006 with Respect to Promulgating the Central Bank of Bahrain and Financial Institutions Law;
- Central Bank of Bahrain Rule Book – Volumes 1- 6
- Commercial Companies Procedure Law promulgated by Order No. (6) of 2002;
- Decree No. (4) of 2001 with Respect to Promulgating the Prevention and Prohibition of the Laundering of Money.
- Commercial Companies Law promulgated by Legislative Decree No. (21) of 2001;
- Penal Code promulgated by Legislative Decree No. (5) of 1976, as amended;
- Civil and Commercial Procedures Law promulgated by Legislative Decree No. (12) of 1971, as amended;
- Decree No. (26) of 1996 Regarding Auditors;
- The Law of Commerce promulgated by Legislative Decree No. (7) of 1987, as amended;
- The Bankruptcy and Composition Law promulgated by Legislative Decree No. (11) of 1987; and

- Decree No. (4) of 1987 to Establish and Organize Bahrain Stock Exchange, as amended by Decree No. (21) of 2002.

This paper will concentrate on the theoretical review and evaluation of the laws and regulations and the judicial framework in light of the OCED principles of corporate governance. The scope will not extend to the practical application of corporate governance principles in the Kingdom of Bahrain; however a separate survey of corporate governance awareness and practices has been conducted and is available for public review.

Background

Overall, many of the principles of corporate governance are embedded in the laws and regulations in force in the Kingdom of Bahrain which relate to economic activities and to commercial companies. As per Article (4) of the Commercial Companies Law, "Any commercial company of whatever type incorporated or based in Bahrain shall be subject to the provisions of this Law". Corporate governance provisions are most prominently found in the Commercial Companies Law and its implementing regulations, the CBB Law and the CBB Rulebook, and the Law to Establish and Organize the Bahrain Stock Exchange. There is a draft of a new Commercial Companies Law which is awaiting consideration by Parliament. The draft Law includes many provisions to strengthen the corporate governance framework. This new Law, along with the Corporate Governance Code, if and when implemented, will significantly enhance compliance with corporate governance principles. A full review of the draft law is outside the scope of this paper; however provisions introduced by the draft law which affect corporate governance practice are highlighted.

From the late 1990s until the last quarter of 2008, the economy of the Kingdom of Bahrain has witnessed growth in investment as a result of a steady increase in oil prices and comprehensive economic, legal and political reforms. New laws and regulations have been promulgated and existing ones amended to encourage foreign and national investment in the Kingdom of Bahrain and to protect investors and other stakeholders. Improving corporate governance practice would also help Bahrain attract greater investment and ensure effective risk management. For the year 2008, Bahrain was ranked amongst the top 20 freest economies in the world by the Index of Economic Freedom published by the Heritage Foundation. In addition to the ease of doing business, Bahraini companies could enhance performance and growth by undertaking other measures to encourage investment, such as creating effective boards of directors, ensuring respect for minority shareholders, and guaranteeing greater transparency and accountability in decision-making.

Most businesses in the Kingdom of Bahrain have taken the form of limited liability companies (with limited liability) "W.L.L.", or private joint-stock companies (Bahraini

shareholding company, closed) "B.S.C. (c)" for activities and services that are required by the law to be provided by a closed joint-stock company. Numerous family-run businesses have also changed their legal structure from individual establishments or general partnerships to limited liability companies or to closed joint-stock companies. Besides the existence of a significant number of banks, financial institutions and large companies in the market, there is a large number of small-sized to medium-sized companies. It is also worth noting that foreigners may own up to a 100% of the business for many business activities and services. Citizens of GCC countries are granted national treatment, subject only to a few exceptions. Additionally, there is a number of State owned companies in which the shares are either fully-owned or partly owned by the government. The government has established a holding company - Mumtalakat Holding B.S.C. (c) which is run on commercial lines, and in which its ownership of the various assets is vested.

According to the information published in the legal website of the Ministry of Industry and Commerce "www.moic2.gov.bh", the number of active companies registered in the Commercial Registry at the time of this Paper is 13,075 companies, including registries of all the branches of any one company.

PART 1: The Supervisory and Regulatory Authorities

In general, the Ministry of Industry and Commerce, through its Directorate of Company Affairs, handles the registration of all types of companies and branches of foreign companies as well as commercial agencies. Further, it regulates and supervises the companies in accordance with the Commercial Companies Law and the provisions of the companies' respective articles of association. The Commercial Companies Law gives administrative and judicial authority to the Ministry of Industry and Commerce who supervise and regulate the companies and take measures against any companies violating the Law. Article (351) of the Commercial Companies Law states: "The duties of supervision, attendance of general assembly meetings, and drafting reports on violations of the provisions of this law shall be undertaken by whomever the Minister of Commerce and Industry designates for this purpose, who shall have the powers of judicial enforcement. The reports shall be submitted to the general prosecutor upon a decision by the Minister of Industry and Commerce or by whomever the Minister designates."

The Bahrain Stock Exchange and listed companies and activities carried out by financial institutions, as per Article (39) of the Central Bank of Bahrain Law, are subject to the supervision and regulation of the Central Bank of Bahrain (CBB). The CBB has issued a regulation specifying the financial activities which fall under its authority, including all investment companies, consultancy and brokerage companies of relation, as well as supporting companies (non financial). The CBB has issued a Rulebook, comprised of six volumes to date, for the licensing, organization, and management of the financial

institutions and the different activities carried out by these institutions in order to ensure the proper implementation of the CBB Law and the Commercial Companies Law, as well as the other relevant laws such as the Anti-Money Laundering Law and the Bahrain Stock Exchange Law. Each volume of the Rulebook deals with specific activities and institutions. The first volume deals with commercial banks, the second with Islamic banks, the third with insurance firms, the fourth with investment firms, the fifth with consultancy firms, and the sixth with the capital market. The volumes are updated quarterly and are available to the public on in the CBB's official website www.cbb.gov.bh. However, they are only published in the English language which is in contravention with the Constitution of the Kingdom of Bahrain which provides that the official language of the Kingdom of Bahrain shall be the Arabic language. This makes it difficult for investors and interested persons who are not proficient in English to access the relevant information.

The role of the CBB is not confined to the supervision and regulation of the financial institutions but starts from the licensing of these institutions to provide financial services. Article (40) of the CBB Law provides that no financial institution shall be established without the approval of the CBB and no persons shall carry out any regulated services unless licensed by the CBB. Article (161) of the CBB Law provides that without prejudice to any greater penalty prescribed under the Penal Code, any person who contravenes the above provision shall be liable to a fine of a maximum of BHD 1,000,000 and the Court shall confiscate all proceeds of the crime. Hence, any company wishing to provide any financial service(s) are required to obtain a preliminary license from the CBB and to subsequently complete the incorporation and registration of the company at the Ministry of Industry and Commerce. The company is prohibited from providing any service(s) before obtaining the final license from the CBB.

In addition to supervision by the CBB and the Ministry of Industry and Commerce, companies carrying out business activities may be subject to the supervision and control of other concerned authorities. To illustrate, industrial related activities are subject to the Directorate of Industrial Projects at the Ministry of Industry and Commerce, tourism related activities are subject to the Directorate of Tourism Affairs at the Ministry of Information, food related activities are subject to the Department of Public Health at Ministry of Health, and so forth. The law relevant to the supervisory, regulatory and organizing authority will usually grant it the judicial authority required to enable it to exercise its role in enforcing the law and taking appropriate measures against any violations thereof.

The Commercial Companies Law permits the Minister of Industry and Commerce to appoint someone from within the Ministry or outside to carry out an investigation of the company's business and any allegations of violations of the law or the company's articles of association by the chairman, board members, managers, or auditors of the company (Article (352)). This can be done at the initiative of the Ministry or upon the

request of shareholders representing at least quarter of the capital of the company. If the Ministry of Industry and Commerce refuses the request of the shareholders or does not make any decision on the matter within 30 days, the Law permits the shareholders to make a request to the judge of the Court of Urgent Matters to order the investigation and to appoint an expert to undertake the investigation (Article (355)). The Law also requires the board members, managers, auditors, and employees of the company to provide investigators with all the necessary information related to the company's affairs (Article (357)). The Law permits any interested person to appeal the result of the investigation in front of the Civil Court within 30 days from the date of notification of the result (Article (356)).

Article (114) of the CBB Law provides that the Governor has the right to assign CBB officials or others to inspect compliance of a licensee or listed company with the provisions of the Law and regulations. The inspectors are authorized to enter the premises and offices of the licensees and the listed companies, to have access to the books, documents and information and to question any person as they deem necessary. They are also authorized to contact banks and other relative institutions in connection with the subject matter of the investigation. Article (115) of the CBB Law provides that the officers of the CBB shall have the capacity of "Judicial Investigation Officers" with respect to criminal offences that fall under their jurisdiction and relevant to the duties assigned to them.

Actions or punishments taken against companies that violate laws or regulations

Acts subject to a penalty and the applicable penalty are dealt with in Part 16 of the Commercial Companies Law. The penalties vary from imprisonment and/ or a fine between BHD 5,000 and BHD 10,000 for violations listed under Article (361) of the Law and a fine of no more than BHD 5,000 for the violations listed under Article (362) of the Law.

Prior to applying any disciplinary measures or punishments the CBB will give a written notice to the licensee stating details of the alleged violation(s) along with supporting evidence. The CBB will also specify a grace period for objecting to the proposed action or punishment, provided that it is no less than 30 days from the date of the written notice (CBB Law, Article (125)).

The CBB may at its discretion amend or revoke the license of any company licensed by the CBB if the licensee fails to satisfy any of the license conditions, or violates any of the provisions of the CBB Law and rules, or if the legitimate interests of the customers or creditors of the licensee require so (Article (48)). Part 9 of the CBB Law also provides for applicable restrictions and other penalties and actions that the CBB may impose or take in respect to a licensee to ensure compliance with the law and regulations and the terms and conditions of the license.

If the CBB estimates that imposing restrictions proves to be futile, then the CBB may appoint an observer member of the board of directors of the licensee for a period specified by the CBB. Such member has the authority to participate in the deliberations of the board and to give opinions on any resolutions passed by the board, or CBB may alternatively place the licensee under administration pursuant to the provisions of the CBB Law (CBB Law, Article (130)). The Bank may also impose on the licensee an administrative fine of a maximum of BHD 20,000 (Article (129)) or suspend the licensee from carrying out the regulated services for a period not exceeding 12 months. The CBB may also issue a public statement on the violation that occurred, in a manner proportionate to the nature and size of the violation (Article (132)).

The CBB Law provides the Central Bank of Bahrain may assume the administration of a licensee or appoint an external administrator to conduct the administration under specific circumstances which include "If the licensee continued to provide regulated services which resulted in inflicting damages to financial services industry in Bahrain" (Article (136)). In addition, Part 11 of the CBB Law, (Articles (160) – (172)) deals with acts subject to penalties and the applicable penalties, without prejudice to any severer action or punishment for acts criminalized under the Penal Code.

The regulatory and supervising authorities have the capacity to enforce the provisions of the law and regulations and take action against the companies that violate these. However, in order for this to translate into practice, a sufficient team of qualified and trained experts is required to carry out the role of the "investigating officer". The main criticism on the effectiveness of these authorities is that there is an insufficient number of qualified inspectors to function at the required level. This weakens their role, as violations may remain undetected or undeterred for a long time. This will only be achieved by increasing the number of qualified and trained officials. Further, there is no clear division in the supervisory, regulatory and enforcement responsibilities within each of these relevant authorities. The specific responsibilities would need to be delineated in order to make their regulatory functions more effective.

PART 2: Board of Directors

In line with corporate governance principles, directors have two overarching duties. The duty of care requires directors to be informed, to act with reasonable care, and to monitor company risks. The duty of loyalty requires that directors act in the interests of the company and all its shareholders, and avoid conflicts of interest.

The board of directors should select the company's executive leadership, monitor the executive's performance, and compensate the executive in line with performance. The board holds the executive accountable, and in turn the board is held accountable to

shareholders. Boards are increasingly expected to oversee risk and independent audits more fully. Other key roles include oversight of company strategy and ensuring compliance with laws. Better practices in terms of board composition should include the appointment of more independent directors to ensure transparency and accountable decision-making, as well.

Responsibilities of the board of directors

In the Kingdom of Bahrain, the current laws and regulations set forth qualifications for board directors and how they will be appointed and removed, but does not detail the responsibilities and duties of directors. In practice, board directors often do not assume the full scope of strategic guidance in the company. The draft Commercial Companies Law and the Corporate Governance Code mandate a more engaged involvement of the board, which, if fulfilled, would greatly strengthen effective governance within the company.

In Order No. (10) Of 2002 promulgated by the Minister of Industry and Commerce, the requirements of the board members of shareholding companies are: 1) To be competent to act; 2) To be free of any conviction of fraud, forgery, or a crime violating the Commercial Companies Law; and 3) To have expertise and specialist knowledge. In addition, Article (2) of the Order provides: "The motive for the appointment must further the interests of the company and be for the purpose of providing elements of technical, managerial and educational expertise". This is line with international principles that state that Board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the company and the shareholders.

Additionally, the Commercial Companies Law outlines the required qualifications of a director: 1) He must personally own a number of shares the nominal value of which shall be at least BHD 10,000 or the person he represents must own a number of shares representing not less than 1% of the company's capital, whichever is higher, unless the company's articles of association provide for a higher amount; and 2) He must disclose any business he conducts that competes directly or indirectly with that of the company.

The Commercial Companies Law outlines how directors are selected or removed. The board of directors may exercise full powers of the company and act as necessary to represent it in accordance with its objectives, except as prohibited by the law, and subject to the following (Article (178)):

- The company's articles of association shall specify the cases in which the board membership is terminated.

- The general assembly may dismiss all or some of the board members even if the company's articles of association provide otherwise.
- The board member may resign his office provided that he resigns in a convenient time otherwise he may be liable to pay compensation.
- The company's articles of association shall specify the extent to which the board of directors can borrow for more than three years or sell company's property or business or mortgage such property or provide guarantees for the third parties or discharge the company's debtors of their liabilities.

As per Article (188) of the Commercial Companies Law, the chairman and the members of the board shall be jointly liable before the company, the shareholders and third parties for all acts of fraud, misuse of powers, mismanagement, and/ or any violation of the law or the company's articles of association. The liability may either be personal relating to a specific member or joint for all board members, unless some of them have objected to the decision creating the liability and put their objection in the minutes of the meeting.

If a director acts in breach of his general duties owed to the company, either the other directors, if they constitute a majority of the board, or the majority members can take action against him in the name of the company, requiring him to compensate the company for any loss it has suffered and/ or to account to the company for any profit made.

Remuneration of directors

The remuneration of directors is an important issue, as corporate governance principles assert that key executive and board remuneration should be aligned with the longer term interests of the company and its shareholders. Disclosing the remuneration of directors – and giving shareholders the right to approve remuneration of directors – is considered a best practice since it allows shareholders to hold directors accountable for company performance. Companies are generally expected to disclose information on the remuneration of board members and key executives so that investors can assess the costs and benefits of remuneration plans and the contribution of incentive schemes, such as stock option schemes, to company performance. Disclosure on an individual basis is increasingly regarded as good practice

Article (188) of the Commercial Companies Law provides that the company's articles of association must specify the manner of determining the remuneration of the members of the board, subject that the total must not exceed 10% of the net profits after deducting the legal reserves and distributing a profit of not less than 5% of the

company's paid-up capital to the company's shareholders. The board of directors is required to report to the general assembly with a comprehensive account of all payments to the board members during the financial year, including salaries, profit shares, allowances, expenses and the like as well as any amounts paid to the board members in their capacity as employees, consultants, or administrators of the company.

It is worth mentioning that the DRAFT Commercial Companies Law prohibits a company from making loans or otherwise extending credit to a director of the company except in small amounts in connection with performing the company business (Article 6.51(b)).

Independence of directors

To exercise impartiality and objective independent judgment where there is potential for conflict of interests, the board should assign independent non-executive members. Particularly in cases where there might be a conflict of interest, it is important that the board should have a sufficient number of non-executive board members capable of exercising independent judgment.

The CBB Rulebook defines an independent non-executive director. To illustrate, Volume 1 of the Rule Book titled Conventional Banks defines a non-executive director as "A director who has no responsibility for implementing the decisions or the policies of the board of a bank and is independent from the bank's shareholders (i.e. is not an employee or under a contract of service to them and does not have any material shareholding in them)". This definition is in compliance with the OECD Principles of Corporate Governance.

To implement governance practice and make changes as may be needed, the board should be able to effectively monitor and manage potential conflicts of interest of management, board members, and shareholders, including the salaries of the executive directors, misuse of corporate assets and abuse in related party transactions.

The CBB imposes a minimum percentage of independent non-executive directors and non-executive directors in the composition of the board for financial institutions and states that an executive director may not occupy the position of chairman of the board. However, the Commercial Companies Law does not require any degree of independence of the board of directors from management. In practice, the chairman of the board is usually a managing director, and is usually the chief executive officer himself. It is important that the board structure has a balance between non-executive board members (supervisory) and executive board members (management) to ensure the board is acting in the best interests of the company and its shareholders and deals fairly

with other stakeholder interests including those of employees, creditors, customers, suppliers and local communities.

Article (6.57) of the Draft Commercial Companies Law defines an "independent director" and imposes a requirement of a minimum of three independent directors on the board of a public company. Article (6.58) of the Draft Law prohibits the chairman of the board of a public company to also hold the post of the chief executive officer of the company, unless the articles of association provides otherwise. These changes, if made, would improve compliance with corporate governance best practices.

Conflict of interests

The Commercial Companies Law prohibits a public servant from sitting on the board of a joint-stock company or participating in the incorporation or carrying out any paid or unpaid work for it. Article (68) provides that any person violating this provision shall refund all gains he has received from the company to the State.

Article (189) provides that no board member shall have any direct or indirect personal interest in the business and contracts concluded on behalf of the company unless this is allowed by the general assembly. The interested board member should notify the board immediately of his personal interest in any matter presented to the board and he may not participate in deliberations or voting on these matters. Under Article (189), any director who violates this prohibition shall be liable to pay compensation to the company for any damages it has sustained as a result thereof.

This is reflected under Article (191) of the Commercial Companies Law with respect to joint stock companies, whereby a board member is prohibited from exercising any business in competition with the company's activities without authorization by the general assembly, otherwise the company may claim compensation from him

The directors have duties to the company and a responsibility to use their powers in ways that seem best for the company and its shareholders, and they are accountable to the shareholders for the way they exercise their powers and/ or the performance of the company. Since any disciplinary measures and/ or legal remedies sought by the company or its shareholders must be ordered and/ or awarded by the competent court, such measures and remedies are only sought and enforced in extreme cases of wrongdoing. In practice, in the Kingdom of Bahrain shareholders rarely exercise their right to question the board of directors because of the complexity of discharging the legal burden of proof of violation, negligence or willful misconduct and because of the costs, the length, and the adverse effects of a lawsuit that may be suffered by the

company in the process. Often, the shareholders elect to simply remove the directors from office.

The directors have many statutory duties. However, currently there is little guidance in the law or judiciary precedence on the extent of the directors' fiduciary duty and duty of skill and care owed to the company, and whether the test of reasonableness is an objective one or subjective one. Therefore, developing clear lines of accountability for management throughout the company and training the Board to acquire appropriate skills and promote compliance with applicable laws, regulations and standards and the principles of corporate governance would strengthen the Board's performance.

The Ministry of Industry and Commerce has issued a series of booklets designed to provide guidance to the board's responsibility and the DRAFT Commercial Companies Law provides greater detail on the board's responsibility. Article (6.63) of the DRAFT Law also provides for the creation of committees to make recommendations to the board or to take other action on matter which are within the competence of the board. Subsection (b) of the abovementioned Article requires public companies to establish a minimum of three committees comprising of an audit committee, a nominating committee and a remuneration committee.

PART 3: Shareholders' Rights and Powers

Good governance protects the rights of shareholders, especially minority shareholders, including their rights to have a say in company management and major transactions and the right to be informed about their investment. By building efficiency and trust in capital markets, it provides investors with greater liquidity, so they can diversify and sell their assets when they need to. Finally, procedures for dealing with business failures protect creditors and limit the liability of shareholders.

In the context of corporate governance, shareholders' powers and rights mainly relate to their voting powers in general meeting and the matters on which they can make decisions for the company or affect decisions taken by the directors with which they disagree. Although the law restraining directors' powers does not provide much protection to shareholders, shareholders have certain rights that they can enforce. These include a secure method of ownership registration, pre-emption rights in the conveyance or transfer of shares, the right to receive financial information and other material information on the company, and voting rights such as the right to elect and re-elect directors, appoint auditors, and receive a share in the profits of the company.

In theory, therefore, the shareholders have an opportunity to overturn the board's decision to appoint new board member(s) or re-elect existing one(s). Although in practice it would be difficult to obtain a majority vote for such a decision, it is possible

that the threat of the shareholders' option to exercise this right could be sufficient to pressure the board to fix remuneration and adopt other policies in a responsible manner.

Secure methods of registering ownership of the shares

All commercial companies acquire a corporate entity upon registration in the Commercial Registry. As per Article (7) of the Commercial Companies Law, the company's managers or board of directors shall be jointly liable for any damages sustained by the company, partners or third parties as a result of non-registration.

The legal requirements for the registration of any commercial company in the Kingdom of Bahrain are aimed at verifying the identity of the founders and shareholders, to ensure their legal and personal capacity ,as well as their financial capacity to establish and acquire shares in a company and carry out the proposed type of business activity. Also, they limit abusive dealing by restricting the registration of managers, directors or shareholders who have material personal interests in competing or related businesses. The requirements also ensure the company will be able to carry out its business activities independently, such as having its own separate physical address, as well as having a legal representative, manager(s) or board of directors, etc. The Commercial Companies Law and its implementing regulations have specified the requirements and they are published by the Directorate of Company Affairs on its website as well as by written guidelines, brochures and publications.

In the past, there has been difficulty in preventing conflict of interest issues, and on occasion majority shareholders as well as board members with interests in other companies have acted in a way that was detrimental to the company, investors and customers or clients. In recent years, however, the Ministry of Industry and Commerce and the CBB have been exerting greater oversight and have been more effective in restricting such behavior.

In general, the requirements for the registration of any commercial company in the Kingdom of Bahrain can be summarized as follows:

1. Filling in the appropriate application forms for the registration of the company (approval of proposed business activities, proposed company name, etc.)
2. If natural persons: the names of the founding shareholders, copies of their passports or C.P.R. cards (for Bahrainis or Bahraini residents), their personal details, residential addresses, C.V.s, bank statements (for non-Bahrainis).
If corporations: legalized copies of the companies' certificates of registration, legalized copies of the companies' memorandums of association and articles of association, the companies' board resolutions for the incorporation of the company and their latest annual audit report.

3. Drafting the memorandum of association and articles of association.
4. Depositing the required minimum capital with an approved bank in the Kingdom of Bahrain.
5. Approval of company's physical address.
6. Letter of appointment of company auditor.
7. Appointing the board members, and/ or company manager(s) and authorized signatories.
8. If branch of a foreign company: a legalized letter of guarantee must be provided by the parent company.
9. Other additional supporting documentation may be required by the respective licensing authorities. For example, the CBB requires filling in special application forms and providing a detailed business plan, feasibility study, and the details of persons proposed to be in controlled functions in any financial institution, as well as other supporting documents.

Equitable treatment of shareholders

The current Commercial Companies Law makes no distinction between shareholders on the basis of their nationality or sex, and Article (10) of the Law provides that "unless otherwise agreed upon...the partners' shares shall be of equal value and relate to property ownership rather than usufruct thereof". Article (15) of the Law provides "If the company's memorandum of association does not specify each partner's dividend, in profit and loss, such dividend shall be determined in proportion to the partner's respective share in the capital." Article (16) of the Law further provides that any agreement in which a partner shall not have a dividend in the company's profit or loss shall be null and void. However, it may be agreed to exempt a partner from the loss if he only provides work for his share.

The equal treatment of shareholders is also an underlying principle of the CBB Rulebook Volume 6. Although Article (111) of the Law allows a joint-stock company to determine some privileges to certain classes of shares with respect to voting, profits, liquidation or proceeds; this is made subject to the shares of the same class being equal and carrying equal rights. Further the rights or restrictions of a specific class of shares shall not be varied unless by way of an extraordinary general assembly meeting with the approval of the majority of votes mentioned above.

Conflict of Interests

The current Commercial Companies Law deals with conflict of interests between the partners and the company as a cause of conflict of interests between the partners in general. Article (38) of the Law provides that no partner may undertake any activity for himself or on behalf of another person in competition with the company, or be a partner in a limited partnership company, general partnership company, or a limited

liability company if such companies are exercising competing activities to those of the company, unless with the consent of the other partners. Further, Article (203) of the Law provides no shareholder shall vote for himself or for whomsoever he represents in matters in which he has a direct interest or on a dispute between him and the company.

The DRAFT Commercial Companies Law however provides more detailed provision on conflict of interests and the duty to disclose conflict of interest. Article (1.16) of the DRAFT Law defines acts or transactions involving a conflict of interests as those carried out by a manager, director or controlling shareholder of a company if he or any of his financial or family relationships is a party to the act or transaction or has a material financial interest, either directly or indirectly, that could reasonably be expected to affect such person's judgment to the company adversely. The word "relationship" includes the director, controlling shareholder, or employ of such person or any person under the controlling influence of such person.

The Law makes any transaction in violation of this provision voidable at the discretion of the company subject that the voidance shall be without prejudice to the rights of third parties who acted in good faith without knowledge of or participation in the violation. Such persons may also be liable to account to the company any gain which he has made from the act or transaction and to indemnify the company for any loss or damage suffered by as a result of the act or transaction as well as other remedies available to the company at the discretion of the competent court.

Certain types of activities prescribed under the company's articles of association may however be excluded from the duty to disclose conflict of interests if they are also approved unanimously by the shareholders, unless the articles of association provide for a lower vote of no less than a majority. Public companies however are not authorized to make any such exclusion. The wording of the DRAFT Law's Article (1.18) that the company may "...specify specific types of activities that do not violate one or more aspects of those duties [those under Articles (1.14) and (1.15) of the Draft Law]" is vague at best. If the activities and the requirement of a simple majority vote is prescribed in a company's articles of association, it could effectively reduce or eliminate the duty of care, good faith, loyalty and non-competition enforced by the necessity of disclosing any conflict of interests by a majority shareholder. Further, the DRAFT Law excludes "transactions and interests which are de minimis in value..." but fails provide a base for classifying any transaction or interest to be of such a minimum value so as to be excluded or to be of a substantial value so as to be included.

Right to participate and vote in general meetings

The Commercial Companies Law states that each shareholder, regardless of the number of shares he owns, has the right to attend the general assembly and has a number of votes equal to the number of shares he owns in the company. Any provision or decision

to the contrary is null and void. Each shareholder may appoint a proxy, from among the shareholders or non-shareholders to attend the general assembly on his behalf, provided that this person shall not be the chairman of the board or a member of the board of directors or any other employee of the company. However, this shall not prejudice the right to appoint a first-degree relative. The delegate shall not represent in this capacity a number of votes exceeding 5% of the issued capital in the general assembly meeting. This restriction means that the votes casted in absentia on behalf of shareholders with more than 5% of the issued capital will not be of equal effect. The current Commercial Companies Law is silent on the use of electronic voting in absentia. However, Article (6.34) of the DRAFT Commercial Companies Law provides that a shareholders' meeting may be conducted by means of electronic or other remote communication for companies with no more than ten shareholders.

Meetings of the general assembly of the shareholders must be convened at least once a year during the six months following the end of the company's financial year. For public companies, such a meeting should be held within three months from the end of the company's financial year. The meeting may be called by an invitation of the board of directors, or by the auditor under special circumstances, or by a number of shareholders representing at least 10% of the company's capital. The Ministry of Industry and Commerce may also invite the general assembly to meet if he deems it necessary.

The board of directors shall prepare the agenda for the general assembly meeting. If the general assembly convenes at the invitation of the shareholders, the auditor, or the Ministry of Industry and Commerce, the agenda must be prepared by whoever requests the meeting. The invitation to the shareholders must be published in at least two daily Arabic newspapers - one of them must be local- at least 15 days before the meeting and must include the agenda of the meeting, as well as the balance sheet, the profit and loss account and an adequate summary of the annual report and the full text of the auditors' report. For limited liability companies, the call for the general assembly to convene may be made by registered mail with a delivery note or by any means proving the knowledge of the shareholders of it at least one week before the date of the meeting. Each shareholder may request the board of directors or managers to include any issues on the agenda, and if such request is refused, the shareholder may take the matter to the general assembly. In this respect, the law in Bahrain does not differ from the OECD Principles, except to the extent that there should be no limitation on voting by means of proxy.

In Bahrain, most shareholder voting requires a simple majority vote (ordinary resolution), except for what the law has reserved for a 75% majority vote (special resolution). Shareholders' power and rights, relating to the issues on which they may vote in general meeting of the company, include the following:

Right to make decisions on fundamental issues affecting the company

- **Voting powers of the general assembly meeting**
 - To elect, re-elect directors and remove directors or vote against their re-election or to file liability action against them (conducted by secret ballot).
 - To determine the board members' remuneration.
 - To discharge board members from any liability.
 - To consider and approve the board's report on the company's activities, its financial position, and the auditor's report on the financial statements of the company during the ended financial year.
 - To approve the profit and loss account, the balance sheet and the statement allocating payment out of profits and determine dividends for the previous year.
 - To appoint external auditor(s) for the following financial year and determine his/ their fees.
 - To consider recommendations and deciding issues relating to bond issue, burrowing, mortgaging and issuing guarantees.

- **Voting powers of the extraordinary general assembly meeting**
 - To amend the company's memorandum of association or articles of association and extending the company's term.
 - To increase or reducing the company's capital.
 - To sell an entire project carried out by the company or dispose of it any other manner.
 - To wind up the company or merge it with another company.

Right to transfer shares, issue new shares, and register shares

An important aspect of the balance of power between directors and shareholders is with respect to the authority of directors to issue new shares and the rights of shareholders in any new share issue or existing share transfer. The directors cannot increase the issued share capital without prior approval from the shareholders by way of a special resolution.

Under the Commercial Companies Law, shareholders have pre-emption rights. This means if any new shares are issued, or existing shares are to be transferred, they must first be offered to the existing shareholders before anyone else. This ensures the shareholders are protected against the erosion of their stake in the company if the board was free to offer new issued shares to other investors. Shareholders may waiver their pre-emption rights at the general meeting or by provision contained in the

company's articles of association, but shareholders must be careful such as to set a limit on the percentage share capital of the "non pre-emptive" shares to be issued during any one period.

The process of registering, transferring and issuing shares differs in different types of companies but is comparable. In a general partnership company, no partner shall transfer his share in the company without the consent of all the partners, or as may be otherwise provided in the company's memorandum of association, and the publication and registration thereof. Any agreement that permits unconditional transfer of shares shall be deemed null and void. With respect to a joint-stock company becoming public, the founders are required to retain shares representing no less than 10% and no more than 40% of the company's capital and must pay the amount equal to the percentage required to be paid by the public for each share upon subscription.

Right to receive relevant information on a timely and regular basis

An important aspect of shareholder rights is the right to receive information about how well or how bad the company is being run. This is crucial to enable the shareholders to use their voting powers and exercise their other rights in an informed and constructive manner. The shareholders in a company have the right to receive information about the financial performance and financial situation of the company and about the company's business. This is provided mostly by the annual report and accounts at the end of each financial year. The Disclosure Standards and Resolution 49/2006 provides for further disclosure requirements for listed companies. This includes the timeframe for publishing financial statements (60 days after year end for annual audit and 45 after the end of each quarter for quarterly financial reviews), in addition to other disclosure requirements that are in the interest of the shareholders.

Article (5.11) of the DRAFT Law provides that a member's right to information or access to records, including financial records, cannot be reduced or removed.

Insider trading and abusive self-dealing

There is a general prohibition on making a profit from "insider dealing" under Article (361) of the Commercial Companies Law. The concept is that persons who have access to information about the shares and other securities, by reason of their position, cannot profit from that knowledge. Typically the situation is that of shares quoted on the stock market where the market price of the shares will go up or down on the release of news about the company. This is therefore dealt with under the Bahrain Stock Exchange Law.

Directors are likely to know more about the financial position of the company and have access to "price-sensitive" information that the other investors do not have, for example that the company's annual profits are poor or the company is subject of a take-over bid. The director buying or selling shares in the company would be obtaining profit at the expense of other investors, shareholders or former shareholders in the company. It is still difficult to successfully bring action against insider trading and abusive self dealing under the current law because of the difficulty in proving such persons acted illegally. Therefore, the law should place adequate restrictions on the ability of directors, managers, auditors, advisors, or other employees to deal in the shares of the company in which they serve and it should be a criminalized offence for anyone to make use of information not made known to the public, to buy or sell shares in a company in a regulated stock market. To counteract this problem, the CBB has issued "Guidelines on Insiders" relating to listed companies, and is currently in the process of issuing a consultation paper on Market Abuse and Manipulation at the time of this paper.

- **Rights of minority shareholders**

Minority shareholders are very restricted in what they can do even where the company is mismanaged or some wrong is done to the company because generally within a company there is majority rule. Although it would be a waste of the court's time to allow minority shareholders to commence legal action in the company's name when the mismanagement or wrongdoing can be easily ratified by way of an ordinary resolution passed by the majority of the shareholders, there are some exceptional cases where a minority shareholder should be able to take legal action in the company's name, for example, when the company acts illegally or when the company acts on a resolution that has not been validly passed, or when there is simply unfair prejudice on the minority.

The Commercial Companies Law permits any shareholder to make a complaint or bring action in his own name in respect of his own personal rights and does not recognize the minority shareholder's right to bring action in the name of the company, regardless whether he personally suffered damages separate and distinct from the loss suffered by the company. Article (215) of the Commercial Companies Law provides that any resolution passed by the general assembly in contravention of the provisions of the law, the company's memorandum of association or articles of association shall be null and void. Any of the shareholders whose objection to the resolution has been put in the minutes of the meeting or failed to attend the meeting for acceptable reasons may

bring a nullity claim within a period of one year from the date of the resolution. The court has the power to overrule any resolution passed to the advantage or disadvantage of certain class of shareholders or to the benefit of the members of the board of directors or others without taking into account the company's best interests. This nonetheless imposes difficulties as nullity action does not entail suspension of the implementation of the disputed resolution unless by court order. Further, any nullity judgment will be without prejudice to the rights of third parties who acted in good faith and without knowledge of or participation in the contravention. Controlling shareholders or the board of directors govern and manage most companies in Bahrain and the minority shareholders' inability to participate in the company means their interests are not always protected.

The DRAFT Commercial Companies Law recognizes under Article (1.20) the right of a minority shareholder(s) representing at least 10% of the company's voting power to bring a "derivative action" on the company's behalf to recover damages to the company itself, albeit it will be in his own name. This still imposes a restriction on who may bring derivative action as a minimum of 10% shareholding is required. In any event, the procedure for bringing derivative action and for appealing decisions of the court requires more clarification.

PART 4: Disclosure & Transparency

Timely and accurate disclosure and transparency on all material matters relating to the company including its financial situation, performance, ownership, and the governance of the company is a key feature of the market-based monitoring of companies and is central to shareholders' ability to exercise their ownership rights on an informed basis as enshrined in the OEECD Principles of Corporate Governance. The annual report and accounts of a company are the principal way in which the directors make themselves accountable to the shareholders.

Public disclosure of some information is required on an annual basis or more frequently in the case of material developments affecting the company. Large companies often make additional voluntary disclosure that goes above and beyond the minimum disclosure requirements under the law in order to attract capital and maintain confidence in the capital markets.

The Commercial Companies Law requires all types of companies to publish their memorandum of association and any amendments thereto. No memorandum of association or any amendment thereto, or any part thereof, shall take effect towards

third parties if not published in accordance with the Law. The memorandum of association of any company is comprised of the company's name, its registered address and branches, if any, the company's objectives, the company's capital (cash and in-kind), the partners' names, titles, nationalities and shareholdings, the beginning and end of the company's financial year, the names of executive managers or directors and persons authorized to sign on behalf of the company, and the term of the company, if it is for a fixed term. Article (22) of the Law provides: "The particulars that are required by law shall be published as ordered by the Minister of Industry and Commerce in the Official Gazette and in one of the local daily newspapers". Further, a copy of the commercial registration details of registered companies may be obtained from the Ministry of Industry and Commerce at the Bahrain Investors Center or a copy may be printed online at the Ministry's website: www.moic2.gov.bh.

The CBB has placed standards for disclosure which apply to listing public companies on the Bahrain Stock Exchange, as well to offering and sale and purchase of stocks in the Kingdom of Bahrain. The standards for disclosure for all companies are implemented with the submission of quarterly and annual reports, as required by the CBB and the Ministry of Industry and Commerce.

Order No (1) of 2004 with Respect to Guidance for Regulations of Prevention and Prohibition of the Laundering of Money in the Bahrain Stock Exchange the companies offering the shares, as well as the brokers, underwriters, financial advisors, placement managers, banks, brokers and all entities connected with the stock exchange are required to place restrictions, regulations and internal systems to enable them to detect and to report any suspicious or unusual transactions.

It is worth mentioning that the current Commercial Companies Law does not obligate the companies to have an internet site. There needs to be more disclosure about the system for remuneration of executives and this system should be subject to the audit of shareholders and their agreement and should ensure that the remuneration of executives and incentive programmes are tied up with long term performance and the risk management of the company. This is dealt with under the DRAFT Corporate Governance Code of the Kingdom of Bahrain, Principle 5, which provides for the establishment of a remuneration committee for public companies specifically for this purpose.

PART 5: Accounting and Auditing Procedures

Shareholders and other stakeholders in a company rely on the annual reports and accounts prepared annually by a firm of independent auditors to be informed on the company's financial performance at the end of that year. It is important to appoint independent auditors to a reliable, objective, and expert opinion on whether the company's financial statements are in compliance with the law and to ensure there is no fraud or error.

Article (217) of the Commercial Companies Law provides that the auditor must not be a member of the board of directors of the company of which he is auditing the accounts nor assume any administrative or supervisory work for the company or be a second-degree relative of a person supervising the company's management or accounts, and must not be buying or selling shares in the company of which he is auditing the accounts. Further, the auditor may not become a member of the company's board of directors or staff before the lapse of two years from the date of discharging him of his liability.

Order No (8) of 1997 Promulgated by the Ministry of Industry and Commerce requires auditors of joint-stock companies to provide the Directorate of Company Affairs with a copies of the financial reports and statements of the company for which they have carried out an audit, whether or not they have been submitted to the general assembly or the board. Further, the auditors are under an obligation to report any violations they discover while carrying out their work.

Independence of external auditors

The external auditors should be independent from the company so that they can give an unbiased professional opinion about the financial statements that will not be influenced by any relationship they may have with the company.

In reality, the auditor firm relies on its good relations with the management of a client company for its appointment and subsequent reappointment as the company's auditor. Also, the auditor relies on the management for the provision of information to carry out the audit work. There is no requirement by the law for the rotation of auditors after any number of years. Rotation would enhance the independence of the auditor because it will not be particularly in the interest of the auditor to go with the wishes of the company. Further, the work of the auditor would be subject to review and criticism of the next auditor taking his place. Therefore the audit firm will be more likely to make a rigorous audit.

Auditors are also required by the Commercial Companies Law (Article (219) and by the CBB Law (Article (61)(g) to give a statement that the licensee's accounts are correct and reflect the true state of affairs of the licensee according to the auditing standards prescribed by the CBB. Article (220) of the Commercial Companies Law and Article (163) of the CBB Law also respectively hold persons convicted of concealing record, information or documents or providing misleading or inaccurate statements or information punishable by imprisonment and a fine, without prejudice to any greater punishment under the Penal Code or any other law.

Studies and reports on corporate governance emphasize the importance of having audit committees to implement governance and monitor the integrity of the company's financial statements and announcements relating to its financial performance and to review the independence and objectivity of the internal and external auditors. The committee will not be under any pressure from the board or management to waiver independency and objectivity. The set up of such a committee for public companies is provided for under the DRAFT Corporate Governance Code.

Judicial framework for corporate governance

A strong independent and transparent judicial system is integral to the enforcement and settlement of disputes. Courts need to resolve disputes efficiently and in a consistent and fair manner. Sovereignty of the law requires the governments to serve public interest rather than private ones and the law should protect all individuals equally and not to put the government above the law. A concern about government owned companies is political interference in the way in which these companies are governed and transparency in dealings.

Conclusion

Bahrain aims to establish an efficient capital market and appears to have taken statutory as well as voluntary steps to implement good corporate governance. However as outlined in this Paper changes must be made to better implement standards of corporate governance in line with the OECD Principles. It is important to finalize and to issue the code of corporate governance of the Kingdom of Bahrain that has been drafted by the National Committee for Corporate Governance. If passed, the Draft Commercial Companies Law will make it a legal obligation for public companies to establish and adopt written corporate governance guidelines consistent with those of the code. The CBB Rulebook also provides for the implementation of the corporate governance principles in financial companies and listed companies.

The principles of corporate governance on their own only provide a reference point and are non-binding. They are intended to provide a source of guidance for stock exchanges, companies and other institutions. Unlike laws, orders and regulations, they do not provide detailed regulations as to how companies should be governed and are therefore written in a guiding tone and language that goes into detail. Although these principles are predominantly created for large financial institutions and listed companies in the stock exchange because ownership of these companies is distributed amongst a large number of shareholders which requires defining the relationship between ownership and management and they influence a large audience directly, these principles also apply to all other types of companies such as general partnerships, limited liability companies, and closed joint-stock companies, as the number of listed companies remains a very small percentage of the total number of registered companies in the Kingdom of Bahrain.