

INTERNAL AND EXTERNAL CORPORATE GOVERNANCE MECHANISMS IN THE CONTEXT OF THE EMERGING MARKET

Ali R. Almutairi ^{*}, Majdi A. Quttainah ^{**}

^{*} Corresponding author, College of Business Administration, Kuwait University Kuwait
Contact details: College of Business Administration, Kuwait University PO Box: 5486, Safat 13055, Kuwait
^{**} College of Business Administration, Kuwait University Kuwait



Abstract

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This review paper highlights the internal and external corporate governance mechanisms in the State of Kuwait. It sheds light on the legal environment by which Shari'ah is a major source of legislation. Since culture is influenced by religion, the ownership structure is, therefore, affecting legislation. Further, it discusses the market for corporate control, which is an important determinant of corporate governance external mechanism. Due to regional geopolitical instability, disruption of the full implementation of corporate governance and code of ethics is prevalent. Nevertheless, Kuwait is on the right path for the reinforcement of corporate governance and its code of ethics.

Keywords: Islamic Banks, Corporate Governance, Shari'ah Supervisory Boards

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1. INTRODUCTION

The State of Kuwait is a country with several factors influencing policies, laws, and legislation. Shari'ah is the main source of legislation. The Holy Quran and the teachings of the Prophet Mohammed constitute Shari'ah, which is fundamental for all legislation, policies, and laws. However, Shari'ah is not the only source of the overall commercial legislative system. Kuwait is a member state in many different regional and global treaties that shape policies, legislations, and laws. Traditionally and prior to the discovery of oil, Kuwaitis relied on primitive economic activities such as glazing sheep, fishing, and diving for pearls. However, the discovery of oil influenced the traditional economic cycle. Such cycle switched from basic and normative industries to sophisticated economic booms due to the transformation of the oil production and related industries as well as agricultural industries despite the desert climate. The latter is due to the government's participation in economic development, which has been an important source to foster and improve these industries and perpetuate their development.

Although Kuwait adopts capitalism as its economy, the country is heavily relying on dual capitalism/socialism economy; two economies under one roof. The social-economic activities are envisaged in the subsidies important basic food items, as well as, but not limited to free healthcare, free education and free elderly care offered by the ministry of social affairs. Consequently, the oil revenue is a major source of government grants and funding to the citizens. Despite the dual economies, Kuwait maintains an open economy with laws that protect newly formed companies as well as established national industries. Kuwait's economy relies on imports, exports, investments, and most importantly the sovereign wealth funds. The latter is the government's investment arm with diverse investments locally, regionally and globally. The sovereign fund is the cornerstone for the socio-economic development of Kuwait.

This review paper contributes to the understanding of the business policy and legal environment in the State of Kuwait. Since Kuwait is considered a promising emerging market and its business system is almost identical to countries in

its region, its uniqueness as a developing country in the world stems from the sociological dimension as its phenomenal economic growth. The reasons for such uniqueness are exceptional ownership structure of corporations, and shareholders activities. Although both said reasons are considered void in the absence of corporate governance (hereafter, CG), administration in Kuwait initiated important steps in the formulation and implementation of CG. Hence, the paper is the first to address the development and the progression of the CG mechanism and the influence of religion and culture.

The remainder of the paper is organized as follows. Section 2 discusses the ownership structure of companies, and Section 3 discusses the market for corporate control, the board of directors' practices, and their remunerations. Section 4 sheds light on shareholders rights and shareholders activism. CG and firm performance and corporate social responsibility are discussed in Section 5 and 6, respectively. Section 7 discussed challenges and limitations and Section 8 provides concluding remarks.

2. OWNERSHIP STRUCTURES OF COMPANIES IN THE COUNTRY

Participation in economic development has been important to foster, flourish, and improve these industries and propagate their development. This leads to exacerbated government's ownership via state-owned enterprises (SOE), which is hindering the enhancement of the legal system of the corporate governance mechanisms due to the differences in the nature of SOE as compared to privately-owned companies. The SOE dominance in Kuwait provides citizens and residents with all required products and/or services, like water, electricity, and subsidized necessary food items (Boursa, 2015). Despite the fact that SOEs were established in Kuwait to facilitate subsidies for essential services and goods to contribute greatly to the enhancement of the socio-economic conditions by providing jobs and training courses for nationals, it is arguably by officials that attaining sound corporate governance is by enhancing both internal and external mechanisms through political, economic, and socioeconomic reforms (Biygautane et al., 2018). As for public listed companies, overall, the ownership structure is characterized by pyramidal shareholdings, large blocks, poor financial reporting, weak transparency practices, unusual complex corporate structure, interlocking directorship, and concentration of power in keyboard directors (Al-Musali et al., 2019). La Porta et al. (1999) and Arora and Chong (2018) indicate that most of the controlling shareholders (i.e., block-holders) of companies in Kuwait are merchant families and the high net worth individuals who represent political figures or royal families that own dominant holding and investment companies. The prevalence of ownership concentration of companies is required by the authorities in Kuwait to disclose such information. Additionally, it is common for non-merchant families to have direct, indirect or both controlling stakes in many corporations. This high degree of family ownership propagates strong

incentives to monitor companies and their management. Almutairi (2013) shows that ownership concentration by Kuwaiti families maximizes corporate value. Consequently, the legal infrastructure of the financial sector in Kuwait is inefficient.

Although Kuwait shares most of the commercial characteristics of the Gulf Cooperation Council (GCC), the corporate governance codes in Kuwait are yet to be improved. The opaque nature of family ownership requires a highly reinforced need for corporate governance structure. This level of governance is required to address the principal-principal and principal-agent problems that can arise. The former is prevalent among the controlling shareholders and minority shareholders. In some instances, shareholders may use the voting power generated by their share ownership to manipulate companies' management decisions. The latter is prevalent in ownership structure known as "pyramid ownership" in which high net worth individuals or royal family members have stakes in various companies in multiple holding companies and company subsidiaries. This type of ownership structure is prevalent in all of the GCC countries. Table 1 depicts the ownership structure of corporations in Kuwait, the GCC, and Italy. They all share the same characteristics of ownership structure. Nevertheless, Italy initiated reforms to ensure compliance with CG codes and ethical standards. This control over companies that are listed on the Boursa Kuwait often generates leadership duality where the Chairman also acts as the CEO of the company.

It is evident that corporations in Kuwait have different ownership structures ranging from government and family-owned corporations to individual and institutional investors. It is highly prevalent that few shareholders control most of the share ownership in Kuwait. The structure is reliant upon the government and its agencies, institutional investors, family, and individuals (Alfaraih, 2012).

Table 1. Ownership structure

| # | Kuwait | GCC | Italy |
|---------------|--------|-----|-------|
| Pyramidal | √ | √ | √ |
| Block-holding | √ | √ | √ |
| Institutional | √ | √ | √ |

3. MARKET FOR CORPORATE CONTROLS (M&A)

The CG Codes help in protecting the interest of the minority shareholders, especially when a change in corporate control is imminent. Revealing the rules and regulations governing any possible acquisition of companies, as well as unusual transactions such as mergers and sell-offs of a large section of a company, enables shareholders to understand the consequences and to protect their rights. Consequently, the clarity of transactions protects the rights of all categories of shareholders. The board of the Boursa Kuwait pursuant to its resolution issued M&A regulations in 2015. The regulations apply to the restricted offer or purchase of shares, as well as traditional or reverse takeover offers. All regulations must be in conjunction with the Listing Rules issued by the board of the Boursa Kuwait (Boursa, 2015). Companies may merge with

others that share the identical legal structure by which the merger is by either amalgamation and consolidation or division and amalgamation. In addition, members of the board of the company involved in the merger process have no rights to cast their votes before the board meeting, subcommittees, or the general assembly of the company.

Nevertheless, board members may cast their vote if their ownership in “a merger holds less than 5% of the shares that have voting rights in the general assembly meetings” (Boursa, 2015). Boursa (2018) states that companies who have an initial agreement regarding a merger should be followed by disclosure so that the authority has initial approval of the memorandum of the merger. When the authority approves the memorandum of the merger, the authority officially announces the merger resolution for the relevant parties involved in the mergers, “the Authority’s approval of the Draft Merger Contract shall be announced in at least two daily newspapers, in addition to the other means set out herein” (Bourse, 2018).

Disclosure is mandatory during an acquisition whether or not parties successfully finalized an initial acquisition offer agreement, and when the offered company notices a crucially important offer via submitting an unconditional offer. Further, the disclosure is mandatory when the responsible authority approves the offering document and when the offered company recommends addition or deletion of certain terms and conditions to the company that submitted the offer. It is as well mandatory to disclose the percentage and time period of the shares collected. Further to the latter, the disclosure is required when all procedures for the execution of the acquisition offers are completed, including any crucial disclosure requirement by the authority (Boursa, 2015).

If a conflict arises from shareholders or blockholders due to the merger decision, the blockholders have the right to object by providing the authority with official required documentation data or documents deemed necessary to decide on the grievance. Upon providing the necessary official documentation, an irrevocable decision will be made by the officials of the authority within a twenty-day period. If the plaintiff fails to hear from the authority within a twenty-day period, it indicates that the authority disapproved the complaint. This could be challenged before the judicial system in Kuwait within sixty days from the date notifying the concerned parties (Boursa, 2015). The characteristics of the Kuwaiti capital market have significant governance implications. Table 2 depicts the comparison of the antitakeover laws in Kuwait in comparison with the GCC and Italy. Table 2 shows that Kuwait and other GCC have not yet adopted the antitakeover law or the poison pill. Nevertheless, Kuwait has addressed an important issue that proper disclosure is of importance during an acquisition whether or not parties successfully finalized an initial acquisition offer agreement, and when the offered company notices a crucially important offer via submitting an unconditional offer. Consequently, the market for corporate control is less prominent in Kuwait since takeover mechanisms are widely used. Therefore, the market for corporate control constitutes an important

governance system that has the capability to allow the transformation of control from inefficient to efficient management teams. Furthermore, it encourages a convergence of interest between corporate management and shareholders.

Table 2. M&A

| # | Kuwait | GCC | Italy |
|------------------|--------|-----|-------|
| Antitakeover law | X | X | √ |
| Poison pill | X | X | √ |

3.1. Board of directors’ practices

In Kuwait, corporate governance significantly influences and sustains a professional, healthy, and safe environment for corporations in the process of engaging and becoming effective members of the world trade organization (Al-Wasmi, 2011). Hence, such mechanisms of corporate governance enhance public firms’ financial performance, liquidity ratios, and on top of all the abilities to achieve financial goals efficiently (Al-Wasmi, 2011). Consequently, Kuwait’s corporate law is crucial to maintain excellent stakeholder relations. The responsibility of the board of directors is to raise corporate interest first, even if this interest affects the (short-term) interest of shareholders (Boursa, 2015). The board of directors must generate a formalized strategy that will be ingrained in all of the firm’s business practices. This strategy must be in writing so that it is readily available for review by all shareholders, particularly those who have significant holdings (i.e., block-holders). In addition, the board of directors is responsible for creating policies relating to risk management of the firm’s activities (Dawd & Charfeddine, 2019).

A continuing process of review, revision, improvement, and mandatory implementation is central to this function. Further, the board of directors is required to appoint a Compliance Officer under the company’s legal department to ensure that the policies are not circumvented (Al-Wasmi, 2011). Additionally, the board of directors’ roles include monitoring and controlling the behaviors of management and the implementation of their business functions in order to ensure efficiency. Moreover, the board of directors must approve a written CG policy for the company, oversee the policy’s implementation, and monitor the level of compliance with the policy on an annual basis. Further, the board of directors must draft a written code of business conduct, which states professional and business ethical standards that serve to regulate the relationship of the company with its stakeholders for protecting their respective rights (AlHaris et al., 2019). Despite the possibility of agency problems and the considerable evolution of the legislation relating to CG, a higher proportion of listed companies have engaged in the process of adopting the recommendations of the CG Code.

Due to the growing alignment between CG Codes, the characteristics of Kuwait’s board of directors are increasingly similar to the best practices at the international level. However, the impact of insider shareholders on the board of directors remains a specific characteristic of many boards of listed companies in the Kuwait stock

exchange. The ownership structure of the Kuwaiti listed companies is still very concentrated. Combined with an absence of active and independent institutional investors, the board is selected by major or controlling shareholders.

3.2. Directors' remuneration practices

In compliance with regulatory requirements, chairs of the board of directors are not allowed to chair any committee unless they are appointed as independent directors. Moreover, the chairman of each committee should be elected from among independent members of the board and the majority of the committee members should be of nonexecutive members. The remuneration committee recommends a remuneration policy to the board of directors, which includes all forms of remuneration schemes, including salary performance-related schemes, pension schemes, share-based remuneration, and severance pay. It also evaluates the CEO's performance based on the company's goals and objectives, as well as the company's performance relative to comparable companies.

The remuneration best practices and policies of specific directors are aligned with the organization's long-term performance and risk as well as regulatory requirements. Such practices and policies are reflective of the organization's objectives and goals, considering the uniqueness and the soundness of the corporation's operations and financial position. In addition, directors' qualifications and contributions to the success of the company constitute a major component in setting directors' remunerations. Most public companies in Kuwait disclose information about the total amount and form of the compensation of top management and directors, as well as the number of shares that each hold, in their annual reports or in the section of the CG of their companies' websites (CSR, 2010). All public companies are required to provide the Capital Markets Authority with detailed records of management and directors' compensations. Concealing any personal benefits leads to serious legal consequences. The board can engage outside consultants or internal auditors of the organization to identify the gaps within the remuneration process and equity-based plans.

4. SHAREHOLDER'S RIGHTS PROTECTION & ACTIVISM

4.1. Shareholder's rights protection

The 2004 International Monetary Fund (hereafter, IMF) report indicates critical concerns of Kuwait's overall corporate governance and shareholder rights protections, in particular, minority shareholder rights protections. At the time of the IMF report, Kuwait had only one provision of minority shareholder protection. To address the IMF concerns, Kuwait has passed two legislations. The first legislation is a comprehensive Capital Market Law (Law 15/1960) enacted in 2010, and the second one is a major amendment of the Commercial Companies Law (Law 25/2012) (Boursa, 2015). These two legislations reserve certain decisions to shareholder meetings, prevent some executive

decisions to be made without the approval of shareholders and grant more and broader access to pertinent information. Further, provisions include appointments and dismissal of managers as well as the board of directors and auditors. They also contain more requirements on disclosure of interests, mandatory takeovers, insider trading, and related party transactions. Although these two legislations still lack some elements, they definitely embody a number of corporate governance-related provisions and provide more protections to shareholders' rights.

4.2. Shareholder activism

Shareholder activism refers to the extent that shareholders can influence firm policies and practices through their ownership position. Activism can be defensive and offensive. In Kuwait, defensive investor activism is common because of family entrenchment. However, offensive investor activism tends to be very limited. For example, in early 1997, Al-Khurafi family group, one of the major shareholders in the KSE market built up a coalition with other shareholders to acquire Al-Sahel Co., which was owned and controlled by Jasem M. Al-Saqr, an influential stakeholder in many KSE-listed companies. After the acquisition, the coalition removed Al-Saqr and his board of directors in April 1997 due to poor performance and several law violations. In addition, in 2013, another coalition led by several family groups (e.g., Al-Marzouq, Al-Ghanem, Al-Nefisi, Al-Saqr, Al-Nisf, and Al-Khurafi) acquired Kuwait Finance House (KFH), one of the major Islamic banks in Kuwait and MENA, and nominated a new board of directors.

The limitation of offensive shareholder activism in Kuwait, especially from small shareholders, is attributed to many reasons such as ownership concentration, restrictions on shareholders' rights, high threshold percentages required for other shareholders' rights, and major shareholder being the manager of the company in most KSE-listed companies. Kuwait authorities and media still need to promote and encourage more responsible shareholder activism by domestic and foreign shareholders.

5. CORPORATE GOVERNANCE AND FIRM PERFORMANCE

Corporate governance in Kuwait has become one of the major concerns for investors since the 1982 crisis of Souk Al-Manakh stock market (unofficial stock market). Weak corporate governance was widely seen as contributing to this crisis. While public companies in Kuwait have improved their corporate governance practices due to the enforcement of corporate governance laws, large private companies voluntarily have made serious changes to their corporate governance practices as well (e.g., increasing financial transparency, introducing structure to the board of directors). These changes are attributed to the new guidelines of the Central Bank of Kuwait (e.g., Basel requirements), the requirements of the OECD corporate governance, the adoption of IFRS and the greater level of globalization of Kuwaiti firms.

In spite of the new wave of laws enacted to improve corporate governance standards, companies in Kuwait have the lowest standards of corporate governance in the GCC (Gulf Countries Council) (Hawkamah, 2009). Statistics show that Kuwait, out of the GCC countries in the year 2009, ranked as one of lowest GCC countries on “Competitiveness Index” (published by the World Economic Forum) and “Ease of Doing Business Index,” (published by the World Bank). Although the concept of corporate governance is well known in Kuwait, some current corporate governance regulations are irrelevant, and some corporate governance mechanisms are either weak or not well organized (Al-Saidi & Al-Shammari, 2014). Empirical evidence in general shows that corporate governance practices, for example, lead to poor corporate performance (e.g., Alfaraih et al., 2012), or has no influence on firm value (Al-Saidi, 2010).

6. CORPORATE SOCIAL RESPONSIBILITY

Although there is no mandatory CSR in Kuwait, many public and private companies voluntarily disclose their CSR practices. The annual report of multinational and local companies in Kuwait highlights to what extent these companies engage in CSR. The incorporation of CSR in these companies has shown a positive outlook on social activities. In Kuwait, an annual CSR conference is held to promote the incorporation of CSR within businesses and to offer companies suggestions and recommendations on how to enhance performance. The CSR conference honors companies that contribute to communities with annual awards.

Healthcare, education and financing aid and charitable trust are the major domains that local companies contribute to communities. Within the first domain, companies fund construction projects of hospitals, medical centers as well as purchasing medical equipment and tools. For example, Zain, a multinational telecommunication company, sponsored and supervised the construction of Zain hospital for Ear, Nose and Throat. In addition, Kuwaiti Projects Company (KIPCO) sponsored a campaign on dyslexia to increase the awareness among students and professionals, and Kuwait Finance House (KFH) donated KD 1.250 million for the construction project of 15 motorway ambulance centers.

As for the education domain, local companies reach out to students and educational institutes to educate on environment pollution, provide training workshops and internships and develop discipline and personal skills. For instance, EQUITE, a multinational petrochemical company, sponsored educational and research programs and provided scholarships and awards for higher education.

In the financing aid and charitable trust domain, companies donate money from their accounts to official trusts and charitable organizations. Some companies allocate a fixed percentage of their annual sales to charities such as Kuwait Red Crescent and Kuwait Zakat House. For example, Kuwait Foreign Petroleum Exploration Company (KUFPEC), donate to the devastating drought crisis in Somalia and Pakistan flood victims.

There are very few studies on CSR in Kuwait. For example, based on a sample of 211 firms listed on Kuwait stock exchange in 2012, Al-Ajmi et al. (2015) show that 49 percent of these companies disclose their corporate social practices. They also report that the level of social responsibility disclosures is positively related to firm size and profitability and negatively related to government ownership. In Al-Shammari (2008), the disclosure of CSR is greater in firm size. Kamla (2007) indicates that the quality of CSR disclosures in Kuwait, among other Arab countries, is similar to the quality of CSR reporting in European countries.

7. CHALLENGES AND LIMITATIONS

To further improve the CG and CG Codes, the legislature in the country should ensure sound and agree upon adopting the best CG practice. Nevertheless, there might be a slight hindrance, especially that higher proportion of the legislatures; the members of parliament, are themselves merchants engaging in business transactions. Thus, reforms of laws will be unsuccessful without reforming the legislative body of the country. With such reforms, soundness and transparency will improve the overall environment. Leading to the implementation and embracing the best CG Codes and practice.

A major limitation is the conflicting data between government organizations/agencies. Hence, data could have provided a clearer picture of the existing internal and external CG mechanisms.

8. CONCLUSION

It is evident that the State of Kuwait is one of the few last countries that enforced CG regulations. Prior to the enactment of the CG law in 2016, Only the banking sector in Kuwait exhibited more CG practices. However, post-June 30th, 2016, nationwide enforcement of the CG law subjected all companies to abide and adhere to the new CG law. The increasing significance of the role played by banks and investment companies in Kuwait toward developing the country as a regional financial hub emphasizes strengthening the principles of CG. The regulation and oversight of investment companies have shifted from the Central Bank of Kuwait to the Capital Markets Authority as of September 13th, 2011.

Although the regulators in the State of Kuwait initiated the reforms during the 1990s; specifically, in 1997, via many different programs such as privatizations and liquidating government's ownership whether, in SOE or Semi State-Owned Enterprises, it is evident that the geopolitical influences disrupted the fulfilment of the CG regulations and code of ethics. Furthermore, to foster CG practices in banks, the Central Bank of Kuwait applied Basel II capital standards on December 31, 2005, and then Basel III capital standards in 2014 with full implementation in 2016. As for the investment sector, many companies voluntarily adopted numerous principles of corporate governance.

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