Lebanese Corporate Governance System: Prospects and Challenges

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Keywords: Emerging market corporate governance, Anglo-Saxon system, relationship-based system.

We would like to thank Sir Jeffrey Owen and seminar participants at the American University of Beirut for insightful comments.

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Abstract

Between developed countries and the Arab world, the Lebanese Corporate Governance system is evolving after 15 years of civil war (1975-1990) with a large number of initiatives. Built on family business structure, block shareholdings, and an active banking system, the Lebanese corporate governance system is moving forward to a market-based system. Regulatory initiatives aim to develop an equity finance culture where external mechanisms allow firms to improve their performance, to reduce their cost of capital and overall, enhance the long-term economic performance. Several positive regional developments will improve the local equity culture but significant challenges lie ahead.

An Overview of the Lebanese Corporate Governance System: Main Challenges

A large number of prior studies focus on different national corporate governance systems. They indicate significant differences, and evolutions led by globalization and politicians. These studies distinguish between two distinct corporate governance systems: The Anglo-Saxon system (including the USA, the UK, Canada, Australia and other Commonwealth law countries), and the relationship-based system (including Germany and Japan). The Latin system, on the other hand, that includes France is a hybrid system. Whatever the classification made for these systems, it distinguishes between market-oriented and network-oriented systems. On the one hand, the Anglo-Saxon market-oriented system uses an instrumental concept of the firm defined as an instrument to maximize shareholder's wealth. On the other hand, the relationship-based system and the Latin system use an institutional aspect of the firm defined as a coalition between various participants such as shareholders, managers, employees, suppliers of goods and services, etc. striving for the continuity of the firm as whole (Moerland, 1995a).

The French Tutorial period in Lebanon during the first part of the twentieth century have led to a number of rules related to the French regime. The Lebanese firms' institutional environment is thus mainly shaped as a Latin system. While regulations and cultural issues played a significant role in determining the pre-civil war Lebanese corporate governance system, globalisation and the need for new economic drivers are, nowadays, the main determinants.

Porter (1992) argues that the corporate governance system is likely to affect national economic performance. He relates the economic slowdown in the USA to an inadequate governance of capital allocation compared to relationship-based system. Still, the burst of the bubble economy in Japan, the Asian financial crisis, and more recently the German economic slowdown have shown the limits of the network-oriented system. Hence, the definition of the most effective Lebanese corporate governance system underlies questions about the forces explaining differences in corporate governance systems, and their role in avoiding and resolving economic crises.

The paper is organized as follows. First, we present a descriptive analysis of Lebanese institutional environment. Second, we analyze the main characteristics of the Lebanese corporate governance system in regard with both the market-oriented and network-oriented systems. Finally, we conclude with a discussion of the developments and challenges that will most probably shape the future of the Lebanese corporate governance system.

The Origins of Corporate Governance Systems: the Lebanese Case

Prior research shows the existence of two main hypotheses that may explain trends in different corporate governance systems: the Legal hypothesis and the Liquidity hypothesis. On the one hand, the legal hypothesis focuses on legal and institutional rules to protect shareholders. Common law legal systems in market-oriented economies provide more significant protections to minority shareholders. They seem to outperform civil law legal systems in network-oriented economies in establishing an environment with active securities markets (Weimer and Pape, 1999). As a consequence, Berglöf (1990) argues that market-oriented systems include a large number of dispersed shareholders and creditors, whereas investors with lower legal protections in a network-oriented system, are reluctant to participate in equity markets, except for large block-holders who can protect themselves against expropriation[i].

On the other hand, the liquidity hypothesis relates to the market organization. It suggests that whatever the legal system or the political constraints, the desire for liquidity may be a force driving the CG system and the ownership structure characteristics. Indeed, investors may be reluctant from holding large positions in individual companies if the equity markets are not liquid enough. Understandably, the emergence of powerful financial intermediaries in Europe and Japan after World War II, may be explained by the absence of liquid and deep equity markets. During this period, financial intermediaries, within these thin markets, had no option other than holding controlling blocks.

The foundation of corporate governance in Lebanon rests on the Commercial Law, with some additional provisions in the Beirut Stock Exchange (BSE) Listing Requirements[ii]. Unfortunately, the Commercial Code is dated and does not address many key corporate governance issues, and the BSE Listing Requirements focus on disclosure and accounting issues only. As a result, many key corporate governance areas are not covered in the legal framework, which can leave minority shareholders vulnerable.

Table 1 refers to hypotheses 1 and 2, and exhibits the main characteristics of the Lebanese corporate governance system in relationship with other corporate governance systems. In contrast with different developed countries governance systems, the Lebanese system is still way behind as investors do not benefit from an effective legal protection. Based on the French-Lebanese historical relationships, lawsuits and legal issues within the Lebanese governance system relate to a civil law system. Although the Lebanese regulation does provide a strong legal protection to investors, the expropriation risk in Lebanon remains low, and large shareholders are used to super-voting stocks to protect their interests. Although a number of initiatives have been considered by the Beirut Stock Exchange to improve stock market liquidity, it remains low and the average daily trading volume not significant.

Table 1

The fifteen-year Civil War exacted a staggering cost on the Lebanese economy and people. By its conclusion fifteen years ago, the country faced major social, political, and economic instability. The sectarian hostilities had produced enormous devastation in infrastructure and a major transformation in the country's societal makeup. More than a quarter of the population was displaced, and approximately a fifth of the Lebanese professional and skilled worker force emigrated. Public institutions were severely damaged and investors, both local and foreign, withdrew their capital outside the country. As a result, local productive capacity was substantially weakened, and per capita income fell by more than one third in real terms compared to pre-war levels. Lebanon ceded its role as the preferred regional trade and financial center to other gulf centers, Bahrain and Dubai. The BSE itself shut down in 1983 and remained closed for 11 years.

In recent years both the public and private sectors in Lebanon have increasingly recognized the importance of good corporate governance in improving company performance, raising capital at the lowest cost, and enhancing long-term economic performance generally. However, while a number of Lebanese companies, particularly banks, have adopted "good" governance practices, there has been little progress in re-establishing the equity culture lost during the civil war or in reforming a number of key weaknesses in the legal and institutional corporate governance structure, leaving Lebanon in the bottom tier of emerging markets.

The Characteristics of Corporate Governance Systems: Toward a Lebanese CG system!

Till the World War II, the Lebanese system was structured around a French culture where legal and institutional rules would have allowed for the establishment of a Latin system. However, the Lebanese specificities led to the emergence of a hybrid system in-between the market oriented- and the network-oriented systems. We analyze the Lebanese system around two main aspects usually used to distinguish between the market-oriented and the network-oriented systems: the financing sources effect -market versus banks- (Berglöf, 1990 and Porter, 1992, Allen, 1993), and the control mechanisms effect -external-markets versus internal-committees- (Franks and Mayer, 1992, Moerland, 1995a).

- *The Financing Sources: Market- versus Bank-based system*

The Anglo-Saxon market-based system is characterized by high number of listed firms, a well functioning capital market (for example, a high market capitalization in percentage of the GDP) and low number of holding companies (Franks and Mayer, 1992). This system is also characterized by short-term relationships in the capital, labor and goods and services markets. Hence, while it seems to be flexible and innovative, it imposes a short-term vision to investors, disfavouring long-term and stable relationships (Gelauff and Den Broeder, 1996). As a consequence, managers in Anglo-Saxon countries may be myopic, and tempted to focus on boosting short-term performance (Porter, 1992).

To the contrary, the relationship-based systems are bank-based systems. Firms within these systems have a higher indebtedness level, more homogenous and concentrated creditors and more concentrated shareholding structures. Moreover, commercial banks have higher shareholdings in these firms, which allow for more stable economic relationships between financing sources (equity and debt), and less frequent acquisitions[iii]. For example, firms in the relationship-based systems[iv], are seen as combinations of stakeholders including shareholders, managers as well as workers, suppliers, government and other partners maintaining close relationships (Moerland, 1995a). Large general banks are salient stakeholders who participate in firms as lenders, equity-holders and supervisory board members. Firms in Latin countries are characterized by financial holdings and cross-shareholdings, government control and family control (De Jong, 1989, Moerland, 1995a,b). Finally, the Japanese system includes a strong cultural dimension where “family” and “achieving consensus” are important. Within this system, there is a large number of inter-corporate networks, called Keiretsu, which involve diversified and vertically integrated companies with the same name. These companies are held together by cross-shareholdings, a web of supply linkages, and other forms of cooperation. They have close relations with their banks who are usually, as in Germany and Latin countries, salient influential stakeholders. Besides the important debt-financing role by international standards (Corbett, 1994), Japanese firms benefit from a significant role played by the stock markets.

Lebanese firms as reported in table 2 (I) are predominantly family businesses with limited access to financial markets. There is currently only a weak equity culture, with most companies raising capital from retained earnings and bank loans. Equity markets are small, with only 11 listed companies (over half of which are banks) amounting to a market capitalization of only 10 percent of GDP well less than a third of the average for emerging markets in a similar stage. Even among these free floats tend to be small and trading volume low. Although the market structure has been a subject of a large number of regulatory initiatives, the market liquidity remains too low.

Table 2

One of the reasons that equity markets are underused is the remaining effects of the fifteen year civil war. Government efforts at reconstruction have resulted in huge fiscal deficits and enormous debt burdens, with government debt service requirements crowding out private sector finance. Slow economic growth has reduced business opportunities and financing needs, including equity finance. Also, family owners of companies have sometimes focused more on keeping control rather than taping equity markets to find cheaper finance.

As a consequence, companies that do not tap the stock market for finance have less of an incentive to provide the protections for minority shareholders. Without a corporate culture that values those protections, investors are less likely to see the stock market as a good place to invest their money. In sum, a low demand for equity finance means less emphasis on minority shareholder protection, which leads to a low supply of shareholder investment and high equity financing costs. As long as companies do not seek equity finance, incentives to improve corporate governance will be weak.

- *The Control and Decision-making: External-Markets versus Internal-Committees*

Franks and Mayer (1992) present an extensive analysis of ownership functions and decision making across countries. They confirm the existence of two distinct systems: the Anglo-

Saxon, and the relationship-based system (i.e., European-Japanese system). While the former is mainly based on external control mechanisms, i.e. market-oriented, the latter uses internal mechanisms, i.e. boards and committees.

The market-oriented system follows a shareholder-oriented approach and has laws aiming to strongly protect shareholders. Given the high cost of "collective" decision-making, managers have a large place in the decision making. The separation between control and ownership on the one hand, shareholders and creditors on the other, cause conflicts of interests, i.e. agency conflicts, among different partners within this system. Thus, the market-oriented system uses three external control mechanisms: outside directors, incentives for managers, and the market for corporate control. First, this system has a unitary board model, where all directors participate in a single board comprising both executive ("inside") and non-executive ("outside") members in various proportions. Independent non-executive directors have no relationship with the company that could affect their independence and objectivity. They are accountable to shareholders for the management of the corporation and on major policy decisions (Bleicher and Paul, 1986, Lorsch and MacIver, 1989). The board of directors has both executive and supervisory responsibilities. Second, managers have performance-based incentives such as share-option plans and bonus plans for a greater alignment of interest with shareholders. Third, the external control by non-banking financial institutions, i.e. insurance companies and pension funds, in the market-oriented system allows for an easy transfer of ownership (Mayer, 1994). For example, the market for corporate control is a flexible mechanism that offers rapid restructuring ways of the ownership and for external growth. Altogether, these external control mechanisms are supposed to reduce the agency costs related to the separation of control and ownership.

To the contrary, the Internal-committees system is a societal-oriented approach that gives more attention to the protection of interest of different stakeholders, and privileges communication as a disciplinary method. In this system, there is a more concentrated ownership that allows large block-holders to have a higher internal control using the board system. This system distinguishes two different control systems: The two-tier approach, also called the Continental European approach, and the Japanese approach (Franks and Mayer, 1992). Within the first system, firms exercise through two boards, in which the upper board, including totally non-executive directors, supervises the executive board on behalf of stakeholders. The supervisory board includes people nominated by employees and other stakeholders, and has the power to hire, supervise, and if necessary, fire members of the executive board. Although this system is permitted in Latin countries, such as France, Italy, Spain and Belgium, the unitary model is the more prevalent model. In France for example, a large proportion of listed firms have chosen the unitary model, due mainly to their family control and cross-holdings. Therefore, shareholders in Latin countries are more influential than in Germany, but are less than in Anglo-Saxon countries. The Japanese approach relates to informal networks based on inter-trading, cross-shareholding and connected directors. Within this system, firms have usually large boards (30 to 35 members). They fulfill ceremonial functions, and contain smaller power groups organized around the president, the chief executive and the representative directors. In this system, banks act as a main relationship investor. Banks offer internal voice and stable shareholding virtually without exit. General assemblies are usually a mere formality, and all directors are nominated by an insider stockholder group and can exercise a significant voice. While board members used to be family members and close colleagues, international institutional investors (e.g. CalPERS) are putting a growing pressure to add independent directors.

Consistent with Latin countries, the Lebanese control system, as reported in table 2 (II) is based on a unitary board model. Because of the central importance of family control over most companies and their boards in Lebanon, most boards have few non-executive directors and very few have independent directors. Boards tend to play little role in reviewing management performance or in strategic planning. Nomination, compensation, or audit committees are very rare. However, as the protection of minority shareholder rights is a key element of good corporate governance, Lebanese institutions, especially market authorities, insist on the need to ensure an adequate disclosure practice and to adopt policies making boards more responsive to shareholders as a group and not just to the families that control a majority of the voting stock.

While there has been improvement in company disclosure of material information such as acquisition and disposal of significant assets, and while accounting standards must now conform with International Financial Reporting Standards (IFRS), there has been little progress in improving Board function. Control remains the priority for Lebanese CG system at the expense of transparency, accountability and board independency. Family businesses are delegating an indirect role to banks implementing a basic form of CG monitoring. Indeed, more involved banks require from firms to audit their financial statements, to identify board members, and to prepare for a “good” governance system.

Although the present CG structure relates more to a societal-internal-committees system, a large number of initiatives have been undertaken in Lebanon to improve liquidity and increase the role of the Beirut Stock Exchange: The improvement of trade frequency, the establishment and listing of Eurobonds, a reduction of dividend taxation rate to 5%, laws about insider trading, foreign ownership, etc. Nowadays, Lebanese laws have the ingredients to establish a shareholder-external market approach. Nevertheless, the economic situation has discouraged investors from participating in such a move. For example, the failure of Lebanese authorities to set-up a market-based system may be explained by the high interest rate paid by government bonds. This makes investors reluctant to invest in a riskier, less liquid, and not necessarily more profitable equity market (for example, the BSE index under-performed over the last 3 years all GCC indices). Without a faster growing economy - - and an increase in competition from new market entrants - - there will be little pressure to improve management of family-run companies or to find the least expensive finance. Unless these conditions take greater hold it is unlikely that many families will risk relinquishing their control.

The Future of the Lebanese CG system: Further Issues

While the macroeconomic climate has not been conducive to developing a greater equity culture or to improved corporate governance, there are a number of profitable and well-governed companies in Lebanon. While most are not yet listed, many are contemplating listing sometime in the future[v]. It is critical that these companies to be encouraged to continue to maintain and improve their corporate governance and to seek equity financing. Of course, for an external monitoring mechanism to be effective, the BSE should place a greater emphasis on good governance by adopting some guidelines similar to the Code adopted by World Bank or Institute For International Finance (IIF) not already found in the Lebanese legal framework. This would focus greater attention on companies that implemented good governance standards, which would help attract more investors, thereby reducing the cost of equity finance. As financing costs fall, more companies would choose to list.

Equity culture is getting a boost internally and regionally. As of today, the only source of capital for the vast majority of businesses in Lebanon is loans from commercial banks. Lebanese banking sector has long tradition in being conservative and active in monitoring their clients. Given the sluggish GDP growth, banks tend to not "rock-the-boat" by having clients adopting some best practices in corporate governance. They are more concerned on having their investments paid off and clients not defaulting.

Over the past 15, the best investment in Lebanon has been treasury instruments with an average of 20% annual compounded returns. In lieu of this, investors have found it hard to move to equity investments. But now, yields in the treasury have dropped from 16.4% to less than 7% annual returns. Another issue is that regional markets are prospering. Kuwaiti stock market with more than 250 listed companies has a market capitalization of 3 times the country's GDP. Qatar, Saudi Arabia and Jordan have relatively well functioning stock markets and equity culture that did not exist a decade ago, now is growing at a fast pace. All these developments are encouraging for Lebanon as many companies operate in multiple markets and dual listing is fashionable.

While the government has recently become aware of the need to develop a more effective corporate governance framework to attract much needed foreign capital flows, it has yet to make much headway in improving the legal or institutional frameworks for corporate governance - - which have always been weak in Lebanon. Law and regulations lack many important corporate governance protections, especially with respect to the composition and operation of boards of directors. Lebanon has also yet to adopt a corporate governance code, even on a comply basis. While the business community has taken greater notice of governance issues, there has been little change in overall corporate culture.

Effective enforcement of company and securities laws in Lebanon is an area that has always been in need of significant strengthening and capacity building. Existing regulatory bodies are not sufficiently developed to investigate complaints or to prosecute violators. A key problem is that the Lebanese judiciary is not independent. For example, a report prepared by the United States Economic Intelligence Unit concludes that the Lebanese government significantly influences the judiciary, while a recent U.S. State Department revealed that foreign investors consider the unpredictable judiciary system as among the most important risk factors in investing Lebanon. Also, judges are not well versed in commercial or securities law. As a result, investors do not trust that contract or commercial law will be enforced. The country’s recent experience with privatizing the mobile telecommunications industry, where the courts allowed government contracts to be voided and where black market mobile operations have been tolerated, is one example.

The existence of widespread public and private sector corruption is key. While this may help answer why the legal and institutional framework for corporate governance is so weak, the existence of significant corruption goes farther by making the overall business environment less attractive to investors, particularly foreign investors. This is especially true with respect to investment opportunities with firms that depend on significant contractual relations with the government. Lebanon, to quote the US Embassy Country Commercial Guide 2003, has “laws and regulations to combat corruption but historically these laws have not been enforced.” Based on the 2003 Corruption Perception Index developed by Transparency International, where the higher the ranking the greater the level of corruption, Lebanon ranked 78 out of 133. On a scale from 0 to 10, with 0 being highly corrupt, Lebanon scored only 3. Furthermore, according to the Lebanese research company Information International, Lebanon loses over $1 billion a year due to corruption. It is widely reported that significant bribes have been paid to win key public contracts. Such a level of corruption is a major cause for concern as the judicial system lacks the ability to provide shareholders and other corporate stakeholders with ample opportunity to receive proper redress for grievances.

In an attempt to control corruption in the private as well as public sectors, the government has given the public prosecutor the legal authority to investigate and prosecute private sector corruption. However, due to a lack of resources and problems in the judiciary, there is little reason for optimism that this initiative will bear significant fruit any time soon.

Two local NGOs have recently been established to raise awareness about the problems of corruption Kulluna Massoul (meaning in Arabic “we are all responsible”) and La Fasad (meaning in Arabic “no corruption”). Despite such initiatives, corruption remains widespread in the Lebanese community.

Table 1- Corporate Governance in Lebanon and The Origins of Alternative Corporate Governance Systems

Corporate Governance Systems	UK/USA	Japan	Germanic System	Latin	Lebanon
I- The Legal Hypothesis					
Legal protection	Yes	Y/No	Y/No	Y/No	No
Law system	Common	Civil	Civil	Civil	Civil
Expropriation risk	Low	Low	Low	Low	Low
Super-voting stocks	No	No	Y/No	Y/No	Yes
II- The Liquidity Hypothesis					
Liquidity	High	High	High/Low	High/Low	Low
Average trading volume (in % of the float)	High	High	High/Low	High/Low	Low
Initiatives to improve market liquidity	Yes	Yes	Yes	Yes	Yes

Table 2 - Corporate Governance in Lebanon and the Alternative Governance Systems

Orientation	UK/USA Market-oriented	Japan Network-oriented	Germanic System Network-oriented	Latin Network-oriented	Lebanon
- What is the concept of the Firm?	Instrumental	Institutional	Institutional	Institutional	Institutional
- Who are the Salient Stakeholders?	Shareholders	Banks, Financial Institutions, employees	Banks, employees	Holdings, gover-nment, families	Family, control shareholdings
I- Financing Sources					
A- The Role of Capital Markets					
- Number of Listed companies	High	High	Low	High	Very Low (11)
- Market capitalization in % of GDP	High	High	Low	High	Very Low (10%)
- Are stock markets important in the economy?	High	High	Moderate/high	Moderate	Very Low
B- Shareholders					
- How concentrated is the ownership structure?	Low	Low/Moderate	Moderate/high	High	High
- Are there cross-shareholdings between firms?	No	Yes	Yes	Yes	Yes
C- Creditors					
- Are Firms highly leveraged?					Yes
- Do banks hold corporate equity?	No	Yes	Yes	Yes	No
II- The control mechanism					
A- Internal-Mechanism					
- What is the Board system?	One-Tier	One-Tier	Two-tier	Optional	One-tier
- Who dominate the board?	Executives	Principal owners	Principal owners	Principal owners	Principal owners
- Do banks sit on boards of firms?	No	Yes	Yes	Yes	No
- What is the Banks control level?	weak control	high (long-term relationship)		Weak control	
- What is the main role of the board?	Disciplinary	Strategic decisions	Strategic decisions	Strategic decisions	Strategic decisions
B- External Mechanisms					
- How are the managers performance-based incentives?	High	Low	Low	Moderate	High
- Is the market for corporate control active?	Yes	No	No	No	No

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[i] An extrapolation hypothesis may complement the legal hypothesis and builds on empirical observations. It suggests that ownership dispersion in Anglo-Saxon countries reflects the achievement of laws protecting minority shareholders. Except for the Anglo-Saxon regimes, it considers that minority shareholders or block

ownership were in the past subject to exploitation and expropriation in most of the existing regimes. In this framework, the primary response of block-holders looking to protect their investments against the risk of expropriation may be to have a substantial shareholding assembled through a family group, a holding company, or a reciprocal cross-shareholding arrangement . The protection of block-controlling shareholders may occur using various techniques such as stock-pyramiding and super-voting stocks which permit them to retain a majority of voting rights even if they hold a minority of equities within a firm.

[ii] The Beirut Stock Exchange (BSE), the first stock market to open in the Middle East, listed both Lebanese and mixed French-Syrian-Lebanese companies, many of which were jointly listed on the Paris Exchange. Listings included key utilities, transport, and construction-related companies.

[iii] Weimer and Pape (1999) show the identities of shareholders of listed firms in the USA, UK, Germany, France and Japan between 1992 and 1994. They find that salient shareholders in the Anglo-Saxon countries are individual investors and non-financial institutions, whereas banks and other financial institutions play a significant role in Germany, France and Japan.

[iv] The relationship-based system is used in Germany, Austria, Switzerland, Sweden, Denmark, Finland, Norway and Netherlands.

[v] Approximately, there are 75 companies in Lebanon with a turnover of more than 50 million dollars annually and with regional offices that could list on the Beirut Stock Exchange if given the incentive to do so.