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Initial public offerings; compare between the Saudi and the London Stock Exchange; through regulation

Regulation of Financial Market

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Dr. Iwa Salami

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Student Name: Abdul-Wahab Alkhadhari

Student ID:0857629

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Abstract:

This paper will provide information about the initial public offerings on the Saudi Stock Exchange, compared with that of London. First of all, it will give a short history of the Saudi stock Exchange. In this section, it will give the number of companies on the Saudi Stock Exchange and compare them over the last ten years. It will examine advantages of an Initial public offering.

The second section, will focus on Initial public offerings on the Saudi Stock Exchange, and examine the various types of initial offerings. Also, it will discuss the definition and requirements of initial offerings. The third section will discuss what the offeree and the offeror means, and who they are exactly.

Finally, it will provide a comparison between the Initial public offerings on the Saudi Stock Exchange and on the London Stock Exchange. In this section, the difference between the Initial public offering on the Saudi Stock Exchange and on the London Stock Exchange will be examined.

Contents

Introduction:

Initial public offering can be defined as a situation in which the issuer, the company, releases common stocks or shares to the public for the first time. In other words, it means the sales of stocks to lots of investors, either known or unknown via public announcement. The process of the sales of the stocks through an initial offering is subject to various conditions.

Companies can select to offer some of their stocks embodying the current capital by selling its current shares, or it may aspire to preliterate its capital by shackling the pre-emptive right of the current shareholders.[1] Such an initial public offering is made only by the beginner companies which seek to expand and develop themselves. Furthermore, it can also be made by the bigger companies that want to make themselves known among the public.

Indeed, there are various reasons behind each company deciding to offer their stocks to the public; the first reason is to get money, as a company which issues their stocks for public sale will receive money for the sold stocks. Thus, IPO permits the company to have more stocks that provide it with good progress at a future time. Furthermore, the company will not repay the investors of the stocks

[1] Capital Market Authority on Saudi Arabia. Implementing Regulations. O*ffers of Securities Regulations* (2008) Article1.

the values of their stocks; however, they will be considered as partners in the profits of the company, and the shareholders have the right to capital distribution only in case of dissolution of the company.

In addition, the shareholders will see that the values of their values are limited comparing to the large number of shares possessed by the company, but the shareholders will view the investment of their shares as helping to improve their shareholdings value.

Multinational IPOs may deal with three syndicates or they can gain the form of the multinational trend. For example, if the issuer is from Europe, he could be represented by the selling syndicate in his local market.

The lead underwriter has the right to impose restrictions on the sales of the stocks in order to guarantee the benefit of the company and to ensure that they and the company make some profit, and do not lose.

According to Bradley and Jordan (2003), public offerings are to be sold to both the institutional investors and to small investors. The broker or the seller of the sale has to be paid through credit, not through commission.

Advantages of an Initial public offering:

According to Georgiou (2006) that among the reasons that urge companies to issue shares to the public is that the company can issue additional stocks, which means that the company will have excessive capital that allows it to expand and develop itself without incurring any debts.

Indeed, the companies which enlist themselves among public companies have the added advantage of increasing large amounts of capital from the general market without resorting to carrying out transactions with individual investors. In addition, he states that such benefits resulting from public offering of shares are as follows:

1- Supporting and making the equity base more variable.
2- Providing capital with cheaper accesses.
3- It ensures the best management and good fit for the employees.
4- It creates various funding chances: equity, convertible debt, cheaper bank loans, etc.

The allocation of shares is based on a set of methods. Lougharn and Ritter discuss this, the methods for allocating the shares are as follows: an underwriting contract, firm commitment contract, all-or-none contract, bought deal and Dutch auction. In general, the procedure of shares sales can be defined as a type of contract between the underwriter and the issuer.[2] It is divided into different types: the firm commitment contract, as both underwriter and buyer agree to the price of the shares, indeed, this method is very suitable and more

[2] Lougharn, T & Rtter, J (2005) Why has IPO underpricing changed overtime? Financial Management 33(3) 5-37.

secure for the issuer, but it is very expensive because its risk falls on the underwriter. According to Williamson (1988) "In the best efforts contract the underwriter agrees to sell as many shares as possible at the agreed upon price, under the all-or-none contract the underwriter ".[3]

In addition to the underwriting contract, there is Stand-by Underwriting. Hazen (2009) explains the idea of stand-by underwriting, which is also known as strict underwriting or old-fashioned underwriting, as representing the stock insurance as the issuer agrees with the underwriter to buy stocks which the issuer could not sell to the shareholder.

However, the large IPO is underwritten by a syndicate of investment banks which are headed by a major investment bank. When the underwriter manages to sell the shares, he will be given a commission calculated upon the value of the shares that he has already sold, which is called the gross spread.

A Short History of Saudi Stock Exchange:

The Saudi stock exchange market is not an old one; it is a very juvenile market whose development as an international market was completed over the last ten years. The first Saudi stock company was established 75 years ago. During the eighties, the number of stock companies was about 48 which increased to double that figure in 1995. However, it could not keep such a constant pace and it diminished in the 2000s to around 88 companies.

[3] Williamson, J (1988) Investment Banking Handbook. New York reuters. New York

At the present time (15-05-2010), the public companies in Saudi Arabia includes 139 companies, which are divided among different state sectors, such as banking and services (11), Petrochemical Industries (14), cement (8), retail (9), Energy and Utilities (2), Agriculture and Food Industries (15), Telecommunication and Information Technology (4), Insurance (28), Multi-Investment (7), Industrial Investment (12), Building and Construction (13), Real Estate Development (7), Transport (4), Media and Publishing (3) and Hotel and Tourism (2).[4]

Al- Rumaihi (1997), that the Saudi stock market had been turned into an official and government institution only in 1984. Then, after one year, the Saudi government established the Saudi shares Registration Company. The Saudi Arabia Monetary Agency (SAMA) or what is known as the Saudi Central Bank established the electronic securities information systems in order make multi-national trading easier and faster.

In addition, the Saudi government established the Saudi stock company known as TADAWUL. This refers to a new financial system that helps safeguard a better atmosphere for investment in Saudi Arabia. The Saudi government has established and reviewed new rules during the last 7 years, as they have applied the best scientific Western economic knowledge. The most important regulation is that known as "Capital Market Law". This law was brought into force on

[4] Saudi Stock Exchange.

07/31/2003. It aims at rebuilding the capital market according to the advantages taken from the international stock market standards. Such laws also aim at guaranteeing the rights of the investors, and to provide the Saudi Stock market with credibility, reliability and trust ability.[5]

It is evident that the Saudi Joint Stock market is known for its recent inception and small size; however, it covers more than 70% of the investment of the capital in the country paradoxically. Despite the early beginnings of the Saudi stock market, it has become the biggest market in the Arab world.[6] At the beginning of the Saudi Stock market, the shareholders were only from Saudi Arabic and Gulf States; however, such restrictions have been mitigated for the time being.

Indeed, the historical background is very important to the current study as it highlights the future behaviour of the stock market. There are many economists who have applied the historical study to the stock for getting benefits to the future. Demir (2006) has analysed the stock market over the past 25 years in order to forecast the future of the stock market. He reached the conclusion that the political, social and historical conditions have greater effects on the joint stock market.

[5] Capital Market Authority on Saudi Arabia. *Capital Market Law.*
[6] International Monetary Fund. *The Middle East and North Africa in a changing oil Market.*

The Types of Public Offering:

In the book entitled *Initial Public Offerings: an International Perspective*, describes several stages of the initial offerings into the following processes. The first step is to apply for registering on the Stock Exchange, and in such a case the Saudi company will register on the Saudi Stock Exchange. The Second step is "the underwriting process, whereby the company deals with financial institutions to guarantee a minimum return after the shares are traded on the stock exchange."[7]

Indeed, the underwriter may be an investment banker or a syndicate of banks. Thus, if there is higher probability of risk, such risk will be diminished through its division to more than one bank. The final step is to offer the shares to the public. The company and the writing are debating about the type of underwriting as there are different types of underwriting.

In a best–effort underwriting arrangement, the underwriter can act as an agent to sell as much of the issue as possible. In all–or–one underwriting, if the underwriter cannot resell the entire issue then the security is withdrawn. The issuer and the company can negotiate the price, the size, and other details, typically referred to as the negotiated underwriting. Another type of

[7] Gregoriou, G (2006) Initial public offerings, An International perspective. p 45

arrangement requires that the highest bidder among competitive bankers underwrite the issues.[8]

The last type is called the standby underwriting arrangement, in which the shares are to be offered at the beginning to the existing stockholders, and if there are any shares which have not be purchased yet, they shall be given to the public. The Firm commitment arrangement is based on the fact that the investment banker has to buy all the stocks from the company in the first stage; then, he has to resell them to the public and ordinary people at a higher price. Finally, is what is known as private placement, in which all shares should be placed for selling privately, not publicly, and in this way, paying of registration fees will be avoided?

The effect of Public Initial Offerings on Saudi Stocks:

Indeed, the Saudi market is described as the strongest market in the Middle East, as it takes more than 50% from the total capital of the Middle East, and the initial public offering helped greatly in supporting the Saudi economy and to make it stronger[9]. The initial public offering played a major role in further pushing the Saudi economy. In 2005, the Tadawul All-Share Index jumped to more than double its value from 8.206 in 2004 to 16.712 in 2005. In February 2006, the market shows other high progress rates that culminated to 20.634,

[8] Gregoriou, G (2006) Initial public offerings, An International perspective. p 45.
[9] International Monetary Fund. *The Middle East and North Africa in a changing oil Market.*

which represents an annum rate increasing of 230%[10]. However, after that, the market conditions were not as good as they were before, but there was slight degradation. Many Saudi people were losing money, so that the Saudi government did their best to restructure and discipline its course.

The problems of the Saudi market stemmed from several factors, including the lack of initial public offering; a lack of corporate transparency; the small time scale and first time investors; the illiteracy in the main principles of the investment, and so on. Thus, the market correction represented a great shock and caused a lot of investors to protest.

However, the largest category of Saudis who were gravely hurt was the Saudi individuals who lost in the market fluctuations. Owing to their little experience, they thought only about the positive aspect of the initial public offering which is its high profit, resulting in a state of irrational exuberance. They had expectations of a very fast profit and overconfidence in their commercial sight that motivated them to sell stock winners too early during the sharp rise, and to keep their stock during the downfall of the market. The up-to date data coming from the Saudi Stock Exchange asserts the major role of the individual investors.

The individual Saudi investors represent 94.5% of stock market trades. For the remaining 5.5%, it is represented by the Arab population staying in the

[10] Saudi Stock Exchange. Reports. *Annual Report*.

Kingdom, and the Gulf Council Cooperation.[11] In other words, the foreign funding participation in the Saudi Exchange Stock is very limited in comparison to the national and pension participation. By contrast, the forgoing participation was mainly by 45% in the Dubai Financial Market.[12]

We can note that the policy of the initial public offering is somewhat arbitrary and it includes many unhealthy practices. Furthermore, the Saudi authorities are involved in such arbitrary practices because they could not prepare the normal investor for how to participate effectively and rationally in the initial public offerings; they did not learn how to be proactive in suspending price manipulators. However, it is unfair to put all of the responsibility on the shoulders of the authorities, as the brokers also have a major role in such mistakes because they focus only on getting commission without studying the market conditions effectively, and the banks are also responsible for such a dilemma due to their bending of rules.

It can be said that the main problem is that of the overconfidence of the investor in the guaranteed profits of the initial public offering participation. Such overconfidence is a classic financial phenomenon which is known as the 'disposition hypothesis,' as the investor is stimulated and psychologically motivated to achieve profits regardless of the other probabilities of not

[11] Saudi Stock Exchange. *Trading By Nationality.*
[12] Dubai Financial Market. *Monthly Bulletin.* April 2010.

achieving any profit, so they sell their stocks faster for the expected profit resulting from it.

Indeed, to gain the best understanding of the initial public offering and how the individual investors could apply it correctly, it is important to pay attention to the condition of irrationality that may have controlled the behaviour of the Saudi people in their participation in the initial public offering. Such unhealthy and irrational trading practices have a serious impact on the investors.

Thus, in order to avoid the disadvantages of the initial public offering process, the authorities have to teach and educate the practitioners about the process of initial public offering in terms of its risk-reward trade-off in the market. In addition, the authorities have to delineate the limits of trading margins to show the normal or the accepted degree of risk aversion. Finally, the brokers should present more clear information about their situation and position.

The Offeree and the offeror:

If there is any legal or commercial agreement between two parties regarding some offer, for example, the initial public offering, in such a case, the offeror means the Exchange Stock, or the person who offers something to another person who is the offeree, the investor or the shareholder. Such offer agreements are valid and applicable when the offer provided by the offeror is to be accepted.

There are some rules concerning the offer acceptance; the first is that the offeror should inform the offree of all data about the offer, and the offree should confirm acceptance of the offer. There should be a case of authorisation coming from the offeror to the offeree to make the offer more valid and enforced.[13]

Comparison between the Initial public offerings on the Saudi Stock Exchange and on the London Stock Exchange:

It is very difficult to make a comparison between the effect of IPO on a recent stock exchange and one which is the oldest in the world- the London Stock Exchange. Indeed, the renaissance of Saudi Arabia in the business field has been starting since the seventies, with the advent of petroleum exploration which was accompanied by the bank system, securities and bonds and the emergence of the Saudi Stock Exchange. In London, the securities had been in existence long before a formal stock exchange was established as it emerged in the sixteenth century.

Michie, R (2005) describes historically the development of public initial offerings. “There existed in London a securities marker long before a formal stock exchange was ever established. As far back as the sixteenth century there is evidence of the buying and selling of shares, belonging to the few joint stock companies then in existence. Though private negotiation between owner and purchaser was the normal means by which sales were accomplished, the growth

[13] Capital Market Authority on Saudi Arabia. Implementing Regulations. *Offers of Securities Regulations* (2008) Article 4&5.

in both the capital and the investors involved did lead to the use of public auctions. However, the ownership of shares remained concentrated within a very small group of wealthy individuals, and so there was little need for intermediaries to bring buyers and sellers together, and no justification for expensive and elaborate markets where business could be conducted on a frequent and regular basis".[14]

Indeed, the London exchange stock had changed early in the seventeenth century. New companies were joined to it, such as the East India Company. At the time before, 1986 "there were only around 15 major joint –stock companies in Britain, with a capital of 4.3$m. The bank of England was founded in 1964. Owing to such developments, there was a remarkable increase in the number of the investors and the values of their shares as in the preceding times, the majority of joint-stock companies owned a small capital that is given by related groups of shareholders". [15]

The First rule or regulation is related to membership. The Exchange shall grant membership in terms of one of the following categories:

1- A Full Member Firm.
2- A General Clearing Member.
3- A Gilt-edged market maker.

[14]Michie, R (2001) The London Stock Exchange, a history. Oxford. New York. p 15.
[15] The same above mentioned source.

4- A fixed interest market maker.[16]

The second rule is the authorisation, which means that the member firm should be approved at all times by the rules of the United Kingdom, or it shall be valid for overseas regulations to be enforced in England. The London Exchange stock can regard the individual or the shareholder as authorised under FSMA or as an overseas person approved by FSMA or any European institution, or an authorised European Investment Firm which is approved and identified by the Banking Co-ordination (second council directive) Regulations 1992[17].

The Third Rule is the Suitability, which means that the member firm shall be compliant with the rules such as "adequate trade execution, recording, reporting and settlement procedures and systems. And it shall hire enough staff with good knowledge and experience, training and competence".[18]

The Fourth rule is that a member firm shall be committed to all the rules and procedures issued by the Exchange, as it shall react positively toward any notice or any requirement or any direction issued by the Exchange[19]. In addition, the member firm shall take reasonable steps to make sure that its workers are committed to the valid obligations resulting from such rules.

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[16] London Stock Exchange. *Rules of London Stock Exchange.* Suitability 1000.1, 1000.2, 1000.3& 1000.4
[17] Office of public sector information . *The banking coordination [second council Directive] 1992. no 3218*
[18] London Stock Exchange. *Rules of London Stock Exchange.* Suitability. 1020.1 &1020.2
[19] The same above mentioned source. Suitability1023.1, 1023.2, 1023.3 & 1023.4

The fifth rule is that related to the resignation of the membership. The member firm has the right to resign by notifying the Exchange in writing at least three months in advance.[20]

The sixth rule is that the shareholder or the member firm has the right to complain against any decree issued by the Exchange in accordance with the rules of the compliance procedures.[21]

The seventh is that related to the notifications, as the shareholder or the member shall be aware of all the circumstances that may result in the contravention of any of the agreed rules.[22]

The eighth rule is the trade confirmations, as the shareholder or the member firm shall not tell his customer that such trade is under the Regulations of London Stock Exchange unless the trade is on the Exchange.[23]

The ninth rule is the trade record, as the shareholder shall keep his record of his shares on the Exchange.[24]

Regarding the Saudi Exchange Stock regulations, they are somewhat similar to the London Exchange Stock Regulation as such principles are universal, but in Saudi Arabia, the situation is different from the UK, as the shareholders or the

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[20] London Stock Exchange. *Rules of London Stock Exchange.* Suitability 1030.

[21] The same above mentioned source. "*Guidance to Rule: A **member firm** may appeal against a decision of the **Exchange** pursuant to these rules and in accordance with rule 1040 Requirements, decisions and directions of the **Exchange** mentioned in rule 1023.4 must be made pursuant to these rules".*

[22] London Stock Exchange. *Rules of London Stock Exchange.* Suitability 1060.

[23] The same above mentioned source. Suitability 1051.

[24] London Stock Exchange. *Rules of London Stock Exchange.* Suitability 1070

member firms in the UK are mostly companies and worldwide institutions. Even so, the case is different in Saudi Arabia as the majority of business is owned and run by families, which makes it more individual and more private. It can be noted that the London Exchange Regulations aim at transparency and honesty and the encouragement of foreign investment.

However, there is some difference in Saudi Arabia’s system of transparency, which is less than that of the UK, because the Saudi Stock Exchange is still at an early stage, and it requires more time in order to understand, assimilate, and know completely about the regulations applied in the London Exchange Stock.

In addition, Islamic law overwhelmingly controls most aspects of life, and it has also affected the regulations of the Saudi Stock Exchange, including the initial public offering. In this respect, Wilson, R (2004) "in Saudi Arabia the Islamic law nominally governs all aspects of commercial life, including financial transactions, but in practices banking cooperation are similar to those in Western countries, though there is a significant Islamic finance sub-sector which has existed informally since the origins of Muslims civilizations in the Arabian peninsula and formally since 1980s" .[25]

Accordingly, the intervention of Islamic law in the economy, especially the Saudi Exchange Stock, imposed a set of special constraints and restraints which describe Islamic Stock Exchange NISE. Thus, it is of great value to the current

[25] Wilson, R (2004) Economic Development in Saudi Arabia. P 56.

study to show the impact of Islamic law on the regulations and the rules of the Saudi Stock Exchange, including what makes it different from the London Stock Exchange's rules and regulations. It is very important that it is taken into consideration that Shari' a law concentrates on maximizing the possible social advantages and removing the potential disadvantages to the society.

Thus, it is necessary to study briefly the initial public offering and Saudi Exchange from an Islamic perspective. In general, the stock exchange is defined as the place where different forms of securities are bought and sold, as one of its common methods is the initial public offering.

Therefore, it is so important to study the Islamic view of the offering of shares to the public through explaining corporate shares. The most important element in terms of the Islamic perceptive is that such shares and bonds which are based on interest should be categorically forbidden. Thus, the major regulation of the Islamic Stock Exchange is the jurist concept of the company (*sharikah*) which is different from the modern firm. The modern concept of company was not known in earlier Islamic history. The Islamic company has a different superficial form to the modern company, but the core is similar, such as *Mufawada* which means that two or more partners come together in a joint company as each one of them has the right to represent the other. Or an Anan Company in which there is no equality in the capital between the partners.

The second difference is the Exchange of shares from the viewpoint of Islamic law. Islamic law agrees to the initial public offering in its modern form, as they approve the modern practice of exchanging ordinary corporate shares, but this should be based on niyah (intention), as the act of buying should be visualized in a different way from the act of buying commodities etc.

According to the Islamic perspective, the shareholder should think of both profit and gain and should not leave or escape the situation at a loss, which is different from the modern cooperation, or the modern initial offering, which is based mainly on the expectation of a profit.

The third point is that Islamic law has its own special concept of shares, which is different from the economic goods. The Islamic law looks at the initial public offering from the perspective of *Gharar*, which means attracting the attention of the firm or the shareholder just to buy the shares, and makes them think only of having profits without paying attention to the expected loss.

Conclusion:

This study discusses the initial public offerings on the Saudi Stock Exchange as it traces the development of the Saudi Stock Exchange in Saudi Arabia, highlighting its own recent age. It discusses its historical background, touching upon the inception of the Saudi Stock Exchange as concomitant with the petroleum excavation in the Saudi lands.

The research tackles how the development and the growth of the Saudi economy affect the growth of Saudi economic practices, such as the initial public offerings.

Furthermore, the research explains the regulations applied in the Saudi Stock Exchange for executing the idea of the initial public offering. It discusses the different definitions of the initial offering adapted from the Western library and it also attempts an Islamic definition of the concept of the initial offering. Comparing the Western initial offering as exemplified in the practices of the London Exchange Stock, and the Saudi Arabia Exchange Stock exemplified in the Islamic law practices, the conclusion can be reached that the Islamic concept of the initial public offering is more humanistic and society –oriented as it not only focuses only the individual's interest and benefit, but it also has a wider vision concerning the interest and benefit to the entire society.

Moreover, the Islamic concept of initial public offering refutes the idea of delusion or *Taghrir* as it is more transparent and clearer It is based on showing the shareholder both the advantages and disadvantages of brokering, and it refuses the idea of permanent gain, as it is based on the probability of loss and gain. However, the Western concept of initial public offering is based on *Taghrir a*s it is only benefits those that do not attempt to draw the attention of the shareholder to any expected probability of loss. It is individual oriented, not society oriented.

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