

**CONTEMPORARY ISSUES IN CORPORATE GOVERNANCE: AN  
ANALYTICAL STUDY WITH REFERENCE TO PAKISTAN**



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## FINAL APPROVAL

It is certified that we have read the dissertation submitted by Ammara Khawaja, Registration No 283-FSL/LLMCL/S10 on "Contemporary Issues in Corporate Governance: An Analytical Study with reference to Pakistan" in Faculty of Shariah & Law. We have evaluated the dissertation and found it up to the requirements in its scope and quality by the International Islamic University for award of LL.M Corporate Law Degree.

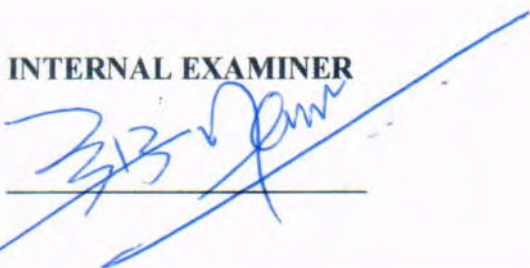
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## DECLARATION

I, Ammara Khawaja, hereby declare that this dissertation is original and has never been presented in any other institution. I, moreover, declare that any secondary information used in this dissertation has been duly acknowledged.

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***DEDICATION***

***TO***

***My Parents***

***Khawaja Abdul Sattar Kashir (Advocate)***

***and***

***Umm-e- Kalsoom***

***For their endless love, support and encouragement***



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*For any errors or inadequacies that may remain in this work, of course, the responsibility is entirely my own.*

**AMMARA KHAWAJA**



## **LIST OF ACRONYMS**

ACCA	Association of Chartered Certified Accountants
AGM	Annual General Meeting
BCCI	Bank of Credit and Commerce International
CBI	Confederation of British Industry
CEO	Chief Executive Officer
CFO	Chief Financial Officer
CG	Corporate Governance
EASD	European Association of Securities Dealers
ECGN	European Corporate Governance Network
FASB	The Financial Accounting Standards Board
GCGF	Global Corporate Governance Forum
IAS	International Accounting Standards
IASB	International Accounting Standards Board
IBA	Institute of Business Administration
ICAEW	Institute of Chartered Accountants in England and Wales
ICAP	Institute of Chartered of Accountants of Pakistan
ICC	International Chamber Of Commerce
IFC	International Finance Corporation
IFRC	International Financial Reporting Standard
IDs	Independent Directors
LUMS	Lahore University of Management Science
OECD	Organization for Economic Co-operation and Development
PICG	The Pakistan Institute of Corporate Governance
SAARC	South Asian Association of Regional Cooperation
SAFA	South Asian Federation of Accountants

SECP	The Securities and Exchange Commission of Pakistan
SOX	Sarbanes-Oxley Act (USA)
TOR	Term of Reference
WTO	World Trade Organization

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## ABSTRACT

*This thesis attempts to analyze the evolution, effectiveness and importance of corporate governance laws and explores the current issues faced by Pakistan, being a transition economy, while implementing the code of corporate governance based on Anglo Saxon model in country. The pragmatic question that research masquerade is that whether a corporate governance model that works for the US and UK, also work for a country like Pakistan? And examine the transplantation of the concept of the independent directors with a view to evaluating their effectiveness in the Pakistan. There are significant differences in the ownership structures and legal system between the countries of origin of the corporate governance and its concepts on the one hand and Pakistan with other. Due to the diffused shareholding structures in the US and UK, the independent directors were ushered into corporate governance norms in those countries in order to operate as a monitoring mechanism over managers in the interest of the shareholders. Each stage in the evolution of board independence bears testimony to this fact. However, transplanting a legal concept to a country such as Pakistan without emphasizing local corporate structures and associated factors is likely to produce unintended results and outcomes that are less than desirable. It is concluded that the ultimate objective of the code of corporate governance should be to incorporate good governance into Pakistani corporate environment, in order to enhance productivity and efficiency, rather than copying the pioneering countries. The institution called Independent Director is at a nascent stage, it needs to be nurtured very carefully to enable it to blossom as a powerful apparatus of corporate governance in our country. Corporate Governance is constantly evolving to reflect the current corporate economic and legal environment. To be effective, corporate governance practices need to be tailor to particular needs, objectives and risk management structure of an organization.*

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## **CHAPTER ONE: AN OVERVIEW OF CORPORATE GOVERNANCE**

### **1.1: Introduction:**

Governance is the focal point of today's efforts to improve life entirely, quality of output, efficiency in delivery of products of an organization, and ensuring the best value for money. To govern means run, rule and dominate with authority in policies and procedures of an organization. It is synonymous to influencing and determining the course of action, while specifying the method of controlling the events and activities so that output is optimized in terms of quantity, quality and timeliness.

Corporate governance, on one hand is about setting up a system of entrusting the directors and managers with responsibilities in relation to running corporate affairs and, on other hand, it is concerned with the accountability of those directors and managers. The whole gamut of corporate governance lies in concepts like transparency, accountability, merit, ethics, fairness and responsibility.

Both the theory and practice tell us that there is multiplicity of factors shaping governance of a business organization. Therefore, business needs to be governed by a set of rules, which reflect interests of all stakeholders. These rules of the game for business are an important dimension of reform process in both sophisticated/developed and developing economies alike. Countries that ignore or lag behind in corporate governance reform will rapidly find themselves at competitive disadvantage in attracting long-term capital for growth. This chapter will shed light on the definition, evolution and theoretical foundation of Corporate Governance.

## 1.2: Definition of Corporate Governance:

Google the word governance and you will find tons of material these days. It is one of the most popular terms in business parlance today, but nobody can tell you what anyone else means by it. What its fame suggests, though, is that individual all over the world are feeling the dearth of acceptable oversight and management of varied things or it is hoped that governance are going to be the simplest way to place things straight again. In the world's progression, this term has been grabbed and applied to what's most frequently a team of senior executives, or their chosen proxies, whose mission is to watch over process performance on an outsized scale, across a company, or across all the regions of a business. Sometimes they are responsible for one big process, sometimes a set of related processes, and sometimes all process. Corporate governance is a region that has developed very hastily in the last decade, particularly since the collapse of Enron and subsequently financial problems of other companies in various countries. The increased interest in corporate governance has mirrored the rise in concern in corporate behavior. The concept of corporate governance is weakly defined because it potentially envelopes a huge amount of distinct economies phenomenon. As a result different people or institutions have come up with different definitions.<sup>1</sup> It is declared by the Institute of directors in their 2010 "factsheet" that there is no single accepted definition of what the expression "corporate governs" means.<sup>2</sup>

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<sup>1</sup> Yilmaz Seker, *What Effects Does Corporate Governance Have on the Banking Sector? Case Study of the Deutsche*, (USA.:GRIN Verlag,2007),3, Available at

<[http://books.google.com.pk/books?id=QB6c10umpE0C&pg=PA5&lpg=PA5&dq=What+Effects+Does+Corporate+Governance+Have+on+the+Banking+Sector?+Case&source=bl&ots=z26MhI\\_9b&sig=u1U3lZDMi6UYQ0qD8V2xA0uQIH8&hl=en&sa=X&ei=VV\\_YUubBOeqw0AWiUGADQ&ved=0CCcQ6AEwAA#v=onepage&q=What%20Effects%20Does%20Corporate%20Governance%20Have%20on%20the%20Banking%20Sector%3F%20Case&f=false](http://books.google.com.pk/books?id=QB6c10umpE0C&pg=PA5&lpg=PA5&dq=What+Effects+Does+Corporate+Governance+Have+on+the+Banking+Sector?+Case&source=bl&ots=z26MhI_9b&sig=u1U3lZDMi6UYQ0qD8V2xA0uQIH8&hl=en&sa=X&ei=VV_YUubBOeqw0AWiUGADQ&ved=0CCcQ6AEwAA#v=onepage&q=What%20Effects%20Does%20Corporate%20Governance%20Have%20on%20the%20Banking%20Sector%3F%20Case&f=false)> (Last accessed January 3, 2012).

<sup>2</sup> Robert J.chapman, *Simple Tools and Techniques for Enterprise Risk Management*, (England: Jhon Wiley & Sons,2011),12,Available at

<[http://books.google.com.pk/books?id=460sgU192\\_8C&pg=PA34&dq=definitions+of+corporate+governance&hl=en&sa=X&ei=jM4OT6WnLcnZrQeK0cDuAQ&ved=0CDkQ6AEwADgK#v=onepage&q=definitions%20of%20corporate%20governance&f=false](http://books.google.com.pk/books?id=460sgU192_8C&pg=PA34&dq=definitions+of+corporate+governance&hl=en&sa=X&ei=jM4OT6WnLcnZrQeK0cDuAQ&ved=0CDkQ6AEwADgK#v=onepage&q=definitions%20of%20corporate%20governance&f=false)> (Last accessed January 3, 2012) (Hereinafter, Chapman, Simple tools and Techniques).

Today's definitions of corporate governance differ particularly in regard to the scope of concept narrower and broader definitions exist, depending on the discipline in which they are used. According to an article that appeared in Financial Times in 1997: "Corporate governance is defined narrowly as the relationship of a company with its shareholder or, more broadly, as its relationship with society".<sup>3</sup> Shleifer and Vishny define corporate governance narrowly as: "Corporate governance deals with the ways in which suppliers of finance to corporation assure themselves of getting a return on their investment."<sup>4</sup> According to Monks and Minnow: "It is a relationship among various participants in determining the directions and performance of the corporation."<sup>5</sup>

Broadly defined, corporate governance focuses on the combination of applicable laws, regulations, and listing rules that facilitate, direct, and monitor corporation's affair in attracting capital, performing actively and efficiently, increasing shareholder value and meeting both legal requirements and general social responsibilities.<sup>6</sup> According to Sir Adrian Cadbury: "Corporate governance is concerned with holding the balance between economic and social goals and between individual and communal goals.....the aim is to align as nearly as possible the interests

<sup>3</sup> A.C. Fernando, *corporate governance: principles, policies and practices*, 3<sup>rd</sup> Edition (India: Dorling Kindersley, 2009), 14. (Hereinafter, Fernando, Corporate Governance).

<sup>4</sup> Mahwish Mumtaz, "Corporate Governance in Pakistan Adopt or Adapt?," (dissertation, University of Cambridge), 5, Available at <http://cmer.lums.edu.pk/Conference2005/images/CG%20in%20Pakistan-%20Adopt%20or%20Adapt.pdf> (last accessed: January 3, 2012) (Hereinafter, Mumtaz, Corporate Governance in Pakistan).

<sup>5</sup> Gregory Francesco Maassen, *An international comparison of corporate governance models*, 3<sup>rd</sup> print (Amsterdam: Spencer Stuart, 2002), 12, Available at <http://books.google.com.pk/books?id=DBZlj7RJ43AC&pg=PA12&dq=definitions+of+corporate+governance&hl=en&sa=X&ei=DGcPT7CdOMrprOfZ8LTrAQ&ved=0CEgQ6AEwA#v=onepage&q=definitions%20of%20corporate%20governance&f=false> (Last accessed: January 3, 2012) (Hereinafter, Maassen, An International Comparison).

<sup>6</sup> Atia Javid, Robina Iqbal, "Corporate Governance in Pakistan: Corporate Valuation, Ownership and Financing", 1, working paper 57 (Pakistan Institute of Development Economics, Islamabad, 2010), Available at <http://www.pide.org.pk/pdf/Working%20Paper/WorkingPaper-57.pdf> > (last accessed: January 4, 2012).

of individuals, corporations and society.”<sup>7</sup> A useful and still widely accepted definition of corporate governance is that set out in the principles of developed by the organization for economic co-operation and development (OECD) in 2004:

“Corporate governance involves a set of relationship between company’s management, its board, its share holder and other stake holder. Corporate governance also provides the structure through which the objectives of company are set, and the means of attaining those objectives, and monitoring performance, are determined”.<sup>8</sup>

The World Bank states:

“Corporate governance refers to that blend of law, regulation and appropriate voluntary private sector practices which enable the corporation to attract financial and human capital, perform efficiently, and thereby perpetuate its self by generating long term economic value for its shareholder, while respecting the interests of stakeholder and society as a whole.”<sup>9</sup>

It is clear from these definitions that good corporate governance is a dire need of the corporations for their development and growth in the current scenario. For attaining sustainable economic development, we should boast of a growing enterprise sector that is more accountable, responsible, transparent and fair not only to its shareholders but also to the whole group of stakeholders. These basic features of good corporate governance are renowned as an essential requirement for getting access to and development of financial market and local and international investors are increasingly demanded them.<sup>10</sup>

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<sup>7</sup> Jeffrey Harrison, Caron St. John, *Foundations in Strategic Management*, (USA: South Western Cengage learning, 2008), 75.

<sup>8</sup> Safdar H. Tahir et al., “Two-Tier Corporate Governance Model for Pakistan” *European Journal of Business and Management* 4, no.69(2012):38, Available at <<http://www.docstoc.com/docs/119824515/Corporate-Governance-Model-for-Pakistan>> (last accessed: September 1,2013) (Hereinafter, Tahir, Two-Tier Corporate Governance).

<sup>9</sup> Maseen, *An International Comparison*, 12.

<sup>10</sup> Fernando, *Corporate Governance*,14.



### 1.3: Evolution of Corporate Governance:

Primarily, the emergence of corporate governance has its roots in the conventional problem of separation by shareholder and control by management. But with the passage of time, experience gained from historical developments of corporate transgression and with the revolution in the rising expectations of the society, a wide structure of corporate governance has been progressively evolved. The broader concept of corporate governance concentrates on bringing a balance between the economy and social goals and between individual and social goals with a view to guaranteeing proficient use of resources by means of aligning as nearly as possible the interests of individuals, corporations and society.<sup>11</sup>

Based on the influential outline of Berle and Means and additions furnished by institutionalists, agency theorists and scholars portray the evolution of corporate governance in conditions of changes in the relationship between ownership and control. The historical evolution of regional governance systems has proved very different in orientation and outcome. Different structures of corporate governance are basically built around different resources of funding and methods of monitoring. This different approach to financing and regulating the corporations in different regions of the world has prevailed since separate origins of capitalism in those places.<sup>12</sup>

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<sup>11</sup> Umar Burki and Muhammad Azeem Qureshi, "Corporate Governance in Family Owned Businesses in Pakistan: A Conceptual Framework," 2, Available at <<http://saicon2011.citilahore.edu.pk/Business%20Ethics/11-1196%20umar%20burki.pdf>> (last accessed: January 15, 2102).

<sup>12</sup> Pierre-Yves Gomez and Harry Korine, "Democracy and Evolution of Corporate Governance", *Blackwell publishing* 13, no.6 (November 2005):743, Available at <[http://www.ifge-online.org/docftp/corg\\_467.pdf](http://www.ifge-online.org/docftp/corg_467.pdf)> (last accessed: January 14, 2012) (Hereinafter, Gomez, Democracy and Evolution).

The evolution of corporate governance gathered up in three main periods, each with its own model of reference for corporate governance, a model that comes to be accepted as standard for the times and is generally adopted, whether a company is large, or small, listed or unlisted.<sup>13</sup>

The **first period** is characterized by the dominance of founding family and stretched from the industrial revolution to the 1920s. The dawn of the new economic array involves two steps: first, the institution of property rights for industry; and, then, the exclusion of the requirement of public approval for incorporation. The French (1808), the American legislation on Code du Commerce General Incorporation (1811 for New York) and the English Joint Stock Company Regulation and Registration Act (1844), stand for the first step in a basic reshaping of the belief of economic autonomy. These acts of legislation unlock the right to the ownership of a business corporation to any person who can afford it, separately of social status, class or heredity and launch that each owner of property has equal rights before the law. In this time family holds and handles the assets of company, decisions are made without the representation of stakeholder and no concept of separation of powers in the company. The type of governance in the business that is adopted by many countries is much closer to aristocracy.<sup>14</sup>

In the **Second period**, Familial governance starts to reach its limits by the end of 19th century. Companies are growing larger and more complex, demanding more financial sources to continue growth than single families can provide and required professionals than owner or his offspring. Once small family business grows out and requires qualified management to handle

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<sup>13</sup> *Ibid.*

<sup>14</sup> Gerry H. Grant, "The Evolution of Corporate Governance and its Impact on modern corporate America", *Management Decision* 41,9(2003):924. Available at <<http://www.tcnj.edu/~library/e-reserve/lasher/Lasher-Evolution.pdf>> (last accessed: January 14, 2102).

the challenges of the size, product multiplicity and modern manufacturing, even in those cases in which ownership residues in family hands.<sup>15</sup>

In all western countries, the limited liability companies developed into the dominant legal form and a chain of laws are passed to more stringently describe and demarcate corporate institutions, for example, securities laws concerning the obligation of disclosure in the US, 1933 and 1934; company laws making a board of directors compulsory in France, 1940 and 1943; and laws establishing the two-tier board in Germany, 1947 and 1957. To solve the major corporate issues and oversee the new skilled management, an annual shareholders meeting introduced in the general structure of publicly held companies. In effect, the managerial revolution leads to the replacement of the old capitalist aristocracy by a new capitalist technocracy. Although in theory independent of management, in practice, the corporate board is often controlled by a managerial technocracy.<sup>16</sup>

In **Third period**, In spite of economic growth, managerial governance starts to meet resistance in the last decades of the 20<sup>th</sup> century. Globalization and technology are the main challenges that demand some restrictions on the commanding management system. Managerial authority is not successful in all circumstance, in distant multinational companies they shows inefficiency and require to be able to act rapidly in global markets. Because of less state intervention in company's matters and concentration of economic wealth in few, companies raise

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<sup>15</sup> Shann Turnbull, "Corporate Governance: Its scope, concerns & theories," *Journal of Economic Literature* 5, no.4 (October 1997):190, Available at <<http://cog.kent.edu/lib/turnbull4.html>> (last accessed: January 22, 2012).

<sup>16</sup> Gomez, *Democracy and Evolution*, 10.

new queries about corporate social responsibility in decision making.<sup>17</sup> The manager is asked to decentralized control inside the company and fulfilled the demands from stakeholders outside the company. These developments go to the heart of the definition of the manager's job and undermine the technocratic claim to authority and specialized expertise. A new class of institutional shareholders as a result of mass ownership and pension reforms has arisen who are not only well organized but also stimulated about their concerns towards management.

Since 1970s laws legislated in United States dealing with the protection of individual's pension fund savings need institutional investors to keep a check over their holdings through their votes. Dynamically, Shareholders are taking keen interest in the governance of both publicly owned and privately held corporations like unions, churches, NGOs and multilateral institutions. Recent enlargement in the number, role and responsibilities of independent director to represent different stakeholders' interest in shareholder meetings and in major strategic verdicts explicit the institution of corporate governance.<sup>18</sup> To understand the evolution of corporate governance forms and democratic governance, here is a table defined by Gomez in his article on "Democracy and Evolution of Corporate Governance."

<sup>17</sup> Jill Solomon, *Corporate Governance and Accountability*, (England: Jhon Willy&Sons, 2005), 3, Available at <<http://books.google.com.pk/books?id=hpDampSSIJ4C&pg=PT20&lpg=PT20&dq=corporate+governance+in+20th+century&source=bl&ots=tgeHLVQ3LS&sig=NgO2rOxOOGw7UyyWVLvPwIUXvDo&hl=en&sa=X&ei=7obYUvD1JMOttAaAsoCYBw&ved=0CDAQ6AEwAQ#v=onepage&q=corporate%20governance%20in%2020th%20century&f=false>> (last accessed January 12, 2012) (Hereinafter, Solomon, Corporate Accountability).

<sup>18</sup> *Ibid*, 6.

**Table 1.1: The evolution of corporate governance forms and democratic governance**

Period	19 <sup>th</sup> century-1920	1920-1970	1970-21 <sup>st</sup> century
Type of capitalism	Family capitalism	Managerial capitalism	Popular capitalism
Equality of rights to ownership	Implementation: creation of rights to ownership independent of social standing	Reinforcement: Strengthened by corporate law. Protection by different standards.	Reinforcement: Strengthened by new rules on the right to vote, protection of minority interests.
Separation of ownership/control	No	Implementation: Generlisation of limited liability form, with general meeting, boards and disclosure requirement.	Reinforcement: Increasing board control over managers.
Representation with public debate	No	No	Mass ownership; stakeholder activism

In the different regions, this contrasting evolution of corporate governance tracked different routes; as a result, European, American and Asian form of corporate scheme reach in different destinations in business practice, corporate law and other related institutional developments.

## **1.4: Theoretical Foundation of Corporate Governance:**

In the wake of the financial and corporate scandals of recent years, corporate governance increasingly is recognized as being at the heart of understanding how and why businesses are run as they are. There are five major diverse and well-established theoretical frameworks of corporate governance that can be identified from the corporate governance literature: agency, stewardship, resource dependence, stake holder and sociological. Many disciplines such as finance, economics, accounting, law, management and organizational behavior played an important role to evolve these theories. . For instance, agency theory crops up from the field of finance and economics and stakeholder theory from a more social-oriented perspective on corporate governance. In the expansion of theoretical aspects of corporate governance all these disciplines have contributed much.<sup>19</sup>

### **1.4.1: Agency Theory:**

The discussion about corporate governance can be traced back to the early 1930s and "The Modern Corporation and Private Property" publication of Berle and Means. They discussed that due to separation of ownership and control and dispersed ownership, executive corporate managers became sovereign without proper check upon them. Further these ideas were reestablished by Jensen and Meckling. They argued about agency relationship that is a contract between principal (shareholder) and agent (manager) to perform some services<sup>20</sup>. However, due to maximization of the personal interest of the managers at the expense of shareholders, agency problem could occur. Managers are the agents of the company's owners and there must be some

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<sup>19</sup> Fernando, *corporate governance*, 46.

<sup>20</sup> Sheila N. Htay, Syed Ahmed Salman and Ahamed K. Meera, "Let's Move to Universal Corporate Governance Theory" *Journal of Internet Banking and Commerce* 18, no.2 (August 2013):5, Available at <<http://www.arraydev.com/commerce/jibc/2013-08/SalmanOpinionv02.pdf>> (last accessed: January 29, 2012).

check and balance mechanism and arrangements for preventing the abuse of power at their side. The costs resulting from managers misusing their position, as well as the costs of monitoring and disciplining them to try to prevent abuse, have been called 'agency cost'. Hence, the theory purposed that principle should make some suitable arrangements to deter the agents from indulging in such activities.<sup>21</sup>

#### 1.4.2: Stewardship Theory:

Based on psychology and sociology aspect Stewardship theory is defined by Davis, Schoorman & Donaldson as "a steward protects and maximizes shareholders wealth through firm performance, because by so doing, the steward's utility functions are maximized". It also shows the relationship between principles and agents like agency theory but from opposite angle. It believes that board of directors as a group of corporate players will play a crucial role in increasing the shareholders' wealth by maximizing the firm performance. This theory supports congruence between top management and shareholders. Based on stewardship theory, directors are the stewards to act the best interests of the shareholders through firm performance and it is not requisite to control the board of directors.<sup>22</sup> USA, Germany, Japan has used this theoretical concepts in developing their corporate governance guidelines. For instance, in order to get more loyalty and to make sure that the companies are well operating, these countries preferred combined board leadership structure (CEO and Board Chairperson should be the same).

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<sup>21</sup> *Ibid.*

<sup>22</sup> M. Hage, *A stakeholders Concern Towards an Economic theory on Stakeholder Governance*, (Netherland: Van Gorcum, 2007), 85, Available at [http://books.google.com.pk/books?id=tH02Gti06KYC&pg=PA85&dq=stewardship+theory&hl=en&sa=X&ei=TZHYUu\\_CO8KRtAb744DgBQ&ved=0CDAQ6wEwATgK#v=onepage&q=stewardship%20theory&f=false](http://books.google.com.pk/books?id=tH02Gti06KYC&pg=PA85&dq=stewardship+theory&hl=en&sa=X&ei=TZHYUu_CO8KRtAb744DgBQ&ved=0CDAQ6wEwATgK#v=onepage&q=stewardship%20theory&f=false) (last accessed: January 15, 2012).



### 1.4.3: Stakeholder Theory:

Stakeholder theory was implanted in the management discipline in 1970 and progressively developed by Freeman by incorporating corporate accountability to a broad range of stakeholders. Indeed, stakeholder theory is less of a formal unified theory and more of a broad research tradition, incorporating philosophy, ethics, political theory, economics, law and organizational science. Stakeholder theory can be defined as “any group or individual who can affect or is affected by the achievement of the organization’s objectives”.<sup>23</sup> Stakeholder theorists proposed that managers are not only workers and servers of the shareholders but have a network of relationships to serve which include the employees, suppliers, business partners, creditors, customers and local community. It broadens the managers responsibility by giving the concept of corporate social responsibility. Many CG guidelines have used the concept of this theory for instance UK’s combined code in which they adopt the idea of CSR.<sup>24</sup>

### 1.4.4: Resource Dependency Theory:

Resource dependency theory observes the board of directors as the lynch pin between a company and the resources that needs to achieve its objective. As, stakeholder theory gives views on relationship with many groups for individual profits, resource dependency focuses on the functions of board of directors in providing access to resources needed by the firm.<sup>25</sup> The

<sup>23</sup> Solomon, *Corporate Accountability*, 45.

<sup>24</sup> Suleyman Gokhan Gunay, *Corporate Governance Theory: A Comparative Analysis of Stakeholder Governance Models*, (USA: iUniverse, 2008), 13, available at [http://books.google.com.pk/books?id=fhTZQkS6D\\_kC&pg=PA13&dq=stewardship+theory&hl=en&sa=X&ei=TZHYUt\\_CO8KRtAb744DgBQ&ved=0CD4Q6wEwBDgK#v=onepage&q=stewardship%20theory&f=false](http://books.google.com.pk/books?id=fhTZQkS6D_kC&pg=PA13&dq=stewardship+theory&hl=en&sa=X&ei=TZHYUt_CO8KRtAb744DgBQ&ved=0CD4Q6wEwBDgK#v=onepage&q=stewardship%20theory&f=false) (last accessed: January 16, 2012).

<sup>25</sup> Christen Mallin, *Corporate Governance*, 2<sup>nd</sup> edition (UK: Oxford University Press, 2007), 21, Available at <http://books.google.com.pk/books?id=bYzLPdylqpcC&pg=PA15&lpg=PA15&dq=what+are+the+theories+of+corporate+governance&source=bl&ots=XHW0WbRAX0&sig=s2Jemmo9k6ywmFCD7i-bCP52b8&hl=en&sa=X&ei=9DemUrzOA-Wc0QW8-YDICA&ved=0CG4Q6AEwBzge#v=onepage&q=what%20are%20the%20theories%20of%20corporate%20governance&f=false> (last accessed: January 16, 2012) (Hereinafter, Mallin, *Corporate Governance*).

resource dependency theory suggests that representatives of independent institutions can play a very effective and meaningful role in getting outside resources that is needed by the company's success. For instance, appointment of legal officer as an outside director helps in providing legal advice to the company's executive, either in board meeting or private communication at a less rate. Company's performance enhances by utilising the outside resources that confirm firm's survival in the age of globalization. According to Hillman, directors bring resources to the firm, such as information, skills, access to key constituents such as suppliers, buyers, public policy makers, social groups as well as legitimacy<sup>26</sup>. Directors have four classified categories, insiders, business experts, support specialists and community influentials. Firm's ex and present executives are insiders, they are professionals in their fields like law, finance and provide their assistance general or by the company's directions. On business strategy, decision making and solving business matters, company has business experts who are current and past executives of other companies. Third category included lawyers, bankers, insurance company representatives and public relations experts and individual specialized support provided by them. Finally, the community influentials are the political leaders, university faculty, members of clergy, leaders of social or community organizations.<sup>27</sup>

#### 1.4.5: Sociological Theory:

The sociological theory mostly concentrates on board compositions and suggests different ways for distribution of power and wealth in society. This theory examined the major challenges to justice and social progress and determined that interlocking and concentration of

<sup>26</sup> Ibid.

<sup>27</sup> G. V. Satya Sekhar, *Business Policy and Strategic Management*, (New Delhi, India: I.K. international publishing, 2007), 13, Available at <http://books.google.com.pk/books?id=nYNPtZNnx9YC&pg=PA13&dq=Resource+Dependency+Theory&hl=en&sa=X&ei=DZbYUuWECIbStQbT7YDwAw&ved=0CCoQ6AEwADgU#v=onepage&q=Resource%20Dependency%20Theory&f=false> (last accessed: January 16, 2012).

directorship in hands of specific class are the main reasons behind this dilemma. This theory required the necessary mechanisms like financial reporting, board composition, disclosure and auditing to encourage equality and justice in society.<sup>28</sup>

### **1.5: Corporate Governance Models:**

Corporate governance, broadly conceived, refers to mechanism by which companies are controlled, directed and made accountable. Many practical forms of governance exist and these are often tailored to the demands of a particular company, institution, time period, and culture or country. The corporate governance systems used throughout the world are generally rooted in either the stock market based outsider model which mostly prevails in Anglo –Saxon countries or the more traditional bank based insider model that can be found in most of other countries of the world. Each system has its own features, represents different corporate structures and diverse aims of corporation.<sup>29</sup>

#### **1.5.1: The Outsider Model:**

The philosophy of outsider model is also known as Anglo-Saxon or stock market capitalism or the shareholder governance system or unitary board model. The outsider system focuses on the separation of ownership from control, financing through the stock market and the use of independent board of directors. The common law countries such as the USA, the UK, Canada and Australia extensively use this system.<sup>30</sup> This is based on the corporate concept of the

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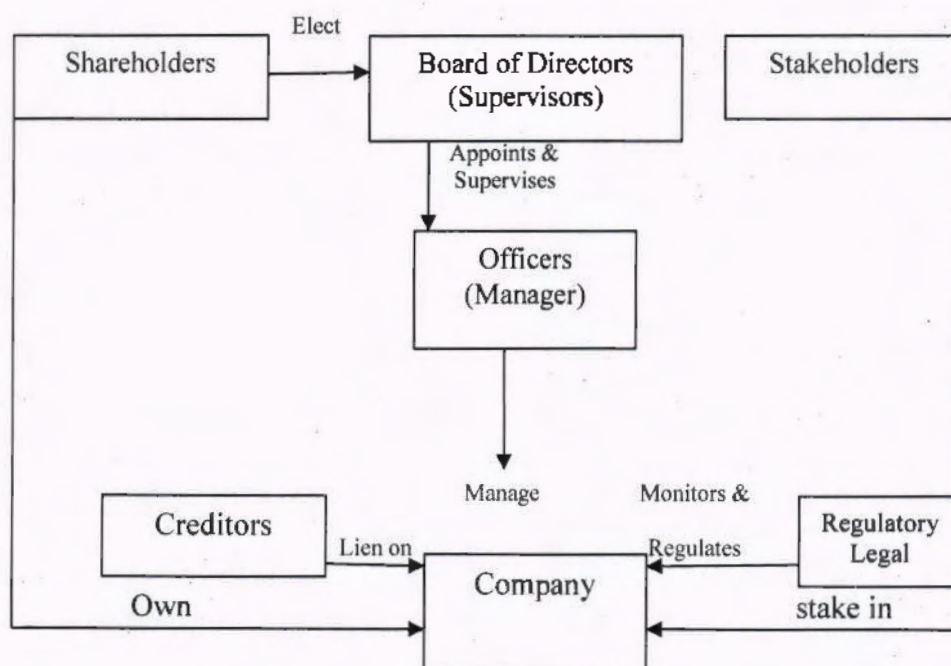
<sup>28</sup> Fernando, *corporate governance*, 51.

<sup>29</sup> Mumtaz, *Corporate Governance*, 5.

<sup>30</sup> Yadong Luo, *Global Dimensions of Corporate Governance*, 1<sup>st</sup> edit., (UK: Blackwell, 2006), Available at <http://books.google.com.pk/books?id=xn4HdRjdBawC&pg=PA40&dq=what+is+the+anglo+saxon+model+of+corporate+governance&hl=en&sa=X&ei=6kAmT4HINMPomAW9n6WuDA&ved=0CDYO6AEwAQ#v=onepage&q=what%20is%20the%20anglo%20saxon%20model%20of%20corporate%20governance&f=false> (last accessed: January 20, 2012).

fiduciary relationship between the shareholders and managers by profit oriented behavior. In this model, boards are constructed in such a way as to mitigate the agency problems arise by the conflicts between principals and agents of the companies. Dispersed ownership, adequate protection of shareholder's rights and interests, a single board comprising executive and non executive directors, active equity markets, active take over market, accountability, high disclosure and tight insider trading rules are the salient features of the Outsider model of corporate governance.<sup>31</sup>

**Fig 1.1: The outsider model of corporate governance**



Source: A.C. Fernando, corporate governance principles, policies and practices

### 1.5.2: The Insider model:

Corporate governance having behind the basic idea that company must be run not only in the interest of shareholder but also for all stakeholder of company because they all participate in

<sup>31</sup> Fernando, *Corporate governance*, 54.



the performance of the company, it is also known as the stakeholder or social model or two-tier model of the company and in return company has a social responsibility towards them. This model facilitates all the shareholders, stakeholders, managers, creditors, suppliers, employees and customers to monitor the company's affairs.<sup>32</sup> It is practiced by majority of European countries and in Japan as well as in many developing and transition countries.<sup>33</sup>

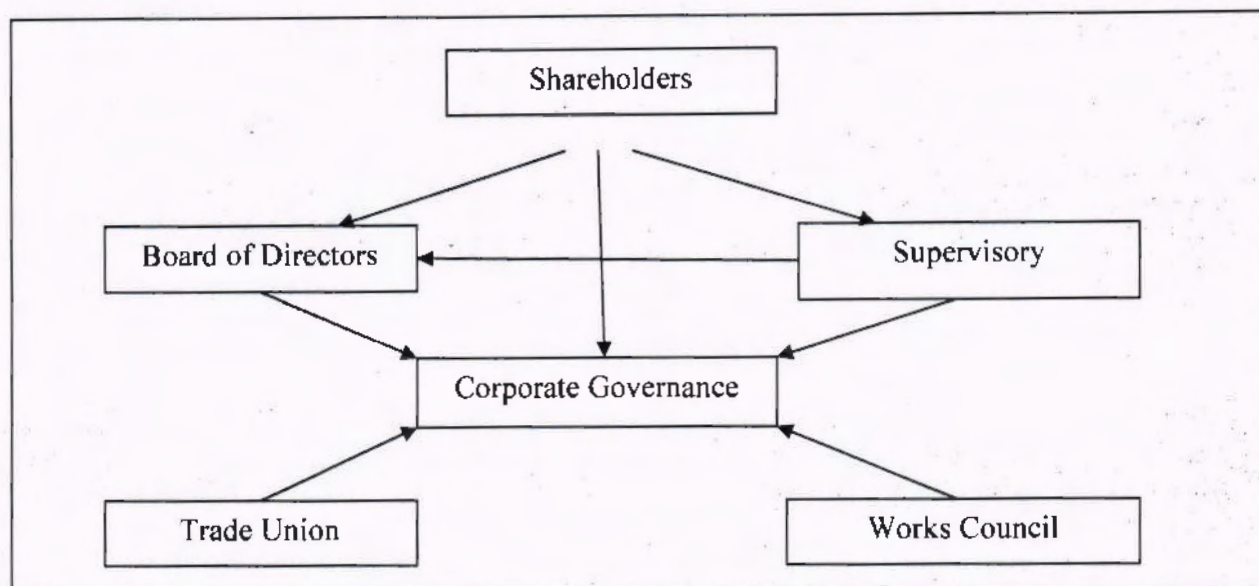
This model has three more sub categories: the bank based German Model that is practiced in Germany, Austria, Switzerland, Netherland, partly in France, Belgium and in Korea; The Japan model is also bank based but controlled by keirestu structure and the family based model applied in Greece, Italy and Turkey. Concentrated ownership, reliance on family, bank and public finance, low stock market capitalization, inflexible economic structure, insider boards as supervisory and management, high employee protection, long term commitments, relationship based institutions, cross shareholdings, relatively under developed financial markets, limited disclosure and inadequate minority protection are the main features of this model.<sup>34</sup>

<sup>32</sup> Zameer Iqbal, Abbas Mirkhor, "Stakeholders Model of Governance in Islamic Economic System," *Islamic Economic Studies* 11, No.2(March 2004):45, Available at <[http://www.irti.org/irj/go/km/docs/documents/IDBDevelopments/Internet/English/IRTI/CM/downloads/IES\\_Articles/Vol%2011-2..Zamir%20Iqbal..Stakeholders%20Model%20of%20Governance.pdf](http://www.irti.org/irj/go/km/docs/documents/IDBDevelopments/Internet/English/IRTI/CM/downloads/IES_Articles/Vol%2011-2..Zamir%20Iqbal..Stakeholders%20Model%20of%20Governance.pdf)> (last accessed: January 23, 2012).

<sup>33</sup> By Zulkifi Hasan, "Corporate Governance: Western and Islamic Perspectives", *International Review of Business Research Papers* 5, no.1( January 2009):281, Available at <<http://www.kantakji.com/fiqh/Files/Companies/w119.pdf>> (last accessed: January 25,2012) (hereinafter, Hasan, Corporate Governance).

<sup>34</sup> Fernando, *Corporate governance*, 54.

**Fig 1.2: The insider model of corporate governance.**



Source: Zulkifi Hasan, "Corporate Governance: Western and Islamic Perspectives."

### **1.6: Convergence in Corporate Governance Models:**

There has been considerable controversy about the desirability and inevitability of convergence in the governance practice of public companies after the publication of an article by two US scholars, Hansmann and karaakman, who predict a shift of European and Asian countries towards the Anglo-American corporate governance, due to the stronger capital markets, higher disclosure and efficient mode of finance and governance.<sup>35</sup> No doubt, both the two models have weakness and strengths regarding their origins, legal structure and nature of business. With the unique governance mechanism and tools, each model has its own precedence over the other. Convergence must not be perceived as a victory of one system over the other and also not be perceived as unification of national legal system. There is most important thing is the possibility

<sup>35</sup> Verica Babic, "corporate governance problems transition economies," Available at <http://www.afic.am/CG/CGProblemsInTransitionEconomies.pdf> (last accessed: January 24, 2012).

and flexibility of the companies to move from one regime to another as their needs and constituencies.<sup>36</sup> Globalization of companies, major world organizations (World Bank, OECD, ECGN, EASD, GCGF, WTO, ICC), influence of international investors, pressure from capital markets, international business standards (IFRS, IASB, FASB, IAS) and scholars as agent of convergence contributed to convergence of different practice of corporate governance. On the other hand, convergence faces many obstacles from the differences in culture, history, ownership structures, legal system and stock markets of a country.<sup>37</sup>

### **1.7: Transplantation of Corporate Governance:**

There are countries that have pioneered in developing various legal frameworks, and are actively involved formulation an assortment of codes and statutes that govern them. These countries are called the origins of such codes and laws. Then there are countries and territories that receive the laws and codes, which originated in some other country and adopt them. These are referred to as transplants in the literature.

It is imperative to consider that the origins have developed these laws and codes in their unique social, political, economic and culture context.<sup>38</sup> A number of studies suggest that a simple adoption cannot be beneficial to the transplanting country until and unless it is well understood and is meaningful to the users in the country of transplant. If a law is simply copied and pasted without any adaption to local conditions then it loses its efficiency.

<sup>36</sup> Stilpon Nestor and Jhon k. Thompson, "Corporate Governance Pattern in OECD Economies: is Convergence under Way?,"2, Available at < <http://www.oecd.org/dataoecd/7/10/1931460.pdf>> (last accessed: January 25, 2012).

<sup>37</sup> Jordy Canals, Building Respected Companies,( USA: Cambridge University Press,2010),110, Available at <[http://books.google.com.pk/books?id=4Q11rMZK3R8C&pg=PA123&dq=convergence+in+corporate+governance&hl=en&sa=X&ei=GkcoT6X6GYnKhAe5\\_fyUBQ&ved=0CEAQ6AEwAjgy#v=onepage&q=convergence%20in%20corporate%20governance&f=false](http://books.google.com.pk/books?id=4Q11rMZK3R8C&pg=PA123&dq=convergence+in+corporate+governance&hl=en&sa=X&ei=GkcoT6X6GYnKhAe5_fyUBQ&ved=0CEAQ6AEwAjgy#v=onepage&q=convergence%20in%20corporate%20governance&f=false)> (last accessed: January 25, 2012).

<sup>38</sup> Tahir, *Two-Tier Corporate Governance*, 38.



The code of corporate governance is usually used in conjunction with the corporate laws of the countries where they are implemented. There are a number of factors that need to complement each other for a transplant to qualify as successful. The issue of governance varies from country to country depending on the level of development of capital markets, legal institutions, ownership structures, existing rules, codes and laws, receptiveness of masses to change and culture. The formal law in the books does not do much for the development of any country unless it is used. In order to work, the system of corporate governance should reflect the political and economic history of the country as well as the social and political attitudes of the people.<sup>39</sup> The major factors that can help determine the success or failure of corporate governance code transplant include path dependence, complementary institutions, social and corporate culture.

**(a) Path Dependence:**

Path dependence theory argues that traditional practices prevalent in countries have much influence on the corporate governance practices that it is likely to adopt.<sup>40</sup>

**(b) Complementary Institutions:**

It is very important for making an imported model fit into a economy with prevailing institution. The regulator, legal structure and well functioning stock exchanges of an economy are supporting institution for a strong corporate system. Corporate governance practices do not work in isolation, a well integrated network of support institutions is needed to effectively implement them.<sup>41</sup>

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<sup>39</sup>Afra Afsharipour, "Corporate Governance Convergence:Lessons from the Indian Experience," *Northwestern Journal of International Law & Business* 29, no. 2 (Spring2009): 339, Available at <<http://scholarlycommons.law.northwestern.edu/cgi/viewcontent.cgi?article=1687&context=njilb>>(last accessed: January 25,2012).

<sup>40</sup> Ibid.

<sup>41</sup> Ibid.

### **(c) Social and Corporate Culture:**

Culture plays very important role in implanting an imported corporate governance model into a country. Hollingsworth, Schmitter & Streeck provide an example of a cultural perspective: "Transactions are conducted on the basis of mutual trust and confidence sustained by stable, preferential, particularistic, mutually obligated, and legally non enforceable relationships. They may be kept together by value consensus or resource dependency that is, through 'culture' and 'community' or through dominant units imposing dependence on others." <sup>42</sup>It defines about the people what they perceive as right or wrong. For functioning well, it is necessary for a foreign model that it meshes well with pre existing rules and ownership structure.

### **1.8: Milestone in the Emergence of Corporate Governance:**

World's corporate history was full of a number of scams and frauds due to non satisfactory system of regulation that required some substantial external regulations for its betterment. By these regulations, market forces should reward those who abide by rules and penalize the wrong doers. Many institutions like government, large institutional investors, shareholder activism and insistence of mutual funds brought out several changes in governance of the companies. They demanded that companies in which they invested should implement better governance policies to run its affairs. Several committees were formed to sort out and study the issues in detail that make suggestions, codes and guidelines on corporate governance.

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<sup>42</sup> Shann Turnbull, "Corporate Governance: Its scope, concerns & theories," *Journal of Economic Literature* 5, no.4 (October 1997):190, Available at <<http://cog.kent.edu/lib/turnbull4.html>> (last accessed: January 22, 2012).

All these measures have brought about a metamorphosis in corporate that realized that investors and society are serious about corporate governance.<sup>43</sup>

### **1.8.1: Development in U.S.A.:**

In U.S corporate governance attained much importance after the water gate scandal in which many companies involved in making political contributions and offering bribes to the government officials that required some improvement in corporate laws. In 1977, the Foreign and Corrupt Practices Act was enacted which was followed in 1979 by Securities and Exchange Commission's proposals for mandatory reporting on internal financial controls. After facing a chain of high profile business crash in 1985, U.S.A. formed many commissions to investigate and sort out the problems that were met by the industries on a road of development. In 1987, one of commission tradeway published its report in which it emphasized the necessity of organized environment, autonomous audit committees and an ideal inside audit function. It also suggested to supporting institutes to build up a standard internal control set up to facilitate corporations to develop their controls.<sup>44</sup>

### **1.8.2: Development in U.K:**

Roots of corporate governance were begun In England by the Bank of Credit and Commerce International (BCCI) scam. The Barings Bank was another indicator in solving the corporate transgression and alerting the people's conscious about corporate crimes. It highlighted the issues that on one side failed the companies due to lack of proper composition and goals of the top management and on other side affected the shareholders and concerning parties. In such

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<sup>43</sup> Rondal K. Morck and Lloyed Steier, "The Global History For Corporate Governance-An Introduction,"16, Working Paper 11062(National Bureau of Economics Research, January 2005) available at <[http://www.nber.org/papers/w11062.pdf?new\\_window=1](http://www.nber.org/papers/w11062.pdf?new_window=1)> (last accessed: January 26,2012).

<sup>44</sup>Chapman, *Simple Tools and Techniques*,41.

scenario, corporate governance assumed more value  
corporate failures.<sup>45</sup>

### **1.8.3: Corporate Governance Committees:**

Throughout the US, UK, and other countries a number of committees have been set up to recommend reforms and regulations in corporate governance. They are a reflection of the individuals that had chaired the committees.

- **Cadbury Committee on Corporate Governance, 1992:**

The stated objectives of the Cadbury Committee was "To help raise the standards of corporate governance and the level of confidence in financial reporting and auditing by setting out clearly what it sees as the respective responsibilities of those involved and what it believes is expected of them". The main inspection of the committee was the liability of the board of directors to shareholders and to the public. The Cadbury code of best practices had 19 recommendations in the nature of guidelines relating to the board of directors, non-executive directors, executive directors and those on reporting and control.<sup>46</sup>

- **The Paul Ruthman Committee:**

This committee restricted the reporting requirement to internal financial controls only as against the effectiveness of the company's system of internal control as stipulated by the Code of Best Practices contained in the Cadbury Report. The final report submitted by the Committee chaired by Ron Hampel had some important and progressive elements, notably the extension of directors' responsibilities to all relevant control objectives including business risk assessment and minimizing the risk of fraud.<sup>47</sup>

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<sup>45</sup> Julian Roche, *Corporate Governance in Asia*, (UK: Routledge, 2005), 35.

<sup>46</sup> Chapman, *Simple Tools and Techniques*, 23.

<sup>47</sup> *Ibid.*

- **The Greenbury Committee:**

In 1995, by the confederation of British Industry (CBI), a committee was organized to ascertain directors' remuneration and to plan a code of good practices for public limited companies. This committee presented the Greenbury Code of Best Practice that had four sections: Remuneration Committee, Disclosures, Remuneration Policy and Service Contracts and Compensation. It was mentioned in its suggestion that a practicable code should be implemented by the companies in UK and companies had to make statement of annual compliance and follow the best practice of it in exercising all of its powers.<sup>48</sup>

- **The Hampel Committee:**

In UK to promote the high values on corporate governance, The Hampel committee was held in November 1995. Cadbury report was developed by it and it purposed following recommendations:

- i) The auditors should report on internal control privately to the directors.
- ii) The directors maintain and review all controls.
- iii) Companies should time to time review their need for internal audit function and control.

The combined code that consolidated the recommendation of earlier corporate governance reports (Cadbury Committee and Greenbury Committee) was also introduced by it.<sup>49</sup>

- **The Combined Code:**

The combined code was derived from Ron Hampel Committee's Final Report, Cadbury Report and the Greenbury Report. As such, compliance of the code is mandatory for all listed companies in UK. The stipulations contained in the Combined Code require, among other things, that the boards should maintain a sound system of internal control to safeguard shareholder's

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<sup>48</sup> *Ibid.*,25.

<sup>49</sup> Fernando, *Corporate governance*,76.

investments and the company's assets. The directors should conduct a review of the effectiveness of the group's system of internal control covering all controls, including financial, operational and compliance and risk management, and report to shareholders that they have done so.<sup>50</sup>

- **The Turnbull Committee:**

The Turnbull Committee was set up by the Institute of Chartered Accountants in England and Wales (ICAEW) in 1999 to provide guidance to assist companies in implementing the requirements of the Combined Code relating to internal control.<sup>51</sup>

#### **1.8.4: World Bank on Corporate Governance:**

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The World Bank report plays vital role in recognizing the complexity of the views on corporate governance. It presents the universally applicable principles like transparency, accountability, fairness and responsibility. Corporate governance relates to hold the balance either it is in economic and social or in individual and communal goals. The framework of governance enhances the utility of resources and demands the liability from the holder of the resources. Disclosure is the basis of any company and openness is the foundation of the public trust in a commercial system that continues the flow of funds in a smooth way. This report highlights the method to establishment of confidence and promotion of enterprise. It marks an important milestone in the development of corporate governance.<sup>52</sup>

#### **1.8.5: OECD Principles:**

One of the most primitive nongovernmental organizations was the Organization for Economic Co-operation and Development (OECD). It worked on making the corporate governance more meaningful and adoptable for all regions. It produced many principles for the

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<sup>50</sup> *Ibid.*

<sup>51</sup> *Ibid.*, 77.

<sup>52</sup> Stilpon Nestor, "International Efforts to improve Corporate Governance: Why and How?," 7, Available at <<http://www.oecd.org/corporate/ca/corporategovernanceprinciples/1932028.pdf>> (last accessed: January 30, 2012).



companies to achieve their target of long term share holder value. It was one who gave a way to code of best practices that was the part and parcel of Cadbury report.

The summary of OECD principles included these essentials:

- i) The rights of shareholders.
- ii) Equitable treatment of shareholders.
- iii) Role of stakeholders in corporate governance.
- iv) Disclosure and Transparency.
- v) Responsibilities of the board.

To the some extent the OECD guidelines are universal and both the corporate governance systems (Anglo-American and Continental European or German) would be somewhat consistent with it.<sup>53</sup>

#### **1.8.6: Sarbanes- Oxley Act, 2002:**

For tackling all the problems associated with corporate collapse and restoring investor's confidence, The Sarbanes-Oxley Act (SOX) is a genuine effort that helped the US companies in achieving excellent governance system. It was legislated to protect investors and to give value to securities laws in the state. Through enhancing the reliability and accuracy, it heightened the standards of corporate disclosures. The Act consist a number of clauses that distinctly change the reporting and public company's director obligations. The most significant feature of the act is that it makes senior officers more accountable and responsible. According to it senior officers are equal in following the constitution of the company as other employees and accountable to their

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<sup>53</sup> *Ibid.*

liabilities. For instance, CEO must be accountable about the corporation's disclosure, financial reporting and control.<sup>54</sup>

### **1.9: The Significance of Corporate Governance:**

Worldwide privatization wave, deregulation and integration of capital markets and economic crises made the corporate governance a major issue in the global economy. Corporate governance is all about governing the companies in such a way that protects the rights of shareholders and other stakeholder that in turn build market trust and sustains the company for long time. It ensures that company obeys the law of the land while carry out its business. To remain competitive in developing countries, attract capital, stimulate the performance, ensure sustainability and combat corruption, companies need to put in the place of good governance institutions. It is said by the James Wolfensohn, former president of World Bank, that "the governance of the corporation is now as important to the world economy as the government of countries".<sup>55</sup> Corporate governance sets the rules to deal with issues related to separation of ownership and control. Boards of directors, which reconcile the interest of owners, managers and other stakeholders, are considered to be the key of effective functioning of companies within the framework of corporate governance. Corporate governance should be adopted to enhance efficiency, minimize the conflicts, improve leadership, mitigate fraud risks, and to meet societal expectations. Not only corporate governance principles but the effective external system of markets and institutions of a country plays an important role to mitigate the issues of a company for instance legal and regulatory environment of a country must guarantees the rule of law,

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<sup>54</sup> Robert A.Monks and Nell Minow, *Corporate Governance*, 4<sup>th</sup> edit. (England: Jhon Welly& Sons, 2008),329.

<sup>55</sup> Janet Dine and Marios Koutsias, *The Nature of Corporate Governance: The Significance of Natioanl Cultural Identity*, (UK: Edward Elgar, 2013) Available at <<http://www.amazon.com/The-Nature-Corporate-Governance-Globalisation/dp/1845427009>> (last accessed: December 24, 2013).



property rights, access to capital, sound exit mechanisms and professional government and regulatory agencies.<sup>56</sup>

Corporate governance can be considered as an environment of trust, ethics, moral values and confidence. Failure in corporate governance is a real threat to the future of every corporation. With effective corporate governance based on core values of integrity and trust, companies will have competitive advantage in attracting and retaining talent and generating positive reactions in the market place. Effective corporate governance can be achieved by adopting a set of principles and best practices. A great deal depends upon fairness, honesty, integrity and the manner in which companies conduct their affairs. Companies must make a profit in order to survive and grow; however, the pursuit of profits must stay within ethical bounds. Companies should adopt policies that include environmental protection, whistle blowing, ethical training programs and so on. Such compliance mechanisms help, develop and build corporate image and reputation, gain loyalty and trust from consumers and heightens commitment to employees.

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<sup>56</sup> Shann Turnbull, "Corporate Governance: Its scope, concerns & theories," *Journal of Economic Literature* 5, no.4 (October 1997):186, Available at <<http://cog.kent.edu/lib/turnbull4.html>> (last accessed: January 22, 2012).

## **CHAPTER TWO: THE REGULATORY AND LEGAL FRAMEWORK CONCERNING CORPORATE GOVERNANCE IN PAKISTAN:**

### **2.1: Introduction:**

The emergence of corporate governance as fair and transparent mechanism to run and administer corporations in manner that would result in long term shareholder value and benefits to the entire society has been fairly a recent phenomenon. There has been perceptible change in people's minds as to the objective of a corporation, from one which was intended to benefit exclusively the shareholders to one which is expected to benefit all its stakeholders. Recent corporate failures -- such as Enron and World Com in the USA, Harris Scarfe, One-Tel, HIH and Ansett in Australia, Parmalat in Italy and Ahold in the Netherland – as well as the Asian crises, there has been a conscious effort to strengthen the corporate governance practices in the developed world, but also in the developing world. In similar vein, actors on the Pakistan capital markets have started to understand the significance of well functioning corporate governance mechanisms.<sup>1</sup> Recent corporate scams such as those involving financial cooperatives company, Taj Company, Crescent Bank, PTCL, Mehran Bank and Forex Company have alarmed the corporate community and public policy makers alike to take corporate governance seriously.

The Securities and Exchange Commission of Pakistan (SECP) thus endeavors to raise the corporate governance standards in the country. The first major effort was made in March 2002, when the Code of Corporate Governance (Code) was issued by SECP. It was subsequently made part of the listing regulations of the three stock exchanges and became applicable to all public

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<sup>1</sup> .Faiza A. Ch, Marc Goergen and Shoeb I. Syed, "Corporate Governance in Financial Sector of Pakistan," Working Paper 06/50(Centre for Management and Economic Research, 2006),4, Available at <[http://cmer.lums.edu.pk/upload/CMER\\_06\\_50.pdf](http://cmer.lums.edu.pk/upload/CMER_06_50.pdf)> (last accessed: March 20,2012).

listed companies and since it's working as watch dog over the legitimate functioning of the corporate sector. It also ensures that the sector is complying with its social responsibilities towards all its stakeholders.

Further a revision made in the code and a new code of corporate governance was issued by SECP in 2102. The revisions in the Code are indicative of the fact that governance standards are dynamic and need to be reviewed to keep the governance framework relevant and effective. The objective was to further improve and raise the standards of corporate governance in the country while at the same time taking into consideration the global developments in corporate governance. While implementing the code, Pakistan being a developing economy faced major obstacles such as complex ownership structure, equity culture, inadequate remuneration of directors, independent director, weak external discipline in the corporate sector, weak legal systems and regulatory framework etc.

## **2.2: Pakistan's Corporate Governance Regime:**

Historically, Pakistani companies have been family-controlled and many still remain in the same manner, in general, through pyramid structures and cross-holdings. Financial support have in general relied on debt financing, hence is the equity market not developing rapidly. However, there are three stock exchanges in Pakistan, Karachi Stock Exchange (KSE) as the largest with Islamabad and Lahore stock exchanges to follow. Major reforms in shaping the best practices (according to Pakistani legislation) for companies in relation to corporate governance have been taken by Securities and Exchange Commission of Pakistan. The legal frame works to run a company in Pakistan is addressed through Companies Ordinance 1984. The legal and regulatory framework of corporate sector is not totally conducive to investor protection and corporate

activity like other emerging economies. No doubt, after the liberalization process, many momentous improvements have been influenced the corporate system. For compliance and incorporating the companies, there are a number of procedures laid in different enactment. To mirror the governance regime in country, it is necessary to have a look on the roots of corporate laws on which existing corporate body is based.<sup>2</sup>

Companies Act 1850 was very first legislation in subcontinent in form of basic principles regarding the incorporation of business that faced many changes in 1857 and 1882. Afterwards, a very effective and inclusive companies Act 1913 was legislated that also used as a piece of law in Pakistan. Some changes were also made in this Act in late 1950s to meet need of corporate entity. After getting independence, Pakistan's corporate entity required a comprehensive legislation to run their affairs in according to national and international standards as companies were growing rapidly. Many laws were legislated for developing a better corporate sector in Pakistan. There is over view of major or other laws that affect the governance of companies.<sup>3</sup>

(a) Companies Ordinance 1984: it is major law of land that covers all aspects of the company.

It oversees all forms of joint stock companies like, public companies (listed and non-listed), private companies, foreign companies, non-profit companies for good purpose etc. Many sections explain the ways of maintaining the financial and other relevant records, their inspections and responsibilities of BOD. Rights and responsibilities of shareholders and stakeholders are also explained by it. According to its requirements, all financial statements are prepared and recorded.

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<sup>2</sup> "Legal and Regulatory Framework," Available at < <http://www.pc.gov.pk/mtdf/35-Legal%20Regulatory%20Framework/35-Legal%20Regulatory%20Framework.pdf> > (last accessed: March 20, 2012).

<sup>3</sup> Amir Sajjad Khan, "Corporate Law of Pakistan," 6, Available at <<http://www.scribd.com/doc/27660777/Corporate-Law-of-Pakistan>> (last accessed: April 10, 2012).

- (j) Special prosecution under the National Accountability Ordinance, 1999: it deals with corporate fraud and misappropriation.
- (k) Competition Act 2010: with objective to enhance economic efficiency and to protect consumers from anti competitive behavior. It sets out procedures relating to review of mergers and acquisitions, enquiries, imposition of penalties, grant of leniency and other aspects of law enforcement.

These relevant laws provide guidance to understand the foundation of prevailing Pakistan's corporate governance structure. In our country, there are many laws to administer companies but we need them in practice not only in papers. Not only legislature but regulating authorities, judiciary and other corporate players have to play a dynamic role in establishing an ideal corporate system.

### **2.3: Islamic Contemplations for Business Morals:**

It is necessary to prop up the interests of all stakeholders that company should be governed in accordance with the highest ethical standards. The principles of corporate governance draw upon the basic human values and business dealings like trust, good intention, competency, fairness, accountability, professionalism and many others. Corporate governance derives its principles from these human dealing and refine them in to the multifaceted net of relationships and interests that build up a company. Being one of strong supporter, Islam and its values always encouraged good corporate governance and supported trade and commerce as long as it is conducted within the framework of Quran and Sunnah.<sup>4</sup> According to the constitution, all

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<sup>4</sup> choudhry salahudin, "OECD principles and Islamic perspective on corporate governance," *Review of Islamic Economics* 12,no.1(2008):34, Available at [http://www.ethicsbasedmarketing.net/articles/sept\\_14\\_2008/Islam%20and%20Corporate%20Governance.pdf](http://www.ethicsbasedmarketing.net/articles/sept_14_2008/Islam%20and%20Corporate%20Governance.pdf) (last accessed:March 15, 2012).

laws should conform to Islam, so primarily SECP draws ethics principles from Islamic laws. The basis of SECP's view on fiduciary duties lies on Anglo-American common law and, significantly, Islamic law, which shows the importance of Islam on business ethics for the corporate governance in Pakistan.<sup>5</sup>

## **2.4: The Role of Judiciary in Development of Corporate Law:**

"Free judiciary ensures economic security", said by ex chief justice of Pakistan Iftikhar Muhaamd Choudhry. Effective regulation is ultimately a function of good governance, which is compromised by the absence of an effective court system. Even the best-designed legal and regulatory frameworks cannot achieve their objectives if they are not accompanied by an independent and efficient judiciary to guarantee and enforce legal rights. The role of effective judicial system is critical for ensuring predictability in economic transactions and for their long term planning. Judicial independence guarantees enforcement of contracts, and fair and consistent application of rule of law to economic life, thereby averting arbitrariness on the part of officials.<sup>6</sup> Economies less attract the investors in the absence of independent judiciary. Judiciary works as bridge in making laws more effective and establishing fair and free judicature system that encourages integrity, accountability and significantly foreign investment in country. It is believed that strong nation has a strong judicial system.<sup>7</sup>

A significant role can be played by judiciary under legal frame work of Pakistan. For instance, the primary corporate governance measures under the Companies ordinance are the

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<sup>5</sup> Ali Adnan Ibrahim, "Corporate Governance in Pakistan Analysis of Current Challenges and Recommendations for Future Reforms," *Washington University Global Studies Law Review* 5, (2006):326, Available at <[http://law.wustl.edu/wugslr/issues/volume5\\_2/p323Ibrahim.pdf](http://law.wustl.edu/wugslr/issues/volume5_2/p323Ibrahim.pdf)> (last accessed: June 20, 2012) (Hereinafter, Ibrahim, Corporate Governance in Pakistan).

<sup>6</sup> Fahad M. Mirza and Muhammd Waqas Masoud, "Impacts of Strong Judicial System on Organizational Effectiveness in Pakistan," Available at <<http://www.slideshare.net/fmmirza/cfakepathimpact-of-strong-judicial-system-on-organizational-effectiveness-in-pakistan>> (last accessed: June 24, 2012).

<sup>7</sup> *Ibid.*



statutory provisions protecting shareholders against fraud and mismanagement. Shareholders can bring suit against a company's management or board of directors, in order to protect shareholder interests. In many cases courts have decided the issues with regard to protect the share holders who have little access to the accounts and to promote new corporate guidelines for enhancing the public interest.<sup>8</sup> It made management more responsible not only to majority but also to all concerning partners. By their valuable decisions, they made clear the methods of preparing audit reports and responsibilities of auditors.<sup>9</sup> By interpreting and applying the provisions of company laws, courts have build up wide case laws.

But in the absence of transparency, accountability, efficiency, independence and human financial and technical resources, the judicial system in Pakistan faces hurdles in developing the corporate laws. Public confidence in judicial system has diminished due to long delays, costly litigation and immense backlog.<sup>10</sup>

According to a vocal critic of the Pakistani legal system, the judicial process involves countless delays, and when decisions are finally rendered by courts, they are often ignored.<sup>11</sup> The traditional delay in resolving a case is a disincentive for shareholder to advocate for their rights by the courts. Many foreign institutions rolled back their business to other countries just because of these prevailing drawbacks in country like royal Bank of Scotland.<sup>12</sup> The National Judicial Policy 2009 shows serious concerns in solving the issues confronting by the judiciary in

<sup>8</sup> A.F Ferguson & Co versus The Securities and Exchange Commission of Pakistan, 2004 CLD 1433(a).

<sup>9</sup> Institute of Chartered Accountant of Pakistan v.s. Messsers Hyderali Bhimji & Co.2002 CLD 1207.

<sup>10</sup> Lubna Hasan, "Rule of Law, Legal Development and Economic Growth: Perspectives for Pakistan," Munich Persoanl RePEc Archive Paper, no. 25565(October 2010), 8, Available at <[http://mpra.ub.uni-muenchen.de/25565/1/MPRA\\_paper\\_25565.pdf](http://mpra.ub.uni-muenchen.de/25565/1/MPRA_paper_25565.pdf)> (last accessed: June 25,2012) (Hereinafter, Hasan, Rule of Law).

<sup>11</sup> Fahad M. Mirza and Muhammd Waqas Masoud, "Impacts of Strong Judicial System on Organizational Effectiveness in Pakistan," Available at <<http://www.slideshare.net/fmmirza/cfakepathimpact-of-strong-judicial-system-on-organizational-effectiveness-in-pakistan>> (last accessed: June 24, 2012).

<sup>12</sup> *Ibid.*

providing justice.<sup>13</sup> In spite of all, recent judicial inclination in Pakistan indicated an unparalleled concern in favor of the minority shareholders. It would be important to state that the Pakistan Courts have given favorable attention to the minority shareholders and have annulled the majority's corporate verdict.<sup>14</sup>

## **2.5: Why Corporate Governance Matters for Pakistan:**

Governor of the State Bank of Pakistan, Dr. Shamshad Akhtar states "Corporate governance is critical to improving economic efficiency and growth. It serves as a deterrent to mismanagement and infuses discipline in the decision making process of boards of directors." Companies enhance their performance and draw investors' attention by applying good governance practices.<sup>15</sup> These principles facilitate them in understanding the basic objective of the companies like protection of share holders' rights and legal requirements of conducting a business etc. It make possible for them to reveal the public how they are conducting their companies. In stabilizing and strengthening worldwide capital markets, these practices have become essential. It becomes important for maximizing the value of company to adhere their internal governance system with best corporate practices.<sup>16</sup>

In 1997, The Asian Financial Crisis brought light on main root cause of economic break down that was inefficient internal governance system of companies. The need for instituting good corporate governance was vanguard agenda of global debate on curative determinations. As a result, corporate regulators became responsible to ensure that are playing a dynamic function in

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<sup>13</sup> Hasan, Rule of Law, 9.

<sup>14</sup> Pfizer Laboratories Limited 2003 CLD 1209; Kohinoor Raiwind Mills Limited vs. Kohinoor Gujjar Khan Mills Limited 2002 CLD 1314.

<sup>15</sup> The counsel Pakistan's premier corporate law magazine, " Revised Code of Corporate Governance," Available at <http://www.counsellpakistan.com/vol-2/legal-updates/afghan-transit-trade-agreement.php> (last accessed: June 25, 2012).

<sup>16</sup> *Ibid.*



originating the legal and institutional structure to maintain the implementation of good corporate governance.<sup>17</sup>

In Pakistan some economic analysts elucidate the causes of weak corporate governance practices that flagging foreign and local investor confidence such as deficiency in the standards of transparency, accountability and disclosure. It is pragmatic that economies adhering good standards of governance attract more capital flows from national and international sources. For reviving investor confidence, it is undeniable need to implement good corporate governance in Pakistan.<sup>18</sup>

## **2.6: Regional Efforts in Pakistan for Incorporating Corporate Governance Practices:**

Since last decade, corporate governance became a favorite subject in the debate of governing system of companies which spotted light on the role of board in listed companies primarily. That made companies responsible not only to interests of major controlling shareholders but to the broader interests of shareholders and stakeholders. Its major keys are integrity, accountability and transparency that are crucial in promoting good governance system in a country.<sup>19</sup>

In Pakistan, the formulation of a code of corporate governance is a chief achievement in governing system of companies. Its journey starts when All Pakistan Chartered Accountants' Conference held in December 1998 decided to take an initiative to evolve and recommend a

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<sup>17</sup>The Securities and Exchange Commission of Pakistan, "Corporate Governance-Shaping the Future of Corporate Sector in Pakistan, *Newsletter*1, issue no.2(December 2001), Available at <[http://www.secp.gov.pk/newsletter/pdf/oct\\_dec\\_01.pdf](http://www.secp.gov.pk/newsletter/pdf/oct_dec_01.pdf)> (last accessed: June 25,2012).

<sup>18</sup> The Securities and Exchange Commission of Pakistan, UNDP Project on Corporate Governance, 6,2003, Available at <[http://www.secp.gov.pk/IACCD/pub\\_iaccd/ProjectReport.pdf](http://www.secp.gov.pk/IACCD/pub_iaccd/ProjectReport.pdf)>(last accessed: June 25, 2012).

<sup>19</sup> Ri Baqi, "Code of Corporate Governance Pakistan," Available at <<http://www.studymode.com/essays/Code-Of-Corporate-Governance-Pakistan-1483272.html>> (last accessed: June 28, 2012).

Code of Good Corporate Governance. This attempt sought to build on comprehensive Codes developed outside of Pakistan, by developing a new code tailored to the circumstances of the Pakistani economy. For this purpose, a committee was constituted comprising of members of professional bodies of accountants, presidents of the three stock exchanges in Pakistan and nominees of the Securities and Exchange Commission of Pakistan (SECP) to undertake the task of formulating recommendations for the Code.<sup>20</sup>

After discussions extending over eighteen months between 1998 and 1999 and consideration of the responses, observations and comments from a large number of institutions, representative bodies, informed professionals and intellectuals, this committee formulated a draft code of corporate governance in Pakistan which was exposed to relevant stakeholders. A Task Force was constituted to assist the SECP to review the recommendations arising from discussion and the consultative process continued for a period of over six months. The Task Force, after due consideration of various comments and observations and after consultations with the SECP developed a Code of Corporate Governance. The SECP introduced the Code in March 2002 and it was subsequently incorporated in the Listing Regulations of the Pakistani Stock Exchanges which is applicable to all listed companies.<sup>21</sup>

In December 2004, the Pakistan Institute of Corporate Governance (PICG) was established as a not-for-profit company aimed at promoting awareness and encouraging good corporate governance practices in Pakistan. As part of its efforts to further enhance the corporate

<sup>20</sup> Noman Hameed and Nida Naeem, "Implications of the Revised Code of Corporate Governance, 2012 issued by the Securities and Exchange Commission of Pakistan" Available at <https://www.google.com.pk/url?sa=t&rct=j&q=&esrc=s&source=web&cd=5&cad=rja&ved=0CEQQFjAE&url=http%3A%2F%2Fpakistan.accaglobal.com%2Fpakistan%2Fmembers%2Fmnp%2F1213%2Fsubcomm%2FPubsec%2Fccg&ei=aRS6UvLdO4zb7AbxhoGAaw&usg=AFQjCNGVXBPOeXtiGjdyl5zDKAuKXMJjA&bvm=bv.58187178,d.Yms> > (last accessed: June 10, 2013) (Hereinafter, Hameed and Naeem, Code of Corporate Governance).

<sup>21</sup> Muhammad Ahmad, "Corporate Governance in Pakistan," 5, Available at <http://www.scribd.com/doc/19068926/Corporate-Governance-in-Pakistan-1> > (last accessed: June 20, 2013).

governance landscape in the country and to keep pace with globally set benchmarks, the SECP, in April 2012, issued a revised Code of Corporate Governance, 2012 for listed companies. The process adopted for the revision exercise was quite extensive and included consultation sessions with various stakeholders including representatives of stock exchanges and professional bodies. The process also benefited greatly from the insights of members of PICG task force who were mandated with the review exercise by the SECP.<sup>22</sup> In the process of adopting good governance practices in country these institutions play very important role.

### **2.6.1: The Role of SECP:**

Pakistan's economy appears well poised for a revival due to current improvements in the economic policies of government and geo-political development in the region. Many investment opportunities are offered by government that catches the attention of foreign investors. In promoting the well organized corporate sector, SECP (the regulator) played tremendous role in Pakistan.<sup>23</sup> For sound regulation of corporate sector, it was established in 1999. Many steps have been taken by SECP to eradicate structural flaws in corporate governance system and to supply impulsion for sustainable economic growth. In developing a code of corporate governance for country, it has propped up the Institute of Chartered Accountants of Pakistan (ICAP). First code of corporate governance is introduced under the flag of SECP's efforts. It has exercised its power under clause 34(4) of the securities and exchange ordinance. SECP further issued directions to Karachi, Lahore and Islamabad stock exchanges to incorporate the provisions of the code in their listing regulations. As a result, the listing regulations were suitably modified by the

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<sup>22</sup> *Sajid Chaudhry*, "Code of Corporate Governance 2002 Proposed amendments to be tabled before Senate body today," Daily Times, January 1, 2011, Business Section. Available at <[http://www.dailytimes.com.pk/default.asp?page=2011%5C01%5C04%5Cstory\\_4-1-2011\\_pg5\\_1](http://www.dailytimes.com.pk/default.asp?page=2011%5C01%5C04%5Cstory_4-1-2011_pg5_1)> (last accessed: June 20, 2013).

<sup>23</sup> *Ibid.*

stock exchanges. SECP organized seminars in many cities of Pakistan to promote good governance practices in country. It offered several programs and workshops for training the corporate players and soliciting public opinion. In the awareness agenda of good corporate governance practices, LUMS, IBA, and ACCA are also active supporters of SECP.<sup>24</sup>

#### **2.6.2: IFC Role in Cropping Corporate Governance in Pakistan:**

IFC helped Pakistan a lot in building and improving governance practices among companies and banks. It assisted in constructing sustained institutional capability for corporate governance. With its help, Pakistan Institute of Corporate Governance becomes the key corporate governance training provider in the country. ACCA Pakistan compiled and drafted “A survey of corporate governance practices in Pakistan 2007” with the association of International Finance Corporation (IFC), SECP, and PICG from listed companies and financial sector institutions of Pakistan. The survey intended to make aware the stakeholders about financial institutions and companies in Pakistan that are following good governance practices. PICG used its developed governance material for top corporate players and in 2007 launched the first board training for directors and senior manager to assist companies in improving their performance.<sup>25</sup>

#### **2.6.3: The South Asian Federation of Accountants (SAFA) and corporate governance:**

Regional efforts in harmonizing corporate governance practices in South Asia also affect the governance developments in Pakistan. A project was conducted by Asian Federation of Accountants (SAFA) for developing good practices on corporate governance in member

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<sup>24</sup>The Securities and Exchange Commission of Pakistan, “Corporate Governance-Shaping the Future of Corporate Sector in Pakistan, *Newsletter*1, issue no.2 (December 2001), Available at <[http://www.secp.gov.pk/newsletter/pdf/oct\\_dec\\_01.pdf](http://www.secp.gov.pk/newsletter/pdf/oct_dec_01.pdf)> (last accessed: June 25,2012).

<sup>25</sup>International Finance Corporation, Working with the Pakistan Institute of Corporate Governance , report,2012, Available at <[http://www.ifc.org/wps/wcm/connect/topics\\_ext\\_content/ifc\\_external\\_corporate\\_site/corporate+governance/news/fature+stories/working+with+the+pakistan+institute+of+cg2](http://www.ifc.org/wps/wcm/connect/topics_ext_content/ifc_external_corporate_site/corporate+governance/news/fature+stories/working+with+the+pakistan+institute+of+cg2)> (last accessed: July 13, 2013).

courtiers: Bangladesh, India, Nepal, Pakistan, and Sri Lanka (the SAFA region). A group composed of representatives from the member countries was given a project to analyse the existing corporate governance system in each member state. The purpose of this project was to discover the weak area in governance system and build up best governance principles for corporate sector of each member country.

The aim of SAFA is to develop such governance practices that are according to international standards and as well as regional business environment of member countries. It is also an apex body of SAARC countries.<sup>26</sup> No doubt while applying best corporate governance practices, member countries got some experience which might be useful for other member country. There is dire need of research work in member countries for highlighting the beneficial effect of corporate governance practices on the performance of their corporate sector. Some research work should be done by each member body for the guidance of regulatory bodies, professional institutes and different governments in the region and that work must be approved by SAFA Assembly.<sup>27</sup> In this respect, it may be interesting to note that International Finance Corporation (IFC), Securities and Exchange Commission of Pakistan (SECP), and Pakistan Institute of Corporate Governance (PICG) have commissioned a survey in Pakistan. The hope is to provide a baseline for future Corporate Governance requirements and initiatives under IFCs Pakistan Corporate Governance Project.<sup>28</sup>

<sup>26</sup> SAFA Group of Corporate Governance, "Best Practices on Corporate Governance for South Asian Countries," 5, Available at <<http://www.esafa.org/About/BP-CorporateGovernanceInSafaCountries.pdf>> (last accessed: July 20, 2013)

<sup>27</sup> Ibid.

<sup>28</sup> Dr. Khawaja Amjad Saeed, "Corporate governance past, present and future," (Paper presented at 2<sup>nd</sup> International Multi Disciplinary Conference, Sarhad University of Science and Technology, Peshawar, Pakistan, September 24-25, 2012), Available at <<https://www.google.com.pk/url?sa=1&rct=j&q=&esrc=s&source=web&cd=1&cad=rja&ved=0CDcQFjAA&url=http%3A%2F%2Fkamjadsaeed.edu.pk%2Farticles%2FJan2012%2FCorporate%2520Governance%2520Past%2C%2520Present%2520and%2520Future.pptx&ei=DDngUoO3DMvwhQe6m4HQCA&usg=AFOjCNE0VbKVdLLME8m>>

#### 2.6.4: World Bank's Contribution:

World Bank in its research recognized Pakistan's improvements in the field of corporate governance and developments in structuring active capital market. It mentioned in 2007 in its report on "Doing Business in South Asia" that Pakistan provides relatively strong protections for minority shareholders against the misuse of corporate assets. According to report Pakistan attained 19<sup>th</sup> position out of 175 countries on the issue of protecting investors. In 2009, another report of World Bank on Getting Finance in South Asia ranked Pakistan first in the region of corporate governance, efficiency and performance among five other South Asian states.

However, it also highlighted a number of areas which needed further concentration, including: greater transparency and disclosure, greater accountability, further disclosure to beneficial ownership, safeguards on stakeholders rights and further improvements to the responsibilities of the Board.<sup>29</sup>

World Bank released its first Overall Corporate Governance Index that was published in DAWN, Lahore on January 10, 2009. It ranked countries out of a maximum of 100. Germany scored 90.8% at the top. Selected ranking of some SAFA countries was as under:

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[nyO6oHBO3Az26fA&sig2=V9X11CLn2L-dSLPFmTir6A&bvm=bv.59568121,d.Yms](http://nyO6oHBO3Az26fA&sig2=V9X11CLn2L-dSLPFmTir6A&bvm=bv.59568121,d.Yms) > (last accessed:june 20,2013) (Hereinafter, Saeed, Corporate Governance).

<sup>29</sup> *Ibid.*

**Table 2.1: Corporate Governance Index**

<b>Sr:</b>	<b>Country</b>	<b>CGI(out of 100)</b>
1	Germany	90.8
2	United States	89.8
3	Singapore	80.9
4	Hong Kong	69.2
5	Malaysia	66.7
6	India	55.4
7	South Korea	55.4
8	Thailand	49.7
9	Philippines	48.9
10	Indonesia	44.7
11	Vietnam	38.1
12	China	35.3
13	Pakistan	34.3
14	Bangladesh	24.3

No doubt, World Bank's reports appreciated Pakistan in implementing good governance system in its corporate sector, catching international investors and casting away the weak areas of system.

## **2.7: The Codes of Corporate Governance:**

The very first effort for incorporating a code of corporate governance was done by SECP in 28th march 2002. It can be divided into three parts mainly: Management, Accounts/ financial set up and auditing mechanisms.

**Management:** Aspects covered in respect of board of directors include qualifications and eligibility to act as director, tenure, responsibilities, powers and functions of board directors, meeting of Board of Directors and key information.

**Accounts/financial set up:** An expanded version of directors' report to shareholders has been included. Frequency of financial report has been increased in terms of releasing quarterly report over and above the half yearly and annual report. Responsibility for release of financial report and corporate compliance has been identified. Disclosure of interest by a director holding corporate compliance has been identified through disclosure of interest by a director holding company's shares and has been made mandatory. The auditors of the company are forbidden to hold shares. Corporate ownership structure is required to be disclosed. Information relating to divestiture of shares by sponsors controlling interest is required to be revealed.

**Audit:** An Audit Committee must be constituted. Provisions governing frequency of meetings, attendance at meetings, term of reference (TOR), and reporting procedures have been laid down. Internal Audit has been made compulsory for every listed company. Head of Internal Audit should have an access to the chair of Audit Committee.

Internal Audit reports are required to be provided for the review of External Auditors. Internal Audit function can be outsourced. However, the person deputed on Internal Audit Functions must be on full time basis. Compliance with IFAC Guidelines on Code of Ethics as adopted by ICAP is a pre-requisite before appointment of external auditors. Auditors are forbidden to



provide services in addition to audit except in accordance with the regulations. Attending AGM by external auditor has been made compulsory.

In 2012, SECP revised the code and issued a new code with better provisions. The Code is a part of the listing regulations of the stock exchanges and is applicable to all entities listed on the exchanges. The listed entities include not only companies but also funds, such as "modarabas" and mutual funds. Furthermore, the requirements of the Code 2012 pertaining to the Board of Directors are also applicable to management companies of such funds, even if these companies are themselves not listed on the stock.

## 2.8: Comparison of the codes:

There is a comparative chart of salient features of major issues relating to Code of Corporate Governance as released in 2002 along with Code of Corporate Governance released in 2012.

**Table 2.2: Comparison of Code of Corporate Governance 2002 and 2012**

S #	Issue	Code 2002	Code 2012	Implication
1.	Independent Director	Encouraged a minimum of one independent director on the board of a listed company.	One independent director is <b>mandatory</b> while preference is for 1/3rd of the total members of the board to be independent directors.	<p>The <b>mandatory</b> requirement to have <b>at least one</b> independent director is introduced.</p> <p>Appointment of independent director at the time of next election of directors.</p> <p>Exception reporting in compliance statement for June 30, 2012 if there is no independent director.</p>

				Independent director who is not running day to day affairs of company has been given a lot of responsibilities e.g (Role of the Chairman of Audit Committee) therefore the code recommends Professional indemnity insurance for independent director.
2.	Criteria for assessment of independence	Criteria was provided	Criteria has been substantially expanded	<p>Definition has been provided (refer to clause i(b) of the Code. However, with all the excluded persons who cannot be the independent directors practically it would be very difficult to find an independent director.</p> <p>Example: As per law close relative of the promoter cannot be appointed as independent director which means that even if a promoter has not been involved in the company affairs for say last 20 years his close relative cannot be appointed as independent director.</p>
3.	Executive Directors	Number of Executive Directors not to be more than 75% of elected	Maximum number of Executive Directors cannot be more than	This requirement has been introduced to improve transparency in governance aspects

		directors including CEO.	1/3rd of elected directors including CEO.	of the company.  Those charged with governance have to fulfill this requirement by required time framework (at the time of next election of directors).
4.	Number of directorships	A director can be on the board of no more than 10 listed companies at any one time.	A director can be on the board of 7 listed companies at the most at any one time.	The change has been brought in order to bring new directors in the listed companies to enhance transparency and improve governance process.  The requirement is applicable by required timeframe (at the time of next election of directors).  Exception: However, the limit does not include directorship in listed subsidiaries of a listed holding company.
5.	Board evaluation	-	The Board has to put in place a mechanism for undertaking annual evaluation of the performance of the Board.	By April 2014 Board has to place an annual evaluation mechanism.  It is recommended that same may be put before shareholders in order to improve transparency and enhance shareholders confidence in the

				board.
6.	Office of Chairman and CEO	The Chairman of a listed company shall preferably be elected from amongst the non-executive directors of the listed company.	<p>The Chairman and CEO shall not be the same person, unless specifically provided in any other law.</p> <p>The Chairman shall be elected from amongst the non-executive directors of the listed company.</p>	<p>The requirement has to be implemented at the time of next election of directors.</p> <p>The requirement has been introduced to enhance transparency because the chairman, if selected from executive directors, may not have the interests of minority shareholders as his/her priority.</p>
7.	Training of the Board of Directors	Mandatory requirement for directors of listed companies to attain orientation courses.	It will be mandatory for directors of listed companies to attain certification under any director training program (DTP) offered by any institution (local or foreign), which meets the criteria specified by the SECP.	<p>Institutes other than Pakistan Institute of Corporate Governance meeting specified criteria of Corporate Governance can give DTP certification.</p> <p>Minimum one director to attain certification starting from June 30, 2012. All directors to be compliant by June 30, 2016.</p> <p>Exception: Individuals with a minimum of 14 years of education and 15 years of experience on the board of a listed company—local and/or</p>

				foreign—shall be exempted from the directors' training program
8.	Appointment and removal and qualification criteria for Chief Financial Officer (CFO) and Company Secretary (CS)	<p>Appointment, remuneration and terms and conditions of employment of CFO and CS determined by CEO and approved by Board.</p> <p>The same mechanism followed for removal.</p>	<p>The appointment, remuneration and terms and conditions of employment of the CFO, CS and the Head of Internal Audit (IA) of listed companies shall be determined by the Board.</p> <p>The removal will also be by the Board for CS and CFO.</p> <p>Head of IA shall be removed on recommendation by chairman Audit Committee.</p>	<p>The CEO's involvement for these key positions has been limited just to suggestions.</p> <p>Head of internal audit cannot be removed unless recommended by chairman of Audit Committee who is necessarily not involved in his appointment.</p> <p>Requirement is applicable with immediate effect.</p>
9.	The Head of Internal Audit (IA)	None	<p>Qualification and experience criteria introduced for Head of IA.</p> <p>Experience: 5 years (relevant i.e. audit only)</p> <p>Qualifications:</p> <p>(a) a member of a recognized body of professional accountants; or</p> <p>(b) a Certified</p>	<p>Persons not fulfilling both the criteria i.e. experience and qualification stand removed immediately.</p> <p>Company has to report compliance in report for period ending on or after June 30, 2012.</p> <p>Exception to rule:</p>

			Internal Auditor; or (c) a Certified Fraud Examiner; or (d) a Certified Internal Control Auditor	Provided that individuals serving as Head of Internal Audit of a listed company for the last five years at the time of coming into effect of this Code shall be exempted from the above.
10	CFO	No person shall be appointed as the CFO of a listed company unless:  (a) he is a member of a recognized body of  professional accountants; or  (b) he is a graduate from a recognized university or equivalent, having at least five years experience in handling financial or corporate affairs	No person shall be appointed as the CFO of a listed company unless he/she has at least five years of experience of handling financial or corporate affairs of a listed company or a bank or a financial institution and is:  (a) a member of a recognized body of professional accountants; or  (b) has a postgraduate degree in finance from a recognized university or equivalent.	Experience:  5 years of corporate or financial affairs experience in listed company is compulsory.  Persons not having this experience shall remain disqualified immediately.  Persons working in non listed companies even multinationals and also partners of the firms cannot be CFO of listed company.  Company has to report compliance in report for period ending on or after June 30, 2012.  Qualification:  Graduate degree has been replaced with Postgraduate degree (masters) or equivalent.



		of a listed public company or a bank/financial institution.		<p>The Guidelines which defines a professional body (Criteria/Guidelines for recognition of bodies of professional accountants and corporate/chartered secretaries for the purpose of prescribed qualification of CFO and Company Secretary Dated 29<sup>th</sup> April 2004) should be read in conjunction with this requirement of the Code.</p> <p>Exception to qualification criteria:</p> <p>Individuals serving as CFO of a listed company for the last five years at the time of coming into effect of this Code shall be exempted from the above qualification.</p>
11	Company secretary	<p>No person shall be appointed as the Company Secretary of a listed company unless he is:</p> <p>(a) a member of a</p>	No qualification criteria in CCG.	<p>The same criteria which had been mentioned in Code of Corporate Governance, 2002 is now included in company rules 1985.</p> <p>Exception to qualification:</p>

		<p>recognized body of professional accountants; or (b) a member of a recognized body of corporate/ chartered secretaries; or</p> <p>(c) a person holding masters degree in Business Administration or Commerce or being a Law Graduate from a University recognized by Higher Education Commission and having at least five years relevant experience.</p>		<p>A person already engaged by a company as Secretary before the 26<sup>th</sup> October, 2002 may continue in that capacity if he has an experience of not less than five years in that position.</p>
12	Remuneration of Directors	-	A formal and transparent procedure to be	The procedure followed for this may be notified to the

			followed and disclosure of aggregate remuneration in the annual report.	shareholders to enhance their confidence in BOD.  Requirement is applicable with immediate effect.
13.	Board Committees	Audit Committee: The Chairman of the audit committee shall preferably be a non-executive director. Reporting Procedure: The Audit Committee of a listed company shall appoint a secretary of the Committee.	Audit Committee: The Chairman of the audit committee shall be an independent director, who shall not be the chairman of the board. Audit Committee shall comprise of non-executive directors. The secretary of Audit Committee shall either be the Company Secretary or Head of Internal Audit. However, the CFO shall not be appointed as the secretary to the Audit Committee. Human Resources and Remuneration Committee introduced.	Only independent director who fulfills requirements of independence as mentioned in the Code can be Chairman of audit committee.  Non executive director and executive director cannot chair audit committee.  Independent director is not involved in day to day operations therefore it would extremely difficult for him to take such role (discussion of external auditors ML, Financial Statements etc).
14.	Internal Audit	There shall be an internal audit function in every listed company. The head of internal audit shall have access to the chair of the Audit Committee.	The internal audit function may be outsourced by a listed company to a professional services firm or be performed by the internal audit staff of the holding company.	It has been specifically allowed to outsource internal audit function.  Code of ethics requirements for outsourcing internal audit activity should be applied.

				<p>In the event of outsourcing the internal audit function, Company shall appoint or designate a full-time employee other than the CFO, as Head of Internal Audit, to act as coordinator between the firm providing internal audit services and the board.</p>
15	Directors report	Important provisions were available.	A few changes have been incorporated.	<p>A few minor changes have been brought into the report. Following is the most important additional requirement introduced:</p> <p>The directors' report shall cover loans, TFCs, "sukuks" or any other debt instruments in which the company is in default or likely to default. There shall be a clear presentation with details as to the aggregate amount of the debt overdue or likely to become overdue and the reasons for the default/emerging default situation and the measures taken by the company to address and settle such default situation.</p>

				Requirement is applicable with immediate effect.
16	Pattern of shareholding	Disclosure requirement were available	Few minor changes have been incorporated.	<p>Professionals must see the revised Code (2012) to understand how to disclose pattern of shareholding as per its requirement.</p> <p>The most important requirement is that the names of shareholders having more than 5% holding now need to be disclosed. Previously the disclosure requirement was for shareholders with more than 10% shareholding.</p>
17	Management letter by external auditors			Time frame has been changed from 30 to 45 days seeing the practical difficulties for external auditors.
18	CCG compliance statement.	Required	Required and specific format is now given in Appendix B of CCG 2012.	Statement available in Appendix B now forms a part of annual report.

Source: Noman Hameed and Nida Naeem, Implications of the Revised Code of C.G.<sup>30</sup>

Currently the following documents are enclosed with the Annual Audited Financial Statements in Pakistan relating to listed companies on Stock Exchanges:

1. Statement of Compliance duly signed by the President / Chief Executive Officer.

<sup>30</sup> Hameed and Naeem, *Code of Corporate Governance*.

2. Statement of Internal Control duly signed by Chief Compliance Officer, Chief Financial Officer and Chief Internal Auditor.
3. Review Report addressed to the Members, Statement of Compliance with the best practices of Code of Corporate Governance duly signed by External Auditors.

The key changes to the Code, 2012 are focused to the areas of constitution of the board of directors, separation of the office of the CEO and Chairman, board committees, removal and qualification criteria for Chief Financial Officer, Company Secretary and Head of Internal Audit, board's evaluation and training of directors.

The board of directors in a company has the overall responsibility for management and direction of its affairs while ensuring the integrity of accounting and financial reporting systems and overseeing the process of disclosure and communications. The relatively large number of listed closely held companies in Pakistan and other emerging markets makes the transition to internationalized behavioural norms particularly important and challenging.

Contrary to the 2002 Code, the 2012 Code makes the representation of at least one independent director mandatory while preferring one third of the board to comprise of directors independent of majority shareholders. It prescribed more broad criteria for assessment of independent directors along with explained transparent procedure for remuneration of directors with appropriate disclosure in the annual report.

The number of executive directors which was restricted to not more than 75% of elected directors including CEO has now been fixed at maximum of one-third of the elected directors. To ensure quality participation and commitment multiple directorships have been limited to a

maximum of seven at any one time. However, this limit excludes directorship in listed subsidiaries of a listed holding company.<sup>31</sup>

Under the new Code, the roles of the Chairman and CEO have been segregated which was not a mandatory provision earlier. Most commonly it is argued that the separation of the Chairman and CEO roles increases the board's independence from management and therefore leads to better monitoring and oversight.

Directors should possess a good understanding of the company's operations as well have sufficient knowledge of areas such as finance, law, and risk management that will allow them to form a broad strategic perspective. In particular, directors must understand their legal and fiduciary responsibilities before they seek to discharge these responsibilities effectively. Directors' training has therefore become essential. The Code 2012, compared to the 2002 Code allows more flexibility and diversity of choice with respect to attaining training from a institution local or foreign that meets a set criteria approved by the SECP. Earlier such directors' training was mandatorily to be acquired only from the PICG which limited the choice and outreach.<sup>32</sup>

Globally, effective boards have board committees on specific areas; this approach allows the boards to concentrate on broader and strategic issues and strengthens the board's governance role. Mainly these committees include Audit Committee, Nomination Committee or Human Resources and Remuneration Committee. The Code, 2012 requires the board of directors of every listed company to establish an Audit Committee and Human Resource and Remuneration Committee. The Audit Committee shall comprise of at least three members comprising of non-

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<sup>31</sup> Musarat Jabeen, "Code of Corporate Governance, 2012—The SECP Initiative," Blue Chip, The Business People's Magazine, May 9, 2013. Available at < <http://bluechipmag.com/code-of-corporate-governance-2012-the-secp-initiative> > (last accessed: September 20, 2013) (Hereinafter, Jabeen, Code of Corporate Governance).

<sup>32</sup> *Ibid.*



executive directors with the Chairman being an independent director. The Human Resource and Remuneration Committee must comprise of a majority of non-executive directors, including preferably an independent director. The CEO may be included as a member of the committee but not as the chairman and also shall not participate in the proceedings on matters directly related to his performance and compensation. Further, considering the critical role of the head of internal audit in ensuring effective internal control arrangements and promoting good corporate governance, detailed qualifications in terms of education and experience have been stipulated. Also, such criteria for the company secretary and chief financial officer have also been laid down.<sup>33</sup>

## **2.9: Contemporary Issues in Corporate Governance in Pakistan:**

Corporate governance has become a topic of a worldwide political debate because of its apparent importance for the economic health of companies and society in general. The system of corporate governance has been built gradually through centuries in developed economies and now it can be identified as a complex web consisting of laws, regulations, politics, public institutions, professional associations and code of ethics. As concern to developing economies, corporate governance is an import, and many developing countries are now in the process of developing the most basic market institutions.<sup>34</sup> They are trying to develop a system of good corporate governance but are made difficult by issues such as weak legal and judicial systems, complex corporate ownership structure, confused relationships between the state and financial sector, absent or under developed institutions and insufficient human resource capabilities. The need for corporate governance in under developed economies extends far beyond resolving the

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<sup>33</sup> *Ibid.*

<sup>34</sup> Julian Roche, *Corporate Governance in Asia*, (UK: Routledge, 2005), 36.

problems stemming from the separation of ownership and control which is the main substance behind the idea of corporate governance.<sup>35</sup>

Pakistan, being a developing economy, is also facing major obstacles in the way of effective implementation of the Code of Corporate Governance. Overall management structure is not conducive to establishing the norms of good governance. Many companies in listed Stock Exchange are not fully practicing the code of good governance.<sup>36</sup> Some of these are complex ownership structure, equity culture, inadequate remuneration of directors, the role of non executive independent director, weak external discipline in the corporate sector, weak legal systems and regulatory framework, lack of quality information, lack of investors' protection, the role of financial press, overburdened court system, fragmented corporate governance law, greater government influence and less autonomy to companies, non uniform guidelines and lack of developed capital market that undermine the effectiveness of corporate governance mechanism employed in Pakistan. The issues related to governance are roadblocks in the development of the market with greater participation of companies and investors.<sup>37</sup> Here is detail of some issues:

### **2.9.1: Imported Corporate Governance Model in Pakistan:**

The present corporate governance modeled on the western Anglo-Saxon model which does not address many of the current crises faced by Pakistan. Mahwesh Mumtaz has tried to see the application possibilities of Anglo-Saxon model of corporate governance in Pakistan and risen the fundamental question whether a Corporate Governance model that works for the US and the UK, also work for a country like Pakistan? she raised the points of differences like prevailing

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<sup>35</sup> Ibrahim, Corporate Governance in Pakistan, 32

<sup>36</sup> M. Mahmood Shah Khan and Nandita Sethi, "Management Education & Corporate Governance: A Case of India and Pakistan," *Research Journal of International Studies*, issue no.12(October, 2009):32, Available at <<http://www.imsiences.net/wp-content/uploads/2012/02/6-Management-Education-Corporate-Governance-A-Case-of-India-and-Pakistan.pdf>> (last accessed: July 20, 2013).

<sup>37</sup> Tahir, Two- Tier Corporate Governance, 39.

ownership structures, state of economic development, governing principles of capital market and cultural issues of both regions developing and developed countries . She explained that prevailing governance issues in our country are more than typical conflict of interest between owners and managers. We are in dire need of implementing such golden principles that facilitate the regulatory institution in disciplining the dominant share holder and protecting the minority shareholder.<sup>38</sup> The very concept of corporate governance modeled on the western system is unworkable here. These efforts are akin to taking a hair of an elephant, transplanting it on the head of a bald man and making him look like a bear.

**(a) Ownership Structure, Common Law, and Civil Law:**

Pakistan's leading corporate ownership structure looks like a concentrated family ownership structure which is different to the Berle & Means model of separation of ownership and control. Management and control of company is kept by majority shareholders. Pakistan has a common law background and its legal structure resembles to Anglo-American model but the ownership structure of country is totally contrary to dispersed ownership structure (Anglo-American model). The regulator paid no heed to this dissimilarity in issuing of the code. Governance systems that created for dispersed ownership cannot work in concentrated ownership structure even it may be failed in suggesting right treatment for the governance issues prevailing in structure.<sup>39</sup>

**(b) Corporate Culture:**

Pakistan's corporate culture is different from the developed countries and the process of change is also very slow due to lack of foreign investment. Adopted policies only work when it

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<sup>38</sup> Mumtaz, corporate governance in Pakistan, 27.

<sup>39</sup> Ibrahim, Corporate Governance in Pakistan, 328.

will match the culture of the country. If regulator only desires a change in culture then it cannot occur. The Code cannot achieve its best result without the help of complementary institutions.<sup>40</sup>

**(c) Empirical Evidence:**

To observe this issue there is a comparison of different model of corporate governance working in corporate world with their merits and demerits.

**Table: 2.3 Comparison of the competing corporate governance models**

S.No	Critical Issue	Current situation in Pakistan	Anglo us Model	Japanese Model	German Model
1	Investors protections	Well defined, yet not very effective	stringent	More stringent	More stringent
2	Participation of shareholders in AGM	Discouraging, unmanageable and cumbersome	low	high	high
3	Ownership concentration and control	High. Majority often controlled by families/managers	discouraging	encouraging	encouraging
4	Disclosure requirements	strict	Most strict	strict	strict
5	Related party transaction	Explicit guidelines	Most strict	strict	strict
6	Check and balance on Audit profession	No real system exists. (ineffective)	The system exists but is outside the content of corporate law	The system exists but is outside the content of corporate law	The system exists but is outside the content of corporate law
7	Duties of care and loyalty:	Insufficient guidance	comprehensive	Less comprehensive	Less comprehensive
8	Independent director	Non existing in real sense	Less non executives	More non executives	More non executives
9	Remuneration of non executive directors	Very low	low	high	high
10	Enforcement by authority	Strongly needed	Self regulatory, no need to be regulated by Authority	Comprehensive role regulatory authority	Comprehensive role regulatory authority

Source: Safdar Hussain et al., Two-Tier Corporate Governance Model for Pakistan.<sup>41</sup>

<sup>40</sup> Mumtaz, Corporate Governance in Pakistan, 26.

We can draw an image in our mind that the outsider system and insider system of corporate governance have their own flaws. No individual model/system of corporate governance is suitable to be adopted for the Pakistan. Regulatory functionaries should introduce a best model for Pakistan that must be according to its ownership culture and law background.

### **2.9.2: The Role of Media:**

A free, independent, and pluralistic media environment that offers the means and incentives for the widest participation can have a deep influence on people's opportunities to access information and services. It helps them to participate in decisions that affect their lives and to hold to account those in positions of power and responsibility. The Pakistani financial press does not provide active deterrence, and as such fails to provide the additional level of enforcement necessary for good corporate governance.<sup>42</sup> There are many hurdles in efficiency of press such as unawareness of the concept of corporate governance, lack of willingness of a corporate firm to share information such as market share, sales volumes, and detailed information regarding financial statements that are the biggest obstacle to corporate reporting.<sup>43</sup>

### **2.9.3: Lack of Speedy Justice:**

The formal codes and structures of governance in country are highly reflective of the U.S. and U.K. systems they have been modelled after, the actual operations of those institutions and of the judiciary in particular, reflect distinctly local forces. As discussed above, the judicial

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<sup>41</sup>Tahir, Two—Tier Corporate Governance, 44.

<sup>42</sup>Haroon .H. H. HAMID& valeria kozich, "Corporate governance in an emerging market: a perspective on Pakistan," *Journal of legal technology risk management* 1, no.1( Fall 2006):28, Available at <[http://www.researchgate.net/publication/228299675\\_Corporate\\_Governance\\_in\\_an\\_Emerging\\_Market\\_A\\_Perspective\\_on\\_Pakistan](http://www.researchgate.net/publication/228299675_Corporate_Governance_in_an_Emerging_Market_A_Perspective_on_Pakistan)>(last accessed: july 24,2013)(Hereinafter, Hamid and Kozich, C.G. in an Emerging Market).

<sup>43</sup>frayal najeeb,"IfC discusses challenges media faces in reporting on corporate governance," *The News*, March 22,2012, Business section, Available at <<http://www.thenews.com.pk/Todays-News-3-98852-IFC-discusses-challenges-media-faces-in-reporting-on-corporate-governance>> (last accessed: July 27,2013).

system of Pakistan is characterized by staggering delays in adjudication. A key factor of particular relevance and which can hinder commercial activity and investment, relates to the lack of speedy justice and conflict resolution.<sup>44</sup> The average time for disposal of a civil suit in a typical High Court, can be several years, which can increase further because of appeals to the Supreme Court. This makes many investors, whether foreign or local, wary of entering into business transactions, as they are unable to rely on the judicial system to provide them with expeditious relief in case of any mishap, even in good economic times. Even where they are reasonably confident about the economic return on their investment, they must factor in the likelihood of breaches of contracts, frauds, negligence etc. of the parties they deal with and the lack of any timely legal protection against the same. The structural inability of the judicial system to provide justice without interminable delays causes investors to enter into commercial transactions solely on the basis of personal trust and relationships.<sup>45</sup>

However, reforms have been introduced to ameliorate the extreme backlog of corporate law cases and to improve ability of the court system to handle such matters. All local and foreign investors with a threshold capital investment can bring their claims directly to the high court's , the court of original jurisdiction, without going through the lengthy process of bringing their claim before the lower courts and then waiting for it to reach the high courts. This largely lethargic system does not present a positive outlook to investors.<sup>46</sup>

#### **2.9.4: Pakistan's Equity Culture:**

Equity culture of Pakistan is not much developed. The KSE (Karachi stock exchange) is the largest of three equity markets in Pakistan and an important emerging market of the region

<sup>44</sup>Legal and Regulatory Framework, Available at <<http://www.pc.gov.pk/mtdf/35-Legal%20Regulatory%20Framework/35-Legal%20Regulatory%20Framework.pdf>> (last accessed: July 28, 2013).

<sup>45</sup> Ibid.

<sup>46</sup> Hasan, Rule of Law, 9.



among the developing countries. It is high risk high return markets where investors seek high risk premium. However, equity financing is still not a priority due to lack of competition in different industries.<sup>47</sup> Majority of companies in our country do not actively trade in stock exchanges just because they have alternative modes of raising capitals. Family controlled companies are often satisfied with their position in market and prefer not to risk weakening family control by selling shares to minority investors. The ownership structure of companies enables them to tap internal sources of financing or financial credit rather than raising capital at stock exchanges. In Pakistan, it is a healthy trend to do business with friend and family that promotes inter corporate financing. Due to little motivation for companies to raise capital from capital markets, there is danger of companies wanting to de-list if they perceive complying with the code as too expensive.<sup>48</sup>

#### **2.9.5: Fragmented Corporate Governance Laws:**

Certain corporate governance provision remains only in the ordinance even after the promulgation of the both codes. Directly, minority shareholders' protection is dealt by the ordinance like winding up by the court in the case of mismanagement or oppression to minority shareholders. Consequently, many companies resisted the code because there are already several laws in effect pertaining to corporate governance. Often these laws are more stringent than the code.<sup>49</sup>

In an increasingly globalised world economy where competition is intense, the adoption of good corporate governance standards can make a real difference to how Pakistani companies are viewed both domestically and within the international community. The introduction of the

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<sup>47</sup> World Bank, Corporate Governance Country Assessment Pakistan, Report ,2005, Available at <[http://www.worldbank.org/ifa/rosc\\_cg\\_pak.pdf](http://www.worldbank.org/ifa/rosc_cg_pak.pdf)> (last accessed: July 27, 2013).

<sup>48</sup> *Ibid.*

<sup>49</sup> Hamid and Kozich, C.G. in an Emerging Market,29.



Code, 2012 marks an important milestone in the development of corporate governance in Pakistan. The Code was met with criticism from corporations and commentators. Corporations believed that complying with the Code's provisions would be very expensive. They also argued that there were numerous practical difficulties in implementing and enforcing the Code. Indeed, one of the legitimate problems pointed out by corporations was the lack of relevant expertise in Pakistan to enforce the Code's provisions. In addition, some commentators believed that the Code was defective, outdated, and had no utility to stakeholders. However, despite these criticisms, the Code in many ways has been ground-breaking, ushering in a new era of corporate governance in Pakistan. The Code is continually developing and evolving through the interpretation of its provisions by the courts and the substantial revisions made to the Code itself by the SECP. Pakistan's courts, for the most part, have not significantly criticized the Code's provisions in the last years. However, the courts have shown an unprecedented concern for the welfare of minority shareholders and have been willing to annul the decisions of majority shareholders in certain cases. In addition, the SECP appears to be substantially revising the Code to facilitate and complement the process of implementing capital market reforms to attract even more foreign investors. To stay abreast of constantly changing circumstances, the SECP would need to closely follow developments in the corporate governance world, identifying trends and put in place standards that conform to international and national acclaimed principles.

## **CHAPTER THREE: EFFECTIVENESS OF INDEPENDENT DIRECTORS IN PAKISTAN'S CORPORATE GOVERNANCE:**

### **3.1: Introduction:**

The Law recognizes a company, as a “legal person” which in its own rights, is capable of owning property, making contracts, conducting litigations and also responsible for doing wrongs. A company cannot pick up a telephone, or post a letter or type an email, even though company law theory treats companies as having sufficient legal personality to create contracts, to own property and so forth. In general terms, the most important human beings in the conduct of the activities of a company are its directors and their board which is headed by a Chief Executive. The company is always to be run in the interest of the stakeholders. It is the responsibility of the board to ensure that the interest of the stakeholders of the company is not vitiated in any way.

The interest of the stakeholders can only be upheld if the integrity and the independence of the board are safeguarded. It is for this reason that the concept of Independent Directors was introduced. Non Executive Independent Directors (hereinafter referred to as ID's) are a vital pillar of sound corporate governance. All those who advocate the need for good corporate governance practices have time and again pressed upon the importance of Independent Directors. The concept of Independent Directors, as we know today, has developed through a process of evolution and is in fact evolving till date. The concept of Independent Directors that began as a good corporate governance practice has now become a corporate legal mandate.

In this chapter I analyse the various developments in law that have led to the concretization of the concept of independent directors with special focus on the laws in Pakistan and the origin and development of the institution of Independent Directors in the Global Scenario and describes how the concept of Independent Directors got introduced and formalized in Pakistan. The law on Independent Directors as it stands today in Pakistan by analyzing the provisions of Companies Ordinance 1984 read along with code of corporate governance 2002 and revised code of 2012 with regard to Independent Directors. Issues, facing by the regulators and promoters while implementing and complying these provisions. And also examine the key functions of the overall board, company's management and others that they are necessary to understand the concern and concept of independent directors.

### **3.2: Company's Management Structure:**

According to the laid down policy, the shareholders elect their representative for the management of company matters. The board of directors is the top administrative body of the corporation and is constituted by the elected representatives.<sup>1</sup> These officers are appointed on the basis of requirements by the Companies Ordinance, 1984 (hereinafter referred to as "the Ordinance"). One director and a company secretary is the demand of the ordinance for single member company, and for private company it requires two directors, for an unlisted public company the requirement is of three directors and for a public listed company seven directors and company secretary respectively.<sup>2</sup> The company should be headed by an efficient board, responsible for the success of the company collectively on the basic principal of company

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<sup>1</sup> A.C. Farnando, *Business Ethics and Corporate Governance: An Indian Perspective*, 1<sup>st</sup> edition, (India: Dorling Kindersley, 2006), 349.

<sup>2</sup> Safdar A. Butt, *Corporate governance: An Introductory Text for Pakistan*, 1<sup>st</sup> edition, (Islamabad: Capital Academic Publishers, 2010), 87. (Hereinafter, Butt, Corporate Governance).

headship. The supporting principles provide for the role of board in the entrepreneurial leadership of the company, strategic aims setting, guarantee apt monetary and human resources are in place and review performance management.<sup>3</sup> The setting down of policies, procedures and programs is taken to be the responsibility of the board, but they may not be able to secure their implementation under the guidance and supervision, or may fail to communicate about their decision to the rest of the staff. Thus to accomplish this task an executive committee is appointed which consists of one or more all time directors along with other top officials, called chief executives and managing directors depending upon the company discretion to name them. The chief executives serve as a link between the operating organizations and the board of directors. Their main work is the interpretation of the policy decisions for benefits of those responsible for the implementation and day to day business problems accruing in the way of operations, also put the important problems before the board concerning the execution of assigned work to them and deal with them intelligently on the issues hindering in policy implementation.<sup>4</sup>

Therefore shareholders, as owners delegate a greater part of their authority to the board passing substantial part of power to CEOs, further delegating their powers to departmental heads and operation in charges. In Pakistan and most of the world this pattern is followed by the majority of companies. Thus the control of management is in the hands of shareholders, the board of directors and in some cases to the chief executives to whom some powers have been handed over by the board.<sup>5</sup>

<sup>3</sup> Nicholas Bourne, *Bourne on company law*, 5th edition, (USA.: Routledge, 2011), 348.

<sup>4</sup> Cynthia M. Krus, *Corporate Secretary's Answer Book*, 4<sup>th</sup> edition, (USA: Aspen Publishers, 2009), 14, Available at <<http://books.google.com.pk/books?id=KQUKFmw0BkAC&pg=SA10-PA12&dq=executive+committee+of+companies&hl=en&sa=X&ei=K2TgUvHIN4nxhQeTu4C4DQ&ved=0CDgQ6AEwAg#v=onepage&q=executive%20committee%20of%20companies&f=false>> (last accessed: June 20, 2103).

<sup>5</sup> Fernando, *Corporate governance*, 189.

### 3.3: Who is a Director?

Lord Cranworth L.C. describes “The directors are a body to who has delegated the duty if managing the general affairs of the company.” A corporate body can only act by agents and it is, of course, the duty of those agents to act best to promote the interests of the corporation whose affairs they are conducting.<sup>6</sup> It is stated in section 2(13) of the ordinance that “a director includes any person occupying the position of director by whatever name called”.<sup>7</sup>

The ‘director’ in general sense is, someone administering, controlling or directing about something, one who supervises, controls or manages, principally as a member of a commercial company, to whom shareholders of a company elect, to direct company’s policies and appointed or elected according to law. To determine whether a person is a director or not, the nature of its duties and office is a significant factor. He is a director if someone is performing the legal functions of a director, the designation or the name by which he is called is not an important matter of concern.

Thus the functions defining the director are control over direction, conduct, management or supervision of the company affairs, and a person with whose directions, instructions the board of directors of a company is used to act is believed to be a director.

This definition however demonstrates to be comprehensive but to some extent have ambiguity and vagueness in it. Some authorities critically recognized on the subject: it is doubtful whether there are any instances in corporate history where any person in a company who is not called a director is deemed or reckoned as such by virtue of his functional responsibility. Section 2(6) of the ordinance stated that directors are collectively referred to as

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<sup>6</sup> *Ibid.*

<sup>7</sup> Section 2(13) of The Companies ordinance 1984.

“board of directors” or simply the “board”.<sup>8</sup> It is the responsibility of the shareholders to elect the right persons as directors. Accordingly the board of directors can be as good as the comprising members are. And similarly the quality of board decisions depends on the abilities and persistence of individual directors.<sup>9</sup> Thus shareholders should be accustomed themselves with right virtues or abilities that are needed in persons running the board of directors.

In Pakistan most of listed companies are family owned or closed groups. These insider shareholders choose those persons as directors who are fit in very well more with their personal requirements not the requirements of the company. This is a gloomy trend because they are supposed to act for the benefits of whole company rather than any stakeholders or shareholders or any particular group. When the major shareholders appoint the ‘yes men’ on the board they simply restrict themselves benefiting from the wisdom of more experienced and better fitting directors.<sup>10</sup>

### **3.4: Classification of Directors:**

Following terms are used for directors in relation to a company.

#### **3.4.1: Executive Directors:**

Executive Directors are employees, holding full time office in the company e.g. finance director, marketing director, operation director etc. simultaneously serve as executive members of the company management. They also get formal salary and fringe benefits from company as employees. There may also be non executive directors in the company who have nothing to do with company management, may only attend committee meetings of the board of directors as a

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<sup>8</sup> Section 2(6) of The Companies ordinance 1984.

<sup>9</sup> Butt, *Corporate governance*, 87.

<sup>10</sup> *Ibid.*

member and get an attendance fee only. They provide guidance and advice to the board and exercise supervision on the executive directors.<sup>11</sup>

#### **3.4.2: Representative and Independent Director:**

Representative Directors are the representatives of particular stakeholders and try to protect the interest of the person they representing. In Pakistan the popular form of directors is representative, and they continue to guard stake holder's interest. Creditors are also allowed to nominate directors on the board. On the other hand independent directors are those members of the board likely to look after the whole company's interest. The current law authorized election of directors through shareholders, naturally even the independent director are elected by shareholders, they are supposed to act in overall interest of company, once elected as a director.<sup>12</sup>

#### **3.4.3: Independent Non Executive Director:**

These directors include both non executive as well as independent directors. They are neither representative of any particular stakeholders nor do they form any part of company's management. Their distinctive trait is that they are not either employees or executive of the company.<sup>13</sup>

#### **3.4.4: Shadow Director:**

These are so called supposed directors, not appointed to the Board, but the board acts on their directions. They are responsible as a Director of the company till they give advice in their

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<sup>11</sup>David Lozell Marten and David M. Martin, *The Company Director's Desktop Guide*, 3rd edition, (London: Thorogood Publishing, 2006), 33.

<sup>12</sup>Butt, *Corporate Governance*, 87.

<sup>13</sup> *Ibid.*



professional capacity. Therefore such a 'shadow' Director may be treated as 'default officer' under the Ordinance.<sup>14</sup>

#### 3.4.5: De-facto Director:

These are the persons are not appointed as a Directors, but acts as a Director and is held out by the company is considered as a *de facto* Director. A *de facto* director unlike a 'shadow' Director is seen by the outside world as acting and claim to act as a company Director. Thus a *de facto* Director is accountable as a Director under the Ordinance.<sup>15</sup>

#### 3.4.6: Alternate Directors:

Alternate directors are those directors who are appointed to act as Alternate Directors for the 'Original Director' in his absence from the country for whatever reason for a minimum period of three months in board meetings holding time. The alternate director will hold the office till the original directors back to hold his office. The automatic re-appointment of retiring applies only to original directors according to the provisions of the ordinance. The alternate directors enjoy the same rights, privileges including the right to vote at the board meetings in place of original directors.<sup>16</sup>

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<sup>14</sup> Len Sealy and Sarah Worthington, *Cases and Materials in Company Law*, 8<sup>th</sup> edition, (United States: Oxford University Press, 200), 359, Available at <http://books.google.com.pk/books?id=VK3J1xpWAxQC&pg=PA359&dq=shadow++Directors&hl=en&sa=X&ei=MnLgUqLyGsOg0wXM24GAAQ&ved=0CCgQ6AEwAA#v=onepage&q=shadow%20%20Directors&f=false> (last accessed: July 10, 2013).

<sup>15</sup> David Kershaw, *Company Law in Context: Text and Materials*, 2<sup>nd</sup> edition, ( U.K.: Oxford University Press, 2012), 320, Available at <http://books.google.com.pk/books?id=RX2cAQAAQBAJ&pg=PA320&dq=defacto+director&hl=en&sa=X&ei=f4PgUp21COS00wXt9IGODQ&ved=0CDAQ6AEwAQ#v=onepage&q=defacto%20director&f=false> (last accessed: July 10, 2013).

<sup>16</sup> Lucy Jones, *Introduction to Business Law*, (USA: Oxford University Press, 2011), 550, Available at <http://books.google.com.pk/books?id=Df0e0Bd05dcC&pg=PA550&dq=Alternate+Directors:&hl=en&sa=X&ei=S e3iUuDpGM7J0AWu7YGGDA&ved=0CEUQ6AEwBTgK#v=onepage&q=Alternate%20Directors%3A&f=false> (last accessed: July 10, 2013).

### 3.5: Appointment of Directors:

The method of appointing the set of directors by their names is usually prescribed in the Articles of the Association of a company, even if the directors are not named in the Articles, they should be determined in writing by name and number by memorandum of the subscriber of the association or by their majority. The subscribers become directors of the company if the above mentioned method is not followed in their appointment, and they shall hold office until the directors are appointed duly in first general meeting. The appointment and reappointment of directors is governed by a company in general meeting through certain provisions in the ordinance.<sup>17</sup>

### 3.6: Legal Position of a Director:

The accurate legal position of the company director is complicated to define. The ordinance also lack in defining their position. At various times they have been explained by judges as managing partners, agents and trustees. Bowen describes it “Directors are described sometimes as agents, trustees at some places and managing directors at some other times”. Each of aforementioned term is not used as complete description of their responsibilities and powers, but is used indicating useful point of view from which they may for the moment and considered for particular purpose.<sup>18</sup>

The company can act only through directors who become their agents in the company transactions made with others. The company being artificial person cannot act in its own

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<sup>17</sup> Geoffery Gibson, *Law for Directors*, (Sydney, The Federation Press), 18, Available at <http://books.google.com.pk/books?id=S3TR02ndkgAC&pg=PA18&dq=appointment+of+a+director&hl=en&sa=X&ei=OljgUoCEO4mN0AXf74HICA&ved=0CDUQ6AEwAQ#v=onepage&q=appointment%20of%20a%20director&f=false> (last accessed: January 3, 2014).

<sup>18</sup> Heta Chouhan, *Legal Position of Directors*, 2, Available at <http://www.scribd.com/doc/53359573/Legal-Position-of-Directors> (last accessed: August 21, 2013).

personal capacity. Thus directors hold a legal position as agents and trustees, likewise directors are company's trustees and agents in money and property matters.<sup>19</sup> This has become a well established fact as a result of numerous court decisions that directors are not agents alone but trustees at the same time. The Karachi High Court in a case title Muhammad Bakhsh & Sons Limited Versus Azhar Wali Muhammad elaborated the relationship between director and company held that director was always to act in good faith towards company. Directors could be treated as trustees of money which came into their hands and on proof of misapplication or misuse thereof, would be held liable to make good that money.<sup>20</sup>

It is decided in other case that the directors of company are trustees for the company and their powers of applying funds of the company and for misuse of powers, they could be rendered liable as trustee and on their death the cause of action survives against their legal representatives.<sup>21</sup> Independent directors on the basis of their specialized skills and professional expertise in specific fields are invited to sit on the board, and represent the interest of investing public and take care of their interest. Independent directors accept a sense of responsibility towards creditors and shareholders. The responsibility stands with the board and the company, as a result of the actions of company officers.<sup>22</sup>

### **3.7: Corporate Governance and Board of Directors:**

The role and activity of the corporate boards is being redefined and witnessed by many forces in the 21<sup>st</sup> century. These changes are mainly affected by the international financial investors, media focus and corporate governance initiatives. This is evident from the series of

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<sup>19</sup> Ellis Ferran, *Company law and corporate finance*, (U.K.: Oxford University Press, 1999), 123.

<sup>20</sup> Muhammad Bakhsh & Sons Limited versus Azhar Wali Muhammad. 1986 MLD 1870.

<sup>21</sup> Ramaswamy Iyer Versus Brameya & Co.1996

<sup>22</sup> William Houston and Nigel Lewis, *The Independent Director: Hand book and Guide to Corporate Governance*, (Oxford: Butterworth- Heinemann, 1992), 6.

corporate devastation occurred in America and other parts of the world, that the board of directors are increasingly being recognized as significant success factor for the corporations, be they large or small, public or private. The value of any is derived by the quality of directors, their competence, commitment, willingness and ability to consider high level of responsibility to the company and its shareholders as a member of board.<sup>23</sup> It is also evident that good governance cannot be ensured by a system with laws of the state governing and with a checklist. The need of the competitive world is a strategic board with broad responsibilities of governing rather than one that acts in response to the CEOs demand.

The long term sustainability of companies and the existence of corporate depend upon winning the confidence of shareholders through exposure and transparency in operations and accountability for their actions to them. This is achieved through voluntarily actions on the part of board of directors and by regulatory frame work such as stock exchanges, securities and exchange and other regulatory bodies. These principles are regarded as principles of corporate governance.<sup>24</sup>

### 3.8: Composition and structure of the Board:

The basis of the composition and structure of the Board is provided in all Corporate Governance regulations. This is the most important execution of any board. This is the means of power distribution to achieve the objectivity in decision making of the Board to protect it from the approach of any single party to dominate the decision making in the company. The

<sup>23</sup> Jhon Zinkin, *Challenges in implementing corporate governance: whose business is it anyway?*, (Singapore: Jhon Willy & Sons (Asia), 2010), 41, Available at [http://books.google.com.pk/books?id=BtL61YdeD9kC&printsec=frontcover&dq=corporate+governance+and+board+of+directors&hl=en&sa=X&ei=Ro\\_gUpKgH8av0QXalYD4Cw&ved=0CCoQ6AEwAA#v=onepage&q=corporate%20governance%20and%20board%20of%20directors&f=false](http://books.google.com.pk/books?id=BtL61YdeD9kC&printsec=frontcover&dq=corporate+governance+and+board+of+directors&hl=en&sa=X&ei=Ro_gUpKgH8av0QXalYD4Cw&ved=0CCoQ6AEwAA#v=onepage&q=corporate%20governance%20and%20board%20of%20directors&f=false) >(last accessed: September 10, 2013).

<sup>24</sup> Jonathan R. Macy, *Corporate Governance: Promises kept, promises Broken*, (U.K: Princeton University Press, 2008), 52.

boards mainly composed of executive and non executive directors.

In the clause (I) of code of corporate governance 2012

*The board of directors is encouraged to have a balance of executive and non-executive directors, including independent directors and those representing minority interests with the requisite skills, competence, knowledge and experience so that the board as a group includes core competencies and diversity, including gender, considered relevant in the context of the company's operations.*<sup>25</sup>

Executive refers to dependent director and non executive refer to independent directors. One third of independent directors are favored in board, for unbiased monitoring and for effective working of board. Dependent directors are also important because they have insider knowledge of the organization which is not available to outsiders, but they can transfer wealth of other stakeholders to themselves by misusing this knowledge.<sup>26</sup>

**(a)Independent board:**

An independent board of directors is an integral element of a country's corporate governance norms in public listed companies. Board autonomy has taken on such a critical status in corporate governance that it has become essential. Thus to enable higher standards of governance as a result, reforms in governance in recent years has ever more zipped up hope as well as liability on independent directors. A board is, composed of members who are not executives of the neither company nor share holders, nor blood relations, or in law of the family. An independent board generally composed of members who have no relations to the firm in any way; hence, there is no or minimum chance of having a conflict of interest because independent

<sup>25</sup> Clause (i) of the Code of corporate governance 2012.

<sup>26</sup> Aamir Khan and Dr. Sajid Hussain Awan, "EFFECT OF BOARD COMPOSITION ON FIRM'S PERFORMANCE: A CASE OF PAKISTANI LISTED COMPANIES," *Interdisciplinary Journal of Contemporary Research in Business* 3, no.10 (February 2012): 855, Available at <<http://journal-archieves15.webs.com/853-863.pdf>>(last accessed: September 15, 2013).

directors have no material interest in a company. It has importance because inside or executive directors have no access to external information and recourses that are enjoyed by the firms outside.<sup>27</sup>

**(b) Dependent board:**

Dependent board members are linked with or the company employees and full time job and they receive remuneration or salary in return. These directors mostly work in higher level management of a company or have vested interest in the company. Independent directors in comparison to dependent director have insider knowledge of company which can be a benefit because they know better about the company.<sup>28</sup>

### **3.9: Corporate Governance and Independent Director:**

The key element to lead and control the performance of a business in the best interest of shareholders and stakeholders is a good corporate governance system. M. Damodaran described corporate governance as a systematic process beyond the scope of plain legislation. He implied that the legislative requirements should only be the starting point for governance authorization practices. Companies must pay attention to these practices not because of fear of sanction, but because in the absence of such governance the companies would fail to achieve true profitability. He spoke about independent directors as functionaries to contribute to the Board with their deviating views. Another speaker referred to them as the “conscience keepers” who could guide

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<sup>27</sup>Umakanth Varottil, “EVOLUTION AND EFFECTIVENESS OF INDEPENDENT DIRECTORS IN INDIAN CORPORATE GOVERNANCE,” *Hastings Business Law Journal* 6, no.2(June 2013):281, Available at <<https://litigationessentials.lexisnexis.com/webcd/app?action=DocumentDisplay&crawlid=1&doctype=cite&docid=6+Hastings+Bus.+L.J.+281&srctype=smi&srcid=3B15&key=3f886e05fe46d516c2e72134fecc32cb>> (last accessed: May 13, 2013) (Hereinafter, Varottil, Evolution and Effectiveness).

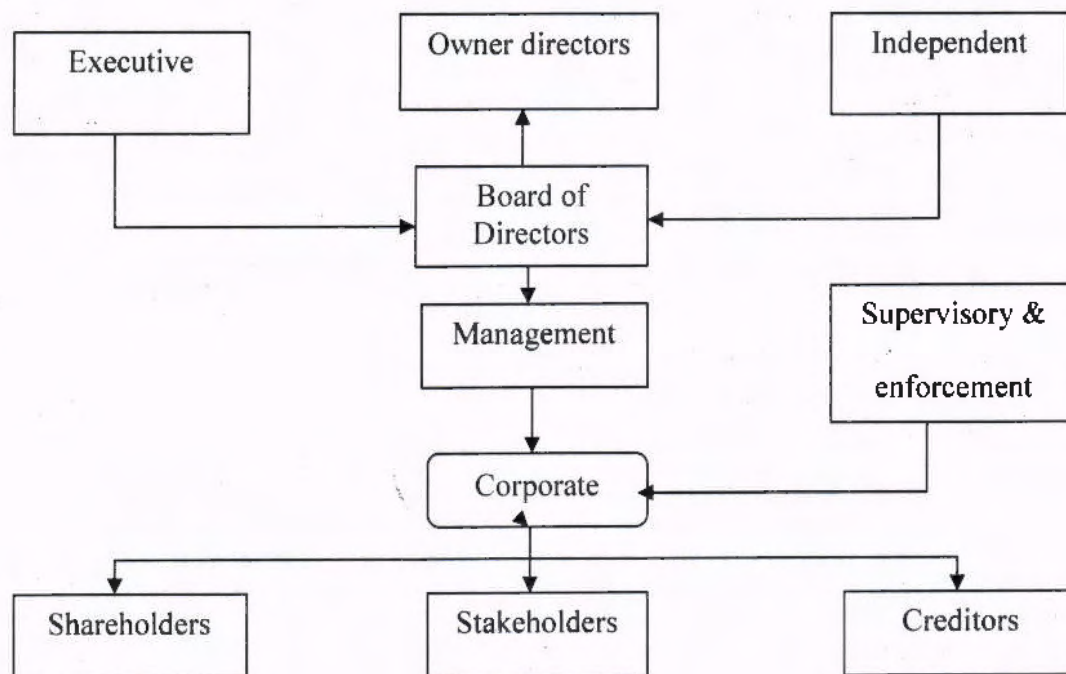
<sup>28</sup>Aamir Khan and Dr. Sajid Hussain Awan, “EFFECT OF BOARD COMPOSITION ON FIRM’S PERFORMANCE: A CASE OF PAKISTANI LISTED COMPANIES,” *Interdisciplinary Journal of Contemporary Research in Business* 3, no.10(February 2012): 855, Available at <<http://journal-archieves15.webs.com/853-863.pdf>>(last accessed: September 15, 2013).



the company towards its right interests when others may have been influenced by other interests.<sup>29</sup>

Independent directors have emerged as the foundation of the worldwide corporate governance movement and broadly fit into the overall structure of corporate governance. The concept of independent director has been initiated to drive the companies towards inculcating the concept of corporate governance in their management. Their increased presence in the boardroom has been called over as an effective restraint to fraud and misconduct, inefficient use of resources, inequality and unaccountability of decisions; and as a forerunner for striking the right balance between individual, economic and social interests.<sup>30</sup>

**Fig: 3.1 The Basic Design of Existing Corporate Governance Systems**



<sup>29</sup> Pranav Mittal, "THE ROLE OF INDEPENDENT DIRECTORS IN CORPORATE GOVERNANCE," *NUJS Law Review* 4(April- June, 2011): 286, Available at <[http://nujlawreview.org/pdf/articles/2011\\_2/pranav-mittal.pdf](http://nujlawreview.org/pdf/articles/2011_2/pranav-mittal.pdf)> (last accessed: June 1, 2013).

<sup>30</sup> *Ibid.*



Codes and stock exchange listing rules of corporate governance usually call for independent outside (non executive) directors play a crucial role in the board. Independence precisely has been described that these directors have no interest in the company that could influence authentic independent and objective judgment. The number or percentage of independent board members on listed company board is usually specified. Remuneration, audit and nomination committees of the board must be mainly comprised of these independent outsider directors.<sup>31</sup>

### 3.10: Origin and Development of the Concept of Independent Directors:

#### Global Scenario:

The very first introduction of independent directors was given by the US in the name of outside directors. It was included in the framework of corporate governance in 1970's as an advisory director. In evaluating independent director's definition on the board many institutions like stock exchange listing regulations, state law and best practices guidelines played a fundamental role. Corporate lawyers also did a great job in drawing major distinction between managerial and non-managerial directors and then further explained affiliated and none affiliated non managerial directors. These finding were published in Corporate Director's Guidebook In 1978.<sup>32</sup>

<sup>31</sup> Bruce F. Dravis, *The Role of Independent Directors after Sarbanes Oxley*, (USA: American Bar Association, 2006), 133, Available at <http://books.google.com.pk/books?id=vbA1scWH4jQC&pg=PA133&dq=importance+of+independent+director&hl=en&sa=X&ei=mJrhUr-iDMKw0AXyz4CYBw&ved=0CDIQ6AEwAg#v=onepage&q=importance%20of%20independent%20director&f=false> (last accessed: May 20, 2013).

<sup>32</sup> Smiti Tewari, "Evolution of Independent Directors in India," Available at <http://jurisonline.in/?p=18535> (last accessed: June 12, 2013).

Additionally, in early 1980s many case laws set standards for independent directors and their monitoring capacity on the board, *Zapata Corp. v. Maldonado* was one of them in which the Delaware Supreme Court held that even for a special committee constituted of independent directors could nevertheless obtain dismissal of the action if it demonstrated this was in the best interests of the corporation. In its dismissal request, the special committee had the burden of demonstrating its independence. This, of course, increased the demand for directors with minimal prior connection to the corporation and its management and helped ratchet up the independence standard.<sup>33</sup>

In 1992 in UK, the Cadbury Committee gave detailed definition of independent director and their role after the series of scams like Bank of credit and Maxwell communication. Further in 1997, the concept of independent director was explained in Hampel Committee (UK) and Blue Ribbons Committee (US). In 2002, after the failure of Enron and WorldCom, SOX legislation passed and it is epitome of the concept of independent director. It demands all the members of the audit committees to be independent with redefined roles and enforces strict penalties for any misdemeanour. After that The New York Stock Exchange revised its listing standards in detail and strict the criteria of independence to all directors. Afterwards, The Higgs report on effectiveness of non- executive directors and Smith Report on audit committees throw light on the position of IDs in CG framework of UK.<sup>34</sup>

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<sup>33</sup> *Zapata Corp. v. Maldonado* 430 A.2d 779 (Del. Sup. Ct. 1981) Available at <[http://highered.mcgraw-hill.com/sites/dl/free/0072933992/336419/ch44\\_Zapata\\_vs\\_Maldonado.html](http://highered.mcgraw-hill.com/sites/dl/free/0072933992/336419/ch44_Zapata_vs_Maldonado.html)> (last accessed: June 15, 2013).

<sup>34</sup> Jeffrey N. Gordon, "The Rise of Independent Directors in the United States, 1950-2005: of Shareholders Value and Stock Market Prices," *Stanford Law Review* 59, issue no.6(2007):<http://www.law.virginia.edu/pdf/olin/conf07/gordon.pdf> on page 18

In developed world after the wake of financial failure, the function of independent directors is under critical examination. Many Reports in the UK and the US state that the current system of ID's has many flaws that need to be corrected in order to strengthen the institution.<sup>35</sup>

#### **Pakistan Scenario:**

Like other emerging Asian countries, Pakistan has high ownership concentration with dominance of family controlled companies along with many state controlled and multinational companies. The agency problem in our country is between a dominant shareholder and minority shareholder. The presence of IDs on the board is a determinant of good corporate governance. They are instigated on board because of their high monitoring ability with aimed to protecting minority shareholders. They are mandated by law, in order to protect the minority shareholders, expropriation of firm resources by insiders and to increase firm profitability and its value.<sup>36</sup>

Securities Exchange Commission of Pakistan) first introduced independent directors as a corporate governance mechanism in the Pakistan corporate regulatory framework in the year 2002. As a regulator, SECP placed the independent director gradually, as first make a friendly introduction then order the listed companies to keep them in their home as watchdogs of their board to protect the interest the of minority shareholder. In previous code it encouraged minimum of one independent director on the board of a listed company which was not mandatory. According to clause (i-b) of present code that at least one independent director is mandatory and 1/3 of total member of the board as independent directors are preferred. The Chairman of the Board is to be elected from among non-executive directors. Same person cannot

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<sup>35</sup> Smiti Tewari, "Evolution of Independent Directors in India," Available at <<http://jurisonline.in/?p=18535>> (last accessed: June 12, 2013).

<sup>36</sup> Butt, *Corporate Governance*, 90.

hold the offices of chairman and chief executive officer. The core purpose of all these steps is just to protect the interest of minority shareholders.<sup>37</sup>

### 3.11: Defining an Independent Director:

The term non executive director, outside director and independent director are frequently used more or less interchangeably. The former is in broad use but has perhaps a somewhat negative flavor, the second is common in the USA and the latter is used increasingly, mainly because the idea of independent is generally fundamental to the nature of the role. A wider concept of independence applies to directors and this has been the subject of most listing requirements and principles of good corporate governance.<sup>38</sup>

According to Higgs' definition: "that a non executive director is considered independent director when the board determines that the director is independent in character and judgment and there are no relationships or circumstances which could affect, or appear to affect, the directors judgment".<sup>39</sup>

Cadbury report defines "independent director, as apart from their directors' fees and shareholdings, they should be independent of management and free from any business or other relationship, which could materially interfere with the exercise of their independent judgment".<sup>40</sup> In ruling of Delaware court, independent directors are defined as "independence means that a director's decision is based on the corporate merits of the subject before the board, rather than extraneous considerations or influences."<sup>41</sup>

<sup>37</sup> Clause i(b) of The Code of corporate governance 2012.

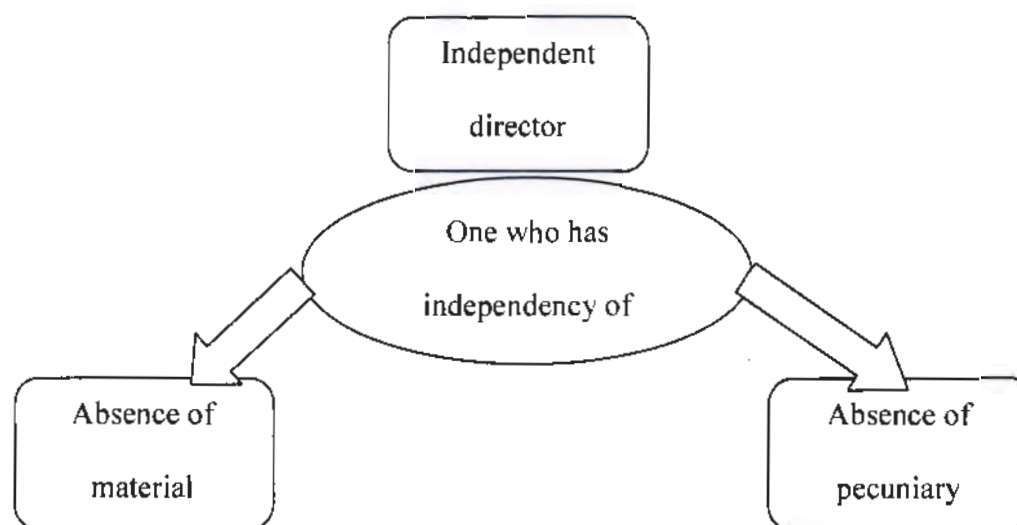
<sup>38</sup> William Houston and Nigel Lewis, *The Independent Director: Hand book and Guide to Corporate Governance*, (Oxford: Butterworth- Heinemann, 1992), 6.

<sup>39</sup> Kala Anandarajah, "Independent Directors — Who Are They and Why Have Them?," Available at <<http://www.lawgazette.com.sg/2004-4/April04-feature3.htm>> (last accessed: june 10, 2013).

<sup>40</sup> *Ibid.*

The term “independent director” has not been defined in the Ordinance. The definition of ID’s is given in Clause (i - b) of the code. It states that: For the purpose of this clause, the expression “independent director” means a director who is not connected or does not have any other relationship, whether pecuniary or otherwise, with the listed company, its associated companies, subsidiaries, holding company or directors. The test of independence principally emanates from the fact whether such person can be reasonably perceived as being able to exercise independent business judgment without being subservient to any form of conflict of interest.<sup>42</sup>

**Fig 3.2: Independent Directors**



Proviso of this clause gives a list of person who cannot be fall in the criteria of independent. It states that:

Provided that without prejudice to the generality of this explanation no director shall be considered independent if one or more of the following circumstances exist:

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<sup>41</sup>Martha Stewart Living Omnimedia, Inc vs Stewart Available at <http://courts.delaware.gov/opinions/download.aspx?ID=43320> (last accessed: June 10, 2013).

<sup>42</sup>Clause (i-b) of The Code of corporate governance 2012.

- He/she has been an employee of the company, any of its subsidiaries or 6 holding companies within the last three years.
- He/she is or has been the CEO of subsidiaries, associated company, associated undertaking or holding company in the last three years.
- He/she has, or has had within the last three years, a material business relationship with the company either directly or indirectly as a partner, major shareholder or director of a body that has such a relationship with the company.
- He/she has received remuneration in the three years preceding his/her appointment as a director or receives additional remuneration, excluding retirement benefits from the company apart from a director's fee or has participated in the company's share option or a performance-related pay scheme.
- He/she is a close relative of the company's promoters, directors or major shareholders
- He/she holds cross-directorships or has significant links with other directors through involvement in other companies or bodies;
- He/she has served on the board for more than three consecutive terms from the date of his first appointment provided that such person shall be deemed "independent director" after a lapse of one term.

Any person nominated as a director under Sections 182 and 183 of the Ordinance shall not be taken to be an "independent director" for the abovementioned purposes.

The revised code lays down an inclusive definition wherein independent directors are those directors who do not have a pecuniary relationship with the company, its promoters, management or its subsidiaries, which may affect the independence of their judgment. This definition put obvious pressure on the need for ethical integrity that demands that their decisions

must be free from doubt as to any conflict of interest. It is truly believed by Experts on corporate governance that effectiveness of board basically depends on the performance of its independent directors.<sup>43</sup> High professional attitude is expected from independent directors in performing their functions especially in decision making process. They critically analysis the performance of management and grab them accountable for their action. Due to lack of attachment, their independency let them to discharge their duties more efficiently.

### **3.12: Number of Independent Director:**

OECD Principles of Corporate Governance defines “Board Independence usually requires sufficient number of members to be independent of management”. In respect of independent directors clause 35(i) b of the revised code provides the number of Ids. It states that at least one independent director on the board of director is mandatory. However, such numbers to be 1/3rd of the total number of the members on the board of directors are preferred. The board shall state in the annual report the names of executive, non executive and independent directors.<sup>44</sup> The chairman of the board shall be elected from among the non executive directors and chairman of the committee shall be IDs who shall not be chairman of the board.

### **3.13: Professional Indemnity Insurance Cover:**

According to clause 35 (i) (c) of revised code, Professional indemnity insurance is encouraged for independent directors only. Professional indemnity insurance protects

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<sup>43</sup> Butt, *Corporate Governance*,91.

<sup>44</sup> Clause (i-b) of The Code of Corporate Governance 2012.



professionals against claims of negligence made against them by clients and also covers the costs of and expenses of defending a legal claim, as well as any damages payable.<sup>45</sup>

### **3.14: Appointment of Independent Director:**

Clause (i) b of the revised code does not prescribe any procedure of appointment of ID's. The provisions of the ordinance, govern Appointment of ID's. Section 178 of the ordinance lay down the provisions with regard to appointment of a director that applies to an ID as well. Every director other than first directors are appointed in the general meeting of the company after furnishing Directors Identification Number (DIN) and declaration for non- disqualification. It must be noted, that the board, which consists of the promoters as the majority shareholders, appoints ID's. It is also a known fact that the will of the promoters dominates the board. Therefore, the appointment of ID's becomes largely dependent on the whims and fancies of the promoters. In such a scenario, it becomes difficult to maintain the independence of ID's. In order to ensure the independence of ID's in the true sense, the appointment procedure needs to be amended. In Pakistan, listed companies are reluctant to take more independent directors than necessary, and are especially reluctant to create a majority of independent directors, because shareholders' interests are at odds with independent directors' corporate watchdog function. Preserving a minority of independent directors on the board limits the threat to large shareholder control.

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<sup>45</sup> Available at <<http://www.business.vic.gov.au/operating-a-business/how-to-start/insurance/professional-indemnity>> (last accessed: June 4, 2013).

### **3.15: Term of Independent Director:**

The term of independent directors is not specifically defined in the both codes of corporate governance but the tenure of other directors is mentioned that is three years. No procedure is laid down in filling up of any casual vacancy in case of independent director.

### **3.16: Remuneration of Independent Director:**

According to clause (xvii) of the revised code, a fair and well transparent process is introduced for determining the remuneration packages of individual directors. Independent directors' remuneration is decided by the board according to the ordinance provisions and the company's Articles of Association. However, it shall not be at a level that could be perceived to compromise their independence. For keeping a check, it is required by the revised that the company's Annual Report shall contain details of the aggregate remuneration separately of executive and non-executive directors, including salary/fee, benefits and performance-linked incentives etc.<sup>46</sup>

### **3.17: Role of an Independent Director:**

In typical set-up of emerging economies, where majority of controlling shareholders (e.g., a family holding more than 80% shares of a company) rule over the management, gives an empty room to Independent directors for playing an important role in companies. In such scenario, conflicts of interest may arise between the majority and minority shareholders. Their presence on the board can deter the majority share holders in manipulating the minority

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<sup>46</sup> Clause (xvii) of The Code of Corporate Governance 2012.

shareholders' rights. A good ratio of them on the board can help in ensuring that minority shareholders' rights are well protected.<sup>47</sup>

Independent directors came into the frame work of corporate governance with a number of advantages like independence in their vision and external perspective into the agendas of the board. Their main function is to oversee the schemes of the company and to direct them according to general policy. They are helpful in providing effective leadership and in balancing the interests of the shareholders, employees and creditors.<sup>48</sup> No doubt, the independent directors' advisory role can be played by professional advisors of company like legal and financial advisors but their liabilities towards the company take them further than others. They are one, who is in capacity to directly contribute and possibly shape the deliberations of the board. It is thus that from a corporate governance perspective, independent directors are required to sit on a number of watch-dog committees, including the audit committee, the nominating committee and the remuneration committee. In their supervisory role, they examine the board performance as a whole and can blow a whistle in case of any transgression.<sup>49</sup>

The clause 35 (xxiv) of the revised code 2012 required that listed companies are required to have independent director as a chairman of audit committee.<sup>50</sup> The role and responsibilities of an independent directors arising out clause 35 (xxix) of revised code would include these:

- Oversight of company financial reporting process and disclosure of its financial information.

<sup>47</sup> Mehwish bilal khan, "The Role of Independent Directors," 2, Available at <[http://www.google.com.pk/url?sa=t&rct=j&q=independent%20director%20by%20mehwish%20bilal%20khan&source=web&cd=4&cad=rja&ved=0CD0QFjAD&url=http%3A%2F%2Fwww.picg.org.pk%2Fknowledgebase%2Ffeature%2FIFC\\_Staff%2FMahwesh%2520Bilal%2520KhanTHE%2520ROLE%2520OF%2520INDEPENDENT%2520DIRECTORS.doc&ei=oBK6UeTwFqWO7QamsoHgCw&usg=AFQjCNGycpvrF036lmngUJbK7DaxkBIw&bvm=bv.47883778,d.bGE](http://www.google.com.pk/url?sa=t&rct=j&q=independent%20director%20by%20mehwish%20bilal%20khan&source=web&cd=4&cad=rja&ved=0CD0QFjAD&url=http%3A%2F%2Fwww.picg.org.pk%2Fknowledgebase%2Ffeature%2FIFC_Staff%2FMahwesh%2520Bilal%2520KhanTHE%2520ROLE%2520OF%2520INDEPENDENT%2520DIRECTORS.doc&ei=oBK6UeTwFqWO7QamsoHgCw&usg=AFQjCNGycpvrF036lmngUJbK7DaxkBIw&bvm=bv.47883778,d.bGE)> (last accessed: June 13, 2013).

<sup>48</sup> independent director who are they why have them? By kala anandarajha  
<http://www.lawgazette.com.sg/2004-4/April04-feature3.htm>

<sup>49</sup> Ibid.

<sup>50</sup> Clause (xxiv) of The Code of corporate governance 2012.

- Recommending to the Board on the appointment, re appointment, replacement or removal of external auditors and fixation of audit fees.
- Review with management, the annual financial statements before approval by the board with particular reference to directors responsibility statement, changes in accounting policy, major accounting estimates, audit finding adjustments, compliance with listing and other legal requirements, disclosure of related part transaction.
- Determining the appropriate measures for protecting the listed company's assets.
- Review of quarterly financial statements of the listed companies.
- Review with management, performance of internal auditors, adequacy of internal control systems, adequacy of internal audit function including their structure, frequency, reporting.
- Ensuring coordination between the internal and external auditors of the listed company.
- Review and discuss significant finding of internal auditors, including internal investigations made by them into areas of fraud, irregularities or major failure of internal control system.
- Facilitating the external audit and discussion with external auditors of major observations arising from interim and final audits.
- Reviewing the whistle blower mechanisms.

The Board of Directors shall give due consideration to the recommendations of independent directors in all these matters. Where board acts contrary to their suggestions, they must record the reasons according to the requirement of the revised code.<sup>51</sup>

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<sup>51</sup> Ibid.

### 3.18: Responsibilities of an Independent Director:

Responsibilities of Independent directors are under the same sky of executive directors of listed companies as they are not explicitly and separately stated in the ordinance or codes. He is not only the guardian of the minority shareholders, Similar to any other executive director; he has fiduciary duties and legal responsibilities in general to oversee the company.<sup>52</sup>

It is developed in many other jurisdictions' case laws that there should be some difference in duties owed by an executive and non executive or independent director. The standard of care and skill will be higher in case of executive director who is keenly concerned in day to day administration of the company. Contrary to it, the standard of independent director who play the role of monitor or advisor would be slightly lower. It is also endorsed by the court that there is a considerable measure of agreement about the duty owed in law by a non-executive director to a company, in expression it does not differ from the duty owed by an executive director but in application it may and usually will do so.<sup>53</sup>

It is important for independent directors to participate actively in board meetings and keep abreast the companies in developments of relevant fields of their expertise. They must be vigilant in performing their duties aimed with genuine interest, growth and development of the company in large. Well awareness of relevant laws and regulations are required in fulfilling their responsibilities independently.<sup>54</sup>

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<sup>52</sup> Vita Health Laboratories Pte Ltd and Others v Pang Seng Meng 4 SLR 162; [2004] SGHC 158. Available at <<http://www.singaporelaw.sg/sglaw/laws-of-singapore/case-law/cases-in-articles/company/1459-vita-health-laboratories-pte-ltd-and-others-v-pang-seng-meng-2004-4-slr-162-2004-sghc-158>> (last accessed: June 12, 2013).

<sup>53</sup> Equitable Life Assurance Society v Bowley & Ors [2003] EWHC 2263 (Comm) (17 October 2003), Available at <<http://www.bailii.org/ew/cases/EWHC/Comm/2003/2263.html>> (last accessed:june 21, 2013).

<sup>54</sup> Julian Roche, *Corporate Governance in Asia*,(USA:Routledge,2005),85.

### 3.19: Effectiveness of Independent Directors in Pakistan:

There are significant differences in the corporate ownership structures and legal systems between the countries of origin of independent directors on the one hand and Pakistan on the other. Due to the diffused shareholding structures in the U.S. and the U.K., the independent directors were ushered into corporate governance norms in those countries in order to operate as a monitoring mechanism over managers in the interest of shareholders. Each stage in the evolution of board independence bears testimony to this fact.<sup>55</sup> However, a transplantation of the concept to a country such as Pakistan without placing emphasis on local corporate structures and associated factors is likely to produce unintended results and outcomes that are less than desirable. Due to the concentrated ownership structures in homeland companies, it is the minority shareholders who require the protection of corporate governance norms from actions of the controlling shareholders.<sup>56</sup> Board independence, in the form it originated, does not provide a solution to this problem. However, companies having independent directors on boards send a very strong signal to investors that the company is well run and governed, and its board is sound enough to ensure that the very best international corporate governance practices are adhered to. But for the effectiveness of board independence in Pakistan, we need more reforms to encourage independent directors that may empower them to play a more meaningful role in corporate governance.<sup>57</sup>

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<sup>55</sup> Juan Ma and Tarun Khanna, "Independent Directors' Dissent on Boards: Evidence from Listed Companies in China," Working Paper 13-089 (Harvard Business School, 2013), 15, Available at [http://www.hbs.edu/faculty/Publication%20Files/13-089\\_1d877d12-f9b0-4d89-9916-2754806df392.pdf](http://www.hbs.edu/faculty/Publication%20Files/13-089_1d877d12-f9b0-4d89-9916-2754806df392.pdf) (last accessed: November 13, 2013).

<sup>56</sup> Mahwesh Bilal Khan, "The Role of independent directors" Available at [https://www.google.com.pk/url?sa=t&rct=j&q=&esrc=s&source=web&cd=3&cad=rja&ved=0CDMQFjAC&url=http%3A%2F%2Fwww.picg.org.pk%2Fknowledgebase%2Ffeature%2FIFC\\_Staff%2FMahwesh%2520Bilal%2520KhanTHE%2520ROLE%2520OF%2520INDEPENDENT%2520DIRECTORS.doc&ei=cI\\_MUqL-MIq60QWAqoGoDg&usg=AFQjCNGycpvrF036lmng-UJ-bK7DaxkBlw&bvm=bv.58187178.d.Yms](https://www.google.com.pk/url?sa=t&rct=j&q=&esrc=s&source=web&cd=3&cad=rja&ved=0CDMQFjAC&url=http%3A%2F%2Fwww.picg.org.pk%2Fknowledgebase%2Ffeature%2FIFC_Staff%2FMahwesh%2520Bilal%2520KhanTHE%2520ROLE%2520OF%2520INDEPENDENT%2520DIRECTORS.doc&ei=cI_MUqL-MIq60QWAqoGoDg&usg=AFQjCNGycpvrF036lmng-UJ-bK7DaxkBlw&bvm=bv.58187178.d.Yms) (last accessed: July 10, 2013).

<sup>57</sup> *Ibid.*

### 3.20: Pakistan's Corporate Performance and Independent Director:

Undoubtedly, it is best for the interest of shareholders, investors, customers, suppliers and all other stakeholders to incorporate good governance practices in the corporate structure. By giving such mechanisms that indicate the fraud and failure in companies, it raises the company's reputation and ranking. Board of directors is like a pillar in the company structure.

Companies with effective corporate governance structure always select a strong board of directors. It is suggested by many economists that independent directors have momentous impact on firm performance in Pakistan.<sup>58</sup> Their analysis showed that the firm performance increased by adding independent directors in their board. The important measures of firm's performance are ROA (return on assets) and ROE (return on equity) and listed companies on Karachi stock exchange are showing both greater. It shows that with independent board Pakistani companies listed at KSE are enhancing their performance.

The existing literature (Hermalin, 2005; Rashid et al., 2010; Shah et al., 2011) shows that if the composition of board is Independent, it will ultimately reflect higher firm performance. But the conflicting point is that some studies (Bhagat & Black, 1999; Ibrahim et al., 2010) also stated, there is some evidence that firms with supermajority independent boards are less profitable than other firms and it suggested that it may be useful for firms to have a moderate number of inside or dependent directors. There are also some other independent variables such as board size, chairman duality, director's compensation structure, audit committee and ownership structure etc, which have combined effect on performance of listed companies of Pakistani stock exchange.<sup>59</sup>

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<sup>58</sup> Ammar Ali Gul et al., "Do Board Independence Carry Value? A Case Study of Pakistani Banks," *Research Journal of Management Sciences* 2(5):(2013),4, Available at < <http://www.isca.in/IJMS/Archive/v2/i5/1.ISCA-RJMS-2013-030.pdf> > (last accessed: june 12, 2013).

<sup>59</sup> *Ibid.*



### 3.21: Independent Director in the Regulator perspective:

Due to recently mismanagement and fraud in companies, the regulators from all over the world are serious in the implementation of guiding principles for developing good corporate governance and ensuring that companies are conducting their business according to ethical and normative rules. One of these principles is to goad the companies to have even-handed individuals on the board. From a regulatory perspective independents can be useful if they perform some functions that increase the value of the firm for outside investors and that they will not be able to implement by themselves.<sup>60</sup> They are independent director who sit on the board with a mission to oversee the management overall. Regulators' point of view about the insertion of independent director is that they are experienced and qualified professional on the board and can improve the performance of companies by their expertise on relevant matters.<sup>61</sup> They are well informed of latest developments in corporate sector as they are also members of other companies' board. There has been a move by the SECP to incorporate the concept of independent directors in codes of corporate governance for standing Pakistani companies at international standard and attracting foreign investors. It codified many rules to ensure that independent directors do not have conflicts of interest and how many other companies, sectors and industries they represent.<sup>62</sup> SECP also organized many workshops and seminars to promote the constructive idea of independent directors in listed companies and to aware its supervisory role on board.

<sup>60</sup> María Gutiérrez and Maribel Sáez, "Deconstructing Independent Directors," 7, Available at <[http://www.uam.es/personal\\_pdi/economicas/paalonso/Archivos/Deconstructing%20Independent%20Directors.pdf](http://www.uam.es/personal_pdi/economicas/paalonso/Archivos/Deconstructing%20Independent%20Directors.pdf)> (last accessed: June 13, 2103).

<sup>61</sup> The role of the independent directors

<<http://www.managementstudyguide.com/role-of-independent-directors.htm>> (last accessed: June 10, 2013).

<sup>62</sup> Zahid Zaheer, "Enhancing Corporate Governance Standards in Commonwealth member countries in Asia," (country paper- Pakistan presented at The Workshop by The Commonwealth Secretariat & Global Corporate Governance Forum, Maldives, June 17-18, 2006), Available at <[http://www.picg.org.pk/knowledge-base/reports/Pakistan\\_Country\\_Report.pdf](http://www.picg.org.pk/knowledge-base/reports/Pakistan_Country_Report.pdf)> (last accessed: June 10, 2013).

### 3.22: Independent Director in the Promoter's Perspective:

The very concept of independent director is discussed in many seminars as an important tool in the governance of corporates. Advocates of corporate governance offered a significant number of independent directors on companies' board which is latterly implicated on listed companies by regulators. Regulators set a number and role of independent directors on the board of companies which have not gone uncontested. The promoters of company saw this addition on board as it is not sound to give authority to strangers as independent directors without corresponding explicit responsibilities.<sup>63</sup>

In supporting their views, they argument that it is promoters who take most of the risks of business as offering personal guarantees and in some cases pledges their shares for credits, In this scenario, it s difficult for an independent director without any stakes in the company's business to decorate the boards. There is no need to offer directorship in company only for the sake of independent advice because the same is available to company from professionals on commercial basis.<sup>64</sup>

They have problems about the current required numbers of independent directors on the board and such amendments are facing resistance from majority shareholders. They are reluctant in applying new governance principles because these are proposed without first prepare the ground for such change in the corporate culture and without strengthening the role and operation of stock exchanges.<sup>65</sup>

They are in view that the emphasis on appointment of majority of independent directors on various committees of the board gives the impression that the directors representing majority

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<sup>63</sup> Fernando, Corporate Governance, 206.

<sup>64</sup> *Ibid.*

<sup>65</sup> Muhammad bashir chau, "Improving corporate governance," *The Dawn*, October 8, 2010, Available at <<http://archives.dawn.com/archives/154145>> (last accessed: July 20, 2013).

interest are being transferred to the secondary position. This requirement would amount to a positive discrimination against the interest of promoter who holds majority shares and financial interest in the success of the company.<sup>66</sup> In a conference held by Pakistan Institute of Corporate Governance on the “Role of the Independent Director” at Karachi, one of the participants Ehsan Malik stressed that “the number of independent, non-executive directors on a company board should remain flexible and focus should be maintained on performance”.<sup>67</sup>

Promoters stated their apprehension that non-executive, independent directors may not always be the best people to understand the working of a corporate body since they get involved in the company’s affairs for just a few times in a year.<sup>68</sup>

However, a healthy trend of implementing corporate governance principles has emerged due to awareness on the topic and the entrance of fresh foreign qualified graduates who understand the true value of corporate governance<sup>69</sup>. Ebrahim Sidat – who is one of the authors of the revised code, defended the mandatory requirements introduced in the code with regard to the presence of non-executive, independent directors on corporate boards, saying the measure would bring more transparency.

### **3.23: In the Perspective of Independent Director:**

With unlimited liabilities, poor remuneration, complex ownership structure, it is very difficult task to be an independent director. In a situation, where it is a necessary evil to have

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<sup>66</sup> “Question Raised over new Code of Corporate Governance,” *The Express Tribune*, October 5, 2012, Available at <<http://tribune.com.pk/story/447091/questions-raised-over-new-corporate-governance-code/>> (last accessed: July 20, 2013).

<sup>67</sup> Conference on the Role of Independent Director, Available at <<http://www.picg.org.pk/confs.php>> (last accessed: June 11, 2013).

<sup>68</sup> *Ibid.*

<sup>69</sup> Haris ziad Ahmad, “Myth of Corporate Governance in Pakistan,” 54. Available at <<http://www.docshut.com/mptnmm/8-myth-of-corporate-governance-in-pakistan.html>> (last accessed: July 2, 2013).

independent director on the board just to comply the law of state and not any other sake, how can it is possible for independent director to play their role in full bloom with the heavy wings of responsibilities.

On the one hand, it's important to ensure that minority shareholders' interests are protected. At the same time, you do not want a situation where nobody is willing to play the role of an independent director for fear of being chased by intelligence officials if something goes wrong with the company even after you have stepped down from a company's board. Many independent directors have resigned, mainly out of fear (bred by ignorance or reality) of ruining their life's reputation. "I would be worried to play the role," says UR Bhat, managing director at Dalton Capital and an independent director on the board of Axis Asset Management. He argues that the remuneration suggested is also not so attractive for him to take the risk of the responsibility that comes with it.<sup>70</sup> Independent directors claimed that they could not make a sound decision, either because they were in no position to second guess or verify information provided by the firm, or because they did not receive information to make judgments.<sup>71</sup>

One of the independent director and CEO of a famous company said "Independent director is a vulnerable position in our country with unlimited liabilities," he said, There is no majority or minority shareholder in the US. Hence, CEOs and corporate boards work for

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<sup>70</sup> Raja Skelkar, "Independent Director, Anyone? Handle it at your Own Risk," *First post Business*, August 3, 2011. Available at < <http://www.firstpost.com/business/independent-director-anyone-handle-it-at-your-own-risk-52833.html> > (last accessed: July 26, 2013).

<sup>71</sup> Juan Ma and Tarun Khanna, "Independent Directors' Dissent on Boards: Evidence from Listed Companies in China," Working Paper 13-089 (Harvard Business School, 2013), 15, Available at <[http://www.hbs.edu/faculty/Publication%20Files/13-089\\_1d877d12-f9b0-4d89-9916-2754806df392.pdf](http://www.hbs.edu/faculty/Publication%20Files/13-089_1d877d12-f9b0-4d89-9916-2754806df392.pdf)> (last accessed: November 13, 2013).

### **3.25: Causes of Ineffectiveness of Independent Directors in Listed Companies of Pakistan:**

As we know that board composition and independence are fundamental issues in corporate Governance. Board independence is very important for governance mechanisms. The board is body charged with having oversight of the operations of the firm and setting its strategy. It should ensure that the company is upholding high standards of probity and conduct and provide probing analysis of the activities of the management. In particular, non executive directors are supposed to give an independent assessment of the quality of management. But in Pakistan there is no concept of independent non-executive directors they exist in papers but in practically absent. Here a lot of companies depict a number of their directors as non-executive and pretence them to be independent, but in reality none of them is independent. There are several reasons for their dependency, ineffectiveness and incompetence on the board of listed companies in Pakistan.<sup>76</sup>

#### **3.25.1: Ownership Structure of Companies:**

It is difficult to appoint truly independent directors and particularly hard to achieve in our country where family ownership is widespread and there is close knit group of corporate leaders. It is difficult for independent directors to perform a scrutiny objective at the best of times, but it is particularly difficult to do so when faced with a dominant in home directors who expect support not criticism. Actually controlling shareholders are keen to run their company in their own way and they hate any kind of interference from outside. They are not prepared to grant any

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<sup>76</sup>Butt, *Corporate Governance*, 92.

of their powers to outsiders. It all depends on controlling shareholders whether they really want to have independent non-executive directors on their company's board or not.<sup>77</sup>

### **3.25.2: Definition of Independent Directors:**

Independence is currently defined with respect to the existence of pecuniary or business relationship and family relationships. These are quite narrow, and in our country where the cultural backgrounds create other forms of social relationships between individuals such as extended other forms familial relationships and friendships and bonds between business families. Minority shareholder representation by independent directors is one of the main methods for a minority shareholder investing in an emerging market to protect its interests in a corporation. The definition of "independent" does not address minority shareholder rights and interests.

### **3.25.3: Absence of Specific Qualification of Independent Director:**

The SECP regulations and the ordinance neither makes any specific provision nor has laid down any criteria for appointment of independent director. Although they set general criteria yet key ingredients are missing with respect to educational qualification and relevant experience of the sector of the board they represent, particularly with reference to independent director. Revised code prescribed the criteria of CFO and head of internal audit. If we apply those criteria then it is very difficult to search directors. The code only has a negative list of the kind of people who cannot be independent director. In Pakistan taking advantage of this, companies most of the time appoint someone who is not an expert or not even remotely related to the foundation of the company, so as to make their post inefficient and non-significant. Promoters have appointed directors just to fulfill the requirement of law. There is a need to lay emphasis on the quality of

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<sup>77</sup>Beenish Ameer, "Corporate Governance- Issues and Challenges in Pakistan," *International Journal of Academic Research in Business and Social Sciences* 3:4(April 2013),84, Available at <<http://www.hrmar.com/admin/pics/1719.pdf>> (last accessed: July 23,2013) (Hereinafter, Ameer, Corporate governance issues).



director appointed as independent director rather than quantity as they play a vital role of 'watch dogs'. Without having the special knowledge and business literacy it is difficult for independent director to protect the interest of minority shareholder.<sup>78</sup>

#### **3.25.4: Procedure for Appointment:**

In Pakistan the appointment of independent director is a matter of pure legal and constitutional compliance. The question of appointment of independent director has always been controversial that independent director are 'handpicked' by the promoter so they prefer to be a friend rather than a protector at the board to protect the interest of the shareholder. The procedure of appointment as ID makes it easier for the promoters to identify a person and put up his name before the nomination committee where it is customarily approved. The name is then taken to the shareholders meeting as a formality, given the manner in which most shareholders' meetings are conducted. The concept that all directors are appointed only with the shareholder's approval is void; no one has heard of even one director's appointment being rejected at the shareholders meeting. It is obvious that promoters would prefer to appoint their acquaintance and faithful persons on their board to have minimum interference of the outside directors. This procedure for their selection raises question on their independence. They cannot be as independent as they are expected to be, if they are going to be appointed by the owners. As long as they are appointed by management, the concept of independent directors is a myth, for truly independent directors.<sup>79</sup>

#### **3.25.5: Age Limit:**

The code does not define the age limit of independent director (minimum and maximum). In section 187 of the ordinance the ineligibility of certain persons to become a director is

<sup>78</sup>Orena Chopra and Pulkrit Agarwal, "Appointment and Qualification of Independent Director," Available at <http://www.lawteacher.net/business-law/essays/abstract-appointment-and-qualification-law-essays.php> (last accessed: June 10, 2103) (Hereinafter, Chopra and Agrwal, Appointment of independent director).

<sup>79</sup> Butt, *Corporate Governance*, 93.



defined; according to that a minor cannot be director.<sup>80</sup> According to majority act 1875 section 3 a person attains his majority in the age of 18 years.<sup>81</sup> But a person of 18 year may not be well educated and will not have adequate knowledge & experience of running a business and to identify the frauds & misdemeanors in the company. The age limit of the independent director must be such that it justifies the position of the independent director. This implies that every single Pakistani, who is above 18 years of age, is qualified to become an ID, which means over 10 corer Pakistanis are eligible to become an independent director.

#### **3.25.6: Few Numbers of Independent Directors:**

Another problem is related to the number of independent directors. In case the company has two independent director, which satisfied the minimum requirement that the company should have, but that directors may not have great influence on the board, as there are only two person present in the meeting, the executive directors may still do thing on their own without hearing non-executive independent directors' opinion. Thus, directors have little power to affect the board decision, and thus they cannot improve the company's corporate governance system.

#### **3.25.7: Term of Independent Director:**

The codes of corporate governance 2002 and with amendments 2012 make no specific provision with respect to tenure of the independent director. As a result, the question of how long the independent director can remain independent remains unanswered. In the absence of any laid down law, there are chances that independent directors can serve on the board for decades that could be persuade their independency. All directors should be appointed for a fix term and when the term expires, they can offer themselves for reappointment on the basis of their performance.

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<sup>80</sup> Sec 187 of Compnies Ordinance 1984.

<sup>81</sup> Sec 3, Majority Act 1875.

### **3.25.8: Absence of Legal Protection:**

Unfortunately, independent directors enjoy very little regulatory support in the form of either protection or power to carry out their duties when in opposition to the rest of the board. With an absence of legal protection for whistleblowers, there are several disincentives for independent directors to blow the corporate governance whistle. There is no separate law under which an independent director operates; he has no legal protection from the management so that he can raise his voice fearlessly. For instance, they may face the threat of lawsuits from management and cornerstone investors for actions that damage the company's share price, and in extreme cases, their personal safety may be placed at risk.<sup>82</sup>

### **3.25.9: No long term benefit:**

Independent non-executive directors are supposed to be professionals like external auditors or institutional investors. But in Pakistan they have no interest to serve as independent directors because they have no long term benefit and they are not happy with such a low benefit.<sup>83</sup>

### **3.25.10: No right to interfere in Day-to-Day Operations:**

An independent director with no right to interfere in the day-to-day operations of the company have right to intervene in any misgivings or misdeeds and are supposed to support the management in getting the delivery of what the objectives of the company are to its shareholders.

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<sup>82</sup>KPMG Audit Committee Institute, "Corporate governance the investor perspective and expectations,"18, Available at <http://www.kpmg.com/SG/en/IssuesAndInsights/CFOPublications/Documents/CorpGovInvestorsPerspectiveExpectations.pdf> (last accessed: June 10, 2013).

<sup>83</sup> Ameer, Corporate Governance issues, 84.

If a director cannot get into a company's day-to-day operations, he cannot understand how it is governed and will not be in the position to fulfil his responsibilities. If independent director does not fulfil their duty as a watch dog then it would amount to committing an offence. As Supreme Court in Municipality of Bhiwandi & Nizampur v. Kailas Sizing Works has observed that

“The authority is not acting honestly where an authority has a suspicion that there is something wrong and does not make further enquiries. Being aware of possible harm to others, and action in spite thereof, is acting with reckless disregard of consequences. It was worse than negligence, for negligent action is that, the consequences of which the law presumes to be present in the mind of the negligent person, whether actually it was there or not.”<sup>84</sup>

#### **3.25.11: Professionals do not have plenty of Time:**

Good professionals are not keen to serve on the boards of listed companies just for getting only a meeting fee. In fact some of them don't have plenty of time to do so. To run the company successfully you need good people, and good people have no time for company matters as they are already busy with their work.<sup>85</sup>

#### **3.25.12: Lack of Resources:**

Lack of resources is a key challenge in the way of independent directors to perform their corporate governance responsibilities. The question is: when do you call in the forensic auditors? The bottom line must be: when you need to establish the facts. But you don't have the tools, you

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<sup>84</sup> Chopra and Agrwal, Appointment of independent director.

<sup>85</sup> Ameer, Corporate Governance issues, 84.

don't have the people, you don't have the team to go in and check on what went wrong. If you don't equip them properly then why too much is expected of independent directors.<sup>86</sup>

#### **3.25.13: Lack of Guideline with Replacement of IDs:**

The guideline for the replacement of an ID in case of his resignation, removal or death is absent and no expiry date mention to fill up office in both codes. In case there is resignation or removal or death of an existing independent directors then promoters can take plea that they are not able to find to a replacement that could be stretch for indefinite time.

#### **3.25.14: Remuneration:**

The ineffectiveness of independent non-executive directors in Pakistan is because of no or less payments to them as compensation or remuneration. They get only preset fee for attending a meeting. The criterion of the remuneration is mentioned in the code that it should be at the level that could distinguish their independence. This is an incorrect belief in Pakistan's listed companies that, if they provide wages to Independent director it will seize their autonomy.<sup>87</sup>

#### **3.25.15: Lack of Interest:**

Independent director's interests are artificial in comparison to executive directors. They are disconnected from the company performance due to having no self interest in the company. It is not possible that a person with little concern on the board and spending others money earned without any pain in all the risks of business and participating very few on the board, how can he

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<sup>86</sup>KPMG Audit Committee Institute, "Corporate governance the investor perspective and expectations,"20, Available at <http://www.kpmg.com/SG/en/IssuesAndInsights/CFOPublications/Documents/CorpGovInvestorsPerspectiveExpectations.pdf> (last accessed: June 10, 2013).

<sup>87</sup> Butt, *Corporate Governance*, 93.

be loyal to the interest of minority shareholders and how is it possible for him to perform well in the interest of small stakeholders when he has nothing to gain but can lose everything on status and reputation etc.<sup>88</sup>

### **3.25.16: Not the Best Job in Town:**

The debate becomes very interesting when it comes to the pay scale of independent directors. It is \$30,000 to \$50,000 a year at the current market rate. Mr Lee pointed out that “it costs much more to hire a receptionist per annum”. At this cost, independent directors are expected to be the gate keeper, the bloodhound etc and when things go immoral, they are held jointly and severally legally responsible.<sup>89</sup>

### **3.25.17: Ways to Compromise Independence:**

Promoters usually invite people whom they know or respect to the board. Sometimes they bring on their friends, families, or people from their community who will not ask uncomfortable questions about how the company is run. In this scenario, It is very difficult for independent director to be independent at place where he sits among his social or business fellows and being a part of strong team, it is also hard to him go against them, he desires to maintain group cohesiveness. He mostly works in accordance with the wishes of the board just to save himself from the liabilities. Any interest direct or indirect, close or remote, other than the interest of the

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<sup>88</sup>Ian zandstra, “Pros and cons of independent director”,3. Available at <<http://www.coopsnsw.coop/PDF/independent%20directors.pdf>> (last accessed: June 12, 2013).

<sup>89</sup>KPMG Audit Committee Institute, “Corporate governance the investor perspective and expectations,”20, Available at <<http://www.kpmg.com/SG/en/IssuesAndInsights/CFOPublications/Documents/CorpGovInvestorsPerspectiveExpectations.pdf>> (last accessed: June 10, 2013).

Company, that influences the thinking of a Director while sitting on the Board is inimical to the concept of independence.<sup>90</sup>

Corporate Governance norms are dynamic in nature and need to evolve regularly in order to keep pace with the ever-changing corporate world. The institution of Independent directors is absolutely indispensable to the corporate governance regime. It would not be wrong to say that Independent Directors are in a way, insurers of good corporate Governance practices. Just like corporate governance practices need to be periodically reformed, in the same flow, the institution of Independent Directors also needs a rhythmic evolution.

SECP have time and again highlighted the need for good corporate governance practices. A strong Corporate Governance mechanism is not possible without a well-defined and truly independent institution of Independent directors.

What we need, is a stronger Legislation upon the subject. The current regime of Independent Directors in Pakistan leaves much scope for improvement. Clause (i-b) of the code was a welcome development when it came. However, it is insufficient and sometimes even flawed to keep up with the present times. The Silence of the Ordinance upon the subject also adds to the ambiguity of the institution of Independent Directors. What the legislators need to realize is that the corporate world is fast changing and therefore corporate governance cannot depend on statutes that are outdated. Provisions relating to corporate governance need to be constantly updated. Good Corporate Governance and more specifically the institution of ID's is the only hope to prevent Corporate Scams and protect the rights of the shareholders and thus it needs to be strengthened. There is a need for strict observance of the code of conduct and

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<sup>90</sup>Ian zandstra, "Pros and cons of independent director", 3. Available at <<http://www.coopsnsw.coop/PDF/independent%20directors.pdf>> (last accessed: June 12, 2013).

principle of self-regulation by the board of directors. The institution called Independent Director is at a nascent stage it needs to be nurtured very carefully to enable it to blossom as a powerful apparatus of corporate governance.



## **CHAPTER FOUR: CONCLUSION AND SUGGESTIONS**

Corporate governance is a way of governing activities of a corporation for the well being of all stakeholders not only for share holders that ultimately leads to better financial performance. It refers to manner in which the affairs of a corporate body are or should be conducted in order to serve and protect the individual and collective interests of all stakeholders. No doubt, Pakistan has made considerable development in efforts of improving corporate governance especially in current decade. World Bank report "Getting Finance in South Asia 2009" has ranked Pakistan first in the areas of corporate governance, performance and efficiency. However entirely tapping the potential of financial markets, and professionalizing management and board of directors will require more efforts to continue. No doubt, good governance ensures that corporations use their resources more effectively, efficiently and pad to better relations with employees and other stakeholders.

The various models of corporate governance that exist globally have evolved as economies and the corporate structure were shaped. The bases of modifications in the corporate governance models were environmental influences such as worldview, culture and the legislative and political framework. Thus, the basic aims of these models are not only to achieve the particular objectives but also to maximize efficiency, economic benefit, shareholder wealth or the protection of minorities. Pakistan is a specific area in point where corporate governance is evolving. The economy is essentially in a state of metamorphose simultaneously growing, developing and being transformed from a command system to a market economy. A significant

recent driving factor of this transformation is the accession of Pakistan to World Trade Organization (WTO).

The empirical question that this research poses is whether corporate governance model that works for the US and the UK, also work for a country like Pakistan? Pakistan is a country much further down on the development ladder, with ownership structures markedly different from diluted ownership structure of developed countries, with its stock exchanges displaying shallowness and its cultural underpinnings heavily influencing how the corporate sector operates. Here, the ultimate objective of the code of corporate governance should be to incorporate good governance into Pakistani corporate environment, in order to enhance productivity and efficiency, rather than trying to emulate the dynamics of those countries which pioneered the Anglo-Saxon model. As we see no individual model of corporate governance is suitable to be adopted for Pakistan. The code of corporate governance espoused by Pakistan will need to be acclimatized keeping the local business environment and market conditions in mind. The governance problems in our country are as more than mere conflict of interest between owners and managers or minority shareholders. In order to be able to devise better policies that are tailored to the unique corporate context of Pakistan, there is dire need to formulate and adapt a hybrid model of corporate governance.

The objective of corporate governance cannot, perhaps, be as effectively met without the inclusion of independent directors in the larger scheme of things. This becomes even more compelling in the context of a burgeoning Pakistani economy with unprecedented amounts of funds flowing into companies from within and outside the country. With this growth of business interest, there is a rise in expectations that our companies would abide by the highest standards of corporate governance in manner clearly demonstrable to the investors. IDs have their origin in

the monitoring role to the management and they found prominent place in the CG books with passage of time. They have found entry into statute books of company law of the developed world long before as basis for sound governance and as a check on management to curb any corporate fraud. In Pakistan, IDs entered into corporate lexicon via Clause i b of the code of corporate governance. we have just imported the concept of IDs from developed world. We just prefer form over substance and structure over process. The concept developed abroad needs to be validated in home conditions, to be work successfully. SECP tried to impose conditions of IDs over companies, but it has not worked very well in Pakistani conditions, companies have adopted it only in form but problem has remained. The practice has remained the alike.

The Code has not touched upon the other many aspects related to the IDs, like experience, age limits and term. It is revealed at a later date that the independent director on the board is not in fact independent- what would happen to the decisions of the board? Some experts have pointed out several deficiencies in the working of independent directors. These include complaints against their inability to find sufficient time and their lack of knowledge regarding the company affairs to fulfill the demands of their position. There is a gap in between the demand and actual number of qualified personnel. We need to contribute fruitfully to this process of transition and for strict observance of the code of conduct and principle of self-regulation by the board of directors. The institution called Independent Director is at a nascent stage, it needs to be nurtured very carefully to enable it to blossom as a powerful apparatus of corporate governance. To address this scarcity, regulatory institutions have to launch programs to professionally train individuals as independent directors. Directors find themselves at the vanguard of the corporate governance revolution. They need to embrace the principles of good

practices. At the same time, investors must also be pro active in their demands and expectations of the highest level of governance by exercising their rights.

### **Suggestions:**

There are some Suggestions to cure these issues:

- The Securities and Exchange Commission of Pakistan acknowledged that its Code of Corporate Governance “draws upon the experiences of . . . countries with a common law tradition” and expressly referred to reports and recommendations from the U.K. and South Africa. But that model has not been widely adopted for a variety of reasons, including that existing governance systems are not easily changed due to path dependent choices-i.e., that past or traditional practices tend to persist even if better alternatives are available, or, more broadly, that history matters. We discussed both insider and outsider based system of corporate governance and it can be seen that no individual system is suitable to be adopted for the Pakistan. There is dire need to formulate and adapt a hybrid model of corporate governance for the betterment of Pakistan corporate sector.
- For this purpose, there should be two tier boards (supervisory board and management board) instead of one tier board. Entire supervisory board will be comprised of non-executive directors whereas management board will consist of only executive directors. These boards will together constitute a joint board headed by a chairman who will also head the supervisory board and management boards. Supervisory board will conduct its affairs with the help of sub committees and this model would aim to fill the board room in the sense of ensuring the balance of representation, talents, power and attitude which is the prime source of poor corporate governance in Pakistan.

- Independence is currently defined with respect to the existence of pecuniary or business relationship and family relationships. These are quite narrow, and in our country where the cultural backgrounds create other forms of social relationships between individuals (such as extended other forms familial relationships and friendships and bonds between business families that transcend generations), it is necessary for definitions of independence to capture such relationship as well. The importance of social institutions cannot be undermined. Admittedly, it is an onerous task for legal definitions to capture such fluid relationships, but guiding principles can nevertheless be set out without attempting very specific definitions.
- If a company truly needs independent directors, they have to be nominated by the SECP. If they have a right to regulate, then surely they have a right to even suggest the appointment of certain directors. So, in the case of listed companies, SECP must have the right to nominate independent directors, and if such legislation is brought in, a lot of good and competent people with managerial acumen will apply to SECP and ask for nominations. There are a lot of individuals who are prepared to work as independent directors and are truly independent because then they'll be accountable to SECP, and not to the promoter. On the contrary it can be argued that the authority may not be given to an outside party to place a director on a company. There may be some merit in having an approved list which means that the SECP could perhaps decided that there are certain qualifications which directors need. They could screen them for positive negative attributes and have a panel to say that these are independent directors that can be on listed companies and let management select or the nomination committee selects who they want in accordance with the requirement and nature of the company.

- The age limit for the independent director should be clearly mentioned in code. Independent director should be age of 30-35 years as a person of that age will have adequate knowledge and experience to identify the fraud, misdemeanour and foul play happening in the company.
- The tenure of the independent director should be fixed up to the period of 6-8 years and no reappointment of the person for the office of independent director. Fixed tenure could have been valid in case an outsider, not known to the promoter, came on to the board as with the passage of time, there is a possibility that he could become friendly with the promoter. The fixed tenure proposition has some value only in case we can ensure that independence was ensured at the time of appointment.
- How to compensate independent directors is a vexed issue. Pay too little, and you may not get the right people. Pay too much, and you compromise independence so the lucrative and attractive remuneration might lead to the defeating of the entire purpose of the legislative intention of setting up the office of an independent director. In many Western and European countries, independent directors are paid handsome remunerations which ensure their motivation to participate positively in board meeting and thus effective decision making. On the contrary, independent directors in Pakistan lose their independence as they are much dependent on the income from any organization. This problem can be mitigated by introducing proper incentives and remuneration packages on performance basis and by developing the fee system like annual fee, meeting attendance fee and additional fee for chairmanship of committees.
- To strengthen corporate governance within the existing system, it is suggested that more could be done to protect the position of independent directors and prevent them from

being easily pushed aside by the rest of the board at times when they are deemed to be uncooperative. There should be some form of security of tenure with rules in place that say if you want to remove an independent director, the regulator needs to know and understand the reasons and be given a veto against it if there are compelling reasons why the independent should not be removed.

- SECP Regulations and companies ordinance neither make any specific provision nor have laid down any criteria for appointment of independent directors. They should have basic knowledge sufficient enough to be qualified that they are able to ask the appropriate and right question on the right time when they are at the board and the most important that they have the ability and capability to stand up for the interest of minority share holder. They need to be sound in judgement with an inquiring mind. Presence of independent director on the board makes sense only if they are well-educated, can add value to the company, and represent minority shareholders interests. It is therefore necessary to introduce positive qualities that individuals are required to display before they can occupy an independent director's board seat. This can be knowledge or experience in the particularly industry in which the company operates, or even general business and managerial skills, or other allied skills in areas such as accounting, marketing ,strategy, law and the like that the individual can bring to bear on corporate boards
- Lack of a clear role for independent directors is a key shortcoming of the corporate governance norms in Pakistan. The law should clearly demarcate the line between independent directors and executive directors by defining their functional responsibilities along with liabilities.



- Independent directors cannot function effectively without a conducive environment. At the outset, it is necessary to ensure that independent directors obtain all relevant information that enables them to make considered decisions on matters. There needs to be a regular flow of information from management (and controlling shareholders) to independent directors. Furthermore, independent directors should have direct access to key company officials without going through management (Or controlling shareholders), as it is important to make sure they receive information that is not filtered at any level and should be allowed to participate in day to day working of the company to have ample amount of information about the working of the company. The independent director should be more vigilant and ask more questions on the board.
- Independent directors will be made more accountable if their performance is evaluated at least once a year. It is important to determine the factors and metrics on the basis of which the independent directors are evaluated. Those should be consistent with the roles and responsibilities of the independent directors and also to extent which the interest of the relevant constituencies have been protected. It is for the chairman of the company as well as the nomination committee to determine the performance of independent director and decide whether the term of such director should be renewed or not. Such a process of constant evaluation of independent directors would motivate them to perform effectively in a manner that fulfils their roles and functions.
- Professionalization can be taken to the next level through additional steps. The first is training for independent directors. Introducing mandatory training at the time of induction as well as continual training on a periodic basis would ensure that independent directors are aware of their roles and responsibilities. Apart from formal training,

informal briefings and caucuses would work as well. In addition, it is necessary for policymakers to explore the possibility of creating a cadre for independent directors through a certification process. A regulatory authority or peer body would register individuals as independent directors upon satisfaction of certain conditions, including qualifications, experience, competence levels, training, and so on. Such a certification would not only ensure uniform standards in independent directors, but would also make such directors accountable to their peers. This is similar to certification of lawyers, chartered accountants, architects and other professionals. It may be premature at this stage in the evolution of corporate governance in Pakistan to insist on certification as a mandatory requirement, but it is an aspect which should be attained eventually and policymaking efforts ought to clearly bear that in mind.

- It is generally acknowledged that implementation of the code has resulted in greater financial discipline, uniform presentation of financial results and an organized and more disciplined corporate culture which has, to a great extent, bridged the gap between various stakeholders, the board of directors and the auditors. Therefore, proper implementation of the code of corporate governance is important for effective governance. It is the responsibility of the board to make sure its practical implementation.
- It is suggested that an institute of directors will need to be established, whose task would be to create a data bank of persons qualified and experienced enough to serve as directors. A number of organizations like SECP, ICAP, ICMP AND MAP can also play a supportive role in identifying professionals with suitable credentials to serve as independent non executive directors.

- It is suggested that the focus should be on the quality of director and not on the quantity of independent director just because we need directors who are capable of doing his work efficiently not to fill the requirement of having them on the board. They deem to play role as watchdogs on the board not as puppets in the hands of majority. So we should stress on their quality not mere on quantity.
- The code of ethics is the set of rules and guidelines for moral behaviour and explains the guidelines for employees to work. The code also strengthens the role of directors and plays vital role in setting the duties of board. For this newly appointed directors and employee should be asked to sign the company's business ethics statement at the time of their appointment and PICG should work to develop a set of detailed guidelines for board members for defining their duties. The companies should follow code and work in better way for the society from which the organization is generating its resources.
- Journalists need to grasp corporate governance concepts to reach awareness on the subject, to report news that business leaders seek and to uncover potential or existing corporate governance issues in companies. Well-informed reporters and editors play a central role in building awareness of the value of corporate governance. Through their investigations, they can show the consequences that result when companies are poorly governed. If the journalists' credibility is perceived as unimpeachable, their analyses tend to influence opinions of leaders in business, government, academia and stakeholder communities. There is a dire need to improve corporate governance reporting in Pakistan included the teaching of corporate governance in journalism schools, giving ideas to journalists on corporate governance stories, and bringing the key stakeholders such as the business people, regulators and the media together to address their issues in front of each

other to resolve the communication gap between each of the groups. Or regulator should take some steps to launch a media guide to corporate governance and train journalists in this regard.

- For regulation to be useful, it is essential that: the regulator is duly empowered, professionally competent, operationally independent, and not only has integrity but is manifestly seen to have integrity. It is extremely important that regulation retains purity of formulation and execution and is not tainted by any political agenda. The regulator is at once a monitor, a policeman, a magistrate and a father-figure and patron of the market. In developing countries, facilitating and incentivizing the development of the market through appropriate regulatory positioning is an additional significant function of the regulator. SECP as a regulatory authority in Pakistan, played an important role to implement the corporate governance in Pakistan so it should focus on enforcing the rule of law on disclosure especially ownership and related parties transactions. It should continue to enhance its enforcement capability. For this purpose SECP should take important steps include increasing the technical size and level of staff in critical areas like accounting etc. SECP, in consultation with ICAP, should develop detailed guidelines for the guidance of Directors on the Board on internal control and risk management issues. It should refine enforcement procedures regarding all accounting, legal and technical issues particular in code of corporate governance.
- Whistle blowing mechanism is strongly recommended, which is a weaker area under existing set up of corporate governance of Pakistan.
- While a number of recommendations have been made in this chapter, not all of them require legislation to implement. Certain aspects require a legislative framework before

they can be effective. These include the definition of independence, voting systems for election of independent directors, clarity regarding the duties, role and allegiance of independent, mechanisms for compensating directors and fixation of liability. However, various other aspects such as commitment in terms of time, procedures for receipt of information and conduct of board and independent director meetings are matters for which the legal regime needs to provide for some basic principles, but the detailed working are to be left to the various corporate players to devise. These matters will vary among companies and hence some level of flexibility is called for. Moreover, these matters will need to be developed in the form of standard practices, and in that behalf, various business associations and director forums could play a more significant role than legislation.

- That institution of independent director, as we have seen, cannot work by itself. It requires to support, and be supported by, a whole host of other attributes such as a stringent accounting and financial disclosure regime, whistle blowing mechanisms, a code of ethics, and even perhaps an open market for corporate control, just to name a few. The role of independent directors should also be supported by other gatekeeper functionaries such as accountants, investment bankers, corporate and securities lawyers, securities analysts, rating agencies and even the business press. The effectiveness of the independent directors also depends on other systemic factors. For example, it even requires courts in Pakistan to be in a position to rule efficaciously on corporate and securities law aspects, set precedents for lower courts to follow and create a set of principles that instill certainty in the functioning of independent directors as ambassadors of enhanced corporate governance. Though law does play an important role in creating

the conditions for institutions like independent directors to carry out their functions, the success of that institution also depends to a large extent on the individuals that occupy that position and the cultures and practices that are prevalent in Pakistan.

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