

Corporate Governance in Pakistan

Reforming the Role of Board of Directors and Critical Analysis of Pakistan's Model



A thesis of LLM Corporate Law

Submitted by

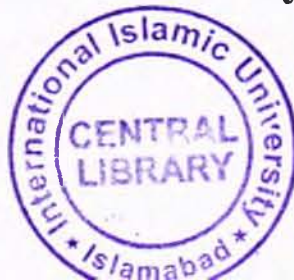
Muhammad Maroof Bhatti

22/FSL/LLM CL/F-04

Supervised by

Nazir Ahmad Shaheen

Faculty of Shariah & Law
International Islamic University, Islamabad



Accession No. TH-10064

LLM
346.066
BHC

1. Companies ; LAW
2. Corporation LAW

DATA ENTERED

Aug 27/3/13

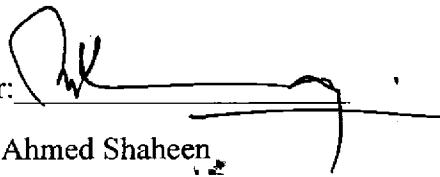
INTERNATIONAL ISLAMIC UNIVERSITY,
ISLAMABAD

FACULTY OF SHARIAH AND LAW

APPROVAL SHEET

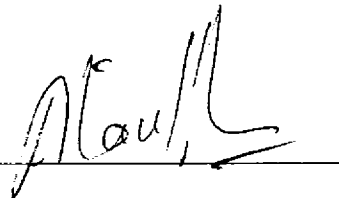
It is certified that I have read the thesis submitted by Muhammad Maroof Bhatti entitled *Corporate Governance in Pakistan Reforming the Role of Board of Directors and Critical Analysis of Pakistan's Model* as a partial fulfillment for the award of the degree of LLM (Corporate Laws). We have evaluated the thesis and found it up to the requirement in its scope and quality for the award of the degree.

Supervisor:



Mr. Nazir Ahmed Shaheen
(Executive Director SECP)

Internal Supervisor:



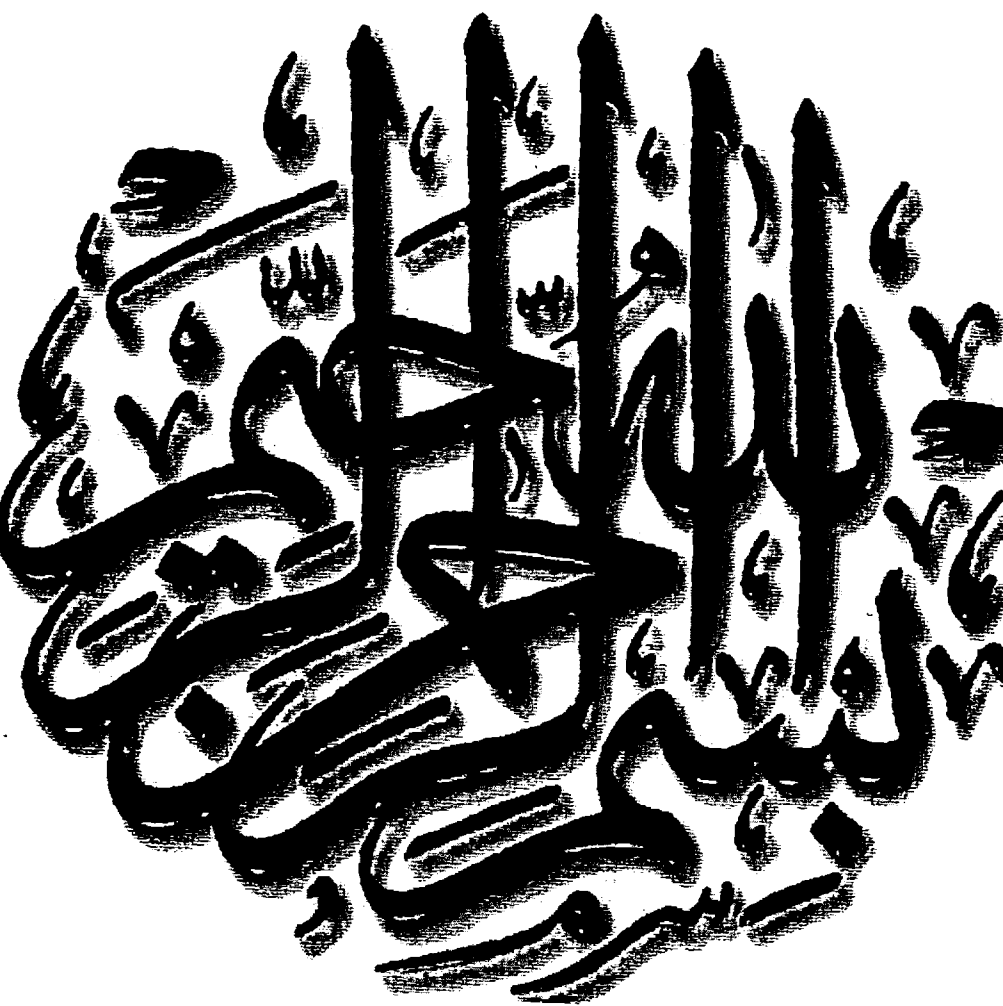
Mr. Attaullah Khan

(International Islamic University)

External Examiner:



Mr. Muhammad Younus
(International Islamic University)



Certificate of Originality

It is to certify that the research entitled "**Corporate Governance in Pakistan** Reforming the Role of Board of Directors and Critical Analysis of Pakistan's Model" conducted by me is the product of my own work, except as specified in acknowledgements and bibliography any material taken from any source such as research papers, books, internet etc. solely to support, elaborate, compare and extend earlier work.



Muhammad Maroof Bhatti

Dedication

This thesis is dedicated to my **FATHER, MOTHER** who always believed, encouraged and supported me throughout my life.

ACKNOWLEDGEMENT

The writing of this dissertation has been one of the most significant academic challenges I have ever had to face. Without the support, patience and guidance of the following people, this dissertation would not have been completed. It is to them that I owe my deepest gratitude.

It is difficult to overstate my gratitude to my supervisor, Mr. Nazir Ahmed Shaheen. Throughout my thesis-writing period, he provided encouragement, valuable comments, insightful criticism and lots of good ideas towards the completion of my thesis.

I wish to thank my Father and Mother, who have always supported me, encouraged me and believed in me, in all my endeavors. I am grateful to my sister and brothers who are always there for my support and help throughout my life. I am also thankful to my loving wife for her patience and support during the completion of thesis writing.

I am also grateful to Mr. Ikram Ul Haque Qureshi Director General, Competition Commission of Pakistan and Mr. Arshad Mahmood Abbassi for being with me as friends and as seniors during my studies and for their continuous professional support and guidance.

I wish to thank Syed Ahmad Hassan Shah, Managing Partner, Hassan Kaunain Nafees, Legal Practitioners & Advisers and Ms. Rahat Kaunain Hassan, Chairperson Competition Commission of Pakistan for their valuable professional guidance and elegance throughout my professional career.

Table of Content

List of Abbreviations.....	v
List of Figures	vi
List of Table	vi
Introduction	1
Chapter 1	5
1.1 Corporate Governance in Developed countries.....	5
1.1.1. European Union.....	7
1.1.1.1. State of Corporate Governance	8
1.1.1.2. Towards Converging Models	9
1.1.1.3. Patterns of Employee Representation.....	10
1.1.1.4. Stakeholder Issues	11
1.1.1.5. Shareholder Participation	11
1.1.1.6. Board structure, their Role and Responsibilities	12
1.1.1.7. Supervisory Body Independence and Leadership	13
1.1.1.8. Disclosures	14
1.1.2. United States of America (USA).....	15
1.1.2.1. Evolution of Corporate Governance.....	16
1.1.2.2. The Driving Forces for Changing in Corporate Governance	20
1.1.3 Corporate Governance in OECD Countries	23
1.2 Corporate Governance in Developing Countries	31
1.2.1 Corporate Governance in China.....	31
1.2.1.1. Recent Developments in China's Corporate Governance and key problems	32
1.2.1.2. Highly Concentrated Ownership Structure	33
1.2.1.3. Insider Control of Corporate Affairs	34
1.2.1.4. Weak Protection of Shareholders Rights.....	34
1.2.1.5. Frequent Insider Trading, Self Dealings and Collusions in Market Manipulations.....	35
1.2.1.6. Falsification and Fabrication of Financial Data	35
1.2.1.7. Weak Independent Board of Directors and Specialized Committees	36
1.2.1.8. Weak Supervisory Board.....	37
1.2.1.9. Weak Auditing Profession.....	37
1.2.1.10. Overcoming the above Problems with Corporate Governance Regime	38
1.2.2 Corporate Governance in Malaysia.....	39
1.2.2.1. Malaysia's View of Corporate Governance	41
1.2.2.2. Development of corporate governance in Malaysia.....	41
1.2.2.3. Malaysian Code on Corporate Governance.....	42
1.2.2.4. Capital Market Master Plan (CMP).....	43
1.2.2.5. Financial Sector Master Plan.....	43
1.2.3 Corporate Governance in India	46
1.2.3.1. Legal and Regulatory Framework	47

1.2.3.2. Laws regulating the corporate sector and capital market	48
1.2.3.3. Stock exchanges and role of market regulator	50
1.2.3.4. SEBI code of corporate governance	51
Chapter 2	54
2.1. Development of Corporate Governance in Pakistan	54
2.1.1. Evolution and History of Corporate Governance	55
2.1.2. Impact of International Developments on State of Corporate Governance in Pakistan	57
2.1.3. In Built Provisions for Corporate Governance in Companies Ordinance, 1984	58
2.2. Development of Company Law in Pakistan	60
2.2.1. Code of Corporate Governance	63
2.2.2. Manual of Corporate Governance	67
2.3. Role of International Donor Agencies on Corporate Governance in Pakistan	68
2.3.1. United Nations Development Program	69
2.3.2. Asian Development Bank	71
2.3.2.1. Financial Markets Governance Program	72
2.3.3. World Bank	74
Chapter 3	77
3.1. The Board of Directors	77
3.1.1. Separation of governance and management	78
3.1.2. Board Structure	79
3.1.3. Provisions of Companies Ordinance Relating to Board of Directors	79
3.1.3.1. Eligibility to become director	79
3.1.3.2. Election of Directors	80
3.1.4. Powers of Directors	81
3.1.4.1. Removal of Chief Executive	82
3.1.4.2. Recommending Dividend	82
3.1.4.3. Appointment of Auditors and Related Matters	82
3.1.4.4. Transfer of Shares and Debentures	82
3.1.4.5. Further Issue of Capital	83
3.1.4.6. Calling of Extra Ordinary General Meeting	83
3.1.4.7. Validity of Acts of Directors	83
3.1.4.8. In Relation to Promotion Expenses	83
3.1.4.9. Maintaining Books of Accounts	84
3.1.4.10. Period for Payment of Dividend	84
3.1.5. Duties and Responsibilities of Directors	84
3.1.5.1. Presiding General Meeting	84
3.1.5.2. Remuneration of the Directors	85
3.1.5.3. Loans to Directors	85
3.1.5.4. Prohibition of Certain Acts	86
3.1.5.5. Appointing CEO and determining Terms of Appointment	86

3.1.5.6. Investments in Associated Companies and Undertakings.....	86
3.1.5.7. Disclosure of Interest.....	87
3.1.5.8. Restriction on Voting by Interested Directors.....	87
3.1.5.9. Disclosure of Shareholding	87
3.1.5.10. Trading of Securities	87
3.1.5.11. Directors Report	88
3.1.5.12. Authentication of Balance Sheet	88
3.1.6. Responsibilities of Directors	88
3.1.6.1. Civil Liability for Misstatement in the Prospectus.....	88
3.1.6.2. Restriction on Allotment	89
3.1.6.3. Allotment of Shares and Debentures to be dealt in Stock Exchange	89
3.1.6.4. Not to Refuse Transfer of Shares	89
3.1.6.5. Purchase of Company's Own Shares	90
3.1.6.6. At Commencing Business	90
3.1.6.7. Statutory Meeting of the Company	90
3.1.6.8. Prohibition Regarding Making of Political Contributions	91
3.1.6.9. Register of Directors	91
3.1.6.10. Maintaining Books of Accounts.....	91
3.1.6.11. Facilitating Inspection of Books of Accounts	91
3.1.6.12. Annual Accounts and Balance Sheet.....	92
3.1.6.13. Furnishing Information, Documents etc. to the Registrar	92
3.1.6.14. To Carry out Orders of the Court	92
3.1.6.15. Statement of Affairs	93
3.1.6.16. Custody of Company's Property.....	93
3.1.6.17. Declaration of Solvency in case of Voluntary Winding up.....	93
3.1.6.18. Meeting of Creditors in Creditors Voluntary Winding up	94
3.1.6.19. Allotment of Shares for Inadequate Consideration	94
3.1.7. Retirement of Directors	94
3.1.8. Penalties and disqualifications	95
3.1.9. Application for listing	96
3.1.10. Provisions of Code of Corporate Governance Relating to Board of Director	101
3.1.10.1. Eligibility to Become a Director	101
3.1.10.1. Election of Directors	102
3.1.11. Powers of Directors	102
3.1.11.1. Appointing CEO and other Executives	103
3.1.11.2. Recommending Appointment of External Auditors.....	103
3.1.12. Duties and Responsibilities	104
3.1.12.1. Declaration at the time of Filing Consent to act as Director	104
3.1.12.2. Casual Vacancy on Board of Directors	104
3.1.12.3. General	104
3.1.12.4. Establishing Sound System of Internal Control	105
3.1.12.5. Defining Roles and Responsibilities of the Chairman and CEO.....	105
3.1.12.6. Meetings of Board of Directors.....	105
3.1.12.7. Trading by Directors and their Spouses	106

3.1.12.8. Determining Closed Period	106
3.1.12.9. Establishing Audit Committee	106
3.1.12.10. Meetings of Board of Directors	106
3.1.13. Directors Report	107
3.1.14. Powers of Directors under the Listing Regulations of the Karachi Stock Exchange	109
3.1.15. Practical Aspects and concerns of the Board composition and performance in Pakistan	109
3.2. Analysis of the state of current board practices and policy recommendations ..	112
3.2.1. Basic description of board	112
3.2.2. Size requirement	112
3.2.3. Adequacy of duties of loyalty and care	112
3.2.4. Insurance for directors	114
3.2.5. Accountability of the Board	114
3.2.5.1. Fair treatment for the protection of all the shareholders' rights	114
3.2.5.2. The exercise of objective independent judgment by the board	115
3.2.6. Access to Information	115
Chapter 4	117
4.1. The Regulators of Corporate Governance	118
4.1.1. Securities and Exchange Commission of Pakistan	118
4.1.2. Pakistan Institute of Corporate Governance (PICG)	121
4.1.2.1. Introduction	121
4.1.2.2. The Formation of PICG	121
4.1.2.3. Activities	122
4.1.3. Stock Exchanges and Regulation	122
4.1.3.1. Regulation by KSE	123
4.1.4. Sector Specific Regulators	125
4.2. Common Strategy Framework	126
Chapter 5	13030
5.1. Two Distinctive Models of Corporate Governance	13131
5.1.1. Managerial company Governance	13131
5.1.2. The Shareholder Model	132
5.1.3. The Stakeholder Model	133
5.1.4. Neither of the Two Models is Ideal	134
5.2. Dual Convergence	136
5.2.1. Factors of Resistance	136
5.3. Analysis of Practiced Model in Pakistan	137
5.3.1. Performance Ranking of Code of Corporate Governance of Pakistan	140
Chapter 6	143
Bibliograpy	147

List of Abbreviations

ADB	Asian Development Bank
CFS	Continuous Funding System
CII	Confederation of Indian Industry
COT	Carry Over Transactions
CSF	Common Strategic Framework
CSRC	China Securities Regulatory Commission
DCA	Department of Company affairs
EU	European Union
FMGP	Financial Markets Governance Programme
FPLC	Federation of Public Listed Companies
FSMP	Financial Sector Master Plan
KSE	Karachi Stock Exchange
MID	Malaysian Institute of Directors
MSWG	Minority Shareholders watchdog group
NBFC	Non-Banking Finance Companies
OECD	Organization for Economic Co-operation and Development
PICG	Pakistan Institute of Corporate Governance
SEBI	Securities and Exchange Board of India
SECP	Securities and Exchange Commission of Pakistan
ROSC	Report on the Observance of Standards and Codes
UNDP	United Nations Development Programme
WTO	World Trade Organization

List of Figures

Figures	Page No.
4.1 Co-relation of Corporate Governance	126
4.2 Common Strategy Framework	128

List of Table

Tables	Page No.
2.1 Chronological Development of Regulatory Framework	61-63
2.2 Performance of Financial Markets	64
2.3 Delisted Companies	65
3.1 Governance/ Management of Affairs of the Business of Company	78
5.1 Summary of the Observance of OECD Corporate Governance Principles, Pakistan and World Average	142

Introduction

In the last few years corporate governance, an issue that was perceived by majority of the people to be a strange and technological, has attained fragile significance and attention in the government policy circles as well as the academic circles. Various reasons explain its existing importance. Corporate governance refers to the structures and processes for the direction and control of companies. It concerns the relationships among the management, board of directors, controlling shareholders, minority shareholders and other stakeholders. Good corporate governance contributes to sustainable economic development by enhancing the performance of companies and increasing their access to outside capital.

The progression of corporate governance does not subsist in segregation but draws upon indispensable principles and values which are expected to leak into all human dealings, including business dealings principles such as utmost good faith, trust, competency, professionalism, transparency and accountability, and the list can go on. Corporate governance builds upon these basic assumptions and demands from human dealings and adopts and refines them to the complex web of relationships and interests which make up a company. The body of laws, rules and practices which materialize from this amalgamation is never stagnant but continuously developing to meet changing state of affairs and necessities in which companies function. However, corporate governance developed with the passage of time owing to the existence of non-transparent conduct of the affairs of the companies by the investors. This resulted in a growing body of laws, rules and practices, which seek out to ensure that high standards of corporate governance continue to apply to the affairs of the companies.

For emerging economies, improving corporate governance can serve a number of important public policy objectives. Good corporate governance reduces emerging

market vulnerability to financial crises, reinforces property rights, reduces transaction costs and the cost of capital, and leads to capital market development. Weak corporate governance frameworks reduce investor confidence, and can discourage investment. Over the past several years, the importance of corporate governance has been highlighted by an increasing body of academic research. Studies have shown that good corporate governance practices have led to significant increases in economic value of companies, higher productivity, and lower risk of systemic financial failures for countries.

Definition:

The term corporate governance has been defined in different ways according to its applicability in various scenarios. However, a basic definition of corporate governance, which has been widely recognized, was given in the Cadbury Report. This definition of corporate governance has been endorsed in various other dialogues on the subject. It states¹;

“Corporate governance is the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies. The shareholders' role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place. The responsibilities of the directors include setting the company's strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship. The Board's actions are subject to laws, regulations and the shareholders in general meeting.”

¹ Report of the Committee on “*The Financial Aspects of Corporate Governance*”, 1992, Professional Publishing Limited, London. Page 14. Also available on European Corporate Governance Institute <http://www.ecgi.org>

International Chamber of Commerce in its web based guide to corporate governance for business managers has defined the subject as²:

"Corporate governance is the relationship between corporate managers, directors and providers of equity, and institutions who save and invest their capital to earn a return. It ensures that the Board of directors is accountable for the pursuit of corporate objectives and that the corporation itself conforms to the law and regulations. "

The Organization for Economic Cooperation and Development has defined the corporate governance as³:

"Corporate governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as the Board, managers, shareholders and other stakeholders, and spells out the rules and procedure for making decisions on corporate affairs. By doing this, it also provides the structures through which the company objectives are set, and the means of attaining those objectives and monitoring performance. "

Purpose of this study:

Pakistan at the wake of 21st century has undergone key policy variations that are privatization, de-regulation and liberalization of the corporate sector to attract foreign and domestic investments.

The focus of this study rests on:

² International Chamber of Commerce <http://www.iccwbo.org/corporate-governance/id3092/index.html> (Last visited January 2006)

³ OECD Principles of Corporate Governance, 2004, OECD Publication Service, France.

1. to review the global trends and practices encompassing corporate governance;
2. to highlight the role of board of directors in an efficient corporate sector along with international board structures;
3. to analyze the role of regulators for the compliance of the corporate governance practices and statutes; and
4. to investigate into the corporate governance models for the smooth performance of corporate sector in Pakistan.

Scheme of Study:

Pursuant to the above mentioned objectives, we have adopted the following scheme of study:

- As corporate governance is relatively a new concept in Pakistan and the material available on the topic is very small, therefore, it becomes important to analyze the corporate governance practices in the developed countries from where it originated. Hence, chapter 1 reviews the subject in the developed and developing countries;
- Chapter 2 highlights the development of corporate governance in Pakistan;
- The role of board of directors for ensuring the corporate governance compliance along with internationally practiced board structures is discussed in detail in chapter three;
- Chapter 4 focuses on the functions of regulators in observance of corporate governance;
- In chapter 5 we have elucidated a practicable corporate governance model (CGM) for Pakistan; and
- Finally the conclusions and policy recommendations, drawn on the basis of prevalent corporate governance practices in accordance with our CGM, are given in chapter 6.

Chapter 1

Corporate Governance in Global Perspective

With the dawn of the twenty-first century corporate governance, an issue that many persons might think strange and technological, has attained delicate importance and attention in government policy circles, academic circles, and the popular journalists through-out much of the world specially in the pitch of developed countries. Various reasons explain its existing importance. This chapter reviews the existing literature and recent developments in the area of corporate governance. Section 1.1 deals with the developments, key policy concerns and problems that are being encountered by the developed countries in implementing the corporate governance models. In section 1.2 we have reviewed the case for developing countries, specially focusing on Asian countries, their challenges and problems with respect to corporate governance regimes.

1.1 Corporate Governance in the Developed Countries:

The recent financial scandals affecting major American firms, such as Enron, WorldCom and Arthur Andersen, and the consequential loss of confidence by the investing public in the stock market have led to remarkable declines in share prices and extensive financial losses to millions of individual investors.⁴ Even before the recent

⁴ OECD Principles of Corporate Governance (endorsed by the Ministers at the OECD Meeting, May 26-27, 1999), Paris, OECD, 1999, In the wake of the financial scandals in the United States and the growing international concern over corporate governance, the OECD Council at Ministerial level at its meeting of May 15-16, 2002, launched a new initiative to strengthen corporate governance. Its final report stated: "the OECD will survey developments in OECD countries on governance in the corporate and financial sectors, with a view to identifying lessons to be learnt and the implications for the assessment of the OECD Principles of Corporate Governance as a bench mark." Can be viewed at www.oecd.org. Last visited April, 2006.

scandals, significant efforts, propelled to a certain extent by earlier financial abuses, had been under way since the early 1990s within the OECD, the European Commission⁵ and individual European countries⁶ to understand the economic consequences of corporate governance and to plan recommendations on suitable governance structures and practices

Corporate governance also has diverse international implications. The companies for the sake of generating more financial liquidity list their securities on various foreign stock exchanges and are bound to follow the laws of each stock exchange. Adding up, one of the argument upon which challengers of "globalization" have challenged multinational corporations, the prime movers of globalization, is that imperfect systems of governance allow corporate decisions to be made without taking account of the interests of all "stakeholders", other than those of corporate managers and shareholders. One recent study⁷ has also concluded that important international economic disputes, such as those within the European Union over the right of state-controlled public utilities to remain immune from takeovers, or the tensions between the United States and Japan over Japanese bank debts, arise out of corporate governance problems.

In view of the current concerns with corporate governance in the developed countries, it is important to have an insight into the prevalent state of corporate regimes in some of the prominent developed countries.

⁵ Weil, Gotshal wqw& Manges LLP, on behalf of the European Commission, Internal Market Directorate General, Comparative Study of Corporate Governance Codes Relevant to the European Union and its Member States (January 2002) available at www.europa.eu.int/comm/internal_market/en/company/news/corp-gov. Last visited April, 2006.

⁶ In addition to numerous articles and studies, prestigious groups and organizations within individual countries produced over 30 recommended codes of best practices in corporate governance over the last decade. For a comprehensive listing of these codes and reports, see Weil, Gotchal & Manges, *ibid.*, at pp.14-16.

⁷ James Shinn and Peter Gourevitch, *How Shareholder Reforms Can Pay Foreign Policy Dividends* (New York: Council on Foreign Relations, 2002), pp.5-6.

1.1.1. European Union:

Europe began its journey towards unification with the first cooperation contracts and alliance in 1948⁸. On April 16, 1948, the Organization for European Economic Cooperation was created, the first entity uniting all of the western European nations consisting of Austria, Belgium, Britain, Denmark, France, Greece, Ireland, Iceland, Italy, Luxembourg, Norway, the Netherlands, Portugal, Spain, Sweden, and Turkey⁹. The main objectives of the OEEC were to organize and manage the economic aid coming from the U.S. under the Marshall Plan. The OEEC helped to liberalize trade between its member states, introduce the first ideas on monetary agreements, and develop a more concrete economic cooperation in general¹⁰. Since these European countries were all experiencing the aftershock of World War II, the idea of unification was a welcome warm blanket. After all, there is strength in numbers.

In 1957, the European Economic Community (EEC) was created with the following goals in mind: establish a common market and approximate the economic policies of the member states; promote throughout the community a harmonious development of economic activities; establish a continuous and balanced expansion; provide for an increase in stability; and accelerate the raising of the standard of living and closer relations between the member states¹¹. The EEC Treaty explicitly identified the goals of a customs union and a common agricultural policy among the member states, and in order to achieve these goals, the treaty provided for the elimination of customs duties and quantity restrictions among member states as well as provided for the facilitation of free movement of persons, services, and capital¹².

The Treaty on EU, also known as the Maastricht Treaty, provided the final step towards a more federal Europe. This treaty outlined three stages toward an economic

⁸See the Creation of the European Community, at <http://eurolandia.tin.it/euro/eng/documenti/percorsi/per1.htm> (last visited May 2006)

⁹ Ibid.

¹⁰ Ibid.

¹¹ Nicolai Ronnebek Hinrichsen, The Constitutional Objection to European Union Membership: A Challenge For the Danish Supreme Court, 15 B.U. INT'L L.J. 571, 576 (Fall 1997).

¹² Ibid.

and monetary union, granted increased power to the European Parliament, and explicitly authorized the European Commission to act in the areas of education, public health, and vocational training. However, the general European public was not accustomed to the European Commission exercising its power in the areas of education, public health, and vocational training. They were quite understandably a bit apprehensive in the expansion and concentration of the latter mentioned powers in a centralized entity even though these powers were in fact mentioned in the original charter. Little did they know that they would later be pleasantly surprised.

1.1.1.1. State of Corporate Governance:

More than the last decade, significance in the function that corporate governance plays in economies, and principally in capital markets, has augmented in the European Union and its Member States¹³. The implementation of a common European currency, the freer surge of capital, goods, services and people from corner to corner of EU, the spirited demands of globalization, the awareness of new technologies, privatization of state-owned enterprises, the escalation and dissemination of shareholding, and increased merger actions among big European companies along with Europe's largest stock exchanges, a remarkable concern on behalf of European issuers and investors, Member States and the European Commission has come to heat in understanding the commonalities and differences among national corporate governance practices, and any connected barriers to the development of a single EU capital market.

Almost all of corporate governance codes are commonly defined as a non-binding set of principles, standards or best practices, issued by a collective body, and concerning to the internal governance of companies. In total thirty-five codes have been

¹³ Comparative study of corporate governance codes relevant to the European union and its member states on behalf of the European commission, internal market directorate general in consultation with EASED - European association of securities dealers & ECGN - European corporate governance network January 2002 available at: http://ec.europa.eu/internal_market/company/docs/corpgov/corp-gov-codes-rpt-part1_en.pdf (last visited June 2006)

issued in EU Member States, with every Member State except Austria and Luxembourg having at least one code. The vast majority of these codes (25) were issued after 1997. The United Kingdom accounts for the largest number of codes (11) almost one-third of the total and also six of the ten pre-1998 codes. These codes are issued from a broad array of groups that include governmental or quasi-governmental entities; committees (or commissions) organized by governments or by stock exchanges; business, industry and academic associations; directors associations; and investor-related groups. However, compliance mechanisms and the status of these codes vary widely. Some codes advocate, or through linkage to stock exchange listing requirements mandate, disclosure by listed companies of the degree to which they comply with code recommendations, together with an explanation of any areas of non-compliance. Even though in some instances disclosure against a code is mandated, all of the codes are voluntary inasmuch as the substantive code provisions need not be implemented. Nevertheless, comply or explain disclosure requirements do exert at least some coercive pressure: the tendency for some companies may be to “comply” rather than to explain. The point is note worthy that even though the corporate governance codes put forward by members of the EU investment community are wholly voluntary in nature, given the investment community’s significant economic power in competitive capital markets, and the power of investor voice and share voting, such codes can have significant influence on corporate governance practices.

1.1.1.2. Towards Converging Models:

The growing interest in corporate governance codes among EU Member States may reflect an understanding that equity investors, whether foreign or domestic, are considering the quality of corporate governance along with financial performance and other factors when deciding whether to invest in a company. McKinsey survey of investor perception indicates that investors report that they are willing to pay more for a company that is well-governed, all other things being equal¹⁴.

¹⁴ McKinsey, Global Investor Opinion Survey, June 2000, McKinsey and Company London. available at <http://www.oecd.org/dataoecd/56/7/1922101.pdf>

These codes emanate from nations with diverse cultures, financing traditions, ownership structures and legal origins. However, the greatest distinctions in corporate governance practices among EU Member States appear to result from differences in law rather than from differences in recommendations that emanate from the types of codes. A significant degree of company law standardization has been achieved throughout the European Union in recent years. However, significant legal differences remain. Some commentators suggest that the remaining legal differences are the ones most deeply grounded in national attitudes, and hence, the most difficult to change. In contrast, the codes tend to express a relatively common view of what good governance is and how to achieve it.

Notwithstanding legal differences among EU Member States, the trends toward convergence in corporate governance practices in EU Member States appear to be both more numerous and more powerful than any trends toward differentiation. In this regard, the codes -- together with market pressures -- appear to serve as a converging force, by focusing attention and discussion on governance issues, articulating best practice recommendations and encouraging companies to adopt them.

1.1.1.3. Patterns of Employee Representation:

The greatest difference in corporate governance practice among EU Member States relates to the role of employees in corporate governance, a difference that is usually embedded in law. In Austria, Denmark, Germany, Luxembourg and Sweden, employees of companies of a certain size have the right to elect some members of the supervisory body. In Finland and France, company articles may provide employees with such a right. In addition, when employee shareholding reaches three percent (3%) in France, employees are given the right to nominate one or more directors, subject to

certain exceptions¹⁵. In all other EU Member States (with the exception of certain Netherlands companies with self-selecting boards), these are the shareholders alone who elect all the members of the supervisory body. This results in a fundamental difference among EU Member States in the strength of shareholder influence in the company. Giving employees an advisory voice in certain issues is one means of engaging employees in governance issues without diluting shareholder influence. Encouraging employee stock ownership through employee pension funds and other employee stock ownership vehicles is another means of giving employees participatory rights in corporate governance, without diluting shareholder influence, and is favoured by some codes.

1.1.1.4. Stakeholder Issues:

Corporate governance is viewed increasingly as a means of ensuring that the exercise of economic power by the corporate sector is grounded in accountability. Different EU Member States tend to articulate the purpose of corporate governance in different ways; some emphasized broad stakeholder interests and others emphasized ownership rights of shareholders. Although the comparative corporate governance literature and popular discussion tend to emphasize fundamental differences between stakeholder and shareholder interests, the extent to which these interests are different can be debated. The majority of corporate governance codes expressly recognize that corporate success, shareholder profit, employee security, well being and the interests of other stakeholders are intertwined and co-dependent. This co-dependency is emphasized even in codes issued by the investor community.

1.1.1.5. Shareholder Participation:

The laws and regulations relating to the equitable treatment of shareholders, including minority rights in takeovers, squeeze-outs and other transactions controlled

¹⁵ European Commission, *"Comparative study of corporate governance codes relevant to the European union and its member states"*, 2002, Well, Gotshal & Manages LLP. Note that in some countries, including France and the Netherlands, employee representatives may have the right to attend board meetings, but not vote.

by the company or the majority shareholders, vary significantly among EU Member States. Notice of and participation in shareholder general meetings, and procedures for proxy voting and shareholder resolutions also vary significantly among EU Member States. Such variations in laws and regulations, especially as relates to shareholder participation rights, likely pose barriers to cross-border investment, and may cause a not-insignificant impediment to a single unified capital market in the European Union.

To the extent that codes address these issues, they generally call for shareholders to be treated equitably; for disproportional voting rights to be avoided or at least fully disclosed to all shareholders; and for removal of barriers to shareholder participation in general meetings, whether in person or by proxy.

1.1.1.6. Board structure, their Role and Responsibilities:

Another major corporate governance difference embedded in law relates to board structure i.e. the use of a unitary versus a two-tier board. However, notwithstanding structural differences between two-tier and unitary board systems, the similarities in actual board practices are significant. Both types of systems recognize a supervisory function and a managerial function, although the distinctions between the two functions tend to be more formalized in the two-tier structure. Generally, both the unitary board of directors and the supervisory board (in the two-tier structure) are elected by shareholders although, as explained above, in some countries employees may elect some supervisory body members as well. Typically, both the unitary board and the supervisory board appoint the members of the managerial body i.e. either the management board in the two-tier system, or a group of managers to whom the unitary board delegates authority in the unitary system. In addition, both the unitary board and the supervisory board usually have responsibility for ensuring that financial reporting and control systems are functioning appropriately and for ensuring that the companies are in compliance with law.

Each board system has been perceived to offer unique benefits. The one-tier system may result in a closer relation and better information flow between the supervisory and managerial bodies; however, the two-tier system encompasses a clearer, formal separation between the supervisory body and those being supervised. With the influence of the corporate governance best practice movement, the distinct perceived benefits traditionally attributed to each system appear to be lessening as practices converge.

As described below, the codes express remarkable consensus on issues relating to board structure, roles and responsibilities; many suggest practices designed to enhance the distinction between the roles of the supervisory and managerial bodies, including supervisory body independence, separation of the chairman and CEO roles, and reliance on board committees.

1.1.1.7. Supervisory Body Independence and Leadership:

Most of European codes place significant emphasis on the need for a supervisory body that is distinct from management in its decisional capacity for objectivity to ensure accountability and provide strategic guidance. Codes that relate to unitary boards emphasize the need for some compositional distinction between the unitary board and members of the senior management team. These codes invariably urge companies to appoint outside (or non-executive) directors and some truly independent directors to the supervisory body. Independence generally involves an absence of close family ties or business relationships with company's management and the controlling shareholder(s). Codes that relate to unitary boards also frequently call for the positions of the chairman of the board and the CEO to be held by different individuals. (This is already usually the case in two-tier board systems.) Codes that relate to two-tier boards also emphasize the need for independence between the supervisory and managerial bodies. For example, like the unitary board codes, they tend to warn against the practice of naming (more than one or two) retired managers to the supervisory board, because it may undermine supervisory board independence.

It is fairly well accepted in law that many supervisory body functions may be delegated, at least to some degree, to board committees. The codes reflect a trend toward reliance on board committees to help organize the work of the supervisory body, particularly in areas where the interests of management and the interests of the company may come into conflict, such as in areas of audit, remuneration and nomination. While recommendations concerning composition of these committees may vary, the codes generally recognize that non-executive and, in particular, independent directors have a special role to play on these committees.

1.1.1.8. Disclosures:

Disclosure requirements continue to differ among EU Member States, and the variation in information available to investors likely pose some impediment to a single European equity market. However, across the EU Member States, the amount of disclosure about corporate governance practices is increasing and there is a converging trend regarding the type of information disclosed. In part, this is due to efforts to promote better regulation of securities markets and broad use of International Accounting Standards. Consolidation and coordination among listing bodies may encourage further convergence. The code movement has also played a role in heightening awareness about the importance of disclosure to shareholders. There appears to be a developing hardening of norms concerning disclosure of individual executive and director remuneration across the EU Member States, following the U.K. example. Moreover, there is a growing interest in both mandatory and voluntary social issue reporting.

Undoubtedly, the codes have served as a converging force. Through comply or explain mandates, several codes require companies to disclose considerably more information about their corporate governance structures and practices than in the past. As to wholly voluntary disclosure, the codes tend to favour greater transparency on all aspects of corporate governance and, in particular, executive and director compensation

and director independence. They also encourage greater transparency as to share ownership and, in many instances, issues of broader social concern.

By and large, codes are supplemental to company law. Companies may choose from among the codes that emanate from the EU Member State of incorporation. Alternatively, so long as there is no inconsistency with the company law in the State of incorporation, companies are free to seek guidance from codes from any jurisdiction. The code movement is a positive development, both for companies and for investors, given its emphasis on disclosure, improved board practices, and shareholder protection.

To recap, there is little indication that code variation poses an impediment to the formation of a single European equity market. Moreover, the various codes emanating from the Member States appear to support a convergence of governance practices. This, taken together with the need for corporations to retain a degree of flexibility in governance so as to be able to continuously adjust to changing circumstances, lead us to conclude that the European Commission need not expend energy on the development of a code applicable to companies in the European Union. Ideas about best practice as reflected in the codes should be allowed to develop over time by the business and investment communities, under the influence of market forces.

A voluntary European Union-wide code could conceivably result in some benefits along the lines discussed above. However, efforts to achieve broad agreement among Member States on detailed best practices that fit well with varying legal frameworks is more likely to express a negotiated lowest common denominator of acceptable practice rather than true best practice. Alternatively, an agreed European Union code might focus on basic principles of good governance.

1.1.2. United States of America (USA):

The term corporate governance in American context refers to the relationships among the professional managers of a publicly held company, its board of directors, and

its shareholders. There has been a revolution in the area of corporate governance in the United States over the last half-century.

1.1.2.1. Evolution of Corporate Governance:

Corporate governance debate in USA started from the year 1950 and it has two distinctive features: (1) it was an era where the participation and performance by American industry in World War II, management had witnessed a complimentary repute within the United States; and (2) by 1950, because of the competence of some persons the management of the companies was handed over in the hands of professional managers from the original creators¹⁶. Adolf Berle and Gardiner Means in 1932 developed a model of public limited companies that largely dominated theoretical analysis of the company for several decades. It was reasonably expressive of boards of directors as late as 1950¹⁷. Berle and Mean's basic assumption was that shareholders in public limited companies were individuals who were usually spread in various parts of the states and were seldom well-informed about corporate affairs. Generally one shareholder in any of the two hundred largest American companies owned a tiny fraction of the company's stocks during the period of 1950 with few exceptions. In modern context, this structure of share holdings forms a major "free riding" problem: no individual shareholders were keen to spend the essential time and attempt to monitor management because their concern was small and, if they execute the same, other shareholders would "free ride" on their hard and time consuming work.

As a result, according to Berle and Means, shareholders who were discontented with management used the "Wall Street Rule" and just sold their shares into the market.

¹⁶ Prior to World War II, many publicly held corporations were managed by persons who founded the corporation or participated in its founding. By 1950, most of these persons were not active in corporate management, even though they or their descendants continued to own very substantial blocks of stock. However, with a few exceptions these descendants were inactive investors and did not participate significantly in management. For another discussion of this early historical material, see generally Robert W. Hamilton, *Cases and Materials on Corporations--Including Partnerships and Limited Liability Companies* (1st ed. 1976) Thomson West.

¹⁷ Adolf A. Berle & Gardiner C. Means, *The Modern Corporation and Private Property* (1932) Transaction Publisher, New Brunswick, New Jersey.

In turn, this process of self-selection meant that shareholders of a company at any one time had a tendency either to have a favorable view of management's acts or at least a submissive approach toward management i.e. a pro-management bias. With this composition of the body of shareholders, management was sure that shareholders would habitually approve management proposals, and that as a matter-of-fact, the power of shareholders to select directors was purely imaginary. The real decision point for the selection of directors was at an earlier time, when management prepared the proxy statement and decided which persons to nominate as candidates for election to the board. The actual shareholders' vote by proxy was simply a ratification of these earlier decisions because shareholders either approve of or agree with management's performance. Berle and Means thus concluded that CEO determined both the size and the composition of his own board of directors. He would individually decide which of his subordinate should be nominated to serve as inside directors and would get potential outside directors and decide who should be invited to join the board of directors¹⁸. In short, the Boards of directors during this era often had between ten and twenty members, most of whom were inside directors and all of whom were personally approved by the CEO. In addition, the CEO largely dominated the decisional process within the board of directors. This domination was based on factors in addition to his control over the selection process such as; the CEO exercised his discretionary powers regarding the career enhancement of the directors hence enjoyed unprecedented authority. During this era outside directors rarely questioned the CEO or management because their selection was also in the hands of the CEO. The CEO controlled the information flow to the board of directors through his control over the briefing books distributed in advance of each meeting of directors, and also the published agenda

¹⁸ Many companies found it necessary to include outside directors on the board of directors because they needed to give stature to their audit committees, which publicly attested to the reliability of the published financial statements. As early as the 1920s some companies had created audit committees composed of outside directors to improve the acceptability of their financial statements. The audit committee typically selected the outside auditing firm, worked with that firm, reviewed the results of the audit, and in effect certified that the audit was conducted independently of management. While audit committees required that some outside directors be placed on the board of directors, they were inevitably a minority of the full board, and in some instances, these outside directors had close financial or personal ties with management, and thus would not have qualified as being "independent" under today's standards. In addition to the audit committee issue, boards of directors of many companies during this period included, as a matter of general policy, a minority of outside directors.

which was prepared in his office. The CEO was also chairman of the board of directors and presided at all meetings. Hence, criticism of, or even frank discussion about, the performance of the corporation and the CEO by the board was difficult. Boards of directors met only infrequently. The powers of the board were exercised by an Executive Committee during the meetings, typically composed solely of the CEO and a few inside directors in whom he had confidence. In this environment, an objective review of the performance of the CEO was difficult, and the decision that an elderly or less-than-competent CEO should be required to step down involved a virtual "palace coup" by a combination of inside and outside directors acting without the knowledge of the CEO.

In certain cases many CEOs recognized their own limitations and voluntarily announced plans to retire before the stage of an involuntary removal might be considered. Usually, the CEO would have groomed a potential successor, and ensured that the board of directors understood that the person was the CEO's choice. The selection of that person usually followed routinely. About the only situation in which the board of directors independently selected a new CEO was the serious illness or unexpected death of a current CEO who had made no decisions about his successor. Professor Myles Mace in 1971 concluded that, in fact, the outgoing CEO usually selected his successor¹⁹. The board of directors was not viewed as an essential part of the governance process in 1950's. Former Supreme Court Justice Arthur Goldberg in 1972 resigned all of his directorships with a public statement saying that boards of directors are "relegated to an advisory and legitimizing function that is substantially different from the role of policy maker and guardian of shareholder and public interest

¹⁹Myles Mace, *Directors: Myths and Reality* 184-90 (1971) Harvard Business School Classics. In a fascinating study, Mace concluded that boards of directors in this era generally did not establish basic objectives, corporate strategies, or broad policies, or ask discerning questions at meetings. *Id.* Rather, Mace concluded, the principal functions of the board were to provide advice and counsel to management and to provide discipline to management when they appeared before the board to discuss policy or defend decisions. *Id.*

contemplated by the law of corporations²⁰. Directors were usually compensated by cash payments, dependent on the number of meetings attended. This compensation was often viewed as the principal incentive to become a director.

One should not draw too dark a picture of this period. It would be a mistake to assume that all corporations during this era were run by egocentric CEOs with boards of directors completely within their control (though many were). Some CEOs utilized boards of directors in a constructive manner, relying on them for advice and guidance, and working to ensure a cooperative relationship.

In the case of a poorly run or troubled corporation, there was always the possibility that an outside group might seize control by successfully soliciting proxies in opposition to management. While management had significant advantages in such a contest (presumably because of the general pro-management bias of shareholders), a long history of mismanagement and poor economic results might persuade shareholders to support the outside group. Indeed, the mere possibility of such a contest ensured some fidelity of management to the interest of the shareholders²¹. In a few instances where there was considerable shareholder unhappiness with management's record, such fights were successful, and the CEO was replaced by the victor.

²⁰ Arthur J. Goldberg, Debate on Outside Directors, N.Y. Times, Oct. 29, 1972, § 3, at 1. Justice Goldberg advocated that outside directors should be named as a "committee of overseers" who would have authority to hire "a small staff of experts" independent of management control. This suggestion was criticized by management who feared that an independent staff would be divisive, but some corporations implemented this suggestion in the 1970s in order to investigate possible misconduct. Today, some corporations have in effect followed this suggestion and created oversight groups not directly under the control of the CEO to assist outside directors.

²¹ The Securities and Exchange Commission USA has long had regulations relating to proxy contests. See, e.g., "FACILITATING SHAREHOLDER DIRECTOR NOMINATIONS" SEC Rules 17 C.F.R. § 240.14a-11 (1997). These regulations view proxy fights not as political contests, with each side free to make charges or counter-charges, but rather as competing factual presentations. The SEC also maintained statistics as to the number of proxy fights occurring each year until the late 1970s (based on the number of filings required by these regulations). The number of filings under these regulations was never very large. For example, there were only 37 filings in 1977. Most of the corporations that were the object of a proxy contest were medium-sized, publicly held corporations. It was unlikely that a proxy contest would be launched against the largest corporations because of the cost of soliciting hundreds of thousands of shareholders.

1.1.2.2. The Driving Forces for Changing in Corporate Governance:

Current developed and complex corporate governance regime is not the outcome of a single day or two days efforts and research rather it has attained this point after having undergone numerous changes and developments in the corporate sector of America. However, some of the significant forces that transformed old corporate governance paradigm are; Institutional investors can generally be defined as organizations that hold portfolios of securities under professional management. The principal institutional investors in the United States today are pension funds created by corporate, state, and city employers for their employees; investment companies (both mutual funds and closed-end funds); insurance companies (both life and casualty)²²; private foundations; university and charitable endowments; brokerage and other securities firms; and a variety of private investment vehicles for wealthy individuals (including leveraged buyout funds and hedge funds).

The holding of institutional investors in the stocks of listed companies was much less in year 1950 almost all of the institutional investors held 10% of all the stocks of American companies. However, the same started to increase dramatically during the period 1960 because of the some important taken place in the area these included the federal and state policies in the form of various exemptions, effect of post World War II effects on the economies and many like events. There is lot of data available that shows the investment by the institutional investors in the securities the figures show that in the year 1950 the total investment was 10% that has attained the level of almost 50% in the year 2000²³. This is an influencing point that the investment by the institutional

²² In the United States, a form of insurance contract known as a "variable annuity" has become popular. A variable annuity is essentially a mutual fund in an "insurance wrapper." It is cast as an insurance product in order to take advantage of the rule that increases in cash surrender value are not subject to income taxation until the insured actually receives payments under the policy. In contrast, in a mutual fund, the shareholder must pay tax on realized gains as they occur. The variable annuity must maintain an amount of life insurance sufficient to avoid classification as a mutual fund, even though the insurance may not be desired by the insured.

²³ The data in this section is drawn from a series of 1998 reports prepared by the Global Corporate Research Council of the Conference Board, 845 Third Ave., New York, N.Y. These reports, subtitled "Institutional Investment Reports," are available by subscription. Much of the information is gathered from the public reports of portfolio holdings by institutional investors.

investors out dated the model theory of public limited companies given by the Berle and Means. This tendency also falsified the views of the Berle and Means that the shareholders do not care for the management affairs of a company. Because of the active involvement of the institutional investors the management of the companies utilizes their utmost capabilities so that the businesses of their companies remain efficient and result oriented so that they may be able to retain the investment by the institutional investors.

However, because of the disclosure requirement under Section 13(d) of the Securities and Exchange Act restrict their investment up to the level of 5%²⁴ because if they acquire more than that they are obliged under to the above mentioned section to disclose the same under a public notice declaring the exact figures²⁵.

The development of American corporate governance attained more perfection when the first recorded event of take over bidding took place in 1960. The process involved two steps firstly through cash tender offer²⁶ and secondly through leveraged buy-out²⁷. The disclosure of Nixon scandals also helped a lot so that such measures to

²⁴ Many investors limit their maximum holdings to two percent or less. A major exception to this policy is Berkshire Hathaway, managed by Warren Buffett. Berkshire owns more than five percent of several portfolio companies (e.g., Coca Cola, Inc.) and controlling interests in several other companies.

²⁵ Section 13(d) was added in 1968 by the Williams Act, 15 U.S.C. §§ 78l-78n (1994), the principal federal statute relating to cash tender offers.

²⁶ In a classic cash tender offer, a bidder would offer to purchase for cash all or a stated percentage of the outstanding shares of a publicly held corporation at a price substantially above their current market price. The source of the cash included both borrowed and equity capital. The offer to purchase would be made public without advance warning and would remain open for a relatively short period. The element of surprise, coupled with the attractiveness of the price being offered, caused many offers to succeed. Partial tender offers were filled on a first-come, first-served basis to encourage persons to tender promptly. Following the successful purchase of a majority of the shares, the remaining shareholders might be eliminated through a "cash-out" merger in which the stock owned by the remaining shareholders would be in effect redeemed for cash. Under American corporate law, cash-out mergers are recognized, though minority shareholders have the right to obtain a judicial appraisal of the value of their shares if they are dissatisfied with the price offered by the controlling shareholders.

²⁷ A "leveraged buyout" is a takeover bid in which most of the cash necessary to buy out existing shareholders is raised by loans that are secured by the assets of the corporation being acquired if the buyout is successful. Leveraged buyouts may raise serious issues of fraudulent conveyance and bankruptcy.

be adopted and necessary amendments to be done that in future these kinds of irregularities may be avoided.

As a result of the above mentioned events the process of the revising the corporate governance stated and a number new amendments were made. Some of them required a report for the CEO's performance with regard to his conduct. The classification of directors came into common use i.e. inside director, outside director and independent director. The separation of CEO and chairman was effectively done and their duties and responsibilities were clearly defined.

The process was on the way when United States faced the financial scandals affecting major American firms, such as Enron, WorldCom and Arthur Andersen, and the consequential loss of confidence by the investing public in the stock market have led to remarkable declines in share prices and extensive financial losses to millions of individual investors. Since half of all adults in the United States own stock either directly or indirectly, corporate governance reform has become a highly charged political issue. The American Congress rapidly responded by passing the Sarbanes-Oxley Act of 2002²⁸, which the New York Stock Exchange quickly followed by adopting sweeping new rules for listed corporations²⁹, thereby effecting the most significant reform in US corporate governance since the creation of the country's securities regulation regime in the 1930s. Some people have charged that Sarbanes-Oxley is just a cynical political reaction to a market crisis at the end of bubble. Although it certainly represents what formerly would have been an unimaginable incursion of the U.S. federal government into the corporate governance area, it also contains many advances for corporate governance and attempts to provide best practices to prevent the misdeeds that have led to the investor losses. Many of these ideas are not new, but have been floating around in one form or another for quite a number of years.

²⁸ Sarbanes-Oxley Act of 2002, H.R. 3763, 107th Cong. (2002).

²⁹ "Corporate Governance Rule Proposals Reflecting Recommendations to the NYSE Corporate Accounting and Listing Standards Committee as approved by the U.S. Securities and Exchange Commission", November 4, 2003 available at www.nyse.com (last visited May 2006)

Many are not outright prescriptive requirements, but rather are items of disclosure, with the burden then on issuers and the market to decide what importance to place on that disclosure. Sarbanes-Oxley strengthens the role of directors as representatives of stockholders and reinforces the role of management as stewards of the stockholders' interest. Sarbanes-Oxley requires the audit committee to be responsible for the outside auditor relationship, including the responsibility for the appointment, compensation, and oversight of a company's outside auditor. And, the Act requires that members of the audit committee be "independent" from company management. The Act in order to check the internal control requires a report in this behalf³⁰. Sarbanes-Oxley also directs the SEC to adopt rules requiring the disclosure of whether a company has a "financial expert" on its audit committee and to define a "financial expert." Sarbanes-Oxley directed us to create the new Public Company Accounting Oversight Board to oversee the accounting profession and public company audits³¹.

From the above discussion the state of corporate governance in United States becomes crystal clear. It brings to the notice that how the concept of corporate governance evolved and how it became complex and more complex with the passage of time. Much of the current problems with the corporate governance regime have been settled however, there is probability that with the changing corporate structures of the companies and due to the effects of globalization some issues demanding even more attention may arise.

1.1.3 Corporate Governance in OECD Countries:

The Organization for Economic Co-operation and Development (OECD) is forum of diversified range of countries with respect to their legal, economic, social and

³⁰ Section 404 of Sarbanes-Oxley Act deals with matters of internal control provisions. The new rules require management to complete an annual internal control report and require the company's auditor to attest to, and report on, management's assessment. Section 404 of Sarbanes-Oxley makes no distinction between domestic and foreign issuers, and, by its terms, it applies to non-U.S. issuers. The rules, therefore, will apply to non-U.S. issuers. However, since these rules might require significant internal changes, the SEC provided non-U.S. issuers with an extended compliance date.

³¹ It was created because of deep failings in the U.S. accounting profession's ability to regulate itself. The Oversight Board is a non-governmental, nonprofit corporation and has begun to organize itself.

political frameworks. The inventive constituent countries of the OECD are Austria, Belgium, Canada, Denmark, France, Germany, Greece, Iceland, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. The following countries became members subsequently through accession at the dates indicated hereafter: Japan (28th April 1964), Finland (28th January 1969), Australia (7th June 1971), New Zealand (29th May 1973), Mexico (18th May 1994), the Czech Republic (21st December 1995), Hungary (7th May 1996), Poland (22nd November 1996), Korea (12th December 1996) and the Slovak Republic (14th December 2000). The Commission of the European Communities takes part in the work of the OECD (Article 13 of the OECD Convention).

Pursuant to Article 1 of the Convention signed in Paris on 14th December 1960, and which came into force on 30th September 1961, OECD shall promote policies designed:

- to achieve the highest sustainable economic growth and employment and rising standard of living in member countries, while maintaining financial stability, and thus to contribute to the development of the world economy;
- to contribute to sound economic expansion in member as well as non-member countries in the process of economic development; and
- to contribute to the expansion of world trade on a multilateral, non-discriminatory basis in accordance with international obligations.

Since, the OECD has come into existence and became functional it is striving its best efforts to achieve targeted goals as mentioned above and the harmonization of the same among member countries. As far as the question of state corporate governance regime is concerned among the member countries the OECD is working on it for a number of years. As it brings together representatives of 30 OECD member countries as well as numerous other countries that participate in the Organization's work it is an

ideal forum for such workout. Together, these countries account for more than 90 percent of world stock market capitalization. Their governments have a vested interest in working on behalf of their citizens to ensure good practice in corporate governance, as an essential element in the promotion of prosperity and economic growth.

In 1999, the OECD published its Principles of Corporate Governance, the first international code of good corporate governance approved by governments. These Principles focus on publicly traded companies and are intended to assist governments in improving the legal, institutional and regulatory framework that underpins corporate governance³². They also provide practical guidance and suggestions for stock exchanges, investors, corporations, and other parties that have a role in the process of developing good corporate governance. Corporate governance arrangements and institutions vary from one country to another, and experience in both developed and emerging economies has shown that there is no single framework that is appropriate for all markets, so the Principles are not prescriptive or binding, but rather take the form of recommendations that each country can respond to as best befits its own traditions and market conditions.

Since the Principles were first published, however, an increase in corporate scandals e.g. such as Enron, WorldCom and Arthur Andersen, has undermined the confidence of investors in financial markets and company boards. In order to take greater consideration to these scandals, OECD governments called for a review of the Principles in 2002³³. Resultantly on April 22 2004, OECD governments approved a revised version of the OECD Principles of Corporate Governance, adding a series of new recommendations and modifying others. The revised text is the product of a consultation process involving OECD members and representatives from the OECD and non-OECD areas including businesses and professional bodies, trade unions, civil

³² See "OECD Principles of Corporate Governance" issued by OECD in the year 1999

³³ The Steering Group for the revision of the Principles was chaired by Ms. Veronique Ingram

society organizations and international standard-setting bodies³⁴. They are designed to assist policy makers in both developed and emerging markets in improving corporate governance in their jurisdictions, as a vital step in rebuilding public trust in companies and financial markets. The main areas of the OECD Principles are I. Ensuring the basis for an effective corporate governance framework; the corporate governance framework should promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities. II. The rights of shareholders and key ownership functions; the corporate governance framework should protect and facilitate the exercise of shareholders' rights. III. The equitable treatment of shareholders; the corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights. IV. The role of stakeholders in corporate governance; the corporate governance framework should recognize the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises. V. Disclosure and transparency; the corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company. VI. The responsibilities of the board; the corporate governance framework should ensure

³⁴ The revised Principles are the result of a wide-ranging consultation process that involved officials from both OECD and non-OECD countries as well as businesses and professional bodies, trade unions, civil society organizations and international standard-setting bodies. Experts from Asia, Latin America, Eurasia, Southeast Europe and Russia also contributed to the Principles, sharing their experiences from a series of Regional Roundtables in 2002 and 2003. A draft of the Principles were also put on the internet for public comments and more than 70 submissions were received from national and international organizations, including the International Corporate Governance Network, Standard and Poor's, the International Federation of Accountants, Institutes of Internal Auditors. Comments were also received from public companies and individual governance experts.

The review was led and concluded by the OECD Steering Group on Corporate Governance, which comprises representatives from all 30 member governments together with observers from the World Bank, the International Monetary Fund, Bank for International Settlements, the Financial Stability Forum, IOSCO and the Basel Committee. The Business and Trade Union consultative committees to the OECD (BIAC and TUAC) also participated in the Steering Group's meetings.

the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders³⁵.

The new Principles call for a stronger role for shareholders in a number of important areas, including executive remuneration and the appointment of board members. They call on companies to make sure that they have mechanisms to address possible conflicts of interest, to recognize and safeguard the rights of stakeholders and a framework in which internal complaints can be heard, with adequate protection for individual whistleblowers. They stress the responsibilities of auditors to shareholders and the need for institutional investors acting in a fiduciary capacity such as pension funds and collective investment schemes to be transparent and open about how they exercise their ownership rights. And they call on company boards to be truly accountable to shareholders and to take ultimate responsibility for their firm's adherence to a high standard of corporate behavior and ethics. For board Directors, this means fostering the best interests of the company and the shareholders who have invested their money in the company which they oversee. But it also involves establishing productive relationships with other stakeholders such as employees and balancing their interests with others. Recent history shows that boards in some cases have failed to play this role, condoning remuneration packages that have no true link to performance, for example, and approving excessively ambitious expansion projects that have undermined a company's stability³⁶. To guard against such practices, the OECD Principles of Corporate Governance call for directors "capable of exercising independent judgment" and for boards able to "exercise objective independent judgment on corporate affairs", independent, in particular from management and in many cases from controlling shareholders and others in a position to control the company. In almost all developed economies, investors have fairly extensive legal rights. In practice,

³⁵ "Principles of Corporate Governance" Issued by OECD in 2004. Can be viewed at www.oecd.org/daf/corporate/principles/

³⁶ OECD (2003), "*Roundtables on Boardrooms*", OECD Observer No. 238, July, 2003 and OECD (2003), *Experiences from the Regional Corporate Governance Roundtables* can be found on web site: <http://www.oecd.org/daf/corporate-affairs/> (last visited June 2006)

however, their ability to exercise them is often restricted. Company by-laws and corporate practices can impose restrictions on investors' ability to submit questions to company boards. Investors' ability to propose or oppose individual members of the board is often limited to the point of being non-existent. More open board elections would enable shareholders to exercise their ownership rights in an effective manner. Shareholders need to be able to pose questions to the board and to put forward proposals to the general meeting of shareholders. Resolutions passed by shareholders should be taken into account by boards.

In brief the revised OECD Principles contain recommendations on these points. Class actions and other litigation on the part of shareholders can play a positive role in bringing discipline to company boards, but mechanisms also need to be considered to avoid abuse and disruption. Strengthening the rights of shareholders, however, should not undermine the ability of a company to carry out its day to day activities and should not allow them to try and second-guess the business judgments of board members. The revised Principles call on policy makers to consider the need for mechanisms to avoid excesses in this area.

An important feature of modern financial markets is the increased weight of institutional investors. Some, such as mutual funds and pension funds, act in a fiduciary capacity on behalf of individual investors. Others, including insurance companies and investment banks, act in their own right. The importance of institutional investors as owners of corporate equity has grown enormously over the past few years, to the point where they have become the principal players in many markets. In 1999, the value of assets owned by insurance companies, pension funds and collective investment schemes or mutual funds amounted to the equivalent of 144% of the GDP of OECD countries, compared with only 38% in 1980³⁷. Institutions acting in a fiduciary capacity, such as pension funds, mutual funds and other collective investment schemes, own shares on behalf of millions of investors.

³⁷ OECD (2004), *Corporate Governance: A Survey of OECD Countries*, Paris. Can be purchased at <http://www.oecd.org/bookshop> (last visited June 2006)

The revised Principles emphasize the important role that institutional investors can play in monitoring company performance and in conveying their concerns to the board of a company. They can challenge or support the board through voting at the general meetings of shareholders and they are well placed to take their concerns directly to the board and to propose a course of action. An increasing number of institutional investors are actively exercising their ownership roles in this way.

However, the exercise of informed ownership through monitoring is costly and institutional investors are also subject to possible conflicts of interest, for example in cases where other commercial relations with the firm in question may take precedence over what might be a desirable course of action from an ownership perspective. Nor do all institutional investors have the same incentive for exercising ownership rights. As a result the Principles focus on those acting in a fiduciary capacity. Such institutions, either for prudential or other regulatory reasons or as a result of their investment strategy, may hold only small stakes in individual companies and so have little incentive to monitor these firms closely. In such cases, these institutional investors' role as owner could be enhanced by exchanging information and plans with other shareholders, leading to coordinated action. This is now happening in some countries, with institutional shareholders pooling their shares in order to attain the thresholds needed for them to be able to take specific action. However, barriers do remain in part related to concern that such coordination could be either anti-competitive or subvert takeover law. The revised Principles contain recommendations to governments for policy action in these areas. For investors to exercise their shareholder rights, they need to be properly informed. This calls for a minimum level of transparency and disclosure on the part of companies. The revised OECD Principles address a range of aspects of this requirement, from the internal preparation of financial reports and internal controls through to the role of the board in approving the disclosure, the accounting standards being used and the integrity of the external audit process. A number of countries have introduced public oversight of the setting of accounting and audit standards. A growing

TH-10064

number of countries also restrict the non-audit services that auditors can offer their clients, so as to avoid creating business interests that might undermine the independence of the audit process. These are areas covered by recommendations in the revised Principles.

Markets work best when information is available to all. Companies have a responsibility in this area, but other intermediaries, such as brokers, analysts and rating agencies, also play an important role. Here, too, the revised OECD Principles call for measures to ensure independence and transparency and to counter possible conflicts of interest.

The revised Principles emphasize the need for effective regulatory systems that ensure that the potential for damaging conflicts of interest remains limited and that there is a level playing field among the major participants in corporate governance, for example, through protection of minority shareholders. Effective implementation and enforcement require that laws and regulations are designed in a way that makes them possible to implement and enforce in an efficient and credible fashion. Supervisory, regulatory and enforcement authorities should have the power, integrity and resources to act professionally and objectively. The division of authority between agencies and supervisory bodies should be well defined and they should pursue their function in an unbiased and even-handed manner without serious conflicts of interest.

By agreeing on these Principles, OECD governments have set the broad foundations for high standards of corporate governance. The legislation needed to enforce these standards is the responsibility of individual governments, and in enacting it, governments and policy makers need to find a balance between rules and regulations on one hand and flexibility on the other. Looking ahead, the governments of OECD countries are committed to maintaining an open dialogue with all the parties involved so that everyone can learn and benefit from the shared experiences of putting these Principles of Corporate Governance into practice.

1.2 Corporate Governance in Developing Countries:

The state of Corporate Governance in most of the developing countries specially in Asian countries is confronting almost same concerns while directing their corporate governance regimes that are in line with that of the developed countries. However, after going through the following detailed view of corporate governance practices and reform initiatives of the emerging countries of our region we can have a good and clear vision of the challenges and problems with corporate governance.

1.2.1 Corporate Governance in China:

China is a giant country with a population of 1.2 billion people. In 1978, China's paramount leader Deng Xiaoping started a series of reforms in its economic system in order to stimulate economic growth and to raise the Chinese people's standard of living. By 1995, China had become the world's third largest economic powerhouse after the United States and Japan, with a total GDP of \$720 billion. China's securities market and a sound corporate governance system play an important role in these economic reforms. The number of listed companies has risen from 14 in the year when China's two stock exchanges (Shanghai and Shenzhen) commenced operation in 1991 to 1,223 by the year 2002³⁸.

Corporate governance is commonly viewed as a system that delineates the rights and responsibilities of each major group of stakeholders in a company, and sets rules and procedures for making decisions about company affairs³⁹. It can also be viewed as the design of institutions and mechanisms that induce or control board directors and management to best serve the interests of shareholders and other stakeholders in a company and to resolve conflicts among them, subject to the constraints of economic,

³⁸ Data has been taken from the China Securities Regulatory Commission Can be viewed at www.csrc.gov.cn (last visited April 2006)

³⁹ OECD. 1998. *Proceedings on Corporate Governance, State-owned Enterprises and Privatization*, Organization for Economic Co-operation and Development.

legal and ethical norms⁴⁰. Sound corporate governance is good for maximizing the shareholder value and productivity of companies. During the past decade, before and after China's entry into the World Trade Organization (WTO) in late 2001, the Chinese government has continued to improve its corporate governance policies to prepare Chinese companies to compete with their foreign competitors. However, there are still several areas that need improvement.

1.2.1.1. Recent Developments in China's Corporate Governance and key problems:

With the establishment of China's securities regulator, the China Securities Regulatory Commission (CSRC), in 1992, more than 300 laws and directives concerning the securities and futures market have been issued. The key legal framework for corporate governance in China consists of the Company Law promulgated in December 1993, the Securities Law promulgated in December 1998, and the Code of Corporate Governance for Listed Companies issued by the China Securities Regulatory Commission and State Economic and Trade Commission in January 2002. Since the establishment of CSRC the corporate governance has made substantial changes in various corporate governance areas that involve the following: (1) rights of shareholders and rules for shareholders' meetings, (2) duties and responsibilities of directors and independence of board of directors, (3) fiduciary duties, (4) performance assessments and incentive and disciplinary systems, (5) information disclosure and transparency, (6) insider information and related party transactions, and (7) the role of the auditor. However, China's government and companies have made substantial progress in recent years to improve corporate governance, many problems still exist. Currently China's corporate sector is facing the following problems with regard to the corporate governance:

⁴⁰ Ho, Simon S. M. 2002. "Corporate Governance and Disclosures in Hong Kong: Key Problems and Prospects." Centre for Accounting Disclosure and Corporate Governance, School of Accountancy, The Chinese University of Hong Kong.

1.2.1.2. Highly Concentrated Ownership Structure:

Corporate governance problems in the Western World originate from the agency problem of the separation of ownership and control within a company, which gives rise to information asymmetry and agency costs⁴¹. Agency theory assumes that human behavior is opportunistic and self-serving in nature; therefore, the fundamental function of the board of directors is to control managerial behavior and ensure that top managers act in the interests of shareholders⁴².

The first key problem in China's corporate governance is the highly concentrated ownership structure in Chinese companies⁴³. Currently only individual shares are traded on the securities markets. The fact that state shares and legal person shares are not traded on the securities markets means that more than 60% of the outstanding shares have been excluded from the market. For example, at the end of 2000, the total shares in both the Shanghai Stock Exchange and Shenzhen Stock Exchange were 374.628 billion shares, and only 35.62% belonged to individual shares while state shares and legal person shares were 37.35%, and 27.03% shares, respectively, with a total of 64.38% non-tradable shares⁴⁴. This has reduced the liquidity of the secondary market and has become the main obstacle of operating the market efficiently.

⁴¹ Fama, E. F. and Jensen, M. C. 1983a. "Agency Problems and Residual Claims." *Journal of Law and Economics*. Vol. 26, pp. 327-349.

Fama, E. F. and Jensen, M. C. 1983b. "Separation of Ownership and Control." *Journal of Law and Economics*. Vol. 26, pp. 301-326.

⁴² Jensen, M.C. and W. H. Meckling. 1976. "Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure." *Journal of Financial Economics*. Vol. 3, pp. 305-350.

⁴³ Cha, Laura M. 2001. "The Future of China's Capital Markets and the Role of Corporate Governance." Luncheon Speech at China Business Summit, April 18, Vice Chairman, China Securities Regulatory Commission.

⁴⁴ CCX International. 2001. 2001 China Listed Company Reports. China Finance and Economics Publishing, Beijing, pp.68-69.

1.2.1.3. Insider Control of Corporate Affairs:

The second key problem in China's corporate governance is the insider control of corporate affairs⁴⁵. The resulting lack of separation between ownership and management, together with the potential for conflicts of interest, make it even more problematic to establish a high level of corporate governance. Despite its majority ownership, the state does not exercise effective control over its companies. The control of China's companies rests primarily with the insider-managers who are often in turn controlled and supported in various forms by their Communist Party and ministerial associates, who do not always act in the interest of the shareholders.

The Chinese government and the party organization can exert a critical influence on company affairs. Documented abuses by controlling shareholders include soft loans from listed companies on a long-term basis; the use of listed companies as guarantors to borrow money from banks; and the sale of assets to listed companies at unfair prices, usually without an appraisal by an independent evaluator⁴⁶.

1.2.1.4. Weak Protection of Shareholders Rights:

The third key problem in China's corporate governance is the weak protection of shareholders' rights⁴⁷. In Chinese companies, majority shareholders are typically very strong and individual minority shareholders are extremely weak to counter the influence of the majority shareholders. Related party transactions between controlling shareholders or a group company and the listed company are often detrimental to minority shareholders. Resultantly minority shareholders are often regarded as speculators expecting to gain a "free ride" on the company's performance.

⁴⁵ See foot note no. 39 supra

⁴⁶ Tenev, Stoyan and Chulin Zhang, 2002. *Corporate Governance and Enterprise Reform in China*, World Bank and the International Finance Corporation.

⁴⁷ See foot note no. 39 and 42 supra

1.2.1.5. Frequent Insider Trading, Self Dealings and Collusions in Market Manipulations:

The fourth key problem in China's corporate governance is the frequent insider trading, self dealings, and collusions in market manipulations⁴⁸. The spread of inside information is not uncommon; it has been the object of speculators to gain windfall profit. One security company was severely punished by the CSRC in 2001 because it made use of inside information concerning an intended takeover. The punishment included confiscation of all profit from the trading and a fine for the insider trading. That security company was suspended from operation for several months. The deterrent effects of the case are obvious but great efforts still need to be made in order to regulate inside trading in the Chinese Securities Market⁴⁹. Another reported famous fraud case of same nature from the Beijing Securities Times (1999) is as follows: During a nine months period from March 1997, a listed property development company in Shanghai was reported in China's premier business newspaper to have utilized 46 individual investors' accounts to engage in self dealings and insider trading in shares of a related company. By December 1997, the company was alleged to have employed over 180 million Yuan to acquire 29% of the target company's stocks, manipulating the latter's share price from 9.50 Yuan per share at the beginning of this period to 18.97 Yuan⁵⁰.

1.2.1.6. Falsification and Fabrication of Financial Data:

The fifth key problem of China's corporate governance is the falsification and fabrication of financial data by listed firms⁵¹. Although Chinese laws on corporate governance appear to generally follow international standards on paper, mandatory disclosure of company information does not necessarily result in greater transparency,

⁴⁸ Tam, On Kit. 2002. "Ethical Issues in the Evolution of Corporate Governance in China." *Journal of Business Ethics*. May, Vol. 37, No. 3; Part 2, pp. 303-320.

⁴⁹ Lin, Thomas. And Yunwei Tang. 2001. "China's Securities Market and Accounting Disclosure Requirements: Current Problems and Suggested Solutions." Working Paper.

⁵⁰ See foot note no. 44 supra

⁵¹ Doe, Julianne and Winnie W. Y. Chan. 2001. "Towards Better Corporate Governance: China's Continuing Struggle." *International Financial Law Review*. London, pp. 21-28.

since investors cannot be assured of the truthfulness and accuracy of company reports. Information disclosures are in many cases not timely and accurate, and not easily understandable by investors. Ministry of Finance survey reported in the *China Reform Daily* on May 5, 2001, that alarmingly indicated approximately 98.7% of Chinese companies falsified their earnings in annual reports for the past accounting year⁵². This demonstrates how a company's management usually enjoys a high degree of autonomy and often operates outside the confines of the government and CSRC. This weak link permits some companies to hide their inefficiencies and mismanagement as well as dubious dealings by somehow overlooking the mandatory disclosure requirements.

1.2.1.7. Weak Independent Board of Directors and Specialized Committees:

The sixth key problem of China's corporate governance is the weak independent board of directors and specialized committees in listed firms⁵³. Company law stipulates that the shareholders' general meeting is responsible for selecting and removing directors, but it does not state who is responsible for nominating directors. A survey in early 1999 revealed that most company officials were still nominated by government departments instead of the board of directors⁵⁴. It is a fact that many company directors found it difficult to exert any substantial influence, other than symbolic, on the board⁵⁵. Another survey conducted in 1999 reported alarming figures that only 3.1 percent of all directors had some degree of independence⁵⁶. CSRC overhauled insider-controlled board structure by promulgating a regulation in August 2001 requiring each listed company to have at least one-third of the board to be independent directors by June 2003. CSRC's regulations require that independent directors must spend enough time on the companies they hold directorship; one person cannot hold more than 5 directorship positions concurrently. But according to a 1999 survey conducted by the

⁵² See the foot note no. 47 *supra*

⁵³ See the foot note no. 44 *supra*

⁵⁴ Schipani, Cindy. A. and Junhai Liu. 2001. "Corporate Governance in China: Then and Now", Working Paper. Can be seen at www.iolaw.org.cn/enl/art5.asp (last visited April 2006)

⁵⁵ Zhang, Yiyong. 2000. "Independent Directors Should Not Become the Deaf Ears." *China Economics*. October 10. Page 17

⁵⁶ See the foot note no. 42 *supra*

OECD, the average percentage of independent directors companies' board of directors was 62% in the U.S. Therefore, China needs to increase its percentage of independent directors.

The Code of Corporate Governance states that the board of directors may establish special committees. But a survey conducted in 1999 reported that only 5.4 percent of the companies have established special committees and only 14 percent plan to set up such committees⁵⁷.

1.2.1.8. Weak Supervisory Board:

The seventh key problem in China's corporate governance is the weak supervisory board in listed firms⁵⁸. Chinese companies have a two-tier board. In addition to the board of directors, Chinese companies also have a supervisory board. The supervisory board usually has labor union, party, and major shareholder representation. However, it only has a loosely defined monitoring role over the board of directors and managers. The supervisory board in China has so far not played any effective governance role. Supervisors are not involved in the selection of directors and managers and have no means of disciplining them. In many companies, the supervisory board duplicates the authority of the board of directors but without corresponding responsibilities.

1.2.1.9. Weak Auditing Profession:

The eighth key problem in China's corporate governance is the weak auditing profession. Many Chinese Certified Public Accountants (the CPAs) do not have enough knowledge about international accounting practices and are not well equipped with computer skills, due to a lack of proper training. Moreover, Chinese CPA firms have many problems in their operations because of lack of sound supervision mechanisms,

⁵⁷ See the foot note no. 42 supra

⁵⁸ See the foot note no. 44, 47 and 50 supra

which gives rise to serious fraud cases in the securities market. Management is accountable for fair presentation of financial information while the independent auditors are accountable for their audit report. However, the CPA's responsibility is not defined clearly. Several empirical studies found some unique auditing situations in China. One such study found that independence and social acceptance of auditing in China appeared to be making slow progress due to government controlled domestic CPA firms⁵⁹. Another found a surprising situation in China's audit market, i.e., the increase in modified audit reports in recent years is followed by a decline in audit market share among large audit firms⁶⁰ and illuminated some major features of the Chinese audit market, such as the lack of audit independence, the shortage of well-qualified auditors, and an environment of massive corruption⁶¹.

1.2.1.10. Overcoming the above Problems with Corporate Governance Regime:

China has made substantial progress in specifying rights of shareholders, duties and responsibilities of directors and independence of board of directors, emphasizing the importance of information disclosure and transparency and the role of the auditor, as well as providing guidelines to guard against insider information and related party transactions. And there are already rules governing many aspects of the corporate behavior of companies, there is a great deal to be done.

All parties involved, such as the CSRC, listed companies, auditors, investors, and banks, other creditors, and public media, should cooperate to speed up the changes and reforms in China's securities market and corporate governance structure, as well as

⁵⁹ Abdel-Khalik, A. Rashad, Kie A. Wong, and Annie Wu. 1999. "The Information Environment of China's and B Shares: Can We Make Sense of the Numbers?" *Journal of International Accounting*. Vol. 34, No. 4, pp. 467-489.

⁶⁰ DeFond, Mark L., T. J. Wong, and Shuhua Li. 2000. "The Impact of Improved Auditor Independence on Audit Market Concentration in China." *Journal of Accounting and Economics*. Vol. 28, No. 3, pp. 269-305.

⁶¹ Xiao, Jason Zezhong, Yikuan Zhang, and Zhihua Xie. 2000. "The Making of Independent Auditing Standards in China." *Accounting Horizons*. Vol. 14, No. 1, March, pp. 69-89.

to improve the standard of living for all Chinese people. However, the reform process must address and redress the above mentioned key problems currently prevailing in the Chinese corporate culture and corporate governance regime.

1.2.2 Corporate Governance in Malaysia⁶²:

The state of corporate governance regime in Malaysia starts from the event when East Asian economies collapsed in the second half of 1997. The period placed a greater concern and recognition of Corporate Governance to the public and private sectors in Malaysia.

The financial crisis was triggered in Thailand when foreign investors lost their confidence and started to withdraw capital due to currency devaluation. The problems transmitted to other neighboring countries. The most affected countries included Indonesia, Malaysia, South Korea, and the Philippines.

In Malaysia, attempts to contain further devaluation caused higher level of interest rate and credit contraction. This created severe contractions in output and corporate profitability which was reflected in massive fall of equity prices. The Kuala Lumpur Composite Index declined by 72% during the period from end-June 1997 to end-August 1998 and the currency was depreciated 40% in relation to US Dollar. Real estate markets declined sharply due to high interest rates and in crisis environment. Banks, which had a significant portion of their loan exposure in the construction and real estate sector; and stock purchase financing were badly affected.

There were different views on the causes of the crisis. Some viewed that the direct reason of the financial crisis was attributed to a downturn of the economy, the collapse of the property and stock markets. However, the more fundamental reasons were state-directed loan policies, lack of competition and lack of prudential regulations.

⁶²CF: Abdul Hadi, M. Fazilah, Md Isshak, Corporate Governance in Malaysia Available at: [www.micg.net/research/CORPORATE%20GOVERNANCE%20IN%20MALAYSIA%](http://www.micg.net/research/CORPORATE%20GOVERNANCE%20IN%20MALAYSIA%20) (last visited July 2006)

Another view indicated the significant impact of too much exposure of the banking institutions on debts to accommodate the economic boom in the early 1990s as a source of the crisis.

No doubt that efforts have been made to improve the corporate culture in Malaysia prior to the aftermath of the financial crisis, however, since then need to strengthen the corporate governance regime became core issue for the legislators and regulators. Since the financial crisis, much has been done to improve the corporate regulatory framework in Malaysia. Indeed Malaysia's initiatives to improve corporate governance have gained increasing international recognition⁶³. It is accepted that systems of corporate governance are a result of different historical developments, different cultures and different economies⁶⁴.

While regulating the businesses, Malaysia faced almost the same issues as most of the developing countries faced. These include strong family ownership, weak board structures, lack of supervisory committees, lack of financial disclosure, political influence on the affairs of the companies, Insider dealings, lack of shareholder's participation and conflict of interest between the shareholders and other stakeholders etc.

⁶³As confirmed by the OECD, Roundtable on Corporate Governance, White Paper on Corporate Governance in Asia (2003), online: Organization for Economic Co-operation and Development <http://www.oecd.org/corporate> , and the findings in Kuala Lumpur Stock Exchange & Price Waterhouse Coopers, Survey, "the Joint Kuala Lumpur Stock Exchange-Price Waterhouse Coopers Survey on Corporate Governance" (25 April 2002), online: Price Waterhouse Coopers <http://www.pwc.com/Extweb/ncsurvres.nsf/docid/> , which indicated that the corporate governance gap between Malaysia and other Asia Pacific jurisdictions like Singapore, Hong Kong and Australia has narrowed. All three target groups surveyed--the Institutional groups, the Independent Non-Executive Directors and the Public Listed Companies confirmed that the corporate governance regime in Malaysia has improved.

⁶⁴ Clarke, T. (2001). "Risks and Reforms in Corporate Governance" in 3R's of Corporate Governance, Responsibilities, Risks and Reform. Malaysian Institute of Corporate Governance: Kuala Lumpur, pp.116-139

1.2.2.1. Malaysia's View of Corporate Governance:

Corporate governance has been defined as⁶⁵:

"Corporate governance is the process and structure used to direct and manage the business and affairs of the company towards enhancing business prosperity and corporate accountability with the ultimate objective of realizing long term shareholder value, whilst taking account of the interests of other stakeholders".

This indicates that corporate governance is not only applied to the shareholders but the other stakeholders as well. From the economic perspective, corporate governance is an important element of achieving an allocative efficiency in which scarce funds are moved to investment project with the highest returns. In practice, efficiency is achieved when at given level of risk, investments project offer the highest return exceeding its cost of capital. The crisis indicated how the failure to regulate good governance affected the mobilization of funds in an effective way. Corporate finance on the other hand, concerns on the effectiveness of corporate governance as an assurance in protecting the invested funds and to generate returns. As highlighted by Scheifer and Vishny (1997), corporate governance mechanisms assure investor in organizations that they will receive adequate returns in their investments⁶⁶. To relate this with the crisis, it is concluded that efforts on shareholders protection were inadequate during the crisis and as such contributed to the destruction of the value of their investment.

1.2.2.2. Development of corporate governance in Malaysia:

The main sources of the Corporate Governance reforms agenda in Malaysia are the Malaysian Code on Corporate Governance by Finance Committee on Corporate Governance, Capital Market Master Plan (CMP) by Securities Commission and Financial Sector Master Plan (FSMP) by Bank Negara Malaysia on the financial sector.

⁶⁵ This definition of corporate governance has been taken from Report on Corporate Governance (2002) by the Finance Committee on Corporate Governance in Malaysia. The Report is available at: <http://www.sc.com.my/eng/html/cg/Oview.html#FCR> (last visited June 2006)

⁶⁶ Shleifer, Andrei and Robert W. Vishny, 1997, A survey of corporate governance, *The Journal of Finance*, vol. LII, no.2, 737-783.

It provides guidelines on the principles and best practices in corporate governance and the direction for the implementation as well as charts the future prospects of corporate governance in Malaysia.

1.2.2.3. Malaysian Code on Corporate Governance:

The Malaysian Code on Corporate Governance adopted the hybrid approach between the prescriptive and non-prescriptive models. The prescriptive model sets standards of desirable practices for disclosure of compliance⁶⁷. The Non-prescriptive model requires actual disclosure of corporate governance practices⁶⁸. The Code allows for a more “constructive and flexible response to raise standards in corporate governance as opposed to the more black and white response engendered by statute and regulation”⁶⁹.

The Code essentially aims to encourage disclosure by providing adequate, timely and relevant information to the investing public so as to facilitate informed investment decisions being made and to evaluate the performance of the companies. The Code also aims to set out “principles and best practices on structures and processes that companies may use in their operations towards achieving the optimal governance framework. These structures and processes exist at a micro level which include issues such as the composition of the board, procedures for recruiting new directors, remuneration of directors, the use of board committees, their mandates and their activities”⁷⁰.

⁶⁷ This approach was adopted by the London Stock Exchange which sets best practice benchmarks with which compliance by listed companies are measured against.

⁶⁸ This approach was adopted by the Australian Stock Exchange. This approach is against the premise that “one size does fits all”. Individual companies should be left to determine its own set of objectives and needs based on its structure and those of the directors.

⁶⁹ Introduction to the Malaysian Code on Corporate Governance (2000), para 1.4.

⁷⁰ Ibid., para 1.3. This follows the recommendations of the Hampel Committee on Corporate Governance (1998). The Report in para 2.1 states that “with guidelines, one asks, how far are they complied with? With principles, the right question is ‘how are they applied in practice?’”

1.2.2.4. Capital Market Master Plan (CMP):

Complementing the reforms is the introduction of Capital Market Master Plan by the Securities Commission to chart the direction of the Malaysian capital market for the next ten years. It was initially announced by the Second Finance Minister and Chairman of Securities Commission in August 6, 1999 and subsequently approved by the Minister of Finance in December 2000 before it's launching in February 2001. The efficient mobilization and allocation of funds together with high degree of confidence to market participants are the visions outlined by the CMP. Corporate governance is a key strategic thrust of the CMP as the Securities Commission considers good corporate governance among public listed companies is vital to achieve the objective of promoting a more conducive environment for investors in the Malaysian capital market. One of the recommendations by the CMP is a mandatory disclosure on the state of compliance with the Malaysian Code on Corporate Governance which was issued in the revamped exchange listing requirements on January 22, 2001 to listed companies.

1.2.2.5. Financial Sector Master Plan:

Financial Sector Master Plan (FSMP) was launched in March 2001 by the Bank Negara Malaysia to chart the future direction of the financial sector. It has the objective of developing a more resilient, competitive and dynamic financial systems that contributes to the economic growth and technology driven. Elements of corporate governance that are recommended by the master plan would include promoting shareholders' and consumers' activisms, regulatory control and priority sector financing. Some of the specific recommendations to the banking sector indicated the requirement of having board committees to further improve corporate governance, the implementation of a transparent and clearly structured early warning system for weak banking institutions, encourage mergers between banking institutions and establish a deposit insurance funds.

The development of corporate governance in Malaysia is also complemented by the institutional development. The establishment includes the Malaysian Institute of

Corporate Governance (MICG) and the Minority Shareholders Watchdog Group (MSWG). MICG was established in March 1998 by the High Level Finance Committee on Corporate Governance. It is a non-profit public company limited by guarantee, with founding members consisting of the Federation of Public Listed Companies (FPLC), Malaysian Institute of Accountants (MIA), Malaysian Association of Certified Public Accountants (MICPA), Malaysian Institute of Chartered Secretaries and Administrators (MAICSA), and Malaysian Institute of Directors (MID). MICG's mandate is to raise the awareness and practice of good corporate governance in Malaysia. The Report on Corporate Governance published by the High Level Finance Committee on March 1999 has stipulated MICG as 'The Recognized Corporate Governance Training Centre' (CGTC).

Bursa Malaysia Berhad (formerly known as Kuala Lumpur Stock Exchange) also partake in the effort of enhancing corporate governance in Malaysia by revamping its Listing Requirements. For instance, Chapter 15 of the Revamped Listing Requirements address issues on corporate governance and one of the paramount requirement spells out that a listed issuer must ensure that its board of directors make the following statements in relation to its compliance with the Malaysian Code on Corporate Governance in its annual report:

(i) a narrative statement of how the listed issuer has applied the principles set out in Part 1 of the Malaysian Code on Corporate Governance to their particular circumstances; and (ii) a statement on the extent of compliance with the Best Practices in Corporate Governance set out in Part 2 of the Malaysian Code on Corporate Governance which statement shall specifically identify and give reasons for any areas of non-compliance with Part 2 and the alternatives to the Best Practices adopted by the listed issuer, if any.

The requirement was aimed towards regulating companies to be more transparent and accountable in their actions in order to gain investors' confidence.

The principal objective of MICG include to be a leading organization for enhancement of corporate governance development and best practices through continuing education programme for company directors, chief executive officers, company secretaries, company advisers, company auditors, accountants, lawyers, members of audit committees and investors in Malaysia;

The high level Finance Committee proposed in their report to set up a Minority Shareholder Watchdog Group to monitor and combat abuses by insiders against the minority and to promote shareholder activism⁷¹. In 2001 the Minority Shareholder Watchdog Group (MSWG) was set up and funded by the five local institutional investors⁷².

The major activities of MSWG includes i Corporate governance monitoring services where quarterly and special reports are issued to the public ii Proxy voting services – minority shareholders can appoint MSWG to attend general meetings on their behalf iii Governance scanning of securities listed in stock exchange iv Provide training, education and awareness programs to promote shareholder activism and the benefits of good corporate governance practices v Receive and investigate complaints from minority shareholders vi Collaborate with the Security Commission on corporate governance issues

Malaysia has certainly come a long way since the financial crisis to promote corporate governance. Legal, institutional and regulatory frameworks have undergone reforms and are still being further improved to institute a sound and effective corporate governance structure to protect investors. In terms of rules and regulations, Malaysia has been in the forefront introducing many regional firsts. This has been attested by the

⁷¹ Finance Committee on Corporate Governance, " Report on Corporate Governance", February 1999, pp197-198

⁷² Investors Digest, February 2002, Kuala Lumpur, p5. The five institutional investors are namely, the Employees Provident Fund (EPF), Permodalan Nasional Berhad (PNB), Lembaga Tabung Angkatan Tentera (LTAT), Lembaga Tabung Haji, and the Social Security Organisation (Socso). All these five institutions are directly or indirectly controlled by the government.

joint study between the emerging market investment bank CLSA and Asian Corporate Governance Association in 2003 where they ranked Malaysia the highest at a score of 9 out of 10 in terms of rules and regulations amongst the emerging markets.

Financial and non-financial disclosures by the public listed companies have also improved. Essentially these companies have diligently complied with the requirements of the Code and the Bursa Malaysia's listing rules. Directors have successfully undergone their mandatory training and have been made more aware of their responsibilities, duties, the need to be transparent and to enhance corporate governance practices. Overall corporate governance practices have improved in Malaysia. In the same study mentioned in the preceding paragraph, Malaysia was ranked an overall 5th position at an average score of 5.5 out of 10, an improvement from the 18th position at an average score of 3.7 two years ago. However, efforts to enhance good governance in corporate life are an ongoing process.

There are still gaps which have to be narrowed or closed. The infrastructure may have been improved and in place but there are still further improvements that can be made.

1.2.3 Corporate Governance in India:

The concept and understanding of corporate governance in India has been attracting public attention for a quite some time and this attitude is influenced by key developments in most of the developed countries. Financial crisis in developed and emerging markets have put corporate and governmental oversight in spotlight. Many progressive companies in India have voluntarily placed a system of good corporate governance. However, more and more companies are realizing the importance and fruitful benefits that flow from the effective placement of good corporate governance regime. India is making notable developments regarding the improvement of over all picture of corporate culture in the country in order to make its companies internationally competitive. In the pursuit of the above mentioned objective government and the private

sector are striving their best efforts to devise more and more reliable corporate governance regime.

1.2.3.1. Legal and Regulatory Framework:

The implementation of corporate governance has depended upon laying down explicit codes, which companies and the organizations are supposed to observe. India has established many rules that enable companies to conduct their business freely and improve their productivity. In recent years, the focus of regulatory agencies has been to put in place a policy environment that enables companies to enhance their competitive advantage and strategies.

The Indian corporate sector normally abides by statutory requirements and various standards. The Narayana Murthy committee on corporate governance has noted with approval that the level of compliance in respect of requirements relating to the board of directors, mandatory constitution of audit committees, and shareholders' grievance committee is very high⁷³. But, at the same time, the committee has noted that many companies are yet to comply with the requirements relating to the constitution and working of remuneration committees, board procedures, and reports on corporate governance.

The responsibility for collection, compilation, maintenance and dissemination of basic statistics on the Indian corporate sector is vested with the Department of Company Affairs (DCA). The DCA has recently introduced a scheme of assigning a unique 21-digit corporate index number (CIN) for registration of companies.

The CIN has been designed to help easily identify or group the companies by state, industry (whether listed or not), economic activity, ownership and year of

⁷³ Ravindran, S. (2003). Report of the "*SEBI Committee on Corporate Governance*" Murthy Panel Agrees to Level of Compliance. www.rediff.com/money/2003/mar/20murthy.htm-25k

incorporation and will be applicable to all companies registering beginning November 2000. The older companies will also be given the new registration number subsequently.

As many analysts have noted in their research on corporate governance, the most important legal right that shareholders have is the right to vote on important corporate matters such as mergers and liquidations, as well as the right to elect the boards of directors. Among the key legal rights that Indian shareholders have under the Companies Act to make management accountable are proportional voting rights and voting through proxies, and the right to remove a director before the expiry of his period of office by ordinary resolution, subject to certain tenorial clauses like life time employment.

1.2.3.2. Laws regulating the corporate sector and capital market:

The basic laws governing the functioning of the corporate world is the Companies Act of 1956 which has been amended about 20 times. The act vests the power to the central government to monitor, regulate and control the affairs of companies. It provides a broad framework for disclosure and reporting to DCA⁷⁴.

The government has passed the Competition Law aimed at tackling abuse of dominance, encouraging meaningful competition, and regulating mergers and demergers of companies in tune with the global practices. A few amendment bills are also under consideration to provide a modern, efficient and time-bound insolvency law, conversion of cooperative business into companies and others.

⁷⁴ All companies are expected to provide information regarding the following in the specified format: employment, important heads of expenditure, overseas operations, foreign collaboration and FDI, foreign assets and liabilities, mergers and acquisitions, capital issues, shareholding pattern, balance sheet abstract and corporate governance practices.

The advisory committee on corporate governance in its report to the Reserve Bank of India (RBI) has observed that the predominant form of corporate governance in India is much closer to the East Asian insider model with promoters playing the dominant roles.

Some of the relevant corporate governance codes in India are:

Voluntary code of Corporate Governance for listed companies - CII - 1998

Kumar Mangalam Birla committee by SEBI - 2000

Companies (Amendment Act), 2000 & Clause 49 of listing agreement -2000

Naresh Chandra Committee by SEBI - 2002

Companies (Amendment) Bill of 2003

N.R.Narayana Murthy Committee -2003

Accounting Standards by the Accounting Standards Board of Institute of Chartered Accountants of India (ICAI);

DC Code suggested by the Disinvestments Commission for PSUs.

The Indian corporate sector normally abides by the statutory requirements and various standards. The most obvious one is financial reporting by the statutory auditor. But the quality and track record of the audit have not been so good and are more tuned to the letter than to the spirit of the law. The financial reports do not contain key performance metrics that can give a sense of what is happening inside the organization. The reason could be that it is a report of an external agent in whose appointment the promoters play a vital role.

Most of the Indian firms including some of the biggest ones, tend to have different standards and practices for different companies in their fold. Various companies under the same business house have different foreign institutional investors influencing their corporate standards and practices. This trend is now fast changing with the restructuring exercise taken up by various business houses.

1.2.3.3. Stock exchanges and role of market regulator:

Stock exchanges provide an organized market for transactions in securities and other financial instruments. There are 23 stock exchanges in the India. Three others set up in the reforms era the National Stock Exchange (NSE), the Over the Counter Exchange of India Ltd (OTCEI), and the Inter-connected Stock Exchange of India Limited (ISE) have been mandated to have nationwide trading network. Majority of the stock exchanges have adopted the screen based trading system (SBTS) to provide automated and modern facilities for trading.

Online trading and transaction in dematerialized form is also available in most of them. A major development in the Indian capital market has been the setting up of the depository. The objective of the depository is to provide for maintenance/transfer of the ownership record of securities in an electronic book entry form and scripless trading in stock exchanges thereby reducing settlement risk.

With the aim of raising more capital and to encourage greater participation of people, steps have been taken to improve the working of the stock market. The operations of the capital and financial markets were streamlined by SEBI as companies are now free to approach the capital market after clearance by SEBI. SEBI has the duty to protect the interests of investors in securities and to promote the development of and to regulate the securities market through appropriate measures⁷⁵.

⁷⁵ These measures provide for: (a) regulating the business in stock exchanges and securities market, (b) registering and regulating the working of stock brokers, agents, bankers and other intermediaries who may be associated with the securities market in any manner, (c) registering and regulating the working of India collective investment schemes, including mutual funds, (d) promoting and regulating self-regulatory organizations, (e) prohibiting fraudulent and unfair trade practices in the securities market, (f) promoting investor education and training of intermediaries in the securities market, (g) prohibiting insider trading in securities, (h) regulating substantial acquisition of shares and take-over of companies, (i) calling for information, undertaking inspection, conducting enquiries and audits of the stock exchanges and intermediaries and self-regulatory organizations in the securities market, (j) performing such functions and exercising such powers under the Securities Contracts (Regulations) Act. 1956, as may be delegated to it and the Central Government, (k) levying fees or other charges for carrying out the defined purposes under various sections, (l) conducting research for the above purpose.

The SEBI has formed a group to review implementation of corporate governance standards and recommend steps to enhance transparency and integrity of the market. The group would take the stock of corporate governance standards and their implementation by the market participants including listed companies. It has also worked out a code of ethics for directors and functionaries of stock exchanges. In order to ensure better corporate governance, exchanges will have to monitor whether the companies listed on the bourse have set up independent boards of directors and audit committees and also are filing quarterly results with the exchange. New companies will be required to disclose their shareholding pattern on a quarterly basis.

1.2.3.4. SEBI code of corporate governance:

Keeping in view the needed changes and the importance of corporate governance as a tool for investor protection, the SEBI has appointed a committee to draw up a code of corporate governance. The code is to be followed by listed companies, their directors, management, employees and professionals associated with the companies.

SEBI, the market regulator, and the Confederation on Indian Industry (CII), a premier industry association, have also constituted committees to establish guidelines for good corporate governance practices to keep pace with the changes brought in by globalization and to help Indian corporations attain international standards in terms of transparency and integrity in the global market.

The recommendations of the Birla Panel call for changes in the existing law⁷⁶. For instance, the committee recommends that the board may consist of the following types of directors: promoter directors, executive directors, and non-executive directors.

⁷⁶ The 30-page Birla panel report covers recommendations under 11 categories: (1) independent directors, (2) nominee directors, (3) chairman of the board, (4) audit committee, (5) remuneration committee, (6) board procedures, (7) accounting standards and financial reporting, (8) corporate management, (9) shareholders, (10) institutional shareholders, and (11) manner of implementation.

Executive directors (like the finance director or personnel director) are involved in the day-to-day management of the companies while the non-executive directors bring external and wider perspective and independence to decision making. Based on the code, a part of the non-executive directors have to be independent directors, such that they do not have any relationship with the company or its promoters. The percentage of independent directors in the board is defined depending on whether the chairman is executive or non-executive. Although not mandatory, financial institutions are asked to refrain from nominating any directors in the board to avoid potential conflicts of interest.

The code also recommends an independent audit committee to act as a bridge between the board, statutory auditors and internal auditors. The committee is expected to monitor the overall financial reporting process and to ensure compliance with accounting standards and other legal requirements. The audit committee derives its power from the authorization of the board. A separate committee to take care of the remuneration of the directors is also prescribed.

The code also prescribes basic procedural requirements in terms of frequency of meetings, the availability of timely information, sufficient period of notice for the board meeting as well as circulation of agenda items well in advance, and more importantly, the commitment of the members of the board. Accordingly, the board meetings should be held at least four times in a year, with a maximum time gap of four months between any two meetings. Further, to ensure that the members of the board give due importance and commitment to the meetings of the board and its committees, a director should not be a member in more than 10 committees or act as chairman of more than five committees across all companies in which he is a director.

The financial reporting and accounting standards have to be upgraded towards international standards. A requirement to be met by all companies is consolidating the accounts of all the subsidiaries in which the company holds 51 percent or more of the

share capital has to be given. Companies which are in multiple lines of business, should make available to their shareholders financial reports in each product segment. Regarding the disclosure and treatment of related party transactions and treatment of deferred taxation, the standards issued by the Institute of Chartered Accountants of India (ICAI) have to be followed.

Although shareholders are the owners of the company, they are not expected to assume responsibility for the management of corporate affairs. The boards of directors, by delegation from the shareholders, are responsible for corporate strategy and operations. Nevertheless, the shareholders are expected to be actively involved in the appointment of directors and have the right to be sufficiently informed about the major decisions concerning fundamental corporate changes or changes in capital structure. There are several other guidelines for keeping the shareholders informed up-to-date about the financial performance and board meetings. Moreover, although financial institutions hold a major share of equity in many Indian companies, it is preferred that these institutes do not seek participation in the board. Instead they may take active interest in the composition of the board and maintain contacts at senior level to exchange views on strategy, performance and management.

To ensure that companies strictly follow this code for corporate governance, the mandatory provisions are implemented through the listing agreement of the stock exchanges. As this is not a very powerful instrument and the penalties for violation are not stringent, it is recommended to bring the necessary amendments in various existing laws including the Companies Act. The listed companies and companies seeking listing are required to have a separate section on corporate governance in their annual reports.

With the amendments made in the Companies Act, the introduction of Competition Bill 2000, the adoption of new SEBI guidelines and changes in accounting practices suggested by ICAI, corporate governance in India is now moving towards

ensuring compliance with the legal and regulatory framework and is geared towards meeting the requirements of majority shareholders.

Chapter 2

Corporate Governance in Pakistan

After having a detailed overview of the current corporate governance practices in the developed and developing economies, the necessity and urge to have a strong corporate governance regime in Pakistan becomes more activated. But unfortunately, Pakistan is far behind from her competing countries in respect of placing good mechanism. This does not mean that Pakistan's officials, law enforcement agencies or other concerned groups of corporate sector are not serious or not aware of the sensitivity or gravity of the issue rather they are at present facing numerous challenges with respect to the sustainable growth of corporate sector. Here in this chapter we sketch the corporate governance practices in Pakistan. Section 2.1 show the way, corporate governance developed in Pakistan. Section 2.2 elaborates development of company law. Section 2.3 narrates the role of international donor agencies to uplift the corporate sector in Pakistan.

2.1. Development of Corporate Governance in Pakistan:

The priorities with respect to sustainable development of corporate sector vary a lot with respect to the different concerned parties e.g. regulators have their own priority, investors or minority shareholder and other stakeholder have their own and above all is the government's deregulation and privatization policies that conflict and overlap among each other. Above mentioned key policy concerns will be discussed in detail while discussing the detailed analysis of the corporate governance regime but here we will discuss the evolution and development of corporate governance

phenomenon, international deriving forces towards better governance, in-built provisions for good governance in Companies Ordinance, code of Corporate Governance, Legal status of manual of corporate governance and the role and initiatives of International donor agencies for ensuring good governance in Pakistan.

2.1.1. Evolution and History of Corporate Governance:

Since the second half of the 19th century, most modern industries and services in Pakistan have been structured under the framework of joint-stock limited liability. Despite this long corporate history, the phrase “corporate governance” remained unknown until late 1990⁷⁷.

The term corporate governance gained attention in Pakistan in the second half of 1990's when financial crisis hit Asian countries. However, corporate sector of Pakistan at that time was not developed at such a level that it can be viewed at the wake of 21st century hence, Pakistan's corporate sector did not suffer from the crisis. Corporate governance has been a central issue in developing countries long before the recent spate of corporate scandals in advanced economies. Indeed corporate governance and economic development are intrinsically linked. Effective corporate governance systems promote the development of strong financial systems irrespective of whether they are largely bank-based or market-based which, in turn, have an unmistakably positive effect on economic growth and poverty reduction⁷⁸.

The main emphasis to the issue of good governance and business ethics became point of great consideration when Government of Pakistan in order to get more and more foreign investment had undergone major policy variations i.e. Privatization of

⁷⁷ This is not surprising. In the USA, corporate governance came into prominence only after the second oil shock in 1979 — when activist pension funds started demanding board level performance for its investors, and junk-bond funded raiders began to target under-performing companies. In the United Kingdom, corporate governance started to be spoken of only in the late 1980s and early 1990s in response to the collapse of the BCCI and malpractices of the Maxwell group, which led to the press questioning the City on its efficacy in monitoring British public limited companies.

⁷⁸ Chakrabarti Rajesh, 2005 Corporate Governance in India – Evolution and Challenges. Can be seen online at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=649857 (last visited June 2006)

state owned enterprises and De-regulation and liberalization process. This decision proved itself a wise one as it resulted in remarkable efficiency in all areas of the corporate as well as related sectors.

Privatization, liberalization and de-regulation initiatives were warmly welcomed by the foreign investors. Meanwhile, some of the developed countries found major irregularities and violations of the mandatory provision of laws by their companies, and it resulted in losing confidence of the investors. Consequently, these major frauds were in no time accessible to the general public through media. The companies where the top management was accused of material violations included companies that were enjoying investor's confidence for a long period. Moreover, subject of corporate governance leapt to global business limelight from relative obscurity after a string of collapses of Enron, the Houston, Texas based energy giant, and WorldCom, the telecom behemoth, shocked the business world with both the scale and age of their unethical and illegal operations. Worse, they seemed to indicate only the tip of a dangerous iceberg. While corporate practices in the US companies came under attack, it appeared that the problem was far more widespread. Large and trusted companies from Parmalat in Italy to the multinational newspaper group Hollinger Inc., revealed significant and deep-rooted problems in their corporate governance. Even the prestigious New York Stock Exchange had to remove its director, Dick Grasso, amidst public outcry over excessive compensation. It was clear that something was amiss in the area of corporate governance all over the world.

Consequently, Securities and Exchange Commission of Pakistan (SECP) in pursuance of its policy of regulation has enacted and enforced various laws and regulations in order to create an "enabling business environment" to overcome the constraints confronted by the companies for smooth and sustained economic development. It has adopted the Code of Corporate governance in order to better

regulate the affairs of the listed companies in March 2002⁷⁹. The compliance of the Code was made mandatory through making it part of the listing regulations of the Stock Exchanges. Since then all the concerned participants are striving their best effort to ensure the compliance, however, there are many concerns that still need to be resolved.

2.1.2. Impact of International Developments on State of Corporate Governance in Pakistan:

As previously mentioned development of corporate governance regime in Pakistan is directly related with international developments specially developments taking place in England and United States of America. While adopting foreign developments at national level require various points to be kept in consideration, it will not always be wise to adopt the same foreign developments at national level because the social, economic and business circumstances of two countries can not at the same time be same. Moreover, it can not be ensured that if certain categories of amendments in Law in United States are successful the same results will emerge in other country by enacting such amendment. It is a fact that a good code or law does not in itself ensure good compliance or result oriented out put. Policy makers unfortunately, did not understand or have neglected this important aspect while drafting code in Pakistan. The reason is the corporate sector of the developed and emerging economy like Pakistan can not be and surely are not at the same level, each has its own distinctive characters, features and concerns. However, one should not infer from this discussion that one should totally rule out the developments taking place in different jurisdictions rather one has to critically evaluate the similarities and differences so that a constructive framework could be launched and practiced. Resultantly all these above mentioned corporate frauds opened a warm debate for transparency in the affairs and business of the companies and conduct of senior management of companies in Pakistan

⁷⁹Code of Corporate Governance is available online at: www.ecgi.org/codes/code.php?code_id=90 (last visited June 2006)

2.1.3. In Built Provisions for Corporate Governance in Companies Ordinance, 1984:

The legal system of a country plays a crucial role in creating an effective corporate governance mechanism and protecting the rights of investors and creditors. The legal environment encompasses two important aspects – the protection offered in the laws (*de jure* protection) and to what extent the laws are enforced in real life (*de facto* protection). Both these aspects play important roles in determining the nature of corporate governance in any country in question.

Recent research has forcefully connected the origins of the legal system of a country to the very structure of its financial and economic architecture arguing that the connection works through the protection given to external financiers of companies, creditors and shareholders⁸⁰. Legal systems in most countries have their roots in one of the four distinct legal systems i.e. the English common law, French civil law, German civil law and Scandinavian civil law. The Pakistan's legal system is obviously built on the English common law system. Since Pakistan was part of British colonial system till 1947 when she got independence, hence, Pakistan inherited common law regime by birth. The Companies Ordinance, 1984 is the grund norm for the corporate governance regime in Pakistan. As all the matters relating to formation of the company till it's winding up originates or draws their power from the Ordinance, it is a well accepted rule that law develops gradually with the social and cultural developments. When speaking of the economic efficiency one can not avoid the role of corporate sector in the general well-being of the society that directly enhances the efficacy. The time when the Ordinance was promulgated in year 1984 the corporate culture of Pakistan at that moment was not much exposed to the international scenario. However, it contained almost all of the mandatory provision that relate to the good governance of a corporate entity. With the development of the society in general and corporate sector specifically the affairs of the company and its ancillary matters became more and more complex. So

⁸⁰Chakrabarti Rajesh, 2005 Corporate Governance in India – Evolution and Challenges. Can be seen online at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=649857 (last visited June 2006)

this complexity of the affairs of the company required that the investors should be provided with more transparent trust worthy environment.

In this evolutionary process a distinct branch that is often related with management finance and law emerged. As the developed countries had already a good managerial and regulatory framework they split corporate governance as distinct branch. In the same way the developing countries also tried to implant the same managerial and regulatory framework irrespective of the fact that corporate culture of the developed and developing countries are far away from each other. Meanwhile, Pakistan also came across the same situation and general public thought corporate governance to be a dragon as there existed such an atmosphere that people were totally unaware of the subject.

However, in actual induction of corporate governance regime was only extension of already inbuilt provisions for good governance of the Ordinance that stress upon the fairness and transparency in managing the affairs and business of the companies.

The Ordinance contained almost all provisions that are considered mandatory for achieving the required level of transparency. These provisions range from the incorporation of the company, meetings especially annual general meeting, conduct of meeting, allotment of shares, redress provisions for minority shareholders, rights of stakeholders, duties and liabilities of board of directors, penalties for mismanagement, accounting and auditing provisions to the transparent winding up provisions. However, effective enforcement of the mandatory provisions of the Ordinance is the core issue at present. No doubt, that there are certain deficiencies in some of the provisions of the Ordinance, a committee is at present busy in further refining some of the lacking provisions for the smooth performance of the companies. In order to have good grip over the statutory and regulatory provisions one should have knowledge of the

development structure of company law in Pakistan i.e. how it emerged and developed to present level.

2.2. Development of Company Law in Pakistan:

At the time of decolonization, the corporate sector was chiefly regulated by the Companies Act, 1913 and same was adopted by Pakistan. Initially, company law was directly administered by the provinces. However, when Constitution of Pakistan 1973 came into force administration of companies was included in federal list leaving behind the administration of companies operating in provinces under the control of provincial governments. On 8th October 1984, foreseeing the out datedness of various provisions of Companies Act, 1913 and in order to include developments of the corporate sector, Companies Ordinance, 1984 was promulgated. In 1993, a committee under the chairmanship of the predecessor Corporate Law Authority's Chairman Mian Mumtaz Abdullah was formed for broadening the scope of the Ordinance. On the basis of the report of this committee certain amendments were proposed and subsequently enforced through an ordinance by the then care taker government. Unfortunately, the ordinance lost its enforcement because of political concerns as it could not be placed in Parliament for its promulgation⁸¹.

In continuance of modernization process of company law in Pakistan, a commission headed by Mr. Justice (Rtd) Shafi ur Rahman was constituted in 1996. Commission reviewed the Ordinance and made its recommendation to the federal government for the next action to be taken by Government. Again the Federal Government failed to discharge its duties in this regard. Meanwhile, the corporate sector in Pakistan was growing day by day and was demanding serious attention by the concerned policy makers and managers for its effective performance. Hence, understanding the needs of the sector and out-datedness of some key provisions of the Ordinance, a committee consisting of Mr. Abdur Rahman Qureshi, Mr. Zafar ul Haq

⁸¹ The development of company law in Pakistan has been heavily drawn from "Practical Approach To The Companies Ordinance, 1984" by Nazir Ahmad Shaheen (2004 Edition) Pakistan Law House.

Hijazi, Mr. Muhammad Hayat Jasra and Mr. Nazir Ahmad Shaheen Additional Registrar of Companies was formed in January, 2001. The committee extensively reviewed the Ordinance and conducted a thorough study of current international trends and practices in collaboration of various market participants. The recommendations of the committee were promulgated in the form of Companies (Amendment) Ordinance 2002.

This was the year when Code of Corporate governance was introduced by SECP. As the members of the review committee were also representing SECP, hence most of the corporate governance provisions were included in the Ordinance through Companies (Amendment) Ordinance 2002. In total 57 amendments were made that included the issues of minority shareholder, allotment of shares, meetings of the companies, Board of director, prohibition of investment in associated companies, quarterly accounts for listed companies, penalty for non-compliance with the provisions of the Ordinance were enhanced and strict penalty for the non-compliance of the provisions of the auditors.

Table below explains the Chronological development of legislative and regulatory framework of company laws in Pakistan.

Table 2.1

1.	Companies Act ,1913	At the time of independence Pakistan inherited the Act that deals with all the provisions of business. The Act was regulated by the provinces till 1973.
2.	Chartered Accountant Ordinance, 1961.	Under Chartered Accountant Ordinance, 1961 Institute of chartered Accountants was established that is responsible for Regulation of Accounting profession. Only members of the Institute can sign the audit reports of all companies except for very small ones. It is Governed through its Council consisting of 16 members that includes 12 elected members and 4 Government nominees.
3.	Securities and Exchange Ordinance, 1969	Securities and Exchange Ordinance, 1969 was promulgated to provide for the protection of investors, regulation of markets and dealings in securities on 28 th June, 1969
4.	Monopolies and	As undue concentration of economic power, growth

	Restrictive Trade Practices (Control and Prevention) Ordinance 1970	of unreasonable monopoly power and unreasonably restrictive trade practices are injurious to the economic wellbeing, growth and development of any economy, hence this Ordinance was promulgated on 26th February, 1970 so that a level playing field to be available to all market players.
5.	Chartered Accountants (Amendment) Ordinance 1983	The Amendment Ordinance was promulgated on 19th June, 1983. The Ordinance aimed at the more transparent accounting and auditing process. In addition to it, it introduced strict penal provisions regarding Professional misconduct by any member if the Institute of Chartered Accountants.
6.	Companies Ordinance, 1984	The Ordinance consolidated and amended the law relating to companies and certain other associations for the purpose of healthy growth of the corporate enterprises, protection of investors and creditors, promotion of investment and development of economy and matters arising out of or connected therewith.
7.	Companies (Amendment) Act 1991	The Act Amended section 2 of the Companies Ordinance and inserted Clause 15-A regarding the definition of Financial Institution. This amendment has been replaced in Companies (Amendment) Ordinance 2002.
8.	Securities and Exchange (Amendment) Act 1994	Amendment of section 2, 32 and two new sections 32A and 32B were inserted.
9.	Securities and Exchange Commission of Pakistan Act 1997	The Act established the Securities and Exchange Commission of Pakistan for the beneficial regulation of the capital markets, superintendence and control of corporate entities and for matters connected therewith.
10.	Securities and Exchange (Amendment) Ordinance 2000	Amendment of section 2, Insertion of new section 5-A, amendment of sections 7, 8, 9, 21, 22, 24, Omission of sections 26 and 28, Substitution of section 32, Insertion of new section 32-C and Amendment of section 33 were made.
11.	Code of Corporate Governance, 2002	The code of corporate governance was drafted and issued with active struggle of Securities and Exchange Commission of Pakistan and Institute of Chartered Accountants of Pakistan in collaboration of various market participants on March 2002.
12.	Companies (Amendment) Ordinance 2002	This amendment ordinance was promulgated on 26 th October, 2002 whereby comprehensive amendments were made in order to keep the Companies

		Ordinance, 1984 up to-date. Total 57 amendments were promulgated under this Amendment Ordinance.
13.	Monopolies and Restrictive Trade Practices (Control and Prevention) (Amendment) Ordinance 2002	With the development of the corporate sector into various sectors different regulatory authorities were established. In order ensure effective market competition amendment in section 25 was promulgated on 26th October, 2002.
14.	Listed Companies (Substantial Acquisition of Voting Shares and Takeovers) Ordinance 2002	This Ordinance was promulgated on 29th October, 2002 in order to provide for a fair and equal treatment to all the investors as well as a transparent and efficient system for substantial acquisition of voting shares and takeovers of listed companies and ancillary matters.
15.	Companies (Second Amendment) Ordinance 2002	This amendment ordinance was promulgated on 15 th November, 2002. This Ordinance was inserted as part viii of the Companies Ordinance. Through this amendment the regulation of Non- Banking Finance Companies was given to Securities and Exchange Commission of Pakistan. The inserted sections ranges from 282-A to 282-L.
16.	Listing Regulation of Karachi Stock Exchange	Listing regulation set forth standards for the companies that intend that their shares to be traded in the Stock Exchange. Code of Corporate Governance is also part of the listing regulation.
17.	Company Law Review Commission, 2004	In order to cope with the current economic scenario, SECP has established CLRC so that the provisions of the Ordinance can be amended so as to meet its objectives and maintenance of a liberal, deregulated and efficient corporate sector in Pakistan.

2.2.1. Code of Corporate Governance:

In 2002, SECP issued Code of Corporate Governance. Compliance of the Code was made mandatory for all listed companies and also for non-listed commercial banks. Despite initial resistance from market, the Code has started gaining ground. In order to facilitate the companies regarding the compliance of the Code SECP has issued

frequently asked questions on corporate governance⁸². The lead is taken by few multinational companies, banks, and particularly family controlled companies. They have started to adopt more transparent and effective corporate governance structures that are more in line with modern competitive practices. General awareness and training programs and credit rating initiatives are becoming common. With the objective to engender sound corporate governance practices and to provides an enabling environment for implementation of the Code, the present Corporate Governance Code issued by SECP is a social and economic requirement and national imperative. It is a very crucial document for the development of the corporate market. However, the corporate governance regulations, it is said, have hurt the capital market and might reduce the already thin size to razor-thin size. It can be observed that market capitalization since the enforcement has increased but number of listed securities remain less prior to the enforcement of the code through listing regulation of the stock exchange. The following table shows the performance of the financial market from the time of implementation of the code of corporate governance⁸³.

Table 2.2

Year	Up to 31-12-2002	Up to 31-12-2003	Up to 31-12-2004	Up to 31-12-2005	Up to 16-11-2006
Total number of listed companies	711	701	661	661	653
Total listed capital (Million Rs.)	291,240.85	313,267.23	405,646.32	470,427.47	517,321.30
Total market capitalization- Rs.	595,205.63	951,446.50	1,723,454.36	2,746,558.97	2,987,314.7 3
KSE-100 index	2701.42	4471.60	6218.40	9556.61	10850.04

⁸²Frequently asked questions on corporate governance Can be viewed online at www.secp.gov.pk/divisions/Portal_CS/Publications.htm (last visited June, 2006)

⁸³ As Karachi Stock Exchange is biggest of all the three exchanges and almost all of the companies that are listed on Lahore or Islamabad stock exchanges are also listed in Karachi Stock Exchange, hence, the data has been taken from the record of Karachi Stock Exchange. For more details visit <http://www.kse.com.pk/progress report> . Last visited November, 2006.

KSE-30 Index					13329.06
KSE All Share Index	1671.09	2833.10	4104.86	6444.64	7251.08

Unfortunately, lack of understanding to the ethical and business standards, delisting process by the companies increased to a great number. Since the enforcement of the code 109 companies have been de-listed out of which only 16 companies have been de-listed as a result of violation of listing regulations of the stock exchange. Majority of the companies have opted the way of buy back share option that shows a tendency on behalf of the companies that they are afraid of the compliance requirements. In spite of the fact that the Exchange has introduced an incentive for top 25 best performing companies' award in order to attract the companies to list them but overall tendency is in negative. Statistics show that 24 companies opted to de-list right after the issuance of the code. Major reason behind this tendency is lack of information about the code and there is an urgent need that corporate governance seminars should be organized for senior management of the companies and for general public so that ambiguities regarding the Code can be resolved. The table below shows the number of de-listed companies since 2002⁸⁴.

Table 2.3

Year	2002	2003	2004	2005	2006
Number of companies de-listed	24	8	18	14	1

Same attitude exist in case of Private limited companies as they find SECP's corporate governance code too arduous and therefore wish not to be listed. Moreover, in order to expand and grow beyond limits, companies have to raise funds from channels other than primary sources⁸⁵. Disclosure of information with responsibility and integrity

⁸⁴ Data has been taken from the record of Karachi Stock Exchange. Can be viewed at <http://www.kse.com.pk/companies/delisted> Last visited 20th November, 2006.

⁸⁵ Hussain Ishrat 2005 "Corporate Governance in Financial Sector of Pakistan" seminar organized by Institute of Business Administration Karachi Pakistan

is mandatory while using others' capital. Listing or TFCs is no longer the only means to raise capital. In the presence of variety of financial instruments and corporate entities such as mutual funds, asset management funds, equity funds, hedge funds, and venture capital funds, it becomes vital that corporate governance practices should not only be relevant to listed companies but for all.

The code of corporate governance doesn't add any thing new to directors' responsibilities. It only further details fiduciary responsibilities of the Board and sets rules for corporate conduct. The Code says that the directors should exercise their powers and carry out their fiduciary duties in the best interests of the company. It further stresses that the auditors should stand on a higher 'ethical pedestal'.

Given the peculiar corporate culture and closely held companies, the good corporate governance becomes all the more significant in Pakistan. Absence of proper laws and regulations under which firms operate, ill defined functions of board of directors, vague relationship between executive dispensation and operational performance, weak linkages between labour policies and firm performance, inadequate financial reporting frameworks and ineffective transparency and accountability mechanism are some of the crucial policy puzzles that are current in the context of good corporate governance in Pakistan.

The SECP promulgated number of laws and regulations in March 2002. The regulations aimed at creating favorable investment climate for the sustainability of economic development. The rules also regulate the working of listed companies⁸⁶. Good governance practices existed in certain sectors of the economy long before the SECP framed the Code. However, for SECP the challenge was how to bring them within the network of the Code without scaring them away. SECP neither left the implementation of the Code to the companies on voluntary basis nor made it obligatory. SECP chose to

⁸⁶Asif and Rais Regulatory Impact Assessment (RIA) of SECP's Corporate Governance Code in Pakistan May 2004. Can be seen at http://ravi.lums.edu.pk/cmer/upload/regulatory_impact_assesment.pdf (last visited April 2006)

be flexible. Its strategy was to prepare a legal framework that afforded an enabling environment and present the Code as the savoir working for the benefits of the companies. In order to avoid any kind of bad feelings perhaps the SECP did not make the code part of Companies Ordinance and subsequently made it listing requirements for the companies in 2002⁸⁷. Even this soft approach could not wipe the apprehensions of the corporate world in Pakistan. Very wisely, the SECP shared their viewpoint with the stakeholders through organizing number of seminars and workshops throughout Pakistan. These interactions aimed at inculcating awareness on the benefits of the Code. Indeed, the Code is the result of a long consultative and brain storming interactions with the stakeholders.

2.2.2. Manual of Corporate Governance:

As a further step to ensure a good market structure and sustainable performance, SECP, after issuing the code of corporate governance and subsequently, making it part of listing regulations, issued a manual of corporate governance. It is a very comprehensive document and in its essence is a good contribution to the overall regime of good governance in Pakistan⁸⁸.

The manual is neither legal instrument nor implicates any obligations on the day to day corporate affairs of companies. Rather it is an explanation of the mandatory provisions of the code and provides guidance to the concerned companies, their officers, directors and auditors. It focuses on all the aspects of corporate governance from its origin to the performance of key liabilities by the managers of companies.

It highlights the linkage between corporate governance and stakeholders. A stakeholder is a person including an entity or group that has an interest or concern in a

⁸⁷ Asif and Rais May 2004 Regulatory Impact Assessment (RIA) of SECP's Corporate Governance Code in Pakistan. Can be seen at http://ravi.lums.edu.pk/cmer/upload/regulatory_impact_assesment.pdf (last visited April 2006)

⁸⁸ Can be viewed online at www.secp.gov.pk/divisions/Portal_CS/Publications.htm (last visited August 2006)

business or enterprise though not necessarily as an owner. Moreover, a stakeholder may be a single person or may be a group or another company. It stresses upon the stakeholders' role that they can play in order to ensure that the company is performing in accordance with its corporate goals. The minority shareholder activism is key concern at present that requires priority among another concerns. Manual entails a good path in order to overcome the issue.

The primary responsibility for the administration and performance of a company lies with the directors. Manual describes a conceptual difference between directors and managers and explains the statutory and fiduciary duties of the directors in detail.

Financial statements of a company are structured financial representation of the financial viability and the transactions undertaken by a company. Finally, manual outlines the role of directors, internal auditors and external auditors for the transparent view of the financial transactions so that investors could be attracted.

However, it is an admitted fact that unless and until the knowledge is transferred to general public mere knowledge is of no use. Same is the case with the manual. SECP has utilized its best efforts to draft an elaborative document for good understanding of the respondents of the code but it failed to effectively transmit to public at large. As the issue of good governance has attained a hot debate, SECP as an apex regulator should utilize the media to achieve positive results of its initiatives.

2.3. Role of International Donor Agencies on Corporate Governance in Pakistan:

International Agencies are helping Pakistan for a long time in order to overcome the various challenges that come across while managing various sectors irrespective of the nature of the challenge. Assistance provided by the agencies ranges from macro level to the micro level. Macro level assistance involves assistance to the government in

strengthening its affairs while micro level assistance involves the general tuning of the private entities.

International agencies have undertaken many key initiatives to enhance the corporate governance regime in Pakistan. These involve various grants to the public sector as well as private sector for the capacity building for good governance, seminars for the introduction and importance of corporate governance etc. Followings are some of the key initiatives that proved them to be important in the history of corporate governance regime in Pakistan.

2.3.1. United Nations Development Program:

SECP in partnership with the United Nations Development Programme (UNDP) and the Economic Affairs Division of the Government of Pakistan launched the SEC-UNDP Project on Corporate Governance in August 2002. Under this project, UNDP provided technical and financial assistance to the SECP for developing and implementing good corporate governance practices and establishing a sound regulatory framework for the corporate sector in the country. The work involved implementation of the Code of Corporate Governance, issued by the SECP in March 2002, creating stakeholder awareness, capacity-building and networking with other emerging markets⁸⁹.

In order to attract sustainable capital, it is imperative for economies in transition to focus on evolving a system that ensures good corporate governance. As the dust settles after the Asian financial crisis, most economic and development commentators feel that a major determinant of the relationship between long-term economic growth and poverty reduction is a well-functioning financial and corporate sector. The inflow of foreign capital brings with it a transfer of technology and managerial skills and factors crucial to the developing countries in their economic progress. At the same time,

⁸⁹ See http://www.secp.gov.pk/divisions/Portal_CS/PDF/ProjectReport.pdf for complete report. (last visited November, 2006)

the confidence of local investors also heightens. This increased economic activity improves human welfare in the form of an efficient allocation of resources and more employment. Therefore, implementing good governance practices has a positive impact on economic growth, which creates opportunities and brings people above the poverty line.

The SECP-UNDP Project has aimed at making a positive contribution towards economic growth in Pakistan by developing a stronger financial and corporate sector. A Corporate Governance Cell was established at the SECP which acts as a resource centre and carries out research and awareness campaigns on various issues related to corporate governance. However, at present it can only be found in the research articles and documents.

As a part of this project, guidelines and newsletters are also being distributed to the corporate community for a better understanding of the issue, and research is being carried out for the harmonization of the provisions of the Code with corporate laws and an assessment of the state of corporate governance.

A monthly briefing series was initiated to further increase public awareness on various aspects of corporate governance. In order to generate meaningful debate, extensive research work is in progress for a working paper series, the first focusing on the role of institutional shareholders in the promotion of corporate governance in Pakistan⁹⁰. Another major initiative of the Cell was the development of corporate governance index, where work has already started, to indicate assessment of practices

⁹⁰Institutional ownership is share ownership by financial institutions (both banks and non-bank financial companies) and non-financial corporations. These include both the public-owned as well as privately owned institutions. Typically institutions are categorized as follows, (i) Non-banking Finance Companies (NBFC): insurance companies, mutual funds, investment companies, leasing, venture capital companies etc, (ii) Banking Companies: These include the commercial banks, (iii) Non-financial Corporation, (iv) All other non-financial entities including trusts and non-profit organizations, (v) Development Financial Institutions and International organizations/fund managers. For more details See http://www.secp.gov.pk/divisions/Portal_CS/WorkingPaperCorpGov.htm (last visited April 2006)

and policies and to reflect the relative level to which a company accepts and follows the Code and guidelines of corporate governance.

An important part of the Project is the exchange of contemporary ideas and collaboration on key issues. SECP officials have been participating in study tours to leading international institutions that are involved in the promotion and development of sound governance practices. In order to encourage participation of stakeholders in the system, it is essential to broaden their understanding of the subject. In this regard, the SECP has been conducting several activities, including seminars and workshops, to increase the awareness of the directors and management of listed companies of their statutory and fiduciary duties. The first seminar under the Project "Strengthening Corporate Governance in Pakistan" was held on 28 November 2002 and included local and foreign participants, who gave an international perspective on corporate governance.

Three workshops were also organized in Islamabad, Karachi and Lahore on the "Responsibilities of Directors and Management of Listed Companies". An important aspect of these workshops was the utilization of the case study method in order to draw lessons from corporate failures in the country and other parts of the world. Participants lauded the efforts being undertaken by the SECP to improve good governance practices.

By complementing resources with UNDP, SECP has managed to act as an agent for bringing positive change in the corporate culture of Pakistan. A more transparent and efficient corporate sector would thus gain investors' confidence and yield positive results towards growth.

2.3.2. Asian Development Bank:

Pakistan has received about \$15.39 billion of assistance in total, since joining the Asian Development Bank (ADB) in 1966, and had disbursed \$10.31 billion as of the end of 2005. Total assistance approved in 2005 included \$776.3 million loans, \$85

million special funds (including Asian Development Fund, Asian Tsunami Fund, and Pakistan Earthquake Fund), \$36 million for other funds, and \$15.28 million for technical assistance grants⁹¹.

Under ADB's country strategy and program (CSP) for Pakistan, approved in May 2002, assistance supports good governance, sustainable poor growth, and inclusive social development. Sub-regional cooperation, sustainable environmental management, and gender and development are crosscutting themes.

2.3.2.1. Financial Markets Governance Program:

The first phase of financial market reforms has been successfully implemented under the capital market development loan of ADB, which was completed in 2002. The SECP took a number of steps to improve the governance and risk management aspects of all the three stock exchanges and implemented the Code of Corporate Governance. The observance of International Accounting Standards was further enhanced to boost investors' confidence. Insurance companies were asked to enter into reinsurance arrangements with reinsurers that had a minimum "A" rating. Further, in line with the evolving international practices, the concept of NBFCs was instituted and implemented. Trading in futures contracts in commodities was initiated in July 2001. Additionally, a number of steps were taken to reposition and transform SECP in terms of human resource and automation.

Although, a lot has been achieved over the last few years, there is a lot that still needs to be accomplished. Market forces demand a more vigorous financial market in the country. In order to promote vibrant and efficient financial markets in Pakistan, ADB has approved an integrated assistance package of three loans and two political risk guarantee (PRG) facilities, under the Financial Markets Governance Program (FMGP) for effecting the second phase of reforms in Pakistan. Based on the experiences gained

⁹¹See http://www.adb.org/Documents/Fact_Sheets/PAK.asp?p=ctrypak (last visited May 2006)

while implementing the first phase of reforms during the last three years, both SECP and ADB have acquired considerable knowledge on the financial sector development in Pakistan. This second phase of reforms builds on the earlier developments.

The FMGP intends to support the development of Pakistan's non-banking financial markets through reform, capacity building and international private sector participation. It will assist the Government in further improving governance and operational efficiency in financial markets that offer a wide range of non-banking products and instruments for savings and investment.

This will strengthen investor confidence and reduce vulnerabilities of the financial system as a whole. In the context of this program, non-banking financial markets will cover equity markets, debt and money markets, contractual savings, and other non-banking financial institutions and services including insurance, leasing and DFI reform. Through the PRG facilities, the program will increase and sustain private sector flows into the country and support Pakistan's access to international capital flows and integration with the world's financial markets. Meanwhile, domestically, a more diversified and efficient financial market will boost productivity, jobs, and strengthen social safety nets.

The main objectives of the FMGP are to strengthen market soundness, stability and investor confidence through improved governance, transparency and risk management, to improve availability of and access to financial instruments for savings and investment and related services and to improve market efficiency and attractiveness to issuers and investors, including institutional and foreign investors.

The assistance package comprises a quick disbursing policy loan, two PRG facilities and two technical assistance loans for capacity building. The Ministry of Finance is the Executing Agency for the FMGP and seeks to facilitate its overall implementation, administer the utilization of loan proceeds and monitor compliance

with all policy related conditions. The SECP is one of the Implementing Agencies, with responsibility for implementation of all conditions and program components within its regulatory and development mandate.

To monitor implementation of the FMGP, the Government prepares quarterly progress reports as well as an annual report on program implementation for submission to ADB. The SECP also regularly updates the progress on reform measures pertaining to the capital market, NBFCs, insurance and pension. Moreover, ADB sends regular review missions to evaluate compliance with the conditions and advises the Government on actions required to keep program implementation on course.

2.3.3. World Bank:

Pakistan joined the World Bank in July of 1950. Since 1952, the World Bank has approved 281 loans and credits for Pakistan (105 loans and 176 credits), totaling more than US\$17.27 billion, of which about US\$9.87 billion remains as borrowers' obligation. The FY07 ongoing portfolio consists of 18 projects under implementation with a net commitment of US\$1.1 billion. The World Bank works in Pakistan in cooperation with various groups including, communities, civil society, government, and other donor agencies⁹².

In 2003, The World Bank provided its technical assistance for combating money laundering and terrorist financing activities and a loan of USD 350,000/- has been approved for this four-year assignment. The major objectives of this exercise are (i) review and harmonize existing laws/regulations for ensuring better documentation and reporting of transactions, (ii) strengthening the capacity of SEC so that it is able to play a more proactive role in curbing money laundering activities and ensuring authentic capital flows within the financial system, and (iii) through the consultative process create awareness among stakeholders about the need for an anti-money laundering framework. The Project will carry out amendments in rules, regulations

⁹² See <http://www.worldbank.org.pk/> (last visited October 2006)

Ordinances/Acts enforced by SECP and bring them in line with international anti-money laundering measures e.g., reporting of irregular financial transactions, customer identification, record keeping standards, internal policies and controls and verification of accounts through coordination with agencies. Studies and reports on best practices for development of the capital market will also be developed in this project. As a part of this project SECP has drafted anti money laundering rules and striving for its enforcement.

There is a broad agreement among members of the international financial community that the observance of international standards and codes are pivotal in strengthening national and international financial architecture. In a world of integrated capital markets, financial crises in individual countries can imperil international financial stability. This provides basic public goods rationale for minimum international standards which would benefit both international and individual national systems. At the international level, international standards enhance transparency as well as multilateral surveillance. They help to better identify weaknesses that may contribute to economic and financial vulnerability, foster market efficiency and discipline, and ultimately contribute to a global economy that is more robust and less prone to crisis. At the national level, international standards provide a benchmark that can help identify vulnerabilities as well as guide policy reform. To best serve these objectives, however, the scope and application of such standards needs to be assessed in the context of a country's overall development strategy and tailored to individual country circumstances.

Corporate governance has been adopted as one of twelve core best-practice standards by the international financial community. The World Bank is charged with assessing the application of the OECD Principles of Corporate Governance. Its assessments are part of the World Bank and International Monetary Fund (IMF) program on Reports on the Observance of Standards and Codes (ROSC).

In June 2005, the World Bank issued its Report on the Observance of Standards and Codes (ROSC) Corporate Governance⁹³. This report provides an assessment of Pakistan's corporate governance policy framework. It highlights recent improvements in corporate governance regulation, makes policy recommendations, and provides investors with a benchmark against which to measure corporate governance in Pakistan. The focus of the assessment is on listed companies, although reference is also made to banks and other financial institutions.

The goal of the ROSC initiative is to identify weaknesses that may contribute to a country's economic, legal and financial vulnerability. Each Corporate Governance ROSC assessment reviews the country's legal and regulatory framework, as well as the practices and compliance of its listed companies, and assesses the framework relative to an internationally accepted benchmark.

In September 2005, the Government of Pakistan and the World Bank signed an agreement confirming the World Bank's grant amounting to US\$454,000 for Capacity Building of the SECP. The objectives of this grant were to strengthen SECP's abilities to build a facilitative and cohesive legal framework for sectors under its purview; and develop independent and high-quality professional service providers and encourage a greater role of SROs in the markets.

Above mentioned initiatives of the international agencies show their seriousness for implementing good corporate governance regime in Pakistan. However, many efforts are still required in order to groom by Pakistan's corporate sector to a level that can be compared with prevalent international trends and practices.

⁹³ See complete report that is available on-line at http://www.worldbank.org/ifa/rosc_cg_pak.pdf (last visited October 2006)

Chapter 3

Board of Directors and Corporate Governance

In exchange for the benefits of limited liability, perpetual life, and transferability of shares, investors grant the power to run the company to a group of people entrusted with the task of making decisions in the best interests of the company and all of its investors, not just a particular segment of investors. In this way, the company is not directed by special-interest investors, and the shareholders are protected against one another's unique agendas. This group of entrusted people, elected by shareholders, is called the board of directors. In this chapter we have focused on the role of board of directors and their responsibilities in a good corporate governance scenario. Section 3.1 highlights board of directors, their general duties and responsibilities in the light of Code of Corporate Governance. Section 3.2 analyses different aspects of board performances in Pakistan.

3.1. The Board of Directors:

The board of directors is the highest governing authority within the management structure at any publicly traded company. It is the board's job to select, evaluate and decide appropriate compensation for the company's CEO(s), evaluate the attractiveness of and pay dividends, oversee share repurchase programs, approve the company's financial statements and recommend or discourage acquisitions and mergers and core policy decisions of a company.

Much of the law regulating companies relates to the board of directors, with many of the specific rules designed to foster investor confidence that directors will do

the right things. The board is responsible for managing or directing the business and affairs of the company. In practice, the board delegates its authority to make day-to-day decisions concerning the operation of the company to full-time employees. Boards appoint a chief executive officer (CEO) to coordinate and oversee these management efforts, and the CEO, in turn, is empowered to hire the top managers.

But, the interests of shareholders, directors, and managers can sometimes conflict. For instance, some shareholders may wish to receive a dividend, while other shareholders and management may prefer to reinvest the profits and promote internal corporate growth of the company. The board is required to manage these conflicting interests by making decisions in the best interests of the company and all of its shareholders at the same time.

3.1.1. Separation of governance and management:

As, chief policy concern of corporate governance is how a company is managed, it is important to understand that governing is not the same as managing. Broadly, governance involves the systems and processes in place that shape, enable and oversee management of a company. Management is concerned with doing with coordinating and managing the day-to-day operations of the business.

The following table is helpful in understanding the conceptual difference between governing and managing the affairs and business of a company.

Table 3.1

The Board	The Management
The mind	The hands
Directors direct	Managers manage
Policy	Action

3.1.2. Board Structure:

In Pakistan, corporate governance structure represents the Anglo-American corporate governance structure, has a single-tier board of directors. The board lays down broad principles, makes major decisions, selects officers and agents, and has officers who execute those policies. In the single-tier system, executive and non-executive directors sit on one board in contrast to two-tier structure.

In order to understand the duties, responsibilities and powers of the board of directors it is necessary to have a deep look into the legal provisions of the Companies Ordinance, the Code of Corporate Governance and the listing regulations of the Karachi Stock Exchange. Following are legislative and regulatory provisions that determine the practical aspects of the board of directors' eligibility, powers, duties, responsibilities and penalties in case of non-compliance of the mandatory provisions.

3.1.3. Provisions of Companies Ordinance Relating to Board of Directors:

Companies Ordinance comprehensively covers almost all the stages of the board of director i.e. eligibility to become director, election of directors, powers of directors, duties and responsibilities of directors, retirement, penalties and disqualifications of directors. These provisions are explained as under;

3.1.3.1. Eligibility to become director:

The following persons are ineligible to become directors: minor, a person of unsound mind, a person whose application is pending to be adjudicated as an insolvent, un-discharged insolvent, convict of offence involving moral turpitude, a person debarred from holding office under section 186, a person declared as lacking fiduciary behavior within the last five years, not a member except in the case of: a person representing government or institution or authority which is a member, an employee director or CEO or nominee of creditors, defaulter in the payment of loan of more than

Rs. 1 million to any financial institution and member of a stock exchange engaged in the brokerage business or his spouse⁹⁴.

The Chief Executive, if he is not already a director, is deemed to be a director, and will accordingly carry all the rights and liabilities related to such office.

3.1.3.2. Election of Directors:

The minimum numbers of directors have been fixed by the law as follows:

Single member company (SMC), should have at least one director; Private company other than SMC, should have at least two directors; Public company (other than listed company), should have at least three directors; and Listed companies should have at least seven directors. In default of and subject to the articles of a company the number of directors and the names of first directors shall be determined in writing by a majority of the subscribers of the memorandum and until it is so determined, all the subscribers of the memorandum who are natural persons shall be deemed to be the directors of the company⁹⁵.

The number of directors is required to be fixed not later than 35 days before the date of AGM⁹⁶. Notice of the meeting in which directors are to be elected shall, among other things, state the number of directors to be elected and the names of retiring directors. The contesting directors are required to file notice of intention with the company not later than 14 days before the date of the meeting. All notices are to be circulated to members seven days before the meeting. A cumulative voting system exists and every member of a company (having share capital) has the right to vote equal to the product of number of shares held by him and the number of directors to be elected. A member may give all votes to a single candidate or to different candidates. The candidate getting the highest votes is to be declared as elected and so on until the specific numbers of directors have been elected. The Creditors or other special interest

⁹⁴ Section 217 of the Companies Ordinance, 1984.

⁹⁵ Section 174 of the Companies Ordinance, 1984.

⁹⁶ Section 178 of the Companies Ordinance, 1984.

holders may nominate directors on the Board of a company in addition to the elected directors on the basis of contractual arrangement⁹⁷.

3.1.4. Powers of Directors:

Specific Functions to be performed through Board Resolution

The directors of a company shall exercise the following powers on behalf of the company and shall do so by means of a resolution passed at their meeting, namely: (a) to make calls on shareholders in respect of moneys unpaid on their shares; (b) to issue shares; (c) to issue debentures or participation term certificate, any instrument in the nature of redeemable capital; (d) to borrow moneys otherwise than on debentures; (e) to invest the funds of the company; (f) to make loans; (g) to authorize a director or the firm of which

He is a partner or any partner of such firm or a private company of which he is a member or director to enter into any contract with the company for making sale, purchase or supply of goods or rendering of services with the company; (h) to approve annual, half-yearly and other periodical accounts as are required to be circulated to the members; (i) to approve bonus to employees; (j) to incur capital expenditure on any single item or dispose of a fixed asset in accordance with the limits as prescribed by the Commission from time to time; (k) to undertake obligations under leasing contracts exceeding one million rupees; (l) to declare interim dividend; and (m) having regard to such amount as may be determined to be material by the Board (i) to write off bad debts, advances and receivables; (ii) to write off inventories and other assets of the company; and (iii) to determine the terms of and the circumstances in which a law suit may be compromised and a claim or right in favor of a company may be released, extinguished or relinquished.

⁹⁷ Section 182 of the Companies Ordinance, 1984.

3.1.4.1. Removal of Chief Executive:

The directors of a company by resolution passed by not less than three-fourths of the total number of directors, or the company by a special resolution, may remove a chief executive before the expiration of his term of office⁹⁸.

3.1.4.2. Recommending Dividend:

A company in general meeting may declare dividends; but no dividend shall exceed the amount recommended by the directors⁹⁹.

3.1.4.3. Appointment of Auditors and Related Matters:

The directors appoint the first auditors of a company within 60 days of the date of incorporation of the company; and such auditors shall hold office until the conclusion of the first annual general meeting¹⁰⁰. Any causal vacancy in the office of auditors may be filled in by the directors. However, the continuing or surviving auditors may continue to act until such vacancy is filled. The directors fix the remuneration of the auditors, in the above mentioned cases, where the auditors have been appointed by them. Where an audit of cost accounts of a company has been directed by the Federal Government (as mentioned in this section), the directors shall appoint and fix remuneration of the cost auditors to be appointed for this purpose¹⁰¹.

3.1.4.4. Transfer of Shares and Debentures:

With respect to transfer deed of shares or debentures that has been lost, destroyed or mutilated, the directors of the company need to be satisfied that such a

⁹⁸ Section 202 of the Companies Ordinance, 1984.

⁹⁹ Section 248 of the Companies Ordinance, 1984.

¹⁰⁰ Section 252 of the Companies Ordinance, 1984.

¹⁰¹ Section 258 of the Companies Ordinance, 1984.

deed has been lost, destroyed or mutilated before the company proceeds to register the transfer of shares or debentures¹⁰².

3.1.4.5. Further Issue of Capital:

The decision to increase the capital of the company by the issue of further shares lies with the directors of such company¹⁰³. With respect to further issue of shares, if existing members decline or do not subscribe to the offer of new shares, the directors have the power to allot and issue such shares in such manner as they deem fit.

Directors (or an officer authorized by the directors) are to sign the circular which is to accompany any offer of new shares under this section.

3.1.4.6. Calling of Extra Ordinary General Meeting:

An extra ordinary general meeting may be called at any time by the directors for consideration of any matter requiring approval of the company in a general meeting¹⁰⁴.

3.1.4.7. Validity of Acts of Directors:

All acts of directors pertaining to a period before any defect in the appointment of their office has been discovered are valid. However after the defect has been discovered, the directors shall not exercise the right to their office till it is rectified¹⁰⁵.

3.1.4.8. In Relation to Promotion Expenses:

The business of a company shall be managed by the directors, who may pay all expenses incurred in promoting and registering the company and may exercise all such

¹⁰² Section 76(2) of the Companies Ordinance, 1984.

¹⁰³ Section 86 of the Companies Ordinance, 1984.

¹⁰⁴ Section 159 of the Companies Ordinance, 1984.

¹⁰⁵ Section 185 of the Companies Ordinance, 1984.

powers of the company as are not by the Ordinance, articles or special resolution, required to be exercised by the company in the general meeting¹⁰⁶.

3.1.4.9. Maintaining Books of Accounts:

The directors can decide to maintain books of accounts at a place other than the registered office of the company¹⁰⁷. The directors, during business hours, have the right to inspect the books of accounts and other books and papers of the company. The directors shall from time to time determine whether and to what extent and at what time and places and under what conditions or regulations the accounts and books or papers of the company or any of them shall be open to the inspection of members.

3.1.4.10. Period for Payment of Dividend:

When a dividend has been declared, it shall not be lawful for the directors of the company to withhold or defer its payment and the chief executive of the company shall be responsible to make the payment in the manner provided under the Ordinance within forty-five days of the declaration in the case of a listed company and within thirty days in the case of other than listed company¹⁰⁸.

3.1.5. Duties and Responsibilities of Directors:

3.1.5.1. Presiding General Meeting:

The chairman of the board of directors should preside as chairman every general meeting of the company¹⁰⁹. But if there is no such chairman or if at any meeting he is not present within fifteen minutes after the time appointed for holding the meeting, or is unwilling to act as chairman, any one of the directors present may be elected to be

¹⁰⁶ Section 196 of the Companies Ordinance, 1984.

¹⁰⁷ Section 230 of the Companies Ordinance, 1984.

¹⁰⁸ Section 250 and 251 of the Companies Ordinance, 1984.

¹⁰⁹ Section 160 of the Companies Ordinance, 1984.

chairman, and if none of the directors is present or is unwilling to act as chairman the members present shall choose one of their member to be the chairman.

3.1.5.2. Remuneration of the Directors:

The directors or the company in general meeting shall determine the remuneration of a director for performing extra services, including the holding of the office of chairman in accordance with the provisions of the articles¹¹⁰.

3.1.5.3. Loans to Directors:

No company, shall, directly or indirectly, make any loan to, or give any guarantee or provide any security in connection with a loan made by any other person to, or to any other person by; any director of the lending company or of a company which is its holding company or any partner or relative of any such director; any firm in which any such director or relative is a partner; any private company of which any such director is a director or member; • any body corporate at a general meeting of which not less than twenty five per cent of the total voting power may be exercised or controlled by any such director or his relative, or by two or more such directors together or by their relatives; or any body corporate, the directors or chief executive whereof are or is accustomed to act in accordance with the directions or instructions of the chief executive, or of any director or directors, of the lending company. Exceptions;

Provided that a company may, with the approval of the Commission, make a loan or give any guarantee or provide any security in connection with a loan made by any other person to a director who is in the whole-time employment of the company for the purpose of: 1. acquisition or construction of a dwelling house or land therefore or for defraying the cost of any conveyance for personal use or household effects; or 2. for

¹¹⁰ Section 191 of the Companies Ordinance, 1984.

defraying any expense on his medical treatment; or 3. the medical treatment of any relative as are ordinarily made or provided by the company to its employees¹¹¹.

3.1.5.4. Prohibition of Certain Acts:

The directors of a public company or of a subsidiary of a public company shall not except with the consent of the general meeting either specifically or by way of an authorization, do any of the following things, namely: (a) sell, lease or otherwise dispose of the undertakings or a sizeable part thereof unless the main business of the company comprises of such selling or leasing; and (b) remit, give any relief or give extension of time for the repayment of any debt outstanding against any director¹¹².

3.1.5.5. Appointing CEO and determining Terms of Appointment:

The directors of every company shall appoint an individual to be the Chief Executive of the company. The directors shall determine the terms and conditions of appointment of a Chief Executive, if required by the company's articles¹¹³.

3.1.5.6. Investments in Associated Companies and Undertakings:

A company shall not make any investment in any of its associated companies and undertakings except through a special resolution which indicates nature, period and amount of investment and the return on such investment in form of loan shall not be less than the borrowing cost of investing company¹¹⁴. However prohibition is not applicable to: banking company, financial institution approved by the commission private company, which is not a subsidiary of a public company, and a company whose principal business is the acquisition of shares, stocks, debentures or other securities.

¹¹¹ Section 195 of the Companies Ordinance, 1984.

¹¹² Section 196 of the Companies Ordinance, 1984.

¹¹³ Section 198 and section 200 of the Companies Ordinance, 1984.

¹¹⁴ Section 208 of the Companies Ordinance, 1984.

3.1.5.7. Disclosure of Interest:

Every director of a company who is in any way, whether directly or indirectly, concerned or interested in any contract or arrangement entered into, or to be entered into, by or on behalf of the company shall disclose the nature of his concern or interest at a meeting of the directors¹¹⁵.

3.1.5.8. Restriction on Voting by Interested Directors:

A director interested in any contract or agreement entered into or to be entered into by the company shall not participate or vote in proceedings of directors where such contract or agreement is to be discussed¹¹⁶.

3.1.5.9. Disclosure of Shareholding:

Every director shall give notice to the company of such matters relating to him as may be necessary for the purpose of enabling the company to comply with the provisions of Ordinance, Register of directors' shareholdings¹¹⁷.

3.1.5.10. Trading of Securities:

Where any director of a listed company makes any gain by the purchase and sale, or the sale and purchase, of any security, within a period of less than six months, such director shall make a report and tender the amount of such gain to the company and simultaneously send an intimation to this effect to the registrar and the Commission¹¹⁸.

¹¹⁵ Section 214 of the Companies Ordinance, 1984.

¹¹⁶ Section 216 of the Companies Ordinance, 1984.

¹¹⁷ Section 220 and 221 of the Companies Ordinance, 1984.

¹¹⁸ Section 224 of the Companies Ordinance, 1984.

3.1.5.11. Directors Report:

The directors shall make out and attach to every balance sheet a report with respect to the state of the company's affairs and other information and such report shall be signed by the chairman of the directors or the chief executive of the company on behalf of the directors if authorized in that behalf. In case consolidated financial statements are to be presented, the directors of the holding shall also make out and attach a report with respect to the state of affairs of the group¹¹⁹. The directors of a holding company shall ensure that, except where in their opinion there are good reasons against it, the financial year of each of its subsidiaries coincides with the company's own financial year¹²⁰.

3.1.5.12. Authentication of Balance Sheet:

Under section 241 the directors shall approve, and the Chief Executive and at least one director shall sign, the balance sheet and profit and loss account or income and expenditure account of the company¹²¹. Where the Chief Executive is not in Pakistan, the above mentioned financial statements may be signed by two directors provided that a statement signed by the directors explaining the reasons for non compliance is attached to the financial statements.

3.1.6. Responsibilities of Directors:

3.1.6.1. Civil Liability for Misstatement in the Prospectus:

With respect to issue of a prospectus containing misstatements, the directors of the company, excluding those without whose knowledge or consent the prospectus was issued, shall along with other persons authorizing the issue be liable to indemnify such persons who are not liable against all damages, costs and expenses to which they may

¹¹⁹ Section 236 of the Companies Ordinance, 1984.

¹²⁰ Section 238 of the Companies Ordinance, 1984.

¹²¹ Section 241 of the Companies Ordinance, 1984.

be made liable by reason of their name being inserted in such prospectus or statement attached thereto¹²².

3.1.6.2. Restriction on Allotment:

Allotments cannot be made of any share capital offered to public for subscription, unless; Minimum subscription has been subscribed and the full amount has been paid to and received in cash¹²³. (b) The amount stated above shall be exclusive of any amount payable otherwise than in cash. (c) All money received from the applicants shall be deposited in a separate bank account, until returned or certificate to commence business is obtained. (d) The amount payable on application shall be full nominal amount of the share.

3.1.6.3. Allotment of Shares and Debentures to be dealt in Stock Exchange:

Where prospectus states that application has been made or will be made for the permission of the share to be dealt in any stock exchange, any allotment made on such application is void: (a) if the permission has not been applied for before the seventh day after the first issue of the prospectus, or (b) if the permission has not been guaranteed before the expiration of twenty one days from the date of closing of subscription or such longer period not exceeding forty-two days¹²⁴.

3.1.6.4. Not to Refuse Transfer of Shares:

The directors of a company shall not refuse to transfer any shares or debentures that are fully paid unless the transfer deed is for any reason defective or invalid¹²⁵.

¹²² Section 59 of the Companies Ordinance, 1984.

¹²³ Section 68 of the Companies Ordinance, 1984.

¹²⁴ Section 72 of the Companies Ordinance, 1984.

¹²⁵ Section 77 of the Companies Ordinance, 1984.

3.1.6.5. Purchase of Company's Own Shares:

With respect to buy back of shares by the listed company, the majority of the directors including the Chief Executive shall in a meeting, make a declaration of insolvency that: (a) full inquiry into the affairs of the company has been made, (b) after such inquiry, they are of an opinion that, the company shall continue to operate as a going concern; and it is capable of meeting its liabilities on time during the period up to the end of the immediately succeeding financial year¹²⁶.

3.1.6.6. At Commencing Business:

With respect to the procedure for commencement of business, the Chief Executive or one of the directors and the secretary are to file with the registrar a declaration that the conditions for commencement of business as are mentioned in this section have been complied with¹²⁷.

3.1.6.7. Statutory Meeting of the Company:

With respect to the statutory meeting of company the directors have the following duties: (a) At least three directors, one of whom is to be the Chief Executive shall certify the statutory report, (b) the statutory report is to be forwarded to every member of the company at least twenty one days before the meeting, (c) at least five certified copies of the statutory report are also to be delivered to the registrar for registration, (d) at the commencement of the meeting and throughout its duration, a list caused to be prepared by the directors showing the names, occupations, nationality and address of the members, and the number of shares held by them respectively is to be produced¹²⁸.

¹²⁶ Section 95A of the Companies Ordinance, 1984.

¹²⁷ Section 146 of the Companies Ordinance, 1984.

¹²⁸ Section 157 of the Companies Ordinance, 1984.

3.1.6.8. Prohibition Regarding Making of Political Contributions:

A company is prohibited to contribute any amount to any political party or for any political purpose to any individual or body¹²⁹.

3.1.6.9. Register of Directors:

The directors shall, within a period of ten days of his appointment or any change therein, as the case maybe, furnish to the company the particulars so as to enable the company to comply with the requirements of section 205 regarding register of directors¹³⁰.

3.1.6.10. Maintaining Books of Accounts:

The Companies Ordinance, 1984 holds directors responsible for compliance with the statutory requirements regarding preparation and maintenance of proper books of account and circulation of financial statements that give a true and fair view¹³¹.

3.1.6.11. Facilitating Inspection of Books of Accounts:

With respect to inspection of books of accounts and books and papers of a company by the registrar or by any officer authorized in this behalf by the commission, every director, along with the officers and other employees of the company are bound to: (a) produce all such books of accounts and books and papers as are in his custody or under his control, (b) furnish information, statements and explanations relating to the affairs of the company required by the abovementioned persons; and (c) provide reasonable assistance for such inspection.¹³²

¹²⁹ Section 197 of the Companies Ordinance, 1984.

¹³⁰ Section 205 of the Companies Ordinance, 1984.

¹³¹ Section 230 of the Companies Ordinance, 1984.

¹³² Section 231 of the Companies Ordinance, 1984.

3.1.6.12. Annual Accounts and Balance Sheet:

Subject to the conditions mentioned below, the directors of every company shall lay before the company in annual general meeting: (a) audited balance sheet and profit and loss account in the case of a company trading for profit; or (b) audited balance sheet and income and expenditure account in the case of a company not trading for profit¹³³.

Conditions:

1. The first accounts shall be laid not later than eighteen months after the incorporation and shall be made for the period since such incorporation. 2. All subsequent accounts shall be laid at least once in every calendar year and shall be made for the period since preceding accounts. 3. In both the above-mentioned cases, the accounts will be made up to a date not earlier than the date of the meeting by more than four months nor shall they cover a period exceeding twelve months unless permission from the registrar has been obtained in this regard.

3.1.6.13. Furnishing Information, Documents etc. to the Registrar:

Under section 261(1) with respect to any document, notice, advertisement or other communication submitted to the registrar, every past and present director, along with the officers and auditors, is bound to furnish, to the best of their power, such information, explanation or document as may be required by the registrar¹³⁴.

3.1.6.14. To Carry out Orders of the Court:

The directors on any order of the Court, which has been initiated by the SECP, shall carry out such changes in the management or in the accounting policies of the company as are specified in such order. On the issue of the Court's order under the section 271 removing from office any director, including chief executive, managing agent, or other officer, such persons shall be deemed to have vacated his office and (i) if the Court's order has removed a director, the casual vacancy in the office of director

¹³³ Section 231 of the Companies Ordinance, 1984.

¹³⁴ Section 261 of the Companies Ordinance, 1984.

shall be filled in accordance with the relevant provisions contained in the articles of association of the company; (ii) if the Court's order has removed from office a chief executive, the remaining directors shall elect another person to be the chief executive; and (iii) if the Court's order has removed from office all the directors including the chief executive, a general meeting of the company shall be called forthwith for electing new directors¹³⁵.

3.1.6.15. Statement of Affairs:

Where the Court has made a winding up order or appointed an official liquidator or provisional manager, there shall be made out and submitted to the official liquidator or provisional manager a statement as to the affairs of the company in the prescribed form, verified by an affidavit. The statement shall be submitted and verified by persons who are at the relevant date the directors, chief executive and secretary of the company¹³⁶.

3.1.6.16. Custody of Company's Property:

All persons who are or have been directors, chief executives, or other officer of the company and who may be having in their knowledge, custody, control or charge, directly or under them any books or papers, property, effects and actionable claims, shall forthwith report and hand over or cause to be handed over possession to the liquidator of all such items and furnish to the liquidator such information and explanations as he may require¹³⁷.

3.1.6.17. Declaration of Solvency in case of Voluntary Winding up:

In case of voluntary winding up: (i) its directors; or (ii) majority of directors including the chief executive (in case where there are more than three directors) may

¹³⁵ Section 271 of the Companies Ordinance, 1984.

¹³⁶ Section 328 of the Companies Ordinance, 1984.

¹³⁷ Section 330 of the Companies Ordinance, 1984.

make a declaration (verified by an affidavit) that after a full inquiry into the affairs of the company, they are of the opinion that: 1. the company has no debts 2. it will be able to pay all its debts in full within such period not exceeding twelve months from the commencement of winding up¹³⁸.

3.1.6.18. Meeting of Creditors in Creditors Voluntary Winding up:

In case of creditors' voluntary winding up, the directors and the Chief Executive shall have the following responsibilities with respect to the meeting of creditors: (a) to lay before the meeting a full statement of the position of the company's affairs and assets and liabilities, list of the creditors of the company and the estimated amount of the creditors' claims. (b) To appoint one of the directors to preside over the said meeting¹³⁹.

3.1.6.19. Allotment of Shares for Inadequate Consideration:

Any director may apply to the Court for a declaration that any shares have been allotted for inadequate consideration¹⁴⁰.

3.1.7. Retirement of Directors:

First directors of a company shall retire on the election of directors in the first annual general meeting¹⁴¹. On the date of the first annual general meeting of a company all directors of the company for the time being who are subject to election shall stand retired from office but the directors so retiring shall continue to perform their functions until their successors are elected¹⁴². Further the directors continuing to perform their functions shall take immediate step to hold the election of directors and in case of any impediment report the circumstances of the case to the registrar within fifteen days of

¹³⁸ Section 362 of the Companies Ordinance, 1984.

¹³⁹ Section 373 of the Companies Ordinance, 1984.

¹⁴⁰ Section 494 of the Companies Ordinance, 1984.

¹⁴¹ Section 176 of the Companies Ordinance, 1984.

¹⁴² Section 177 of the Companies Ordinance, 1984.

the expiry of the term laid down in section 180. The directors elected shall hold office for a period of three years¹⁴³. A director shall cease to hold office in the following circumstances: becomes ineligible under clause (a) to (h) of section 187 of the Companies Ordinance 1984¹⁴⁴; absent in three consecutive meetings or all meetings of the Board for a continuous period of three months, whichever is longer, without leave of absence; or he, his firm or private company, in which he has interest, accepts an office of profit except as CEO, legal/technical advisor and banker without sanction of the company or accepts a loan or guarantee in contravention of section 195 of the Companies Ordinance, 1984. Every director so interested shall be liable to a fine which may extend to 5,000 Rupees. If an administrator is appointed by the commission under section 295 then on and from the date of appointment of the Administrator, the management of the affairs of the company shall vest in him, and he shall exercise all the powers of the directors or other persons in whom the management vested and all such directors and persons shall stand divested of that management and powers and shall cease to function or hold office.

3.1.8. Penalties and disqualifications:

With respect to allotment of shares, if the conditions mentioned in this section have not been complied with, the directors of the company, apart from those who prove that the default in repayment of the money was not due to any misconduct or negligence on their part, shall be jointly and severally liable to repay that money with surcharge at the rate of one and a-half per cent for every month or part thereof from the expiration of the fiftieth day¹⁴⁵. With respect to unsuccessful or unaccepted applications for allotment of shares if money received for applications is not repaid within ten days of closure of subscription lists, the directors shall be jointly and severally liable, unless he proves that the default was not due to any misconduct or negligence on his part, to repay the money with surcharge at the rate of one and a half percent for every month or part thereof from

¹⁴³ Section 180 of the Companies Ordinance, 1984.

¹⁴⁴ Section 188 of the Companies Ordinance, 1984.

¹⁴⁵ Section 68 of the Companies Ordinance, 1984.

the expiration of fifteenth day and, in addition, to a fine not exceeding five thousand rupees and in the case of a continuing offence to a further fine not exceeding one hundred rupees for every day after the said fifteenth day on which the default continues¹⁴⁶.

3.1.9. Application for listing:

Where permission for listing of securities has not been applied for before the seventh day after the first issue of the prospectus or if the permission has not been granted, the directors shall be jointly and severally liable, unless he proves that the default was not due to any misconduct or negligence on his part, to repay the money received for applications from the expiration of the eighth day together with a surcharge at the rate of 1.5% per month or part and in addition, to a fine not exceeding five thousand rupees and in the case of a continuing offence to a further fine not exceeding one hundred rupees for every day after the said fifteenth day on which the default continues¹⁴⁷.

If any officer makes defaults in complying with any of the provisions of subsections 76(1) to (4) regarding transfer of share and debentures then he shall be liable to fine up to Rs.5000¹⁴⁸.

Every officer who is responsible for contravention to file with the registrar a declaration that the conditions for commencement of business as are mentioned in this section have been complied with, shall be liable to a fine not exceeding 1,000 rupees for every day¹⁴⁹.

In case of non-compliance with the provisions of section 157, every officer shall be liable: in case of listed company to a fine not less than 10,000 rupees and not

¹⁴⁶ Section 71 of the Companies Ordinance, 1984.

¹⁴⁷ Section 72 of the Companies Ordinance, 1984.

¹⁴⁸ Section 76 of the Companies Ordinance, 1984.

¹⁴⁹ Section 146 of the Companies Ordinance, 1984.

exceeding 20,000 rupees and to a further fine not exceeding 2,000 rupees for every day¹⁵⁰.

In case of non-compliance with provisions of section 159, every officer of the company shall be liable: in case of listed company to a fine not less than 10,000 rupees and not exceeding 20,000 rupees and to a further fine extending 2000 rupees for everyday.

If a director refuse to transfer shares under section 77, every director of the company shall be liable to a fine not exceeding 20,000 rupees and to a further fine not exceeding 1,000 rupees for every day.

In case of non-compliance with provisions of section 160, every officer shall be liable sub section 8, in case of listed company to a fine not less than 5,000 rupees and to a further fine not exceeding 2,000 rupees for every day.

The acts of directors are not invalid due to defective appointment, although such a director is not to exercise powers till such defect in appointment has been rectified¹⁵¹. Heavy penalties exist for violation of section 185, comprising a fine of up to Rs. 10,000 and debarment from being appointed as director for up to three years.

If the Court declares a director to be lacking fiduciary behavior if he makes default in disclosing interest in any contract or arrangement to be entered into the person is debarred from being appointed as a director for a period of five years¹⁵².

If a person who is not qualified to act as director but who represents himself as such may be punished with a fine of Rs. 200 per day for each day of contravention¹⁵³. Moreover, a person who is not qualified to act as director, being an un-discharged

¹⁵⁰ Section 157 of the Companies Ordinance, 1984.

¹⁵¹ Section 185 of the Companies Ordinance, 1984.

¹⁵² Section 187 of the Companies Ordinance, 1984.

¹⁵³ Section 189 of the Companies Ordinance, 1984.

insolvent, is more severe and may comprise of two years imprisonment and/or Rs. 10,000 fine¹⁵⁴.

Every person shall be punishable with a fine extending 5,000 rupees or with imprisonment of six months for noncompliance with section 195. Under section 195(6), all persons, who are knowingly parties to contravention of subsection (1) & (3) of section 195, shall be liable jointly and severally, to the lending company for the repayment of the loan or for making good the sum (with mark-up not less than the borrowing cost of lending company) which the lending company may have been called upon to pay by virtue of the guarantee given or the security provided by such company. Sub section 4 of section 196 provides that any director who contravenes with any provision of section 196 shall be punishable with a fine which may extend to one hundred thousand rupees.

The Companies Ordinance, 1984 holds directors responsible for appointment of Chief Executive and determination of terms of appointment¹⁵⁵. Whoever contravenes or fails to comply with any of such provisions or is a party to the contravention of the said provisions shall be liable to be punishable with: fine which may extend to ten thousand rupees; and may also be debarred for a period not exceeding three years.

If the directors fail to furnish the particulars to enable the company to comply with the provisions of section 205, may be punished with a fine which may extend to Rs. 500 and a further fine which may extend to Rs. 50 for every day after the first during which the default continues¹⁵⁶.

If the directors fail to comply with the requirements of section 208, regarding investment in associates then every director of a company who is knowingly and willfully in default shall be liable to fine which may extend to one million rupees and in addition, shall jointly and severally reimburse to the company any loss sustained by the

¹⁵⁴ Section 190 of the Companies Ordinance, 1984.

¹⁵⁵ Section 204 of the Companies Ordinance, 1984.

¹⁵⁶ Section 205 of the Companies Ordinance, 1984.

company in consequence of an investment which was made without complying with the requirements of the said section¹⁵⁷.

Any director who fails to comply with the provision of section 221 shall be liable to be punishable with imprisonment for a term which may extend to two years; and fine which may extend to Rs. 5,000¹⁵⁸.

Any director who fails to comply with the provision of section 224 shall be liable to be punishable with: fine which may extend to Rs. 30,000; and a further fine which may extend to Rs. 1,000 for every day after the first during which the default continues¹⁵⁹.

Companies Ordinance, 1984 holds directors responsible for compliance with the statutory requirements regarding preparation and maintenance of proper books of account and circulation of financial statements that give a true and fair view.¹⁶⁰ If a listed company fails to comply with the statutory requirements in this regard, every director including the CEO and CFO of the company, who has knowingly been the cause of the default, is liable to be punishable with: (a) imprisonment for a term which may extend to one year; (b) fine which shall not be less than Rs. 20,000 not more than Rs. 50,000; and (c) a further fine which may extend to Rs. 5,000 for every day after the first during which the default continues.

If a company fails to comply with any of the requirements of section 236, every director, including the chief executive, of the company who has knowingly by this act or omission been the cause of any default by the company in complying with the requirements of this section shall: (a) in respect of a listed company, be punishable with imprisonment for a term which may extend to one year and with fine which shall not be less than twenty thousand rupees nor more than fifty thousand rupees, and with a further

¹⁵⁷ Section 208 of the Companies Ordinance, 1984.

¹⁵⁸ Section 221 of the Companies Ordinance, 1984.

¹⁵⁹ Section 224 of the Companies Ordinance, 1984.

¹⁶⁰ Section 230 of the Companies Ordinance, 1984.

fine which may extend to five thousand rupees for every day after the first during which the default continues; and (b) in respect of any other company, be punishable with imprisonment with imprisonment for a term which may extend to six months and with fine which may extend to ten thousand rupees¹⁶¹.

Every director or any officer shall deem to have vacated his office and shall be disqualified for holding such office for period of 5 years, if default is made in complying with the provisions of section 231¹⁶².

Every director or Chief Executive in default shall be liable for a fine not exceeding 5,000 rupees for contravention of section 241¹⁶³.

Every director in default shall be punishable with fine extending 20,000 rupees and further fine extending 5,000 rupees in case of continuing default for every day and every officer who willfully authorize or permits or is party to default shall be liable to imprisonment of either description extending to 1 year and fine¹⁶⁴.

Any default or failure on their part, in handing over books, papers or property of the company in their control, charge, control knowledge or custody, shall be punishable with imprisonment of either description which may extend to one year and with fine which may extend to ten thousand rupees and the Court may direct the books, papers, property and effects to be delivered to the liquidator in case of default or failure, and in the event of non-compliance with the directive, to order the person in default to pay further amount by way of compensation equal to the value of the property as the Court may determine¹⁶⁵.

¹⁶¹ Section 236 of the Companies Ordinance, 1984.

¹⁶² Section 232 of the Companies Ordinance, 1984.

¹⁶³ Section 241 of the Companies Ordinance, 1984.

¹⁶⁴ Section 261 of the Companies Ordinance, 1984.

¹⁶⁵ Section 330 of the Companies Ordinance, 1984.

Every director making such declaration of solvency without any reasonable grounds shall be punishable with imprisonment for 6 months and with fine extending 10,000 rupees or both¹⁶⁶.

The Director or any chief executive in default shall be punishable with fine extending 5,000 rupees and further fine of 100 rupees for every day in case of continuing default¹⁶⁷.

Every director who is party to such allotment shall be liable jointly and severally to compensate the company, the amount by which the consideration received is lesser than the amount that ought to be received in respect of the allotment of shares, if it is proved that he had knowledge of the fact that consideration so received was inadequate, or he failed to take reasonable steps to ascertain whether such consideration was in fact adequate¹⁶⁸.

3.1.10. Provisions of Code of Corporate Governance Relating to Board of Director:

In order to make the procedures of the listed company's transparent, fair and effective the code has to the great extent mentioned and has stressed upon the role and function of the board of directors. Following is complete description of the eligibility, elections, powers, duties and responsibilities of the directors under the code.

3.1.10.1. Eligibility to Become a Director

A listed company cannot appoint as director a person: (a) who is serving as director of 10 other listed companies; or (b) whose name is not borne on the register of National Tax Payers (not applicable to nonresidents); or (c) who is a defaulter of a banking company, DFI or NBFC, (d) who is a member in default of a stock exchange,

¹⁶⁶ Please see section 362 of the Companies Ordinance, 1984.

¹⁶⁷ Please see section 373 of the Companies Ordinance, 1984.

¹⁶⁸ Please see section 494 of the Companies Ordinance, 1984.

(e) If he or his spouse is engaged in the business of stock brokerage. However, specific exemption in this regard can be sought by the commission¹⁶⁹.

3.1.10.1. Election of Directors:

Listed companies are required to encourage effective representation of independent non-executive directors, including those representing minority interests, on the Board¹⁷⁰. However, the application of the clause is voluntarily. Listed companies are encouraged to have at least one independent director representing institutional equity interest of a banking company, Development Financial Institution, Non-Banking Financial Institution, Mutual Fund or Insurance company¹⁷¹. The director shall be selected by such investor company through a resolution of its Board of Directors. There shall not be more than 75% executive directors on the Board¹⁷².

Executive directors are the working, whole-time directors of a company while Non-executive directors, on the other hand, are largely independent persons who are expected to lend an outside viewpoint to the Board of Directors of a company and do not undertake to devote their whole working time to the company. The guiding factor in distinguishing between executive and non-executive directors of a company is the extent of their involvement in managing the affairs of the company.

3.1.11. Powers of Directors:

The following powers are exercised by the Board of Directors on behalf of the company and decisions on material transactions or significant matters are documented by a resolution passed at a meeting of the Board: (a) investment and disinvestment of funds where the maturity period of such investments is six months or more, except in the case of banking companies, Non-Banking Finance Companies, Mutual Fund, trusts

¹⁶⁹ Clauses iii, iv & v of the Code of Corporate Governance.

¹⁷⁰ Clause i (a) of the Code of Corporate Governance.

¹⁷¹ Clause i (b) of the Code of Corporate Governance.

¹⁷² Clause i (c) of the Code of Corporate Governance.

and insurance companies; (b) determination of the nature of loans and advances made by the company and fixing a monetary limit thereof; (c) write-off of bad debts, advances and receivables and determination of a reasonable provision for doubtful debts; (d) write-off of inventories and other assets; and (e) determination of the terms of and the circumstances in which a law suit may be compromised and a claim/ right in favor of the company may be waived, released, extinguished or relinquished¹⁷³.

3.1.11.1. Appointing CEO and other Executives:

Appointment, remuneration and terms and conditions of employment of the Chief Executive Officer (CEO) and other executive directors of the listed company are determined and approved by the Board of Directors¹⁷⁴.

3.1.11.2. Recommending Appointment of External Auditors:

The Board of Directors of a listed company shall recommend appointment of external auditors for a year, as suggested by the Audit Committee¹⁷⁵.

The directors of listed companies shall exercise their powers and carry out their fiduciary duties with a sense of objective judgment and independence in the best interests of the listed company. Directors are responsible for the proper running and management of the company. This responsibility is fiduciary in nature. The fiduciary duties of directors can be summarized as follows: (a) The duty of honesty; (b) The duty of care, skill and diligence in the discharge of their duties; (c) Duty to act bona fide in the interest of the company; (d) Duty to use powers for proper purpose.

¹⁷³Clause viii (d) of the Code of Corporate Governance.

¹⁷⁴Clause viii (e) of the Code of Corporate Governance.

¹⁷⁵Clause xxxix of the Code of Corporate Governance.

3.1.12. Duties and Responsibilities:

3.1.12.1. Declaration at the time of Filing Consent to act as Director:

The directors of listed companies shall, at the time of filing their consent to act as such, give a declaration in such consent that they are aware of their duties and powers under the relevant law(s) and the listed companies' Memorandum and Articles of Association and the listing regulations of stock exchanges in Pakistan.

3.1.12.2. Casual Vacancy on Board of Directors:

Any casual vacancy in the Board of Directors of a listed company shall be filled up by the directors within 30 days thereof¹⁷⁶.

3.1.12.3. General:

Every listed company shall ensure that: (a) a "Statement of Ethics and Business Practices" is prepared and circulated annually by its Board of Directors to establish a standard of conduct for directors and employees, which Statement shall be signed by each director and employee in acknowledgement of his understanding and acceptance of the standard of conduct; (b) the Board of Directors adopt a vision/ mission statement and overall corporate strategy for the company and also formulate significant policies, having regard to the level of materiality, as may be determined it. Frequently Asked Questions prepared by the commission states that the 'Statement of Ethics and Business Practices' should be signed by all directors and employees of listed companies. Significant policies for this purpose may include; (a) risk management; (b) human resource management including preparation of a succession plan; (c) procurement of goods and services; (d) marketing; (e) determination of terms of credit and discount to customers; (f) write-off of bad/doubtful debts, advances and receivables; (g) acquisition / disposal of fixed assets; (h) investment; (i) borrowing of moneys and the amount in excess of which borrowings shall be sanctioned/ ratified by a general meeting of

¹⁷⁶Clause xvi of the Code of Corporate Governance.

shareholders; (j) donations, charities, contributions and other payments of a similar nature; (k) determination and delegation of financial powers; (l) transactions or contracts with associated companies and related parties; (m) and health, safety and environment.

A complete record of particulars of the above mentioned policies along with the dates on which they were approved or amended by the Board of Directors shall be maintained.

3.1.12.4. Establishing Sound System of Internal Control:

The Board of Directors shall establish a system of sound internal control, which is effectively implemented at all levels within the company¹⁷⁷. The Code, however does not mention any bench mark framework for the sound system of internal control.

3.1.12.5. Defining Roles and Responsibilities of the Chairman and CEO:

The Board of Directors shall clearly define the respective roles and responsibilities of the Chairman and Chief Executive, whether or not these offices are held by separate individuals or the same individual¹⁷⁸. A committee of Board of Directors can only 'recommend' the terms and conditions of employment of the CEO and executive directors to the board. The appointment, remuneration and terms of employment must be approved by the Board of Directors in a meeting.

3.1.12.6. Meetings of Board of Directors:

The Board of Directors of a listed company shall meet at least once in every quarter of the financial year¹⁷⁹. Written notices including agenda of meetings shall be circulated not less than seven days before the meetings.

¹⁷⁷Clause viii (d) of the Code of Corporate Governance.

¹⁷⁸Clause ix of the Code of Corporate Governance.

¹⁷⁹Clause xi of the Code of Corporate Governance.

3.1.12.7. Trading by Directors and their Spouses:

Where any director, CEO or executives of a listed company or their spouses sell, buy or take any position, whether directly or indirectly, in shares of the listed company of which he is a director, he shall immediately notify in writing the Company Secretary of his intentions¹⁸⁰.

3.1.12.8. Determining Closed Period:

Each listed company shall determine a closed period prior to the announcement of interim/ final results and any business decision, which may materially affect the market price of its shares¹⁸¹. No director, CEO or executives shall, directly or indirectly, deal in the shares of the listed company in any manner during the closed period. The closed period, referred to in the Code, restricts the directors of every listed company from dealing in its shares, whether directly or indirectly. The closed period should start from the day when any document / statement, which forms the basis of price sensitive information, is sent to the Board of Directors and terminate after the information is made public.

3.1.12.9. Establishing Audit Committee:

The Board of Directors of every listed company shall establish an Audit Committee¹⁸². Moreover, the Board of Directors of every listed company shall determine the terms of reference of the Audit Committee.

3.1.12.10. Meetings of Board of Directors:

The Chairman of a listed company shall ensure that minutes of meetings of the Board of Directors are appropriately recorded and circulated to directors and officers

¹⁸⁰ Clause xxvi of the Code of Corporate Governance.

¹⁸¹ Clause xxvi of the Code of Corporate Governance.

¹⁸² Clause xxx of the Code of Corporate Governance.

entitled to attend Board meetings not later than 30 days thereof, unless a shorter period is provided in the listed company's Articles of Association¹⁸³.

In the event that a director of a listed company is of the view that his dissenting note has not been satisfactorily recorded in the minutes of a meeting of the Board of Directors, he may refer the matter to the Company Secretary. The director may require the note to be appended to the minutes, failing which he may file an objection with the Commission in the form of a statement to that effect. In order to strengthen and formalize corporate decision-making process, significant issues shall be placed for the information, consideration and decision of the Boards of Directors of listed companies.

3.1.13. Directors Report:

The directors of listed companies shall include statements to the following effect in the Directors' Report, prepared under section 236 of the Companies Ordinance, 1984: (a) the financial statements, prepared by the management of the listed company, present fairly its state of affairs, the result of its operations, cash flows and changes in equity; (b) proper books of account of the listed company have been maintained; (c) appropriate accounting policies have been consistently applied in preparation of financial statements and accounting estimates are based on reasonable and prudent judgment; (d) international Accounting Standards, as applicable in Pakistan, have been followed in preparation of financial statements and any departure there from has been adequately disclosed; (e) the system of internal control is sound in design and has been effectively implemented and monitored; (f) there are no significant doubts upon the listed company's ability to continue as a going concern; (g) there has been no material departure from the best practices of corporate governance, as detailed in the listing regulations¹⁸⁴.

¹⁸³ Clause xii of the Code of Corporate Governance.

¹⁸⁴ Clause xix of the Code of Corporate Governance.

The Directors' Reports of listed companies shall also include the following, where necessary: (a) if the listed company is not considered to be a going concern, the fact along with reasons shall be disclosed; (b) significant deviations from last year in operating results of the listed company shall be highlighted and reasons thereof shall be explained; (c) key operating and financial data of last six years shall be summarized; (d) if the listed company has not declared dividend or issued bonus shares for any year, the reasons thereof shall be given; (e) where any statutory payment on account of taxes, duties, levies and charges is outstanding, the amount together with a brief description and reasons for the same shall be disclosed; (f) significant plans and decisions, such as corporate restructuring, business expansion and discontinuance of operations, shall be outlined along with future prospects, risks and uncertainties surrounding the listed company; (g) a statement as to the value of investments of provident, gratuity and pension funds, based on their respective audited accounts, shall be included; (h) the number of Board meetings held during the year and attendance by each director shall be disclosed; (i) the pattern of shareholding shall be reported to disclose the aggregate number of shares (along with name wise details where stated below) held by: (i) associated companies, undertakings and related parties (name wise details); (ii) NIT and ICP (name wise details); (iii) directors, CEO and their spouse and minor children (name wise details); (iv) executives; (v) public sector companies and corporations; (vi) banks, Development Finance Institutions, Non-Banking Financial Institutions, insurance companies, modaraba and mutual funds; (vii) and shareholders holding ten percent or more voting interest in the listed company (name wise details).

Explanation: for the purpose of this clause, clause (b) of direction (i) and direction (xxiii), the expression "executive" means an employee of a listed company other than the CEO and directors whose basic salary exceeds five hundred thousand rupees in a financial year.

(j) all trades in the shares of the listed company, carried out by its directors, CEO, CFO, Company Secretary and their spouses and minor children shall also be disclosed.

3.1.14. Powers of Directors under the Listing Regulations of the Karachi Stock Exchange:

The board of directors of a listed company should approve the transfer pricing policy for a related party transaction before such transaction is entered into¹⁸⁵. However, applicability of regulation number 38 is deferred till December, 2006 by the commission.

Under sub clause 7 of the listing regulation 38 the board of directors at each Board meeting will formally approve the records of all related party transactions and under sub clause 8 the related party transactions which are not executed at arm's length price will also be placed separately at each Board meeting along with necessary justification for consideration and approval of the Board and before the Audit Committee of the company.

3.1.15. Practical Aspects and concerns of the Board composition and performance in Pakistan:

Pakistan's corporate structure is at present facing enormous policy concerns because of the globalization of the over all business undertaken by the companies. As mentioned earlier that in Pakistan we have a single-tier board structure, it is the key problem with the performance of the companies at present. The merits and de-merits of the single-tier and the two-tier board model will be discussed while evaluating the practiced model of the corporate governance in Pakistan in the final chapter.

Governance of the board of directors is the most neglected part in our country rather it is justified to say that no attention has been paid yet for increasing the performance of the board as it is directly related to the performance of companies. As board of directors are entrusted with the duty to run the affairs of the company for the general well being of the shareholders while keeping and safeguarding the interests of the other stakeholders, hence, they are the back bone of any company. While making any policy to enhance the efficiency of a company the specific consideration must be

¹⁸⁵ listing regulation number 38 (2) of Karachi Stock Exchange.

paid to the effectiveness of the board of the directors. However, such exercise has not yet been made in Pakistan because of some of the fundamental economic constraints.

One of the major practical concerns with Pakistan's corporate structure is the concentrated family ownership among the big companies¹⁸⁶.

In Pakistan, much research has been undertaken with respect to the family concentrated ownership patterns and its effects on the corporate performance. However, the area of the board of directors has been neglected to a great extent, in these researches.

Family owned companies can be defined as a mode of organization where the primary source of management, finance and market information comes from within the family. Therefore it is essentially a much wider network based on trust and shared ideals of the members, where the members also extend to wider relations such as uncles, aunts, cousin's etc. Another important factor is the extent of family involvement, which also extends to 2nd and 3rd cousins and close family friends. Similar to the other countries in the South-Asian region, an important way to expand businesses has been through inter-marriages. Cases of marriages between prominent business families are the norm rather than an exception (for instance Mansha's and Saigols). The caste system also serves as an important and larger institution that individuals can rely on to meet their various business needs. Therefore it actually performs the function of a much larger business group or an umbrella group that firms within a particular caste are able to rely on, when they require capital, business advice or political connections etc. This kind of reliance is based on a group i.e 'beyond' the 'family' and does not exist in the West.

Resultantly, these family dominated companies give birth to family dominated board of directors that are deterrent to the interests of the minority shareholders and interested stakeholders. Despite the fact that code requires the disclosure regarding the

¹⁸⁶ Bari, F. Cheema, A and Siddique, O. 2003. Corporate Governance in Pakistan: Ownership, Control and the Law, LUMS, Lahore, Pakistan. (last visited April 2006).
http://dprc.lums.edu.pk/index.php?option=com_publications&view=publications&Itemid=21

patterns of shareholding, major equity owners of the companies appoint dummy directors on the board in order to avoid such policy checks.

The western corporate world has adopted a different policy in their corporate ownership structure i.e. diversified equity ownership structure where the ownership is so much scattered that dominance of this nature as we face in Pakistan can not exist at all. Many other developing countries like India, Indonesia and Malaysia etc. are also facing similar kind of discrepancies. However, they have resolved the issue by effective representation of the independent directors as an important part of their companies.

Another concern is the representation of the nominee director on the board. As nominee director is appointed by any institutional investor, it assures that an independent representative is having supervisory role on the activities of the board.

The code requires that board of directors of each listed company include at least one independent director representing institutional equity holder but unfortunately such environment does not exist. The reasons for lacking this attitude are (a) institutional share holding is very less; (b) even if some of the institutional investor nominates any director he lacks the expertise to the long term goal of the company; (c) most of the nominee directors play a passive role that result in the form of rubber stamping. Hence, there is an urgent need for the capacity building of such institutional investors so that positive result can be achieved through nominee directors¹⁸⁷. Nominee directors are required to adopt a more proactive role as the code lays emphasis on the role of non-executive directors.

Another concern with the performance of the board of directors is duality in role of the CEO and the chairman of the board of the directors. The code in itself does not provide that the positions of CEO and the chairman shall be held by the different persons rather it leaves it on the discretionary powers of the board. However, in international practice the Codes that relate to unitary boards also frequently call for the

¹⁸⁷ Mahmood and Sharif working paper *Institutional shareholders and their role in promotion of corporate governance in Pakistan*. Can be viewed online at http://www.secp.gov.pk/divisions/Portal_CS/WorkingPaperCorpGov.htm (last visited April 2006)

positions of the chairman of the board and the CEO to be held by different individuals. Codes that relate to two-tier boards also emphasize the need for independence between the supervisory and managerial bodies. For example, like the unitary board codes, they tend to warn against the practice of naming (more than one or two) retired managers to the supervisory board, because it may undermine supervisory board independence.

3.2. Analysis of the state of current board practices and policy recommendations:

3.2.1. Basic description of board:

Pakistan has a one tier board system. Board tenure is three years, except for appointed directors (nominee directors). The Code recommends that executive directors (working or whole-time directors) should not constitute more than 75 percent of the elected directors and that the chairman should be elected from the non-executive directors. It is not mandatory to elect a permanent chairman; companies may opt for electing a different chairman for each meeting. The absence of a permanent chairman weakens the accountability of the board. In practice, in family firms boards are mainly a family affair. Among business groups, interlocking boards are common.

3.2.2. Size requirement:

The minimum number of directors for a listed company is seven.

3.2.3. Adequacy of duties of loyalty and care:

Our law is lacking in the development of Fiduciary duties. It does not provide clear general duty of care but only a limited extent of duties of loyalty. Fiduciary duties make sure that directors' power are well regulated and provide a means of reducing

agency costs between shareholders and directors¹⁸⁸. At present, fiduciary duties and particularly the duty of care are a weak force for directors to act in the best interests of shareholders.

Existing fiduciary duties are based primarily on a limited amount of case law, which is skinny and emphasizes loyalty to the company and not to shareholders and the provisions on conflict of interest in the ordinance. Implicitly, the duties require that the affairs of the company must not be conducted in an unlawful or fraudulent manner, or in a manner not provided for in the articles or in a manner oppressive to shareholders or creditors or prejudicial to the public interest.

The ordinance specifies some fiduciary-type duties. If directors fail to disclose conflicts of interest with company transactions, or if when there is a conflict of interest and they vote at board meetings, then they may be declared to lack fiduciary behavior. The list of case law on the issue is not longer¹⁸⁹. However, fiduciary duties are quite specific, and relate to conflicts of interests and their disclosure by directors. The Code supplements the written and case law. Clause vii of the code provides that directors of listed companies must execute their powers and carry out their fiduciary duties with a sense of objective judgment and independence in the best interests of the company. The Code also mandates directors to confirm at the time of election that they are aware of their duties under the law, company by-laws and listing regulations. These duties are

¹⁸⁸ Although directors are not technically agents and shareholders are not technically principals, the agency theory of the firm has "dominated corporate legal scholarship for at least two decades." See Robert B. Thompson and D. Gordon Smith, *Toward a New Theory of the Shareholder Role: "Sacred Space" in Corporate Takeovers*, 80 TEX. L. REV. 261, 268 (2001). For the argument that the corporate law literature has overemphasized the importance of agency costs, see Robert K. Rasmussen and Douglas G. Baird, *The Prime Directive*, draft available at http://papers.ssrn.com/sol3/Papers.cfm?abstract_id=930187. (last visited July 2006)

¹⁸⁹ In the case of *Muhammad Bakhsh & Sons Ltd. v Azhar Wali Muhammad* 1986 MLD 1870 (Karachi), it was held that the nature of the relationship between a director and the company was fiduciary in nature and that a director was always required to act in good faith vis-à-vis the company. Other cases include: *Shahid Saigol v Kohinoor Mills Ltd.* PLD 1995 Lahore 264, where it was held that a director can only be declared to lack fiduciary behavior under section 217 of the ordinance if he contravenes the provisions of sections 214, 215(1) and 216 of the ordinance; and *Haroon Ayoob Abdul Karim v Sulleman Ahmad and 4 others* 1983 CLC 162 (Karachi), where it was held that a director is in a fiduciary relationship with the company and not with shareholders.

vital to shareholder protection, but may be too important to be left to the soft law of the Code.

3.2.4. Insurance for directors:

The concept of the insurance of the directors is not developed in Pakistan. Even many companies are not aware of the concept of the directors' liability insurance. Resultantly, there are almost no suits against directors and liability insurance is rarely used or understood.

3.2.5. Accountability of the Board:

There is nothing specific on derivative action or direct suits against directors and only criminal actions are explicitly mentioned in the law for the sake of the accountability of the board. As mentioned earlier there are limited cases of such nature and suits against directors are rare. However, under the National Accountability Bureau Ordinance (1999) the sponsors, CEO, and directors can be held liable if they fail to repay company's loans.

3.2.5.1. Fair treatment for the protection of all the shareholders' rights:

The code requires the directors to work out their powers independently, in the best interest of the company and all shareholders and not for undue benefits of dominated shareholders of the company. However, in practice many boards are dominated by the controlling family that is a limitation for the board to be accurately accountable to all shareholders¹⁹⁰.

¹⁹⁰ Cheema A. 2003, Corporate Governance in Pakistan: Issues and Concerns, The Journal Economics Resources, Vol-8 No.2 NIPA Karachi, Pakistan.

3.2.5.2. The exercise of objective independent judgment by the board:

As mentioned earlier while discussing the provisions of the ordinance and the code that independent directors must be there to ensure the proper conduct of the corporate affairs of the companies, multinationals, banks and state-owned enterprises have one or two independent directors on their boards, but it is still rare to find independent directors on the boards of most family held companies. The shareholders who intend to differ from the decision of the management can request for their objection to be recorded in the board minutes.

The Code states that the boards of listed companies must establish an audit committee, composed of at least three directors who meet every quarter. The majority must be non-executive. However, practically, non-executive family members end up dominating audit committees, which frequently include the CFO as a voting member.

3.2.6. Access to Information:

As the ordinance and the code mandate the access of all the documentations to the board, the vast majority of directors are insiders i.e. controlling shareholders; access to information is not a problem in practice. This will become a more important issue once independent directors are more common.

In nutshell, a robust duty of care is absent, as is developed guidance on the duty of loyalty. Suits against directors are rare. In business groups, boards are dominated by executive and non-executive members of the controlling family and by proxy directors appointed to act on their behalf. Inter-locking directorships are often used to retain majority control.

Family-dominated boards are less able to protect minority shareholders, and risk a loss of competitiveness as other boards become more professional. One of the objectives of the Code is to revitalize the role of boards in the governance of companies.

In order to make the board more professional and accountable to all shareholders, it is necessary for outsiders to play a more prominent role on the boards of listed companies. But the current compensation is inadequate to attract independent directors with the necessary knowledge and experience, especially for member who will serve on the audit committee, where financial and accounting expertise is required.

In the case of state owned companies and multinationals, there is often a direct relationship between the state/foreign owner and management, again bypassing the boards. Many important corporate decisions are thus never made at the board or at annual general meeting level and, as a result, boards being distinct from management, are frequently not the driving force behind corporate strategy and strategic issues.

Chapter 4

Regulator and Corporate Governance Compliance

So far we have analyzed the international developments on the issue of corporate governance in the developed and developing countries, Pakistani statutes regulating corporate sector and board practices established and practiced in Pakistan and the role of international donor agencies in improving the corporate governance awareness and compliance in Pakistan.

Regulation of the corporate sector is core issue for creating a competitive corporate governance regime in Pakistan. The legislation in itself can not ensure good compliance until and unless these legislations are regulated in letter and spirit. Hence, the issue of corporate governance demands an apex regulator that can ensure good compliance of the legislations.

Pakistan's corporate sector, at present, has achieved a good reputation regarding the regulation of the laws and the by-laws to ensure the proper functioning of the corporate sector. However, when we come across the developments taking place along the globe in the field of the corporate governance, we find that regulation of the corporate sector is facing many pitfalls thus requiring serious efforts in order to enhance enforceability of laws and by-laws through effective regulation.

The rest of this chapter is as follows; section 4.1 describes the regulators of corporate governance, section 4.2 discusses the common strategy framework, proposed to create harmony between different regulators and governing bodies.

4.1. The Regulators of Corporate Governance:

At present corporate sector is chiefly regulated by the Securities and Exchange Commission of Pakistan (SECP) and State Bank of Pakistan (SBP) . In addition to it there are industry specific regulators i.e. Oil and Gas Regulatory Authority (OGRA) for the additional regulation of oil and gas companies, Pakistan Telecommunication Authority (PTA) for the regulation of telecom sector and Pakistan Electronic Media Regulatory Authority (PEMRA) for the regulation of media and communication companies. The volatile regulator above all, for the issue of corporate governance, is the Stock exchange as the compliance of the provisions of the code has been enacted in the regulation no.38 of the listing regulations.

In this chapter, we draw our attention on the issue of role of the regulators for ensuring good compliance of the corporate governance provisions along with key problems and recommendations.

4.1.1. Securities and Exchange Commission of Pakistan:

SECP was set up in pursuance of the Securities and Exchange Commission of Pakistan Act, 1997. This Act institutionalized certain policy decisions relating to the constitution and structure, powers, and functions of the commission, thereby giving it administrative authority and financial independence in carrying out its regulatory and statutory responsibilities.

The commission became operational in January 1999. It was initially concerned with the regulation of corporate sector and capital market. Over the time, its mandate has expanded to include supervision and regulation of insurance companies, non-banking finance companies and private pensions. The commission has also been entrusted with oversight of various external service providers to the corporate and financial sectors, including chartered accountants, credit rating agencies, corporate

secretaries, brokers, surveyors etc. The challenges for SECP have amplified manifold with its increased mandate.

The corporate sector of Pakistan has witnessed an accelerated growth in the registration of companies over the past few years in pursuant to the major policy reforms. On 30 June 2005, there were 45,448 companies registered with the commission under the Companies Ordinance, 1984. Of these, 44,319 were companies limited by shares, including 2,757 public limited companies, 41,320 private limited companies and 242 single member companies. In addition, there were 286 associations not-for-profit, fifty-six limited by guarantee companies, 176 trade organizations, 606 foreign companies and five companies with unlimited liability¹⁹¹.

The annual corporate growth is now well in excess of 3,000 entities. As compared to the financial year 2004-05, the corporatization increased by 40 percent.

SECP regulates the affairs of companies through administering and enforcing the Ordinance. In this regard, it takes appropriate initiatives to strengthen and develop the legal framework, curb illegal and fraudulent business activities, and enhance compliance of registered entities with legal and regulatory requirements. In its developmental role, the commission has been encouraging development of the corporate sector and ensuring public facilitation, particularly at its company registration offices situated in eight cities.

Despite the apex structure of SECP, its role has been rather authoritative instead of consultative. A large number of companies unfortunately, still lack in awareness of an efficient corporate governance model and its perspective toward the development of sound business environment.

¹⁹¹ See commission's annual report 2004-05. www.secp.gov.pk (last visited August 2006)

The claim of SECP stands no where that all the stakeholders were consulted at the time of drafting the Code. Rather, empirical evidences¹⁹² show that the consulted stakeholders mainly included regulators themselves, concerned policy makers, stock exchanges, auditing and accountancy firms and trade associations, representing different interests. The research shows that the representatives of the listed companies were ignored in the consultation process. None of the listed companies have come up with an answer that its representatives were included in the formulation of the Code of Corporate Governance. They were also critical of the process of consultation which was undertaken after the rules were framed or enforced. Furthermore, listed companies also expressed doubts that their views are made public or incorporated fully in the draft.

SECP, while drafting the code recommended that the listed companies to organize training courses for enhancing the capacity of its staff with their duties and responsibilities and could not fore see that the corporate sector is still an infant that needs to be groomed to a great extent. However, the number of courses conducted by the listed companies are very few and insufficient as it is perceived by the companies to be a bit costly. Another fact that is perceived by the companies is to be over burdening the financial stability of the company by publishing of the quarterly accounts.

On the approval of the board of directors the external auditors of the company are appointed for a period of one year and Code requires that listed companies have to change their external auditors after every five years. However, this clause for mandatory rotation of auditors for a listed company after every five years of the Corporate Governance Code has been suspended by the Lahore High Court¹⁹³. The court was of the opinion that any rules framed or a regulation enforced must be seen with the protective eye if it came in conflict with the spirit of the basic statute.

¹⁹² See Asif and Rais May 2004 Regulatory Impact Assessment (RIA) of SECP's Corporate Governance Code in Pakistan.

http://www.eastasiaforum.org/testing/eaber/sites/default/files/documents/LUMS_Rais_2005.pdf

¹⁹³ See footnote 96 supra

However, there must be check and balance on the authority of regulators and it should not be exercised unquestioned so that healthy and competitive corporate sector could be ensured.

4.1.2. Pakistan Institute of Corporate Governance (PICG):

4.1.2.1. Introduction:

In modern day business scenario, sound corporate governance has emerged as a crucial success factor in national and international markets. To ensure fairness, transparency and accountability in the corporate sector and to safeguard the interest of all stakeholders, especially the minority shareholders, countries all over the world are keen to encourage good corporate governance. Empirical researches also propose the rule that adherence to good governance practices tend to attract more capital inflows.

Although governments play a central role in shaping the legal, institutional and regulatory climate, the corporate sector in itself must play a vital role. Fair contribution and collective will of all major stakeholders improve the corporate governance culture of any country. However this can be achieved through an institutional arrangement to provide a platform where all major stakeholders may collectively discuss governance practices, identify problems and their solutions and evolve best governance practices.

4.1.2.2. The Formation of PICG:

In 2004, pursuant to above mentioned goals, the Pakistan Institute of Corporate Governance was set up as a not-for-profit company, limited by guarantee and without share capital. The prime objective for the formation of PICG was to undertake activities geared towards achieving good corporate governance by creating an enabling environment for effective implementation of the Code of Corporate Governance in Pakistan.

PICG is expected to become a leading provider of knowledge and awareness in Pakistan related to corporate governance practices. It endeavors to encourage best practices in corporate governance in public and private sectors, with focus on capacity building and enhancing the potential of board of directors, management, investors, policy makers and other stakeholders, in short covering all the issues related to corporate governance at national and international level.

4.1.2.3. Activities:

PICG in pursuance of its objectives was meant to perform the following activities and generate income (wherever possible) there-from: (a) Education and training, (b) Awareness creation, (c) Resource center and research, (d) Issue of guidelines and publications, (e) Forum of discussions and representing views, (f) Consulting services

In line with its objectives, the institute has started serious efforts in order to discharge its obligations and has conducted number of awareness seminars regarding the performance, duties, responsibilities and trainings of board of directors concerning corporate governance in Pakistan. However, PICG has to go a long tiresome line of action for the establishment of competitive corporate governance regime in line with international developments. So far PICG could not establish its website that is a major source for ensuring general awareness of the subject of the code in its true letter and spirit. Moreover, the activities of PICG are chiefly limited within the territorial boundaries of Karachi.

4.1.3. Stock Exchanges and Regulation:

The compliance of the provisions of the Code was made obligatory through making it part and parcel of the listing regulations of the each of the stock exchanges. At present, there are three stock exchanges in Pakistan and Karachi Stock Exchange (KSE) is having the biggest capitalization among all. Almost all the companies listed on

Islamabad or Lahore Stock Exchanges are also listed in KSE. KSE is a guarantee limited company that started its functioning in year 1949. It has been awarded best performing stock exchange in the world in year 2002 and is still among the attractive markets for the investment along the globe. The total strength of its members is 200. There are 156 corporate members and out of which 9 are the listed companies. KSE is fully automated stock exchange and following T+3 settlement cycle for the securities. All the business of the scripts taking place in the KSE are carried through central depository company.

The development of the share market is a necessary institutional innovation in order to facilitate the adoption of limited liability form of business, so that the Pakistani companies can compete the companies of the developed economies. One recent example is the listing of the National Bank of Pakistan's shares in the London Stock exchange. OGDCL is also going to enlist itself in near future. KSE performs a dual role with respect to its performance i.e. as primary and secondary market. It serves as an institution for the issuance of new capital for the companies and provides a framework through which ownership of the existing shares can sold or bought. This secondary market function is more important as compared to the primary function as it provides check and balance on the management and ownership structure of the companies. Hence, the success in well-managing secondary market puts upon a positive growth and confidence in its functioning as primary market.

KSE has made number of effective efforts so that it may achieve the above mentioned goals and still striving its best efforts in this regard.

4.1.3.1. Regulation by KSE:

In order to attract more and more market participants, KSE has made remarkable regulations as it is a self regulatory entity. To ensure the confidence of the investors and other market participants, KSE well regulated as compared to stock markets in the region. However, owing to certain embedded pitfalls in the business structure and

practices prevalent in Pakistan at present, it has to go long way in order to become true competitive to the stock market of the developed economies. This situation can be assured by seeing the 2004-05 performance as it witnessed major decline in its index that resulted in form of loss of millions of rupees by the investors.

The regulatory function of KSE is confined to prescribing appropriate behavior of the broker members of the exchange, and in ensuring that the companies seeking listing on the exchange, and those already listed; meet the specified minimum level of performance and standards of information disclosure by the board of directors of the listed companies. It has powers to impose sanctions on the companies that are found guilty of transgressing the rules and by-laws of the exchange. If KSE is of the opinion that certain company has not met certain disclosure requirements it may call upon the company to provide that information disclosure. It can even suspend the trading of the shares of the company that is in violation of the directions of the exchange. The disclosure of information is a main pillar of the corporate governance regime. The final power that is available to the exchange is to de-list the securities of the company that is in violation of the mandatory provisions of KSE.

KSE in order to enhance the performance has introduced major performance based incentives and has taken various steps to enhance the liquidity in the market. Previously, trading was carried out in physical as well as CDC scripts but now it has made it mandatory that all the transactions shall be carried through CDC scripts. Carry over transaction (COT) has been replaced by the introduction of continuous funding system (CFS) in order to enhance the liquidity in the market. It has issued a manual for the compliance of the mandatory provisions including corporate governance provisions as a part of awareness programme.

In addition to the above mentioned regulation process of the KSE there are certain loop holes in the legislative, regulatory as well in the field of coordination among various market participants. The solution to these problems in Pakistan is demutualization of the stock exchanges. A tiresome field work has been done in this

regard i.e. conversion of not for profit business to a limited liability form of business. The role and regulations of the brokers is also a major key problem as it requires that their dominance over the performance is directly influenced by them.

4.1.4. Sector Specific Regulators:

In past few years, the corporate sector in Pakistan has witnessed a robust growth in almost all the areas of corporate sector. This robust growth is backed by the major policy-variation initiatives of the Government of Pakistan. These initiatives involved the privatization of some of the giant state owned enterprises like Pakistan Petroleum (PPL), Oil and Gas Development Company Limited (OGDCL), Kot Addu Power Company (KAPCO), Pakistan Telecommunication Company Limited (PTCL) and the list go on and on. In addition to privatization many sectors like telecom were deregulated in order to attract more and more foreign direct investment. With the implementation of such initiatives more and more sectoral regulators were established and the process is still on-going.

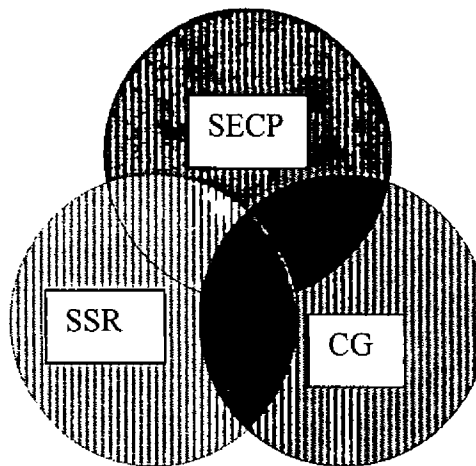
At this moment, the Code is applicable on the companies that are listed and their shares are publicly held. The statistics show that at present out of 652 listed companies, there are 14 oil and gas companies, 10 telecom and communication companies, around 10 cable and media companies and good volume of commercial and investment banks¹⁹⁴.

SECP is the common regulator for all the companies registered under Companies ordinance, 1984. Commercial and investment banks are regulated by the State bank of Pakistan, Oil and gas companies are regulated by Oil and Gas Regulatory Authority, Cable and media companies are regulated by the Pakistan Electronic Media Regulatory Authority and telecom sector is regulated by Pakistan Telecommunication Authority.

¹⁹⁴ The data has been taken from the site of the Karachi Stock Exchange. See <http://www.kse.com.pk/> (last visited April, 2006)

Above mentioned regulators regulate the companies with respect to business conducted and activities undertaken by the each sector's companies. Hence, Irrespective of the sectoral boundaries all the companies fall under the regulatory regime of SECP as far as these are companies. However, during performing their business each comes under the regulation of sector specific regulator in addition to SECP. When all these companies are listed on the stock exchange, they also come under the regulation of the specific rules and regulations of the stock exchanges. Resultantly, a company is at minimum regulated by three regulators i.e. SECP, Sector specific regulator (SSR) and stock exchanges (KSE).

Figure
4.1



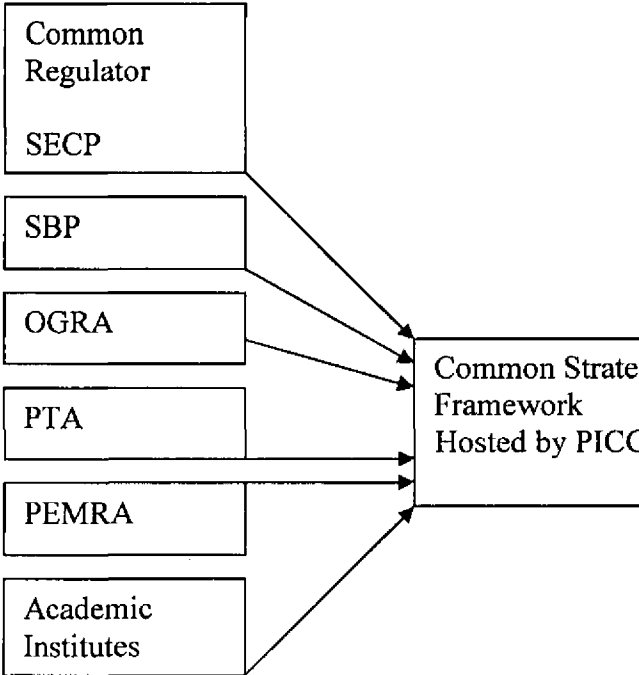
4.2. Common Strategy Framework:

In summing up there exist an interface among various regulators. This interface has not yet been given attention and rather has been neglected to a large extent. Hence,

we purpose “Common Strategic Framework” that can enhance the current state of compliance of corporate governance regime in Pakistan. The figure below explains the practical aspects of the strategy and its arising benefits.

Under the umbrella of PICG all the regulators should create such an enabling environment where all the policy and regulatory framework should be discussed.

Figure 4.2 Com



At present some interactions exist between SECP and SBP, however, it is the need of the time that all the regulators must lay down a common strategy so that the corporate governance practices that are in line with international standards can be achieved. When all the regulators will interact among one another the harmonization of the legislative as well as regulatory differences should be addressed. The compliance with the corporate governance provisions should not only be enforceable by the stock exchanges or SECP but the sectoral regulators should extend their hands for resolving the compliance issues.

As Pakistan's corporate sector is in the state of transition, listed companies should be given good incentives for ensuring compliance of the provisions of the Code. The incentive should not be in the form of award as KSE has launched top 25 best performing companies award rather companies should be given various incentives including tax rebate etc.

The companies through the Common Strategy Framework should encourage and educate the management and boards of directors of the companies about the advantages of the adoption of competitive as well as best ethical standards. PICG has arranged some seminars in this regard however; this collective approach will end up in more positive results as compared to individual efforts. In this exercise the major academic institutions, including business management and legal institutions, should be given research projects so as to keep well acquainted with practical and academic developments in the field of corporate governance.

Once this strategic frame work becomes functional, the compliance with the corporate governance provisions as well as good competitive practices will gain ground be among Pakistan's corporate sector. Resultantly, Government's privatization and de-regulation policies will give birth to a well groomed and matured corporate sector that will attract more and more foreign direct investment coupled with good corporate governance practices.

Chapter 5

Corporate Governance Model

The starting point of discussion for legal scholars, and economists who study corporate governance systems is the acknowledgement that there exist multiple systems of corporate governance around the world¹⁹⁵.

Globally, there are several corporate governance models that have been adopted and implemented not only by their countries of origin, but by other countries too. For several years now there has been debate over the issue that what is the perfect model for governance of the companies. This reason has motivated numerous academic studies, both theoretical and empirical in nature and comparisons between the effectiveness of Anglo-Saxon Model, German Model, Japanese and East Asian Model of corporate governance and the ownership structures in these countries has frequently been made¹⁹⁶.

The approach here is comparative so that we learn from the experiences of the developed countries while devising our model for governance of the corporate entities. It aims at understanding how there can be a diversity of corporate governance structures and where they are going. Section 4.1 of this chapter recalls the characteristics of the traditional models of corporate governance, which seek to answer the generic problem of controlling the actions taken by the leaders of large managerial companies. It also elaborates the question of the effectiveness of the control exercise in practice by referring to the two theoretical models in the Anglo-Saxon countries and in several continental

¹⁹⁵ La Porta R, Lopez-de-Silanes F, Shleifer A. 2002a. Government ownership of banks. *Journal of Finance* 57(1): page 265-301

¹⁹⁶ Mumtaz Mahwesh 2004 Corporate Governance in Pakistan *Adopt or Adapt?* University of Cambridge Research

<http://cmer.lums.edu.pk/Conference2005/images/CG%20in%20Pakistan-%20Adopt%20or%20Adapt.pdf>

European countries. Section 4.2 lays the hypothesis of a possible convergence of the traditional models of governance towards a hybrid model, characterized by the presence of strong minority shareholders in the capital structure of large, publicly owned companies. The principal practical factors of convergence towards this hybrid model and of opposition to the convergence are presented in the section 4.3.

5.1. Two Distinctive Models of Corporate Governance:

In this section, we recall the general terms in which the problem of managerial company governance is traditionally posed. We then briefly present the two traditional theoretical models; the shareholder or externally controlled type on the one hand and the stakeholder or internally controlled type on the other.

5.1.1. Managerial company Governance:

The concept of corporate governance relates to the separation between ownership and the power to make decisions in large companies where exist a strong degree of interests of minority shareholders. It denotes the way in which key decisions in managing the affairs of the companies are taken, the extent to which interested groups or stakeholders are in a position to influence company's corporate decisions. These are the shareholder model (external control exercised by shareholders) and the stakeholder model (internal control exercised by various parties having an interest in the company — banks, industries, employees, public institutions).

Between the two models described there exists in reality a variety of possibilities according to the relationship of forces in place in the company, and also according to the legal and regulatory environments that affect more or less the strong concentration of equity capital among the shareholders. The system of governance existing in the company will approximate one or the other of these two concepts, either by prioritizing maximizing the market value or preserving the coherence of all the partners.

5.1.2. The Shareholder Model:

The shareholder model of corporate governance is based upon the agency theory. The agency theory perspective of corporate governance assumes that companies are dispersely owned that is in line with Berle and Means' 1932 definition of the American 'modern' corporation. The main consequence of dispersely owned company is that there exists a separation between the owners of the companies (principals) and those who control the company's daily operations (agents or managers)¹⁹⁷. As a result, corporate governance is conceptualized around the problems where principals-risk bearing shareholders, are interested in maximizing their investments and monitoring the agents who might be dodging or working towards enhancing their individual interests.

Thus, agency theorists aim to understand how investors get the managers to give them back their money and hence minimize agency costs¹⁹⁸. Agency theory research has devoted a lot of efforts to outline the incentives of managers and owners and to identify market mechanisms to minimize potential agency costs. Particularly, within the management dimensions of the role of the Chief Executive Officer, often related to his/her incentives within the company.

The scholars of agency theory have also paid a great deal of attention to uncover the role of the third point in their conceptualization of the corporate governance triangle i.e., the board of directors. Boards are the intermediary governance body between shareholders and management. In principle, directors' interests are aligned with those of owners as they are elected by shareholders to represent their collective interests in their monitoring of management. Studies of boards of directors in the context of corporate governance examine the extent that different board characteristics such as board composition (insiders/outside directors, board subcommittees, and dual leadership) or interlocking directorates will minimize agency costs. For example, an insider director

¹⁹⁷ Aguilera V. Ruth (January 2004) '*CORPORATE GOVERNANCE*' Department of Business Administration College of Business & Institute of Labor and Industrial Relations University of Illinois at Urbana-Champaign

¹⁹⁸ Shleifer, Andrei and Vishny, Robert W. (1997) 'A Survey of Corporate Governance', *Journal of Finance*, (2):737-783.

might be more likely to pursue managerial interests such as empire building if his compensation is tied to company revenues.

One of the distinguishing features of the shareholder model of corporate governance is the single-tier board of directors. The one-tier board model entrusts both management and control to the hands of the board of directors, who are vested with universal powers. In larger companies, managerial power is irrevocably devolved to groups of directors (committees) or individuals below board level. Shareholder model is being successfully practiced in UK, USA, Australia, Canada and New Zealand with slight degree of variations.

5.1.3. The Stakeholder Model:

The stakeholder theory has expanded the company's boundaries by defining companies as an 'open systems'. Here external links are part of each and every company. A key factor of this perspective is the recognition of stakeholders (e.g. employees, suppliers, customers among others) and their relationships (e.g. employee ownership). This is the reason that it is commonly known as stakeholder model of corporate governance.

According to this view, companies are not always driven solely by shareholder value maximization because managers may be altruistic about employee empowerment, owners may be concerned about the survival of the company as in the case of family businesses, and market pressures for profitability are more long term due to the existence of patient capital and the underdevelopment of capital markets. Since discussions about suppliers and consumers within the corporate governance equation are scarce, yet there is significant contributions exist regarding the role of employees¹⁹⁹.

The Stakeholder model is mainly practiced in Germany, across the continental Europe and parts of Asia including Japan. The German model has large shareholders,

¹⁹⁹ See footnote 100 supra

often comprised of founding families, banks, insurance companies or other financial institutions who own the bulk of the shares. This close ownership structure enables large shareholders to internally monitor the day-to-day operation of the company. Cross-shareholding among insiders is common and information flow is controlled and obscure. Stakeholders such as organized labor play a substantially greater role in the governance of companies under the German model. In Germany, a co-determination system exists that provides representation of workers on boards of directors.

The characteristic/ distinctive feature of the stakeholder model is the two-tier board of directors i.e. the board of director is further classified into board and supervisory board. German company law has traditionally relied upon statutory regulation, in which the two-tier board model (including co-determination) is firmly rooted. Non-statutory rules became a supplementing regime only very recently in 2002, when the government commission for corporate governance presented a consolidated German Corporate Governance Code.

The central feature of internal corporate governance lies in the organizational and personal division of management and control by a two-tier structure that is mandatory for all public companies, regardless of size or listing of companies²⁰⁰. While the clear responsibility of the management board is the running of the business, the role of the supervisory board is not easy to describe. Its legal functions are primarily the appointment, supervision, and removal of members of the management board.

5.1.4. Neither of the Two Models is Ideal:

As both the shareholder model and stake holder model are widely practiced in majority of the countries, in practice, in each of the two corporate governance models, managers have been able to develop strategies to root themselves in their positions in a

²⁰⁰ Maassen Francesco (Gregory 3rd Edition). An International Comparison of Corporate Governance Models. A Study on the Formal Independence and Convergence of One-tier and Two-tier Corporate Boards of Directors in the United States of America, the United Kingdom and the Netherlands.

way that has proven detrimental to shareholders' interests²⁰¹. Actually, if we understand by corporate governance the system by which companies are controlled directly or indirectly by shareholders and other stakeholders, the resounding recent scandals of corporate mismanagement on a worldwide scale (Enron, World com and Parmalat) make it impossible to present either one of the two models as ideal.

In general, the systems which use the stakeholder model (German capitalism, French capitalism and companies which mutually hold large blocks of each other's shares) are characterized by the limited transparency of the companies in relation to minority shareholders and by control held by leading executives who are part of an often complex mutual interest system. Cloudiness is characteristic of this system. It may flow from the fact that players with informational advantages prefer to keep the company unclear in relation to others. Continental companies may also prefer to keep hidden from their employees' executive salaries, incentive compensation, and managers' stock options in order to avoid increasing social strains²⁰².

In contrast the countries that are following shareholder model of corporate governance are also facing many serious violations by the managers and boards of their companies e.g. problem of free riders.

This model reduces corporate governance to the sole relationship between shareholders and management. The only legitimate stakeholders whose interests are taken into consideration are the shareholders. Other groups, such as employees, customers and suppliers, the state and society in general, are not properly taken into consideration. It is assumed that their interests are sufficiently protected by laws and contracts and are not really relevant to corporate governance mechanisms.

²⁰¹ Esther Jeffers 2005 Corporate governance: Toward converging models? *Global Finance Journal* 16 (2005) page 221– 232. and Roe, M. (2000). Political preconditions to separating ownership from corporate control. Working Paper, Columbia Law School.

²⁰² See foot note 104 supra.

Other limits of the shareholder model include that it does not encourage the innovation process since this process requires a financial commitment incompatible with the pursuit of liquidity.

However, Enron's collapse maybe what demonstrated the most confines of this model of corporate governance. Not only billions of shareholders' dollars were nowhere to be found, and thousand of employees dispossessed of their jobs, their retirement savings brutally diminished, which is bad enough, but it is the most shocking because the entire private as well as the public entities that were supposed to monitor the company's activities and public disclosures failed to do so effectively. So the question is not just the wrongdoing or criminal behavior of corporate managers and directors but the failure of a system to perceive and stop such fraudulent practices. As the report of the staff of the Senate Committee on Governmental Affairs clearly stated, No one in the meaningful system of controls devised to protect the public detected Enron's problems, or if they did, they did nothing to correct or alert investors²⁰³.

5.2. Dual Convergence:

Pursuant to such inherited problems in models of corporate governance that has failed to safeguard the interests of the shareholders and society at large, the debate for the convergence of these two models has focused the attention of the current research in this field. Many countries are trying their best to resolve the issues and concerns of the convergence process. The key concern as faced by the EU is the difference in the legal regimes of the countries. However, this process of convergence is a lengthy one and requires tiresome efforts by the respective countries.

5.2.1. Factors of Resistance:

Other factors delay the convergence towards a unified model of corporate governance. The rules of corporate governance cannot simply be exported, as they are.

²⁰³ See foot note 104 supra

One of the essential reasons for that flows from the different economic, judicial, and social frameworks of each country, illustrated by many examples.

Whereas the U.S. system identifies the social interests with the interests of the shareholders, French law traditionally separates these two interests. European models of corporate organization — German law uses the concept of a corporate constitution — view the company as an institution of stakeholders, in which not only the owners but also workers and the public at large have legitimate interests that need to be reflected in corporate organization and behavior.

Under French law the company is considered to be an autonomous economic agent. A company is not analyzed as a contract but as an institution with an autonomous existence, its own finality, which is independent from its shareholders. At the same time this status sets finality for the exercise of this autonomous power which the managers do not control and which even the shareholders do not completely control: the social interest.

In other ways French law goes beyond Anglo-Saxon law in the organization of corporate governance. In France the questions shareholders may vote on are broader than in the United States.

Rules and principles regulating corporate management are differently developed in the U.S and in continental European countries. Whereas in the U.S. rules are abundant and extremely developed, indicating exactly what are the legal norms, the European approach relies more on principles and obligation to respect them, and tend to consider that substance prevails over form.

5.3. Analysis of Practiced Model in Pakistan:

From the above discussion it becomes crystal clear that none of the two most practiced models can ensure the good corporate governance in any country. Hence, the developed countries are devising new frameworks for re-shaping their legal and

economic regimes in accordance with the requirements of the contemporary businesses i.e. either convergence or innovations in the corporate governance models.

As already mentioned that Pakistan inherited its legal regime that of UK, in the same way it also adopted the same model as practiced in UK i.e. shareholder model of corporate governance (Anglo-Saxon). Hence, the question arises whether the Anglo-Saxon model of corporate governance adopted by Pakistan, does indeed fulfill the requirement of being representative of the problems that are peculiar to Pakistan.

However, in practice we find that the situation with the corporate sector in Pakistan is showing great degree of variation as compared to the corporate sector's of the developed countries. Pakistan's corporate sector is at the moment lacking the required spirit for the over all growth and well being of the corporate culture in Pakistan.

Pakistan has strong ownership structures in the corporate sector i.e. family dominated structure. Hence, the agency problems stem from the disparity between ownership and control, giving rise to conflicts of interest among the various participants. Moreover, control is maintained through pyramiding and cross-holdings between companies. And so the voting rights held by the families exceed the cash flow rights that they hold, thus influencing the decision-making. This is the characteristic feature of the German companies that are facing strong ownership structures in their companies. The Anglo-Saxon model work in the presence of strong minority shareholders and institutional investors however, in Pakistan the role of the institutional investors has not much to do. In order to ensure good conduct of the directors the German model postulate the two tier model of the board of directors but Pakistan has one tier board model that is the characteristic feature of the Anglo-Saxon model.

This tendency of Pakistan while adopting the corporate governance regime can be called the transplantation of such a system that does not accord with the certain pre-requisites that are required to be analyzed. The countries that transplant corporate governance models/codes of corporate governance need to ensure that the code

recognizes the contextual nature of corporate governance and its dependence on the legal, regulatory and institutional environment. Each model has its own unique set of characteristics that suit the dynamics of the countries from where it originated. Other countries and territories try to be like these models and adopt the ones that might fit best with their socio-economic conditions²⁰⁴. The issues of governance vary 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 culture²⁰⁵.

Legal transplantation in itself cannot guarantee the same results in the host countries as they do in the country of its origin. The major factors that can help while determining the success or failure of a corporate governance code transplant include path dependence, complementary institutions, and social and corporate culture. The presence of deeply well-established path dependencies can slow down a successful transplant, if there are marked differences in the newly obtained code and the path that the importing country has been on for many years. Another important concern to help make an imported model to work is to create a fit of the new model with the prevalent institutions in the economy. One institution or code of law, in isolation, cannot undertake the responsibility of corporate governance.

However, we are of the opinion that the above mentioned inherited differences in the continental and Anglo-Saxon could not be stressed upon while adopting the procedure of adoption or transplantation in the case of Pakistan. Hence, it will not be incorrect to say that the adoption of such a rigorous way for the adoption of strong corporate governance practices is an immature action. The underlying point behind is the underdeveloped corporate sector of Pakistan. Rather, it will be justified in saying that at

²⁰⁴ Claessens, S., Djankov, S., and Lang, L.P. (2000) 'The Separation of Ownership and Control in East Asian Corporations', *Journal of Financial Economics*, 58, pp. 81-112

²⁰⁵ Pistor, K., Keinan, Y., Kleinheisterkamp, J., and West, D.M. (2003), 'Evolution of Corporate Law and the Transplant Effect: Lessons from Six Countries' *The World Bank Research Observer*, Vol. 18, No. 1 (Spring 2003), pp.89-112

the time of the implementation of the code, the corporate sector of Pakistan was an infant that required much attention that we could not provide to it.

As the introduction of the code has been analyzed to a great extent in chapter two and chapter three, the exact assessment of the infant corporate sector of Pakistan has been undermined. This is a fact that Pakistan's corporate sector has started its maturity process just at the wake of the 21st century when it attracted foreign direct as well as indirect investment pursuant to major investment policies reform initiatives of the Government. However, it remained un-answered that if at all the corporate sector has gained momentum to a considerable pace, how was it threatened by the enforcement of the code. The alternative strategy could have been to enhance the business ethics and standards through awareness programs by harnessing the capacity of the corporate entities rather than threatening the companies through enforcing the Code.

In the beginning of the chapter, we stated that here we have adopted a comparative perspective; however, at this point we reach towards the conclusion that it is the need of the time to perceive the current needs of the corporate sector of Pakistan in order to provide it a healthy environment for its growth. We should be liberal to adopt the principals that accord with the specifications of our system and we should not limit ourselves to a specific country in such process. This phenomenon is the convergence of the corporate governance models. It has attracted much attention in the developed economies and they are devising new strategies. Hence, first of all we should have grip over the fundamentals and requirements of Pakistan's sector and then adopt the principles required to it, irrespective of the fact whether it is the part of shareholder or stakeholder model.

5.3.1. Performance Ranking of Code of Corporate Governance of Pakistan:

Despite some of the inherent above mentioned problems with the corporate governance regime, Pakistan has shown a good performance in relation to its regional competitors. This has been affirmed in the ROSC assessment of the World Bank wherein Pakistan's corporate governance has shown very positive results as compared to other

countries in the region. The assessment is made according to the OECD principles of corporate governance being a benchmark.

The detail of the assessment and performance raking of Pakistan's corporate governance regime is given in the table 5.1. Although the table shows an appreciable performance, yet there is an immediate need for reviewing the over all corporate governance framework that is at the moment practiced. The focus should be given through priority allocation among the various concerns that are creating hindrance in the way of global competitiveness of Pakistan's corporate sector.

Table 5.1

**Summary of Observance of OECD Corporate Governance Principles:
Pakistan and World Average**

Principle		Pakistan	ROSC Average
I. ENSURING THE BASIS FOR AN EFFECTIVE CORPORATE GOVERNANCE FRAMEWORK			
IA	Overall corporate governance framework	100	N.a
IB	Legal framework enforceable and, transparent	75	N.a
IC	Clear division of regulatory responsibilities	75	N.a
ID	Regulatory authorities have sufficient authority, integrity and resources	75	N.a
II. THE RIGHTS OF SHAREHOLDERS AND KEY OWNERSHIP FUNCTIONS			
IIA	Basic shareholder rights	75	69
IIB	Rights to participate in fundamental decisions	75	64
IIC	Shareholders AGM rights	75	63
IID	Disproportionate control disclosure	50	50
IIE	Control arrangements should be allowed to function	50	56
IIF	The exercise of ownership rights should be facilitated	25	28
IIG	Shareholders should be allowed to consult with each other	75	N.a
III. EQUITABLE TREATMENT OF SHAREHOLDERS			
IIIA	All shareholders should be treated equally	75	56
IIIB	Prohibit insider trading	50	56
IIIC	Board/Mgrs. disclose interests	75	45
IV. ROLE OF STAKEHOLDERS IN CORPORATE GOVERNANCE			
IVA	Legal rights of stakeholders are to be respected	100	69
IVB	Stakeholder redress	50	68
IVC	Performance-enhancing mechanisms	100	68
IVD	Stakeholder disclosure	75	75
IVE	"Whistleblower" protection	50	N.a
IVF	Creditor rights law and enforcement	75	N.a
V. DISCLOSURE AND TRANSPARENCY			
VA	Disclosure standards	75	73
VB	Accounting standards	75	77
VC	Independent audit annually	75	66
VD	External auditors should be accountable to the shareholders	50	N.a
VE	Fair & timely dissemination	75	67
VF	Research conflicts of interests	75	N.a
VI. RESPONSIBILITIES OF THE BOARD			
VIA	Acts with due diligence, care	50	55
VIB	Treat all shareholders fairly	50	49
VIC	High ethical standards	75	68
VID	The board should fulfill certain key functions	50	46
VIE	The board should be able to exercise objective judgment	50	41
VIF	Access to information	100	68

Source: All Completed ROSCs FY02-FY04

Source: Corporate Governance Country Assessment of Pakistan June 2005 page 8.

http://www.worldbank.org/ifa/rosc_cg_pak.pdf (last visited June 2006)

Chapter 6

Conclusion and Policy Recommendations

Corporate governance has attained delicate importance and attention in government policy circles, academic circles, and the popular journalists throughout much of the world especially in the pitch of developed countries. Previously, the term corporate governance was perceived by the majority of people including the top management of the companies and the board members as a strange and technological issue. This study elaborated various reasons explaining its existing importance and sensitivity.

A major corporate governance difference embedded in law relates to board structures i.e. the use of a unitary versus a two-tier board models. However, notwithstanding structural differences between two-tier and unitary board systems, the similarities in actual board practices are significant. Both types of systems recognize a supervisory function and a managerial function, although the distinctions between the two functions tend to be more formalized in the two-tier structure. Generally, both the unitary board of directors and the supervisory board (in the two-tier structure) are elected by shareholders although, as explained in the study, in some countries employees may elect some supervisory body members as well. Typically, both the unitary board and the supervisory board appoint the members of the managerial body i.e. either the management board in the two-tier system, or a group of managers to whom the unitary board delegates authority in the unitary system. In addition, both the unitary board and the supervisory board usually have responsibility for ensuring that

financial reporting and control systems are functioning appropriately and for ensuring that the companies are in compliance with law.

The objective of the study was to critically evaluate the importance of the role of board of directors for ensuring the good corporate governance practices and how their capacity in this regard can be enhanced so as to make them more cost effective and accountable. In line with this objective the research elaborated an in depth review of the strong ownership patterns in the stocks of the companies hence, reducing the efficacy of the performance by the board of directors. In the same way the institutional investors perspective has been discussed along with their benefits for good corporate governance regime in Pakistan.

All these issues and concerns could not be addressed properly and effectively without elucidating the current trends in the development of the international corporate governance practices in the wake of global corporate market. In addressing the main concerns of the Pakistan, corporate governance regime the study also analyzed the importance of the role of the regulators for ensuring compliance with the code at individual as well as collective level.

The developed countries are devising new frameworks for re-shaping their legal and economic regimes in accordance with the requirements of the contemporary businesses i.e. either convergence or innovations in the corporate governance models. As Pakistan inherited its legal regime that of UK, in the same way it also adopted the same model as practiced in UK i.e. shareholder model of corporate governance (Anglo-Saxon). Hence, to fulfill the requirement of being representative of the problems that are peculiar to Pakistan, the study analyzed the efficacy of the Anglo-Saxon model of corporate governance adopted by Pakistan.

It was found that although Pakistan is following the one-tier board model but the corporate governance can be effectively addressed through the two tier board model in the perspective of the current characteristics of the Pakistan's corporate sector. In

order to effectively promote corporate sector, it is proposed to adopt Common Strategic Framework for Pakistan.

Although Pakistan stands at good position as compared to the world average compliance of the codes, there is still an urgent need to address the neglected areas of corporate governance regime.

Policy Recommendations:

In the light of the findings of this study following policy actions are recommended to be taken to enhance the role of board of directors and efficacy of corporate governance in Pakistan;

1. Since the socio-economic circumstances of Pakistan are much different so any one model is inappropriate. We must have a convergence model, based on one-tier and two-tier models with flexible provisions, which might allow the required changes in future.
2. There must be an internalization of corporate governance in the affairs of the companies so that maximum compliance could be ensured without focusing upon unnecessary regulations by the regulators. But the door of required legislation should ever remain open.
3. To meet the international standards, an independent board of directors should be activated as per the provision of the code of corporate governance, eliminating the old system of family based boards which is common practice in Pakistan. Awareness among the current directors regarding the fiduciary, duty of loyalty and care must be systematically enhanced. Moreover, the independent directors should be offered attractive remuneration packages, so that competent directors can work on the boards of companies.
4. An active audit committee under the independent chair should be appointed as it is the key that attracts the investors.
5. Some of the countries have declared director trainings compulsory for a person who intends to act as a director of the any company. However Pakistan

Institute of Corporate Governance has started its efforts for generating awareness of the sensitivity of corporate governance and its potential benefits. Yet more is to be done practically to meet the frequent changes in the trends of contemporary corporate governance.

6. To mobilize private sector in the wake of corporate governance, a performance based set of checklist should be introduced to attract the voluntary compliance by the companies. In this regard special concessions (e.g., tax rebates/subsidies,) and awards of excellence can be incorporated, to boost the efficiency and motivation of the directors.

7. Last but not the least, there should be an interface between various regulators of corporate sectors which has not yet been given attention and rather has been neglected to a large extent. Hence, the study proposes "Common Strategic Framework" (CSF) that can enhance the current state of compliance of corporate governance regime in Pakistan. This CSF should comprise of a collective thought provoking effort of all regulators (whether general or industry specific), in collaboration with academic institutions, under the umbrella of Pakistan Institute of Corporate Governance, focusing on policy dialogues, harmony of legal framework, trainings, incentives, promotion of corporate governance practices and promotion of fair competition.

Bibliography

Books

1. Adolf A. Berle & Gardiner C. Means, 1932. 1991. *The Modern Corporation and Private Property*. Transaction Publisher, New Brunswick, New Jersey.
2. John Armour, Joseph McCahery. 2006. *After Enron: Improving Corporate Law and Modernising Securities Regulation in Europe and the US*. Hart Publishing, Oxford.
3. Randall K Morck. 2005. *A History of Corporate Governance Around the World: Family Business Groups to Professional Managers*. University of Chicago Press.
4. Joseph A. McCahery, Piet Moerland, Theo Raaijmakers, Luc Renneboog. 2002. *Corporate Governance Regimes - Convergence and Diversity*. Oxford University Press.
5. George Bermann and Katharina Pistor. 2004. *Law and Governance in an Enlarged European Union*. Hart Publishing Oxford.
6. W. Hamilton, *Cases and Materials on Corporations--Including Partnerships and Limited Liability Companies* (1st ed. 1976) Thomson West.
7. *Companies Ordinance*, 1984.

Research Articles:

1. Abdel-Khalik, A. Rashad, Kie A. Wong, and Annie Wu, 1999. "The Information Environment of China's and B Shares: Can We Make Sense of the Numbers?" *Journal of International Accounting*. Vol. 34, No. 4, pp. 467-489.
2. Aguilera V. Ruth (January 2004). "*CORPORATE GOVERNANCE*" Department of Business Administration College of Business & Institute of Labor and Industrial Relations University of Illinois at Urbana-Champaign
3. Arthur J. Goldberg, Debate on Outside Directors, *N.Y. Times*, Oct. 29, 1972.

4. Asif and Rais, 2004. "Regulatory Impact Assessment (RIA) of SECP's Corporate Governance Code in Pakistan". May 2004. Also available at http://ravi.lums.edu.pk/cmer/upload/regulatory_impact_assesment.pdf
5. Bari, F. Cheema, A and Siddique, O., 2003. "Corporate Governance in Pakistan: Ownership, Control and the Law". LUMS, Lahore, Pakistan
6. CCX International. 2001. *2001 China Listed Company Reports*. China Finance and Economics Publishing, Beijing, pp.68-69.
7. Cha, Laura M. 2001. "The Future of China's Capital Markets and the Role of Corporate Governance." Luncheon Speech at China Business Summit, April 18, Vice Chairman, China Securities Regulatory Commission.
8. Chakrabarti Rajesh, 2005 Corporate Governance in India – Evolution and Challenges. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=649857
9. Cheema A. 2003. "Corporate Governance in Pakistan: Issues and Concerns". *The Journal*, Vol-8 No.2 NIPA Karachi, Pakistan.
10. Claessens, S., Djankov, S., and Lang, L.P. (2000). "The Separation of Ownership and Control in East Asian Corporations." *Journal of Financial Economics*, 58, pp. 81-112
11. Clarke, T. (2001). "Risks and Reforms in Corporate Governance in 3R's of Corporate Governance, Responsibilities, Risks and Reform". Malaysian Institute of Corporate Governance: Kuala Lumpur, pp.116-139
12. DeFond, Mark L., T. J. Wong, and Shuhua Li, 2000. "The Impact of Improved Auditor Independence on Audit Market Concentration in China." *Journal of Accounting and Economics*. Vol. 28, No. 3, pp. 269-305.
13. Doe, Julianne and Winnie W. Y. Chan, 2001. "Towards Better Corporate Governance: China's Continuing Struggle." *International Financial Law Review*. London, pp. 21-28.
14. Esther Jeffers, 2005. "Corporate governance: Toward converging models?". *Global Finance Journal* 16 page 221– 232.
15. Fama, E. F. and Jensen, M. C. 1983a. "Agency Problems and Residual Claims." *Journal of Law and Economics*. Vol. 26, pp. 327-349.
16. Fama, E. F. and Jensen, M. C. 1983b. "Separation of Ownership and Control." *Journal of Law and Economics*. Vol. 26, pp. 301-326.

17. Finance Committee on Corporate Governance, " Report on Corporate Governance", February 1999, pp197-198
18. Global Corporate Research Council of the Conference Board, 845 Third Ave., New York, N.Y. 1998 reports
19. Ho, Simon S. M. 2002. "Corporate Governance and Disclosures in Hong Kong: Key Problems and Prospects." *Centre for Accounting Disclosure and Corporate Governance, School of Accountancy, The Chinese University of Hong Kong.*
20. Hussain, Ishrat, 2005. "Corporate governance in financial sector of Pakistan". *Institute of Business Administration Karachi Pakistan*
21. Introduction to the Malaysian Code on Corporate Governance (2000), para 1.3, 1.4, Investors Digest, February 2002, Kuala Lumpur, p5.
22. James Shinn and Peter Gourevitch, 2002. How Shareholder Reforms Can Pay Foreign Policy Dividends. (New York: Council on Foreign Relations, 2002), pp.5-6.
23. Jensen, M.C. and W. H. Meckling. 1976. "Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure." *Journal of Financial Economics*. Vol. 3, pp. 305-350.
24. Kuala Lumpur Stock Exchange & Price Waterhouse Coopers, Survey, 2002. "the Joint Kuala Lumpur Stock Exchange-Price Waterhouse Coopers Survey on Corporate Governance" (25 April), online: Price Waterhouse Coopers <http://www.pwc.com/Extweb/ncsurvres.nsf/docid/>
25. La Porta R, Lopez-de-Silanes F, Shleifer A. 2002a. "Government ownership of banks." *Journal of Finance* 57(1): page 265-301
26. Lin, Thomas. And Yunwei Tang. 2001. "China's Securities Market and Accounting Disclosure Requirements: Current Problems and Suggested Solutions." *Working Paper*
27. Maassen Francesco (Gregory 3rd Edition). "An International Comparison of Corporate Governance Models." A Study on the Formal Independence and Convergence of One-tier and Two-tier Corporate Boards of Directors in the United States of America, the United Kingdom and the Netherlands.
28. Mahmood and Sharif. "Institutional shareholders and their role in promotion of corporate governance in Pakistan. Available online http://www.secp.gov.pk/divisions/Portal_CS/WorkingPaperCorpGov.htm

29. McKinsey Investor Opinion Survey, June 2000
30. Mumtaz, Mahwesh, 2004. "Corporate Governance in Pakistan: *Adopt or Adapt?*" *University of Cambridge Research Paper*.
31. Myles Mace, Directors, 1971. Myths and Reality. pp184-90.
32. Nazir Ahmad Shaheen, 2004 ed. "Practical Approach To The Companies Ordinance, 1984"
33. Nicolai Ronnebek Hinrichsen, The Constitutional Objection to European Union Membership: A Challenge For the Danish Supreme Court, 15 B.U. INT'L L.J. 571, 576 (Fall 1997).
34. OECD (1999) "OECD Principles of Corporate Governance" issued by OECD, Roundtable on Corporate Governance, White Paper on Corporate Governance in Asia (2003), online: Organization for Economic Co-operation and Development <http://www.oecd.org.coporate>
35. OECD. 1998. Proceedings on Corporate Governance, State-owned Enterprises and Privatization, *Organization for Economic Co-operation and Development*.
36. Pistor, K., Keinan, Y., Kleinheisterkamp, J., and West, D.M. (2003), "Evolution of Corporate Law and the Transplant Effect: Lessons from Six Countries" *The World Bank Research Observer*, Vol. 18, No. 1 (Spring), pp.89-112
37. Principles of Corporate Governance (endorsed by the Ministers at the OECD Meeting, May 26-27, 1999), Paris, OECD, 1999, www.oecd.org.
38. Ravindran, S. (2003). Murthy Panel Agrees to Level of Compliance. March 20, www.rediff.com
39. Report on Corporate Governance (2002), Finance Committee on Corporate Governance in Malaysia.
40. Robert B. Thompson and D. Gordon Smith, 2001. "Toward a New Theory of the Shareholder Role: "Sacred Space" in Corporate Takeovers". TAX. L. REV. 261, 268 (2001).
41. Robert K. Rasmussen and Douglas G. Baird,. "*The Prime Directive*". available at http://papers.ssrn.com/sol3/Papers.cfm?abstract_id=930187.
42. Robert W. Hamilton, Cases and Materials on Corporations--Including Partnerships and Limited Liability Companies (1st ed. 1976).

43. Roe, M., (2000). "Political preconditions to separating ownership from corporate control". Working Paper, Columbia Law School.
44. Sarbanes-Oxley Act of 2002, H.R. 3763, 107th Cong. (2002).
45. Schipani, Cindy. A. and Junhai Liu. 2001. "Corporate Governance in China: Then and Now", *Working Paper*. Can be seen at www.iolaw.org.cn/en1/art5.asp
46. Shleifer, Andrei and Robert W. Vishny, 1997. "A survey of corporate governance." *The Journal of Finance*, vol. LII, no.2, 737-783.
47. Shleifer, Andrei and Vishny, Robert W. (1997). "A Survey of Corporate Governance". *Journal of Finance*, (2):737-783.
48. Tam, On Kit, 2002. "Ethical Issues in the Evolution of Corporate Governance in China." *Journal of Business Ethics*. May, Vol. 37, No. 3; Part 2, pp. 303-320.
49. Tenev, Stoyan and Chulin Zhang, 2002. Corporate Governance and Enterprise Reform in China. *World Bank and the International Finance Corporation*.
50. U.S. Securities and Exchange Commission "Corporate Governance Rule Proposals Reflecting Recommendations to the NYSE Corporate Accounting and Listing Standards Committee", November 4, 2003 available at www.nyse.com
51. Weil, Gotshal wqw& Manges LLP, on behalf of the European Commission, Internal Market Directorate General, Comparative Study of Corporate Governance Codes Relevant to the European Union and its Member States (January 2002) available at www.europa.eu.int/comm/internal_market/en/company/news/corp-gov.
52. Xiao, Jason Zezhong, Yikuan Zhang, and Zhihua Xie, 2000. "The Making of Independent Auditing Standards in China." *Accounting Horizons*. Vol. 14, No. 1, March, pp. 69-89.
53. Zhang, Yiyong, 2000. "Independent Directors Should Not Become the Deaf Ears." *China Economics*. October 10. Page 17.
54. Muhammad Bakhsh & Sons Ltd. v Azhar Wali Muhammad 1986 MLD 1870 (Karachi).
55. Shahid Saigol v Kohinoor Mills Ltd. PLD 1995 Lahore 264.
56. Haroon Ayoob Abdul Karim v Sulleman Ahmad and 4 others 1983 CLC 162 (Karachi).

Weblography

1. Code of Corporate Governance www.ecgi.org/codes/code.php?code_id=90
2. Williams Act, 15 U.S.C. §§ 78l-78n (1994),
3. www.adb.org/Documents/Fact_Sheets/PAK.asp?p=ctrypak
4. www.csrc.org *China Securities Regulatory Commission*
5. www.kse.com.pk/
6. [www.kse.com.pk/progress repot](http://www.kse.com.pk/progress%20repot) . Last visited 16th November, 2006.
7. www.oecd.org/daf/corporate/principles/ "Principles of Corporate Governance"
Issued by OECD in 2004
8. www.oecd.org/daf/corporate-affairs OECD (2003), "*Roundtables on Boardrooms*", OECD Observer No. 238, July, 2003 and OECD (2003), *Experiences from the Regional Corporate Governance Roundtables*
9. www.kse.com.pk/companies/delisted Last visited 20th November, 2006.
10. www.oecd.org/bookshop OECD (2004), *Corporate Governance: A Survey of OECD Countries*, Paris.
11. The Creation of the European Community, at [http:// eurolandia.tin.it/euro/eng/documenti/percorsi/perl.htm](http://eurolandia.tin.it/euro/eng/documenti/percorsi/perl.htm)
12. www.oecd.org/dataoecd/38
13. www.secp.gov.pk/divisions/Portal_CS/WorkingPaperCorpGov.htm
14. www.worldbank.org.pk
15. www.worldbank.org/ifa/rosc_cg_pak.pdf
16. www.secp.gov.pk/divisions/Portal_CS/Publications.htm