



**PRIVATE RENT SEEKING BY INSIDERS, AND MINORITY
SHAREHOLDERS' PROTECTION IN PUBLICLY HELD
CORPORATIONS IN PAKISTAN**

BY

ASMAH SYED

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ABSTRACT

Investor protection has been the prime focus of recent research. Minority shareholders' rights and their protection have been considered important for good corporate governance. If the rights of minority shareholders are not protected, then there would be an increase in the agency cost and will also enhance the cost of raising external finance. Weak corporate governance increases agency cost. In Pakistan, the minority shareholders rights are not protected in the manner that could attract investment from outsider investors. The high agency cost in Pakistan is one of the main reasons of general public investment in public listed companies. The minority shareholders rights are provided in different corporate laws of Pakistan, but the problem is with its compliance and enforcement in true spirit. Enforcement mechanism can be enhanced by different means such as more powerful regulator can ensure compliance to minority shareholders rights. Furthermore, if more powers are given to the Securities and Exchange Commission of Pakistan (SECP) and Stock Exchanges, this may solve some problems of compliance and enforcement. Some judicial powers may also be delegated to SECP for effective enforcement. The reduced agency cost with effective enforcement of minority shareholders rights is important for good corporate governance which can ensure investment in equity market of Pakistan.

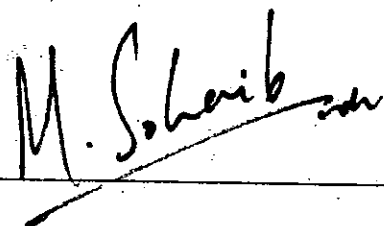
FINAL APPROVAL

It is certified that we have read the dissertation submitted by Ms. Asmah Syed, Registration No. 262-FSL/LLMCL/F09 on "**Private Rent Seeking by Insiders, and Minority Shareholders' Protection in Publicly Held Corporations in Pakistan**" in Department of Law, Faculty of Shariah & Law. We have evaluated the dissertation, and found it upto the requirements in its scope, and quality by the International Islamic University, Islamabad, for award of LL.M Corporate Law Degree.

VIVA VOCE EXAMINATION COMMITTEE

SUPERVISOR:

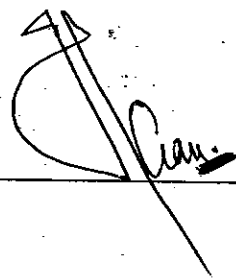
Mr. M. Sohaib Sheikh

A handwritten signature in black ink, reading "M. Sohaib", written over a horizontal line.

INTERNAL EXAMINER:

Dr. Inam Ullah Khan

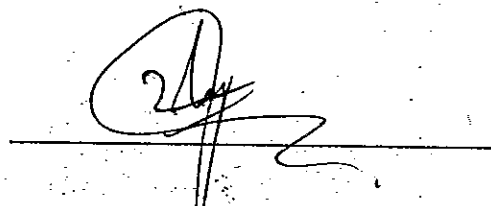
Asstt. Professor, Faculty of Shariah & Law, IIUI.

A handwritten signature in black ink, reading "Inam", written over a horizontal line.

External Examiner:

Mr. Misbah-ul-Mustafa

Kondi & Kondi Associate Lawyer

A handwritten signature in black ink, reading "Misbah", written over a horizontal line.

DECLARATION

This is hereby declared that this thesis has not been copied from any source. This is further declared that this research has entirely been done on the basis of my personal efforts made under sincere guidance/advice of my worthy supervisor. No portion of work substantially presented herein has been submitted in support of any application for any other degree or qualification of this University or any other university or institute of learning.

Asmah Syed ,

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DEDICATION

This Thesis is dedicated to my parents, who have throughout been a source of inspiration, and gave all-out support to me.

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I would like to acknowledge my gratitude to my parents who supported me in acquiring higher degree. I am also thankful to my supervisor Mr. Sohaib Sheikh, and my respectable teachers Dr. Muhammad Munir, and all others teachers, colleagues and friends who supported me for this research. I am especially thankful to my teacher Mr. Imtiaz Ahmed Khan who inspired me to pursue and conduct research on this topic. He guided me on every step of research in completion of thesis. I am also thankful to all others who helped me out to conduct and complete this project.

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ABBREVIATIONS & ACRONYMS

AGM	Annual General Meeting
CLA	Corporate Law Authority
CO	Company
CO. LTD	Company Limited
CRO	Company Registration Office
EOGM	Extra Ordinary General Meeting
EC	European Community
ECC	European Community Council
GDP	Gross Domestic Product
LLP	Limited Liability Partnership
LTD	Limited
MMC	Multi Members Private Company
PC	Public Company
PVT	Private
RPT	Related Party Transactions
SECP	Securities and Exchange Commission of Pakistan
SMC	Single Member Company
SRO	Statutory Regulatory Order
UK	United Kingdom

LIST OF CASES

1. *Atlos Autos Ltd and another v Registrar Join Stock Companies* (1991 CLC 523)
2. *Brooke Bond Pakistan and another v Aslam Bin Ibrahim and another* (1997 CLC 1873)
3. *Bawany Sugar Mills v Securities and Exchange Commission of Pakistan* 2003
4. *Carpenter v United States* (1987) 484 USA 19
5. *Dewan Salman Fibre Ltd Islamabad v Dhan Fibres Ltd Rawalpindi* (PLD 2001 Lahore 230)
6. *Ebrahimi v Westbourne Galleries Ltd* [1973] AC 360
7. *Kohinoor Raiwind Mills Ltd v Kohinoor Gujar Khan Mills* (2002 CLD 1314)
8. *Lipton (Pakistan) Ltd and another* (1989 CLC 818)
9. *Phizer Laboratories Ltd* (2003 CLD 120)
10. *Pak Water Bottlers (Pvt.) ltd and 2 others* (2003 CLD 1624)
11. *Pakland Cement Ltd* (2002 CLD 1392)
12. *Pakistan in Associated Biscuits International Ltd v English Biscuits Manufacturers (pvt.) Ltd*, (2003 CLD 815)
13. *Pfizer Laboratories ltd and another* (2003 CLD 1209)

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CHAPTER ONE

BACKGROUND OF THE STUDY

1.1 INTRODUCTION

Recent financial crisis all over the world triggered States to reform their corporate sector. Capital market of Pakistan is underdeveloped that is main reason of bad corporate governance. Pakistan is an emerging market and there have been some reforms in recent years. Global trend of reforming their corporate sector also required that corporate sector of Pakistan should be improved. Investor protection is considered important for good corporate governance which ensures investment in the country. This investment can be from local as well as from foreign investors. Minority shareholders do not have access to management of the company because they do not have enough voting to elect any director on the board of directors of the company. They also do not have enough voting to have any say in the general meetings of the company. The decisions are made by the majority shareholders and therefore they decide what favors to them. This phenomenon provides private rent seeking opportunities to majority shareholders and managers of the company. Expropriation of funds of the company causes bad governance and discourages investment. There are many ways of getting private benefits by the majority shareholders. The directors and managers are appointed by the majority shareholders therefore they work for the interest of majority shareholders. The majority shareholders appoint directors from their family, relatives and close friends. They are given high pay and privileges, loans on discounted rates and other privileges. This provides them opportunities to expropriate the funds by tunneling of funds. They can make transactions to other companies, where they have more interests, at favorable terms and conditions. They invest in associated companies and associated

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undertaking for purpose of tunneling funds to get more advantages. This provides opportunities to tunnel funds at the cost of minority shareholders.

Minority shareholders are not in position to make accountable to managers and directors. This phenomenon increases cost of agency. Minority shareholders rights are provided in the corporate sector of Pakistan but problem is their compliance in enforcement. For instance, the Companies Ordinance, 1984 (hereinafter referred as 'Ordinance') provides procedure for election of directors which favor minority shareholders to elect director on the board of directors and similarly the Code of Corporate Governance 2002 and the Code of Corporate Governance 2012 encourage minority representative on the board of directors but practically this is not done. There are some other minority shareholders rights but problem is their compliance and enforcement. If shareholders rights are enforced then this may decrease agency cost and protect minority shareholders rights.

The judiciary is main source of providing enforcement mechanism but the judiciary of Pakistan is not efficient due to number of reasons. The cases are delayed and corruption is deeply rooted in the system. The lack of facilities and backlog of cases are also a problem in disposal of cases. The judges are not expert in corporate sector and this cause inefficiency in the system. SECP has not enough powers to adjudicate the corporate conflicts. Some powers may be delegated to SECP and Stock Exchanges for speedy disposal of cases.

This will ensure good governance and sense of protection to the minority shareholders. This research focuses on shareholders rights and their protection in context of Pakistan. Author will try to trace out the reasons of agency cost and means of ensuring minority shareholders rights in public listed companies in Pakistan. The research also focuses on the ways and means

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of reducing agency cost in Pakistan. Author will try to discuss these issues in context of Pakistan and try to suggest improvement in corporate governance.

Corporate sector in Pakistan is highly concentrated where families and State hold major businesses. Families and State own and control substantial numbers of companies both as private and public companies. Families and State control companies in different ways. Common way to control companies is to hold majority shareholding, where they have at least 51% shareholding or more. This allows them to control the companies and consequently have control over the management. There are some dispersed shareholdings but that is a rare phenomenon. Some shareholders have shareholdings in blocks but their percentage is not enough to challenge the control held by families and State.¹

The control both by State owned enterprises and family based corporations seek benefits due to their position on the cost of minority shareholders. This phenomenon is called private rent seeking. These private benefits includes the inside trading by the beneficial owners², high pay and privileges to related persons (family member in case of family owned enterprise and politically motivated personnel in case of state owned enterprises), funds flow, related party transactions³ loans to directors, investment in associated companies⁴ etc. The insiders,⁵ are those

¹ Imtiaz Ahmed Khan, "Role of International Organizations in promoting corporate governance in developing countries- A case study of Pakistan" *International Company and Commercial Law Review* 23, 7 (2012), at 223.

² The term beneficial owner has been defined in Section 220 of the Companies Ordinance, 1984. This means the director, chief executive, managing agent, chief accountant, secretary or auditor of the company, and person holding at least 10% shareholding in the company.

³ A transaction is called related party transaction when it is made with family member's suppliers, distributors, exporters etc as well as any contract with a company owned by the same group.

⁴ The word 'Associated Companies' is defined in S. 2(2) of the Companies Ordinance, 1984. Associate Relation exists in the following situations:-

- i) Owner, partner or director of a company or undertaking holds or controls shares with at least 20% control in some other company or undertaking;
- ii) Those companies which are under common control;
- iii) One company is the subsidiary of other company; and
- iv) A Modaraba managed by a company

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persons who are either majority shareholders or control the corporation either through member of executive or non-executive post on either board of directors or on management side, control the corporation either through member of executive or non-executive post on Board of Directors. They are also involved in management by appointing family members on key executive posts. This phenomenon is against the interests of minority shareholders. The Companies Ordinance, 1984 and the Code of Corporate Governance, 2002 provides an opportunity to the minority shareholders to appoint member on the board but practically this is not an easy task. Many rights are provided to the shareholders and especially to the minority shareholders but again the problem is their enforcement. Strong families and political forces resist reforms which are meant to provide fair play. Corruption is the main hindrance in good governance. The cost of investment is very high due to expropriation of company's resources by the insiders. This also affects rate of return on the investment in the form of dividend. Many companies do not pay dividends to its shareholders because they normally show loss. This loss is mainly because of mismanagement and expropriation. Many reforms have been made during the last 10 years or so with establishment of Securities and Exchange Commission of Pakistan (SECP) replacing erstwhile Corporate Law Authority. Many powers were given to SECP through the SECP Act 1997. SECP took a number of steps for good governance.⁶

The SECP with the help of Chartered Accountants of Pakistan and Institute of Corporate Governance in Pakistan is working on developing good corporate governance regime where the investor are protected and the dominant groups can be restricted to take benefits due to their positions in the forms of private rent seeking. The number of proposals have been initiated and

This precise definition of the word associate is given in, Nazir Ahmed Shaheen, *Practical Approach to the Companies Ordinance 1984* (Rawalpindi: FLH, 2011) 7.

⁵ Rafael La Porta, Lopez-de-Silanes, Shleifer and Vishny, *Investor Protection and Corporate Governance Journal of Financial Economics* 58(2000) at 22.

⁶ Khan, "Role of International Organizations," at 229-232.

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implemented by the Apex Regulator⁷ through amendments in the laws, rules and regulations as well as by introducing reforms through structure of Apex Regulator, Stock Exchanges. One of the major steps taken by the Apex regulator was the issuance of Code of Corporate Governance in March 2002. As per international practice⁸, SECP started revision of the Code after the lapse of almost ten years to incorporate further developments and shortcomings in previous versions of the Code. It, therefore, issued draft Code of Corporate Governance for public opinions. The final revised version of the Code was issued in April 2012 with important amendments keeping in view new developments and requirements since issuance of the first Code. The Code was included in listing regulations of all stock exchanges operating within Pakistan. Some other powers were transferred to SECP from courts. Many amendments were made in the laws. SECP issued a number of rules and regulations. The problem was, however, the implementations and enforcement of these laws, rules, regulations and Code. The judicial enforcement is another problem in this regard. A good enforcement both at administrative and judicial level can ensure good governance. This good governance can reduce agency cost and provide relief to minority shareholders. This will help to develop market and boost economy.

This phenomenon is not limited to Pakistan or other developing countries. A lot of work has been done in other jurisdictions including the United Kingdom (UK) and the United States of America (USA). They have identified different issues of the private rent seeking, safeguard of minority shareholders and abuse of powers by the controlling shareholders. They have also discussed different means to resolve the same. Pakistan can take benefits of these jurisdictions to

⁷ Securities and Exchange Commission of Pakistan is an apex regulator in Corporate Sector which was established through The Securities and Exchange Commission of Pakistan Act, 1997 which was operative on 1st of January, 1999.

⁸ Major jurisdictions revised their Code of Corporate Governance after certain period of time. The objective is to accommodate new developments and needs. For example, the UK issued its first Code in 1992 and later on issued revised versions of the Code in 2003, 2006, 2008 and 2010.

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improve good governance. This research focuses on private rent seeking by the controlling shareholders and protection of minority shareholders in context of publically held corporations in Pakistan.

1.2 STATEMENT OF PROBLEM

In this research, the researcher has tried to discuss four issues. Firstly, what are the private rent seeking channels in Pakistan through which the insiders expropriate the funds of company at the cost of minority shareholders? Secondly, what are the reasons of high agency cost in corporate governance in Pakistan? Thirdly, what are the problems of compliance and enforcement of minority shareholders problems in corporate sector of Pakistan? Fourthly, what are the means and mechanism for reducing agency cost and enforcement of minority shareholders rights in Pakistan?

1.3 HYPOTHESIS

Researcher considers that good corporate governance with effective enforcement mechanism can reduce agency cost and ensure compliance to minority shareholders rights. This mechanism of reducing agency cost and improved enforcement can be effective in underdeveloped market of Pakistan.

1.4 LITERATURE REVIEW

There is scarcity of material in Pakistani context of Corporate Law. Some scholars have done some work on corporate governance of Pakistan.

Ghani and Ashraf have discussed business groups and their impact on corporate governance in Pakistan. They concluded that the expropriation of minority shareholders is main

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phenomenon of business groups in Pakistan. Business groups especially the family owned enterprises controlled the companies through different means and use their dominance for their personal benefits at the cost of the minority shareholders. Families owned enterprises appoint family members, relatives or close friends on the board of directors who work to safeguard their interests instead of company as a whole.⁹ Their study was limited to effect of family owned enterprises on firm performance. They did not discuss the solution of minority shareholders protection.

Ali Cheema and others have discussed nature of corporate governance in Pakistan. They have also examined effect of ownership structure and control on corporate governance in Pakistan. They find that concentration of ownership in corporate sector is a main reason for underdevelopment of corporate governance in Pakistan. This underdeveloped market provides them opportunities to expropriate funds of the firms. The status quo always favors vested interests as good governance may make them accountable to the owners. Owners always try to get maximum benefits out of their investment but weak governance hinder for such maximization of their investment. The dominant shareholders and managers have more opportunities in underdeveloped market and bad governance.¹⁰ This is a comprehensive study in respect of highlighting history and causes of development of corporate sector in Pakistan. They have discussed agency cost in Pakistan and describe judicial reform as one solution for reducing such agency cost but they did not underline specific judicial reform process for such a resolution.

Rasul Bakhsh and other have examined regulatory impact assessment of SECP's corporate governance code in Pakistan. They concluded that there is trend of acceptance of code

⁹ Ghani W.I. and J. Asharaf, "Corporate Governance, Business Group Affiliation and Firm Performance: Descriptive Evidence from Pakistan" *LUMS (CMER W.P. No. 05-35)* (2005), at 1-26.

¹⁰ Ali Cheema, Faisal Bari and Osama Siddique, "Corporate Governance in Pakistan: Issues of Ownership, Control and the Law" *LUMS paper series* (2003): 57-59.

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by the business groups but there is need of more rigorous implementation of the Code in light of prevailing corporate structure of Pakistan.¹¹ The study was based on analysis of interviews of stakeholders conducted by the author. They did highlight that there is need of rigorous implementation of the code but they failed to highlight problem of enforcement of code. The problem of true implementation of the Code of Corporate Governance 2002 and subsequent code issued by SECP in 2012 is the nature of code itself. The problem lays the way in which it is operated. Implementation of code is compulsory as this is part of listing regulations but the way it is implemented is defective in the sense that the companies are required to just include in their annual reports a statement of compliance without being giving any evidence of true spirit. Underdeveloped market is also not efficient enough to ensure its implementation. Developed market can encourage as well force companies to comply with code as this may punish defaulting companies in different ways. One way is to lower share price of the company. Other way is to remove non performing managers from the board but the question is whether family owned companies will remove director from the board who is part of family? This is very significant question in Pakistan where most of the businesses are controlled by the families.

Mahwish Mumtaz has discussed problems of corporate governance in Pakistan. She highlighted the need of implementation of Code of Corporate Governance 2002 according to prevailing circumstances of Pakistan. She concluded that implementation of foreign corporate governance reforms in Pakistan may be counterproductive keeping in view the social, economic and political situation of Pakistan. She emphasized phase implementation of the Code and development of other supporting institution of Pakistan. This may improve corporate governance

¹¹ Rasul Bakhsh Rais and Asif Saeed, "Regulatory Impact Assessment of SECP's Corporate Governance Code in Pakistan" LUMS Paper Series, *CMER Working Paper No. 05-39 (2005)* at 13-14.

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in Pakistan.¹² She has not discussed and explored the ways and means to improve supporting institutions. Supporting institutions such as Stock Markets, Financial Institutions and Institutional Investors can also play their role in improving governance mechanism.

Osama Siddique has discussed in detail the judicial problems concerning Pakistan. He is of the view that the focus of reform programs conducted by Asian Development Bank in 2001 and United States Aid in 2009 in Pakistan were not successful as focus of first programme was on backlogs and reducing delays by increasing number of judges in the courts. The second program 'enhancing the justice with Pakistan' was also not successful due to conflict between Pakistan Government and USAID. He further stated that the judicial problems of Pakistan may not be resolved by increasing number of judges and increasing the budget of the judiciary. The judicial problems need special attention by the policy makers.¹³ This study was focused on judicial reforms in context of general judicial system of Pakistan. He did not discuss judicial problems in context of corporate sector of Pakistan.

Reports on the Observance of Standards and Codes (ROSC) are conducted by International Monetary Fund (IMF) and World Bank to assess weaknesses of corporate governance of developing countries and to highlight issues of corporate governance in these developing countries and suggest different measures to improve the same. For this purpose, the World Bank and IMF conducted report on corporate governance of Pakistan in 2005. This report

¹² Mahwesh Mumtaz, 'Corporate Governance in Pakistan-Adopt or Adapt? Paper presented at a conference at Lahore on 3-5 June 2005 organized by Securities and Exchange Commission of Pakistan (regulator) and Lahore University of Management Sciences, Lahore. Available at <<http://cmer.lums.edu.pk/Conference2005/images/CG%20in%20Pakistan-%20Adopt%20or%20Adapt.pdf>> accessed on 20.10.2012 (This was thesis presented in University of Cambridge for partial fulfillment of degree of LLM) at 27-29.

¹³ Osama Siddique, 'Approaches to Legal and Judicial Reform in Pakistan: Post Colonial Inertia and the Paucity of Imagination in Times of Turmoil and Change' (2011) *Development Policy Research Centre DPRC Working Paper 4*, LUMS, Lahore available at <http://dprc.lums.edu.pk/components/com_publications/attachments/DPRC-WP4-Siddique.pdf> accessed 18.10.2012.

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highlighted agency problem and investor protections as main causes of concern for policy makers. The report further stated that institutional incapacity and weak enforcement mechanism are main hindrance in investor protections. These require reforms for development of corporate governance in Pakistan.¹⁴ This type of report highlights causes and concerns of corporate sector of a particular country in order to provide guideline to policy makers for concerned country.

Ali Adnan has discussed challenges which SECP may have to face in new corporate scenario. Delay in judicial decisions is one of main problems in providing justice to common citizens in general and corporate sector in particular. His observation was that as per routine of decisions in Pakistan cases normally take four to six years in courts of first instance and subsequent appeal can further extends this duration.¹⁵ This study is limited to challenges which SECP may have to face after its reform agenda. This study has narrowly approached the issues concerning corporate sector of Pakistan in new era of reforms taking place all over the world.

Imtiaz Ahmed has discussed in detailed the nature of corporate governance in Pakistan and the role of financial institutions in developing good corporate governance in Pakistan. His conclusion is that financial institutions have contributed in improving good governance but lack of enforcement is a hurdle in such reforms. The recent financial crisis triggered good corporate governance all over the world and Pakistan was not an exception to it. International bodies especially the financial institutions were engaged in improving corporate governance in developing countries and they invested money to improve governance of these countries. The international financial institutions provided loans to developing countries including Pakistan in this regard. But problem could not be resolved as these financial institutions did not focus on

¹⁴ The World Bank and IMF Report on the Observance of Standards and Codes (ROSC) June 2005 on Pakistan - available at <http://www.worldbank.org/ifa/rosc_cg_pak.pdf> latest accessed on 20.10.2012.

¹⁵ Ali Adnan Ibrahim, 'Corporate Governance in Pakistan: Analysis of Current Challenges and Recommendations for Future Reforms', *Washington University Global Studies Law Review* 5, 323 (2006): 323-332.

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enforcement mechanism of Pakistan. This has limited fruit of reforms.¹⁶ This study was limited to role of international organizations with reference to their interest in Pakistan. International financial institutions focus on reforms which are directly related to their interests.

Attiya has discussed in detail corporate ownership in Pakistan. She concluded that weak investors' rights are the main problems in Pakistan in attracting investment. She further added that the protection is required for both majority and minority shareholders. Weak enforcement is one reason of state of ownership structure in Pakistan. Investors need some legal protection of their financing and concentration of ownership is one reason of this phenomenon. She concluded that the required protection for both majority and minority shareholders is defective in the sense that majority shareholders make blocks to protect themselves. However, the minority shareholders may not insist on making blocks because this limits their ability of diversification of investment. If minority shareholders rights are protected, then they may enjoy diversification and get maximum benefits instead of making blocks. Other reasons of becoming majority are to get private benefits of their holdings. They control the firms so that they can appoint directors and control the management and get benefits of this control. Good governance can stop expropriation of funds rather than providing them more rights.¹⁷ She, however, did not discuss in detail how the minority shareholders can be protected in context of Pakistan.

Sikandar A Shah has discussed in detail mergers and the rights of minority shareholders in Pakistan. He has discussed protection of minority shareholders in the context of mergers and acquisition in Pakistan. He also discussed the role of courts in safeguarding rights of minority shareholders. Lack of judicial capacity to handle these issues is hindrance in ensuring rights

¹⁶ Khan, "Role of International Organizations," at 232-233.

¹⁷ Attiya Javid and Robina Iqbal, "Corporate Governance in Pakistan: Corporate Valuation, Ownership and Financing" *PIDE Working Papers 2010:57* (2010), at 80-81.

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provided to the minority shareholders in laws. In some cases the courts did provide some protection but in most of cases, the minority shareholders failed to get remedy.¹⁸ This study was limited to role of courts in providing rights to minority shareholders in mergers and acquisitions in listed companies of Pakistan.

Khanna has discussed in detail in his research channels of expropriation by dominant shareholders. The dominant shareholders in family and State owned enterprises use different devices for this purpose. They use pyramids, cross-ownership, and interlocking directorships to expropriate the funds of the companies. Weak governance mechanism cannot limit these expropriations. This phenomenon is more common in concentrated ownership jurisdictions such as Pakistan where families and State has dominance in corporate sector and market is underdeveloped.¹⁹

Imtiaz has also discussed reforms in Pakistan during last two decades. The reform agenda started in late nineties with establishment of SECP through the Securities and Exchange Commission of Pakistan Act, 1997. SECP replaces corporate law authority and become autonomous body having financial and regulatory authorities. SECP started reforming corporate sector. The first step towards these reforms was to issue first Code of Corporate Governance in 2002. This was the first breakthrough but it could not be implemented in its true spirit due to the nature of Code of Corporate Governance in which it is implemented. SECP further revised Code of Corporate Governance in 2012 with some amendments. Some provisions in the previous Code were voluntary and were not required to be implemented rather companies were guided and encouraged to implement. These provisions related to allowing and providing an opportunity to

¹⁸ Sikander A. Shah, "Mergers and the Rights of Minority Shareholders in Pakistan" *CMER Working Paper Series No. 04-31*, Lahore University of Management Sciences, Lahore Pakistan (2005).

¹⁹ Khanna, Tarun and Krishna, Palepu, "The right way to reconstruct conglomerates in emerging markets", *Harvard Business Review* 77, 4 (1999) at 125-134.

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minority shareholders to appoint directors on the board. The other voluntary provisions were to appoint non-executive and independent directors on the board. New Code of Corporate Governance 2012 has converted voluntary provisions into mandatory provisions. It has also introduced new provisions according to new development in Pakistan.²⁰ Ali Cheema and other discussed in their research that Securities and Exchange Commission of Pakistan with the help of Chartered Accountants of Pakistan and Institute of Corporate Governance in Pakistan has been working on developing good corporate governance regime, where the investors are protected and the dominant groups can be restricted so that they could not take benefits due to their positions in the forms of private rent seeking.²¹ This reform agenda of SECP, however, was not restricted to issue Code of Corporate Governance only. Some other steps were also taken by SECP. In the second phase, number of proposals have been initiated and implemented by the Apex Regulator through amendments in the laws, rules and regulations as well as by introducing reforms through structure of Apex Regulator, Stock Exchanges. Stock markets were also reformed with establishing of central depository companies (CDCs). This allowed conversion of physical shares into electronic forms that allowed transparency as well as quick transfer of shares. Stock exchanges in Pakistan were also proposed to be integrated and demutualised to have more transparent and effective running and monitoring of the exchanges. This process is still pending due to political and vested interests. The situation definitely has since been improved but not resolved. There is further need of reforms towards the resolution of these above highlighted issues concerning Pakistan corporate governance.

In the western world, a lot of research has been carried out on this topic. La Porta and others have discussed in detailed investor protection and corporate governance. They are of the

²⁰ Khan, "Role of International Organizations," at 232-233.

²¹ Cheema, "Corporate Governance in Pakistan," at 23-29.

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view that expropriation of minority shareholders by majority is common phenomenon in many jurisdictions especially jurisdictions having underdeveloped markets. They have discussed in detailed the ways which are employed by these dominant shareholders to expropriation of funds of the companies. They use different techniques for such expropriation of funds such as selling of assets of the firms or products to companies which are privately owned by them, appointing board members and executives who do not have relevant experience, providing loans to directors on favorable terms.²² This phenomenon is common in jurisdictions such as Pakistan where families have control over the businesses. Good governance can limit these expropriations from the hands of majority shareholders but these can be done when there are reforms at broader level.

J. Coffee has highlighted minority shareholders' rights. He said that minority protections depends not only general corporate laws but also other supporting institutions such as stock markets and financial institutions play an important role in development of corporate governance which in turn enhances minority protections.²³ This research has focused problems of minority shareholders' rights in the context of UK.

I. MacNeil has discussed in detail the problems of corporate governance in China. China is a socialist economy but there is rapid transformation to market economy with State having control over the business enterprises. He argues that the underlying significance of minority shareholders' rights and their protections is widely accepted element for development of corporate governance.²⁴ This research is focused on Chinese context.

²² Rafael La Porta, Lopez-de-Silanes, Shleifer and Vishny, "Investor Protection and Corporate Governance" *Journal of Financial Economics* 58 (2000) at 3-27.

²³ J. Coffee, "Does Law Matter? The separation of ownership and control in UK", *The Journal of Legal Studies* 30, 2 (2001) at 459-484.

²⁴ Iain MacNeil, "Adaptation and Convergence in Corporate Governance: The Case of Chinese Listed Companies", *Journal of Corporate Law Studies* 2 (2002) at 333.

CHAPTER ONE: BACKGROUND OF THE STUDY

Classens and others have discussed in detail nature of corporate structure in East Asian countries and have discussed in detail the channels of private rent seeking in these jurisdictions. These jurisdictions are dominated by families and use different tactics to expropriate funds of the companies at the cost of minority shareholders. Weak governance mechanism is the main reason of expropriation of funds.²⁵

Advance jurisdictions including the UK and the USA had started good governance practices long before actual financial crisis occurred. Academics have discussed issues and identified to policy makers for improvement in this regard. Substantial work has been undertaken in these jurisdictions but lack of extensive research in developing countries such as Pakistan has been major problem. Some authors referred above have tried to explore issues concerning Pakistan but there is a lot of work yet to be undertaken in this regard. These authors have identified and highlighted different issues of the private rent seeking, safeguard of minority shareholders and abuse of powers by the controlling shareholders and have also discussed different means to resolve the same but there are still need of substantial research and work in these areas. Scarcity of research on resolving agency cost and minority shareholders' rights in the context of Pakistan was motivation of this research. This research is different from other works done in context of Pakistan in the sense that the previous works do have highlighted different problems in corporate governance in the context of Pakistan but they were limited in their approach to resolve these issues. This work has highlighted specific solutions to the problems of minority shareholders and reduction of agency cost in the context of corporate governance in Pakistan.

²⁵ Classens S. Djankov S, Lang L.H.P., "The separation of ownership and control in east Asian corporations" *Journal of Financial Economics* 51 (2000) at 111-135.

CHAPTER ONE: BACKGROUND OF THE STUDY

1.5 OBJECTIVES

This research is directed towards the goal of how the investors especially minority shareholders can be protected and how the private rent seeking by the insiders can be minimized in Pakistan. The minimization of the agency cost can help to develop good corporate governance in Pakistan.

1.6 METHODOLOGY

The methodology in this thesis will comprise both the theoretical and empirical aspects of the research. The focus will be on both the primary and secondary sources including traditional material including books, Articles, cases, Acts, Laws, regulation published and unpublished papers, seminar proceedings, Conference papers, Annual Reports of SECP, Karachi Stock Exchange, Lahore Stock Exchange, Islamabad Stock Exchange and Listed Companies. Other sources may include frequent visit to libraries, internet databases, search engines, electronic journals, and key websites.

1.7 LIMITATION OF THE STUDY

This study is limited firstly to jurisdiction of Pakistan, secondly, to inter se problems of shareholders in corporate sector of Pakistan. This study is further restricted to problems of agency cost and minority shareholders rights in corporate sector of Pakistan.

CHAPTER TWO: THE NATURE OF CORPORATE STRUCTURE IN PAKISTAN

CHAPTER TWO

THE NATURE OF CORPORATE STRUCTURE IN PAKISTAN

2.1 INTRODUCTION

This chapter will focus on nature of corporate sector of Pakistan. The corporate sector of Pakistan is highly concentrated where the families and state are major stakeholders. They dominate the board structure and management of the companies. This phenomenon provides them an opportunity to expropriate the funds of the company. They also dominate the meetings of the shareholders. The minority shareholders are not in a position to challenge their expropriation and private benefit seeking opportunities. This chapter will also discuss board structure, management, chief executive. The role of the board and chief executive is very important in corporate structure because they are responsible for running the day to day affairs of the company. Third issue to be discussed in this chapter is the phenomenon of separation of ownership from control and their effects on corporate sector of Pakistan.

2.2 NATURE OF CORPORATE STRUCTURE OF PAKISTAN

The nature of corporate structure is very important because this determines the corporate governance structures and its related problems. In Pakistan the families, state and multinational companies controls major portion of corporate sectors. These families, state and multinational companies also control listed companies. They try to hold and then control the firms for their benefits.²⁶ They exploit from their positions and the minority shareholders are the effectees of these sectors. There is need for good corporate governance structures so that these minority shareholders can be protected from the exploitation of the majority shareholders.

²⁶ Khan, "Role of International Organizations," 223-4.

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2.3 THE FAMILY BASED CORPORATIONS

The family based corporations are those corporations in which families have more than fifty percent shares. However there are other methods of controlling these companies. The pyramiding, cross shareholding and interlocking managements are other forms of controlling the companies. In such type of companies families can control over the management and can use its position ignoring the rights of minority share holders. For example they can elect the directors of their own choice and can perform the day to day affairs according to their own will.²⁷

The most important characteristic of such type of company is that the company is controlled by the family. Therefore they take all important decision at the family meeting. There are different techniques of controlling family owned firms. This may either be direct method whereby the family owned majority of shares in the company. The other method is indirect where the company is controlled through medium of pyramiding and cross shareholding. This may also include through associated and subsidiary companies. The concentration of ownership in Pakistan is very high from its counterpart Asian countries and East Asian countries.²⁸

The family owned enterprises are largest stakeholder in Corporate Sector of Pakistan. The families are dominant in corporate structure of Pakistan both in private²⁹ as well as in public companies. According to statistics more than 50% of private companies are held by two members and mostly are husbands and wives just to fulfill minimum requirement of members for a private company.³⁰

²⁷ Khan, "Role of International Organizations," 223-4.

²⁸ Cheema, "Corporate Governance in Pakistan," 23-29.

²⁹ According to Companies Ordinance, 1984 private companies other than single member private companies must have at least two members with maximum fifty members.

³⁰ Khan, "Role of International Organizations," 223-4.

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2.4 THE STATE-OWNED CORPORATIONS

The state owned corporations are those corporations which are owned and control by the state as it is clear from the name. In such type of companies more than fifty percent shares are hold by the state. The state makes important decisions relating to the corporations. The state appoints its own directors and controls all the affairs of the companies.

The state is second largest stakeholder after families in corporate sector of Pakistan. The state owns companies both as incorporated and un-incorporated enterprises. Many state owned enterprises are operating as listed as well as private companies. During last two decades State corporatized many state owned enterprises and some are on the agenda of the State. As far as top 40 listing companies at Karachi Stock Exchange are concerned, the state³¹ owns 14 out of top 40 listed companies. These state owned companies account for 52.8% Capitalization of total Capitalization of 40 listed companies.³²

The State-owned enterprises are politically motivated and every Government after coming into power takes controls of these companies. The Directors and Management of the Boards remain on such positions on the sweet will of the State. The focus of Government is not the qualification and experiences rather the political affiliation of the person for appointment on Boards.³³

2.5 MULTINATIONAL COMPANIES

The multinational companies are third major stakeholders in the equity market of Pakistan. As far as top 40 listed companies at Karachi Stock Exchange is concerned, there are 5

³¹ The state includes Federal Govt., Provincial Govt. and the Semi-Govt.

³² Cheema, "Corporate Governance in Pakistan," 23-9.

³³ Khan, "Role of International Organizations," 223-4.

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multinational companies which constitute 17% capitalization in top 40 listed companies at Karachi Stock Exchange of Pakistan.³⁴

The presence of foreign companies both as listed and non-listed private companies in corporate sector of Pakistan is a healthy sign for economy of country. These are major source of foreign direct investment in the country. These can pursue the state to play its role to improve its overall Corporate Governance with empowered and effective regulator. The State can pursue further foreign direct investment if there is improved Corporate Governance.

This means that multinational companies have major part in Corporate Governance in Pakistan. These can set standards and precedent for local listed companies of Pakistan.³⁵

2.6 ROLE OF BOARD OF DIRECTORS IN PAKISTAN

The board structure means the directors of the companies. There are different numbers of the directors in different types of the companies. There is one director in single member company³⁶, two members in private company³⁷, three directors in the public company³⁸ and seven directors in the listed companies.³⁹

These directors are appointed through the proper procedure. Only natural persons are appointed as directors of the companies.

³⁴ Cheema, "Corporate Governance in Pakistan," 23-9.

³⁵ Khan, "Role of International Organizations," 23-4.

³⁶ S. 174 (1) (a) of the Ordinance.

³⁷ S. 174 (1) (b) of the Ordinance.

³⁸ S. 174 (1) (c) of the Ordinance.

³⁹ S. 174 (2) of the Ordinance.

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There are two types of the directors; first those who just attend the meetings of the directors, these are known as the non executives directors. Second are those who involve in the day to day affairs of the companies.

The role of board of directors is very important because they manage the company. There are advantages and disadvantages of the board. Since in big companies it is not possible to involve each and every member of business affairs therefore the powers are delegated to these board members to run the company. This is an advantage but at the same time since members are not involved in business affairs therefore they can take personal benefits at the cost of the members. However, the power is with the members to appoint⁴⁰ and remove directors⁴¹ who are not performing. But the power to remove a director is a very difficult one. In some countries the power to remove a director is very easy. A simple majority of members can remove a director in UK.⁴²

Problem in Pakistan is that the family owned enterprises and state owned enterprises appoint directors of their family members, friends and relatives who work for their interest. It is not feasible for minority shareholders to appoint a director or even remove a director from the board. It is therefore problematic for the minority shareholders to be a minority. The majority shareholders expropriate the funds of the company at the cost of minority shareholders.

2.7 ROLE OF MANAGEMENT IN PAKISTAN

The word management connotes to board of directors. Normally all the members of the board of directors are not involved in management. Some are involved in management but some

⁴⁰ S. 178 of the Ordinance.

⁴¹ S. 181 of the Ordinance.

⁴² Paul L. Davies, Principles of Modern Company law (London: Sweet & Maxwell, 2008), 409-419.

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are not. Those who are involved in management are called executive directors and other as non-executive directors.

There are all some persons who are not part of board of directors but they run the affairs of the company with executive directors. These persons are appointed by the board of directors. Board can hire and fire these personnel for managing affairs of the company. These persons act on the direction of the board of directors. Board is to make policy and management is to execute that policy.

The management is in fact are main actors in company affairs. They can take advantage of their positions. Again dominant families try to appoint executives of their choice who works for their benefits.

2.8 POSITION AND ROLE OF CHIEF EXECUTIVE IN PAKISTAN

Sections 198 to 204 of the Companies Ordinance 1984 relate to the chief executive of the company. In these provisions it is discuss how to appoint the chief executive and what the procedure for his appointment and his removal is and what the restrictions on its appointment are and so on.

Every company appoint the chief executive as it commences its business for the period at least till the first annual general meeting unless he resigns or otherwise ceases to hold office or as the period is fixed by the directors of the company and that period is expired.

The directors of the company appoint the chief executive of the company within fourteen days of its vacancy falling vacant or after the election of the directors.⁴³ The chief executive can

⁴³ S. 199 of the Ordinance.

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be any person or an elected director. No person shall be appointed as the chief executive of the company who is ineligible to be the director of the company. The chief executive's office term should not exceed from three years but he will continue his duties till the appointment of new chief executive or till the express termination of office.

The terms and conditions for its appointment shall be determined by the directors of the companies in annual general meeting in accordance with the provisions of the articles of the company.⁴⁴ The chief executive if not a director of the company he shall be deemed as the director of the company and entitle all the rights and privileges subject to the liabilities of his office.

The directors of the company by the special resolution can remove the chief executive of the company before the expiry of its term or the company by special resolution.⁴⁵ The chief executive of the public company shall not directly or indirectly engage in any business which is of the same nature in which he is working as a chief executive.⁴⁶ The chief executive of a public company disclose to the company in writing the nature of his personal business and his interest therein.⁴⁷

Chief executive is the head of the operational directors as well as the other directors. So the position of chief executive is very important. In the good governance if chief executive and directors are separate then the accountability can be performed in the better way as in the meeting of the directors, the chief executive will defend his own acts. He may be influential in meeting of directors because of his key position.

⁴⁴ S. 200 of the Companies Ordinance 1984.

⁴⁵ S. 202 of the Companies Ordinance 1984.

⁴⁶ S. 203 (1) of the Companies Ordinance 1984.

⁴⁷ S. 203 (2) of the Companies Ordinance 1984.

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The position of chairman of board of directors is very important. He is considered to be the leader of the board and ensure that board plays an effective role in fulfilling all its responsibilities prescribed under the Companies Ordinance and the Code of Corporate Governance.⁴⁸ Chairman of the board of directors preside over the meeting of board of directors. The chairman of board of directors is responsible for conducting meeting of board of directors. Chairman of board of directors is also presiding over the general meetings of shareholders and to conduct the same. He is to ensure that minutes of the meetings of the board of directors are recorded appropriately.⁴⁹ The chairman of board of directors is normally the chief executive. The old version of Code of Corporate Governance prescribed that the chairman of listed company shall preferably be elected from among the non-executive directors of the listed companies.⁵⁰ It also provided that the board of directors will clearly define the respective roles of both offices. This provision of the Code clearly separated the office of the chief executive and the chairman of the board. The problem with this provision was that it was not mandatory rather recommendatory provision. The new Code of Corporate Governance has further emphasized on the office of the chairman of the board to be separated from chief executive officer. It says that the chairman of the board and chief executive officer shall not be the same person unless specifically provided in any other law. It also provides that the chairman shall be elected from amongst non-executive directors.⁵¹ This provision may enhance accountability process as the chairman of the board can act independently of the executive directors. He will not defend executive decisions of the executive directors.

⁴⁸ Clause vi of the Code of Corporate Governance 2012.

⁴⁹ Clause viii of the Code of Corporate Governance 2012.

⁵⁰ Clause xi of the Code of Corporate Governance 2002.

⁵¹ Clause vi of the Code of Corporate Governance 2012.

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2.9 SEPARATION OF OWNERSHIP AND CONTROL

The concept of separation of ownership and control was first elaborated by two professors Barle and Means in 1932. This theory is called Barle and Means theory. Since then there has been academic debate on this theory. According to this theory there is a disperse ownership. Disperse ownership means that shareholders are dispersed and no shareholders have enough shares to control the company. The management is controlled by those persons who are not owners. Means the owners do not have control rather control is taken over by the professionals who may own some shares but they are not owners in the sense to control the company. Therefore these managers expropriate the funds of the company because of their control over the company and use those funds of the company for their personal benefits. The real owners who are shareholders suffer loss and get less benefits which they otherwise would have had they operated the companies with their own. This management take such decisions which benefit them. This theory become very popular and is still form part of academic discussion despite the fact that the dispersed ownership is very limited and is generally exists only in the UK and the USA. In most of the countries there is concentrated ownership. In Pakistan, India, Japan, Germany and all other countries there is the concentrated ownership.

But the problem with concentrated ownership is then again separation of ownership and control in the sense that some owners who are minority shareholders do not have control over the firms and therefore majority shareholders control the firms and appoint management of their choice and then get benefits. So problem in concentrated ownership is between the minority shareholders and majority shareholders. In other words there is problem between the owners themselves.

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The problem in dispersed ownership and even in concentrated ownership is that there are too many owners of a single company and it is impossible to collect all the owners for any matter relating to the company to take action against those directors who are not working for the benefits of the company.⁵² So there may be such rules and regulations which can be helpful for all the shareholders of such type of companies, so as the protection can be given to all the shareholders. The regulator or courts can provide remedies to these dispersed shareholders and also to minority shareholders in concentrated owners.

2.10 CONCLUSION

Highly concentrated ownership at corporate governance of Pakistan is main cause of agency problem. The family owned enterprises appoint family members, relatives and close friends on key positions of the company and provide those benefits at the cost of minority shareholders. The state owned enterprises also appoint political motivated persons on the board of directors without giving importance to their qualification and experience. This causes bad governance in state owned enterprises. The role of directors and chief executive is very important because they play key role not only in day to day affairs of the company but also influential in the general meetings of the members.

⁵² Iain MacNeil, "Activism and Collaboration among Shareholders in UK Listed Companies", *Capital Markets Law Journal* 4 (2010): 3.

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CHANNELS OF PRIVATE RENT SEEKING IN PAKISTAN

3.1 INTRODUCTION

This chapter discusses channels of private rent seeking in Pakistan. The dominant shareholders and managers use different techniques to expropriate funds of the company. This chapter focuses techniques of private rent seeking employed by the insiders in expropriating the funds of the company at the cost of the minority shareholders. The first issue which is discussed in this chapter is the insider trading employed in the stock market of Pakistan by the insiders. The second issue is the appointment of irrelevant persons as members on the board of directors. This allows them to expropriate funds of the company. Third issue which is to be discussed is related party transactions and consequently tunneling the funds of the company. The fourth issue that is to be discussed is the role the corporate governance in limiting rent seeking opportunities by the insiders.

3.2 PRIVATE RENT SEEKING AND EXPROPRIATION OF THE FUNDS

As discussed earlier⁵³ the ownership structure in corporations in Pakistan is concentrated means that few shareholders own shares in the form of blocks. The blocks in the sense that they own 51% or more shareholding in companies and due to this they can control the companies.⁵⁴ The State and families are major stakeholders in corporate sector of Pakistan. The control both by State owned enterprises and family based corporations seek benefits due to their position on

⁵³ See Introduction at page 1.

⁵⁴ Khan, "Role of International Organizations," at 224.

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the cost of general public. This phenomenon is called private rent seeking.⁵⁵ These private benefits includes the inside trading by the beneficial owners, high pay and privileges to related persons (family member in case of family owned enterprise and politically motivated personnel in case of State owned enterprises), funds flow, related party transactions⁵⁶ (A transaction is called related party transaction when it is made with family member's suppliers, distributors, exporters etc as well as any contract with company owned by the same group); loans to directors, investment in associated companies etc.

The insiders are those persons who are either majority shareholders or control the corporation either through member of executive or non-executive post on either board of directors or on management side.⁵⁷

The phenomenon of private rent seeking is common in concentrated ownership structures such as Pakistan. The controlling shareholders of companies can control the management due to their shareholdings in the companies. They can appoint directors on the board on their will. They can remove and appoint them whenever they so wish. This is not problematic for them due to control held by them. They normally appoint persons from their families, friends and persons of their confidence in family owned enterprises. On the other hand, the directors in State owned enterprises are appointed having political association. So these directors act for the benefits of these families and Government.⁵⁸

In Pakistan, the high percentage of concentration of ownership by the families provides them an opportunity to get private benefit of the controlling the companies. The minority

⁵⁵ Javid and Iqbal, "Corporate Governance in Pakistan" at 78.

⁵⁶ Khan, "Role of International Organization" at 224.

⁵⁷ See footnote 5.

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shareholders who cannot control the firms due to small shareholding are the main affectees of this phenomenon. The directors who are considered to be the supervisors of the affairs of the company and to act for the benefits of all shareholders do not perform their legal and moral roles due to a number of reasons. Firstly, because they are appointed by the majority shareholders, therefore, they try to safeguard their interests. Secondly, they are under pressure of these majority shareholders because they know that they may be removed from directorship if they will not work for the benefits of the majority shareholders. Thirdly, they are also involved in personal benefits and expropriation of funds of the company at the cost of minority shareholders.⁵⁹

There are number of methods by which the majority shareholders and management expropriate the funds of the company.⁶⁰ This private rent seeking by the majority shareholders and the management causes market underdevelopment and problem of financing.⁶¹ The families finance their companies either from their personal sources or from bank loans.⁶² Therefore, they are not interested in good governance of corporate sector which is essential for external financing.⁶³ These families are not aware of the potential benefits of good governance.⁶⁴ Once

⁵⁹ Khan, "Role of International Organizations," at 223-224.

⁶⁰ Michael C. Jensen and William H. Meckling, "Theory of the Firm: Management Behaviour, Agency Costs and Ownership Structure" *Journal of Financial Economics* 3, 4 (1976) at 2-10.

⁶¹ Khan, "Role of International Organizations," at 223-224.

⁶² Ali Cheema, Faisal Bari and Osama Siddique, "Corporate Governance in Pakistan: Issues of Ownership, Control and the Law" in F. Sobhan and W. Werner (eds.) *A Comparative Analysis of Corporate Governance in South Asia: Charting a Road Map for Bangladesh*. Bangladesh Enterprise Institute.

⁶³ Mahwesh Mumtaz, "Corporate Governance in Pakistan-Adopt or Adapt?" Paper presented at a conference at Lahore on 3-5 June 2005 organized by SECP (regulator) and Lahore University of Management Sciences, Lahore. This was a dissertation presented in University of Cambridge by M. Mumtaz. Available at <http://cmer.lums.edu.pk/Conference2005/images/CG%20in%20Pakistan-%20Adopt%20or%20Adapt.pdf> > accessed on 27.07.2011.

⁶⁴ Organisation for Economic Co-operation and Development (OECD) (2011), *Corporate Governance in Asia 2011: Progress and Challenges*, Corporate Governance, OECD Publishing. <http://dx.doi.org/10.1787/9789264096790-enelectronically> available at <http://www.oecd-ilibrary.org/docserver/download/fulltext/2611011e.pdf?expires=1330302132&id=id&accname=oid018225&checksum=2199CAF696179244B29F7E388A45B978> > accessed on 26.02.2012.

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the corporate sector is governed efficiently, there, will be more entrepreneurial activities and new projects due to external finance. The reason of the smaller external investment in Pakistan is the weak governance mechanism in the country. The minority shareholders are main victims of this private rent seeking, therefore, there is need to provide some safeguard to them so that they can invest money in the companies without fear of being expropriated by the majority shareholders. This could be done by protecting minority shareholders from expropriation of majority shareholders and by the management. SECP has done number of reforms for this purpose but the same is not enough to attract external finance and development of the market.

3.3 INSIDE TRADING

Inside trading means a person doing business by using of his position for his personal benefits and interest, not thinking about the company's interest and it will be definitely done on behalf of the other's money and the public would suffer. A director must not take advantage of his position including the duty not to make a personal profit from his position and a number of statutory provisions designed to eliminate conflicts of interests and abuses by the directors of their position.

According to section 224 of the Companies Ordinance, 1984 the directors who make any gain by the purchase and sale of the securities within six months such directors have to report and tender the amount of such gain to the company, and also he shall send and intimation to the registrar and SECP.

The researcher would like to add the insider trading is normally common where the market is not developed and the regulator is also not vigilant. There have been number of crisis in the market where the majority shareholders and the brokers were able to expropriate the

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money of small investors. The market of Pakistan is very small, narrow and illiquid due to this, the brokers, management and controlling shareholders can take advantage of their positions. The brokers, who hold, substantial shareholding of listed companies can move the stock market at their will and therefore take advantage of such fluctuation. They can manipulate the market by artificial raise in the prices of shares and start purchasing shares at high value or through their mutual trading once the market goes up the innocent shareholders purchase shares and they suddenly through shares in the market and share price goes down very quickly.⁶⁵ The small shareholders who are not aware of this fact purchase shares at very high value and then sell it at very low price with fear that they may lose everything. They try to avoid big loss and therefore compromise at comparatively less loss.

The other phenomenon is undertaken by the majority shareholders and the management. They sell their shares when they know that the price of shares will go down and purchase shares from innocent small shareholders when they know that the price of shares will go up. They are in position to know these facts because they are involved in the affairs of the company. They exploit their position and cause harm to the minority shareholders.

The third phenomenon is the regulator. There are chances of regulator being expropriate the minority shareholders because they are known to the fact of fluctuation in the price of listed companies. The employees of SECP are also insider but the law does not prohibit them from sale and purchase of shares. The employees of SECP should also be included in the law as being insider. They should also be under the regulations of insider.

⁶⁵ I.A. Khawaja, and A. Mian, "Unchecked Intermediaries: Price manipulation in an Emerging Stock Market", *Journal of Financial Economics* 78 (2005): 203-241.

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A circular was issued by SECP⁶⁶ asking its employees to take permission from authorities before sale and purchase of shares but that circular was not implemented in true sense. The idea is to include them in the legal prohibition and the rules of insiders should also apply on the employees of SECP.

3.4 PAY AND PRIVILEGES

Section-191 of the Companies Ordinance, 1984 does not regulate the amount that a director is to receive as remuneration from the company for his services. The Ordinance has left the matter to the general meeting of the shareholders. Table A provides that remuneration of directors shall from time to time be determined by the company in general meeting subject to the provisions of the Companies Ordinance, 1984. It further provides that the remuneration of the directors for performing extra services including the holding of the offices of the chairman shall be determined by the directors or the company in the general meeting in the light of their articles.

The remuneration to be paid to any director for attending meeting of the directors shall not exceed the scale approved by the company or the directors as the case may be in accordance with the provisions of the articles of the company.

The directors who normally belongs to the family members and friends in family owned companies and politically motivated persons in State owned enterprises also expropriate the funds of the company through hefty pay and privileges. The shareholders invest in the company for three reasons. Firstly, they invest to get management in the company and to run the company. Secondly, they invest to get dividend from the profits of the company. Thirdly, they invest to get capital increase by increase in share price. The first option is not possible in big companies

⁶⁶ This was informed by an official of SECP during interview with him.

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because as one have to invest substantial amount which normally beyond the capacity of general investors. However, this is possible in small companies as the investment required is not a huge amount of money. The second option is to get dividend. The dividend is normally not paid because the company's profit is expropriated. Some companies manipulate the accounts of company and therefore show loss. The funds of the company are utilized and showed as expenses. These expenses are basically the hefty pay and privileges of the directors and other management who are family members. The family members are not interested in the dividends because, the same ratio of dividend has to pay to the minority shareholders; therefore, they try to take money benefits in the form of pay and privileges instead of dividend. The third option is also not feasible because when company do not show profits, then how the shares of the company will rise. The minority shareholders are, therefore, the main victims of this phenomenon. The other reason is that even if the company show profits but the market does not represent true value of the shares. The insiders manipulate the market. There is need to redress all these issues, otherwise, the minority shareholders will remain the victims of these phenomenon.

3.5 APPOINTMENT OF FAMILY BASED AND POLITICALLY MOTIVATED IRRELEVANT EXECUTIVES AND NON-EXECUTIVES IN FAMILY-OWNED AND STATE-OWNED ENTERPRISES RESPECTIVELY

The researcher would like to add the other problem in public companies is that the members of the family are appointed irrespective of their qualification and experience. In the researcher point of view the purpose is to give them maximum benefits. The family stretch money of the money through these tactics instead of declare dividend. Similarly, the political motivated persons are appointed in the State owned companies ignoring the relevant experience

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and qualification. This is another form of corruption which is common in public companies. This causes multiple damages to the company. Firstly, because they are incapable of performing duties, therefore, the companies suffer heavy losses. Secondly, they are part of family; therefore, they are given maximum benefits. The funds of the company are wasted and therefore the company does not perform well and loses in profits. Thirdly, the company cannot manage its finances and liabilities. This may cause threat of bankruptcy. Fourthly, the company fails to give dividend due to lack of profits. Therefore, there is a need to check the qualification of the directors. Though, the shareholders are given powers to appoint directors but there are fewer chances of merit because family holds such amount of shares that they can appoint directors of their choice. The minority shareholders cannot or do not have any say in the general meeting. The regulator should check through appropriate manners the appointment of directors at least in listed companies. There is a need of legislation in this regard.

3.6 LOAN TO DIRECTORS

Another important issue of private rent seeking is the loan to the directors. The Companies Ordinance, 1984 prohibits the loan to the directors and prescribes it a criminal offence and prescribes imprisonment up to six months with or without fine. The approval is required from SECP for the purpose of giving loans to the directors. Section 195 of the Companies Ordinance 1984 prohibits giving loans to directors. It also prohibits giving guarantee in respect of loan to directors from any other lenders.

A company with the approval of the SECP can make loan or give guarantee or provide security for a loan made by any person to a director who is whole-time employee of the company, provided, such loan is obtained by the employee-director for the following purposes;

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- Acquisition or construction of a dwelling house;
- Purchase of land for construction of a dwelling house;
- Defraying cost of any conveyance for personal use;
- Purchase of household effects;
- Defraying any medical expenses of himself or any relative.

The provisions of section 195 of companies ordinance 1984 elaborates the types of loan which are not covered by the directors;

- Any loan made, guarantee given or security provided by a private company or by a banking company;
- Any loan made or guarantee given by a holding company to its subsidiary;

Though, there is a strict criterion for giving loans to the directors but there are chances of misuse of the procedure. The directors may take loan for number of purposes prescribed by the law. The new amended law in 2002 has further enhanced the criterion for loan to the directors. The law prescribes that when loan is given to a director, the mark up should not be less than borrowing cost of the company.⁶⁷ This has enhanced minority protections to some extent as far as loan to directors is concerned.

3.7 INVESTMENT IN ASSOCIATED COMPANIES

Another safeguard in minority protections is the limitations on investment in associated company. Section 208 of Companies Ordinance 1984 is related with the investment in associated

⁶⁷ Proviso to Section 295 (5) of the Companies Ordinance 1984

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companies. According to the provisions of section 208, a company can make investment in any of its associated companies or associated undertaking subject to the following conditions:

- A special resolution is passed by the company at a general meeting;
- The resolution must indicate;
 - Nature of investment
 - Period of investment
 - Amount of investment
 - Terms and conditions
 - Return on investment should not be less than borrowing cost

Any change in the nature or terms and conditions of the loan shall be made only by a special resolution. All investments should be made by a company on its own and shall be made and held by it in its own name. Recently, the SECP has issued regulations called 'the Companies (Investment in Associated Companies or Associated Undertakings) Regulations 2012' to further regulate the investment in Associated Companies and Associated Undertakings. These regulations provide in detail the requirements besides those mentioned in S. 208 of the Ordinance for investment in Associated Companies and Associated Undertakings. These regulations require from providing maximum information to the members before general meeting and they have the right to inspect this information before meeting. This information is required to be annexed with the notice meant for transaction of special business required under clause (b) of sub-section 1 of section 160 of the Ordinance.⁶⁸ The objective is to provide them

⁶⁸ Regulation 3 of the Companies (Investment in Associated Companies or Associated Undertakings) Regulations 2012

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sufficient opportunity to discuss the same in general meeting and to raise objection if any regarding these investments.

The regulations also prescribed certain conditions and restrictions for investment in associated companies and associated undertakings.⁶⁹ The company is required to maintain register of all such investments and same is required to be available for inspection of members.⁷⁰

SECP has taken number of steps to protect the interests of the minority shareholders but the problem with this provision is that the investment can be made with approval of general meeting. As discussed in the above pages that passing a special resolution by the controlling shareholders may not be a problem because they hold substantial amount of voting securities. So, this safeguard is not enough to control investment in associated companies.

3.8 RELATED PARTY TRANSACTIONS (RPTS)

In Pakistan, the company law requires certain transactions in which the director or officer of the company has some interest to be disclosed and approved by the board of directors. The directors⁷¹ and officers⁷² of the concerned company are required to disclose their interest in any transaction to be made by the company. Such director is prohibited from taking part and vote in meeting of board of directors meant for consideration and approval of such transaction.⁷³ The court may declare any such director who contravene the aforementioned provisions to be lacking

⁶⁹ Regulations 6-8 of the Companies (Investment in Associated Companies or Associated Undertakings) Regulations 2012

⁷⁰ Regulation 9 of the Companies (Investment in Associated Companies or Associated Undertakings) Regulations 2012

⁷¹ Section 214 of the Companies Ordinance 1984

⁷² Section 215 of the Companies Ordinance 1984

⁷³ Section 216 of the Companies Ordinance 1984

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fiduciary behaviour⁷⁴ and such director shall be ineligible for such post for a period of five years.⁷⁵

The scope of RPTs in Pakistan is limited. The law includes only those transactions within the meaning of RPTs in which director or officer has some interest in that transaction. This did not include the other persons which may come within definition of related party. These may include persons other than directors and officers of the company. These may include dominant shareholders, associates, relatives, and friends. It is necessary to enhance the scope of RPTs because majority shareholders may escape from prohibition.

In Pakistan, the Code of Corporate Governance was amended on 12.12.2008 and this amendment was made applicable since January 1, 2009 to make board of directors of all companies incorporated under the Companies Ordinance, 1984 responsible for all related party transactions.⁷⁶ Amended provision⁷⁷ of code imposes responsibility on board of directors to review and approve all transactions with related party and then place before the audit committee. Board is also made responsible to discuss the RPTs which are not on arm's length price. Board is to give justification for those transactions which are not on arm's length price and also place it before the audit committee for their consideration. Board is made responsible to determine price of such transactions. The company is also required to maintain a record of all such transactions. The same provision is maintained under new version of the Code.

Term related party has not been defined in the Code of Corporate Governance 2012 or in the Companies Ordinance, 1984 which may create confusion. Similarly, the determination of

⁷⁴ Section 217 of the Companies Ordinance 1984

⁷⁵ Section 187 (g) of the Companies Ordinance 1984

⁷⁶ Clause xiii-a of the Code of Corporate Governance 2002

⁷⁷ Clause xiii-a of the Code of Corporate Governance 2002

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price, consideration, and approval of RPTs from board of directors may not solve the purpose of minority protections. In Pakistan the corporate sector is concentrated in which the families hold major shareholding in even listed companies. The directors are normally family members, relatives or friends and, therefore, under direct influence of the controlling shareholders. Therefore asking board to consider, determine, and approve the RPTs will not achieve any purpose. The minority shareholders will not have any role in these transactions and to make accountable the related parties.

3.9 TUNNELING OF FUNDS

There are many methods of expropriation of funds of the company by controlling shareholders and the management. The profits of the company are utilized by the controlling shareholders and management for their personal benefits. This problem is severe in public listed companies. The tunneling of funds of the company is a major source of utilizing funds of the company for their personal benefits at the cost of minority shareholders. These include but not limited to transferring of funds to other associated and holding companies which are owned by the controlling shareholders and management. They may transfer funds to those companies in which they have more financial interests. The method may include making contracts with these companies at less than the market value. This may include supplying to their private owned companies or partnership raw material from companies where they are managers at less than market value or purchase from their own companies or partnerships raw material at more than the market value. The object is to give them maximum benefits.⁷⁸ The reasons for these transactions are that they will get more cash flow rights from their private companies or

⁷⁸ Michael C. Jensen and William H. Meckling, "Theory of the Firm: Management Behaviour, Agency Costs and Ownership Structure" *Journal of Financial Economics* 3, 4 (1976) at 71-72.

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partnership than they will otherwise get from public companies where they work or controlling shareholders. The minority shareholders therefore get less than they deserve as compared to their investment. The funds of the company are for all shareholders because they are all owners and not just the controlling shareholders or managers. There is need to check these transactions and to save the funds of the company from the hands of the controlling shareholders and the managers. The SECP has tried to control these transactions through provisions in the law and the Code of Corporate Governance 2012 but the same will be effective only when these are enforced in effective manner because mere making provisions are not enough unless these are enforced. So there is need of enforcement mechanism either by the regulator, stock exchange or judiciary.

3.10 ROLE OF CORPORATE LAW TO LIMIT RENT SEEKING BY CONTROLLING SHAREHOLDERS

The rent seeking opportunities are common in underdeveloped market such as Pakistan.⁷⁹ There are many ways of controlling these rent seeking opportunities. The problem of underdeveloped markets is not to eliminate these opportunities rather it can be minimized at the first instance. The corporate law which deals with matters concerning corporate sector is the main tool to handle these issues. The corporate law which include but not limited to the Companies Ordinance 1984, SECP Act 1997, the Securities and Exchange Ordinance 1969, Listing Rules of three stock exchanges, Code of Corporate Governance 2012 and many other rules and regulations introduced by SECP can limit these rent seeking opportunities. But as discussed in the preceding pages that there is a need of enforcement mechanism to redress these issues. There may be some type of redresser mechanism at SECP or stock exchanges for

⁷⁹ Khan, "Role of International Organizations," at 232-233.

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complaints of minority shareholders.⁸⁰ The judicial capacity is also required to be enhanced for this purpose.⁸¹ Therefore, for good governance, it is necessary to protect minority shareholders.⁸² This will cause development of market⁸³ and more equity finance in the companies and will encourage investment.⁸⁴ More protections of the investors will encourage more local investors as well as foreign investment as well.⁸⁵ This will boost economy of the country and therefore development of the country as well.

3.11 CONCLUSION

The ineffective and bad corporate governance in Pakistan allows insiders to expropriate funds of the company at the cost of the minority shareholders. The system provides insiders tunneling of funds. They employ different techniques to expropriate funds. Board of directors which is main body to run the affairs of the company is controlled by the majority shareholders and that board fails to restrict majority shareholders from expropriation of the funds of the company. This allows ineffective governance to prevail in the system.

⁸⁰ Ibrahim, "Corporate Governance in Pakistan," at 323-332.

⁸¹ Khan, "Role of International Organizations," at 232-233.

⁸² Rafael La Porta and others, "Legal Determinants of External Finance", *The Journal of Finance* Volume LII, No. 3 (1997), at 1131-1150; Rafael La Porta and others, "Law and Finance" *Journal of Political Economy* Volume 106, No.6 (1998), at 1113-1155.

⁸³ Rafael La Porta and others, "Investor Protection and Corporate Valuation", *The Journal of Finance* Vol. LVII, No.3 (2002), at 1147-1170.

⁸⁴ Rafael La Porta et al, "Legal Determinants of External Finance" *The Journal of Finance* Volume LII, No. 3 (1997): 1131-1150; Rafael La Porta et al, "Law and Finance" *Journal of Political Economy* Volume 106, No.6 (1998): 1113-1155.

⁸⁵ Khan, "Role of International Organizations," at 232-233.

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CHAPTER FOUR

MINORITY SHAREHOLDERS' PROTECTIONS

4.1 INTRODUCTION

This chapter will discuss in detail the minority shareholder rights and their protection in the system. The first issue to be discussed is the availability of the rights of the minority and the problems faced by the minority shareholders in the corporate sector. The second issue to be discussed is the compliance and enforcement of minority shareholders rights. The third issue to be discussed is the agency problem in Pakistan and the ways and means to reduce this agency cost in the corporate sector of Pakistan.

4.2 THE MINORITY SHAREHOLDERS' RIGHTS

The protection of minority shareholders' rights is very important for good corporate governance. The minority shareholders who do not have access to management in the company are the main affectees of bad governance. There are many minority rights which are considered as necessary. The first important right is to receive notice of the meeting of shareholders. The law provides protection in the sense that it is the duty of the directors to send notice of meeting to every shareholder.⁸⁶ The objective of the notice of the meeting is to provide them with the information that if they are willing to participate and to discuss any issue. Therefore, they can prepare themselves for the meeting. This right is attached with the shares and is therefore, a general right for every shareholder. However, this is for the protection of minority shareholders in the sense that the minority they are normally not involved in the affairs of the company or meeting and therefore majority may be aware of the meeting and its agenda but minority may not

⁸⁶ Section 160 (1) (a) (i) of the Companies Ordinance 1984

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be abreast with the meeting and its agenda. This is an important right and is normally available in all jurisdictions including Pakistan.

The second important right is to take part in the general meeting of the company,⁸⁷ where important issues are discussed and resolutions are approved. The shareholder may participate personally or through proxy. This right is also attached with shares. Every shareholder has the right to participate in the general meeting irrespective of the number of shares. A shareholder who has just one vote has the right to participate in the meeting of the company. He can discuss issues and take part in the voting for passing the resolution.⁸⁸ The problem with this right is that the decisions are made by the majority shareholders. The majority rule allows the majority to approve the resolution of the company. Minority shareholders cannot pass resolution at their own but they have at least right to discuss it and to raise their concerns in the meeting.

The third important right is to appoint directors of the company.⁸⁹ The Ordinance provides this right to the shareholders. The shareholders can also remove director from the company⁹⁰. Section 178 of the Ordinance provides mechanism for the election of directors. The elections of directors are conducted through cumulative voting system. Though this method provides opportunity for minority shareholders to appoint directors on the board but practically this is a difficult task. In cumulative voting system, the shareholder has votes equal to the number of shares multiplied by number of directors to be elected.⁹¹ For example, if there are four directors to be appointed and member has one hundred shares, in this case he will have four

⁸⁷ Section 160 (1) (d) of the Companies Ordinance 1984

⁸⁸ PL Davies, *Gower and Davies Principles of Modern Company Law* (8th edition, Thomson S & M, London 2008) at 45

⁸⁹ Section 178 of the Companies Ordinance 1984

⁹⁰ Section 181 of the Companies Ordinance 1984

⁹¹ Nazir Ahmed Shaheen, *Practical Approach to Companies Ordinance, 1984* (Rawalpindi: Federal Law House, 2011) at 668.

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hundred votes. He can give all his votes to one candidate or may divide between different candidates. Minority shareholders may have their combined candidate and give all their shares to that and thus can appoint one or more directors on the board.

The other important minority rights are right to get dividend, to receive periodical reports of the company, sell the shares at their will and transfer the same, recourse to the regulator, stock exchange or judiciary for the compensation of their complaint.

Receiving dividend is the right of the shareholders. It becomes right only once it is declared by the general meeting on the recommendation of the directors.⁹² The shareholders can decrease dividend but they cannot enhance the rate of dividend declared by the board of directors. Once it is declared by the board and approved by the general meeting, then it becomes duty of the company and any default in payment of the dividend is liability of the chief executive.⁹³ The time period which was mentioned earlier is not removed and power is delegated to Commission to announce period within which the company has to pay dividend after its declaration.⁹⁴ However, there is problem with regard to declaration of dividend. The dividend is declared by the board of directors. This is exclusive jurisdiction of the directors to announce dividend. The general meeting just gives *ex post facto* approval of such dividend. General meeting has very limited powers in this regard. The general meeting cannot increase or even announce any dividend when it is not recommended by the board of directors.⁹⁵ There are some restrictions in the Companies Ordinance with regard to declaration of dividend. First is the

⁹² Section 248 (1) of the Companies Ordinance 1984

⁹³ Section 251 (1) of the Companies Ordinance 1984

⁹⁴ Section 251 (1) of the Companies Ordinance 1984

⁹⁵ Section 248 (1) of the Companies Ordinance 1984

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dividend must be declared out of profit of the company.⁹⁶ They cannot declare dividend when company is in loss. Secondly it cannot be declared by selling assets of the company unless the business of the company is selling and buying assets.⁹⁷ Directors may not even declare dividend when company is in profit. They may declare some profit as dividend and retain some profit as funds in case of financial difficulty of the company. The directors may declare bonus shares or right shares instead of dividend. Bonus shares are issued in lieu of cash dividend. When directors consider that company needs some finance and they also want to give benefit to shareholders they issue bonus shares instead of cash dividend. They can also raise finance through rights shares.

To receive periodical reports is also right of the shareholders. Under the Companies Ordinance, 1984 the company is required to provide and disseminate certain periodical reports to its members. There are more restrictive conditions for preparation and distributing periodical reports to its members. The listed companies are required to prepare and disseminate to its members quarterly⁹⁸, half yearly⁹⁹ and annual reports¹⁰⁰. The strict conditions with regard to listed companies are meant to provide more safeguard to public in listed companies. The UK has dispensed with private companies from calling general meeting and passing resolution.¹⁰¹ The private companies may submit written resolutions of directors and members without fulfilling the formalities of the general meeting.¹⁰² This trend may also be introduced in Pakistan because this will decrease the cost of private companies. The calling of general meeting bears some cost

⁹⁶ Section 249 of the Companies Ordinance 1984

⁹⁷ Section 248 (2) of the Companies Ordinance 1984

⁹⁸ Section 245 (1) of the Companies Ordinance 1984

⁹⁹ Section 245 (2) of the Companies Ordinance 1984

¹⁰⁰ Section 233 (4) of the Companies Ordinance 1984

¹⁰¹ Section 288 (5) of the Companies Act 2006 of the UK

¹⁰² Section 288 (3) of the Companies Act 2006 of the UK

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depends on the size of the company. Therefore, there is no harm if private companies in Pakistan are dispensed with fulfilling the formalities of the general meetings on the pattern of the UK.¹⁰³

The selling and transferring shares in private companies are restricted. The members of the private companies are not allowed to transfer their shares at their will.¹⁰⁴ They have to take permission of the board of directors. This restriction is provided in the articles of association of the company. The board of directors cannot restrict absolutely which means that if the shareholder wants to purchase shares, they can put limits with regard to the selling of shares. They can either purchase themselves or may ask to sell shares to particular person. The reason behind this logic is that the private companies are considered as quasi partnerships. This means that they are considered like partnership regarding the selling of shares and change in the management. Though, legally these are not partnerships but courts in England consider them as quasi partnerships for the purpose of change in managements and transfer of shares.¹⁰⁵ The private companies are formed, managed, and operate like partnerships. Discussion of private companies is beyond the scope of this thesis. The research will remain focus on public listed companies, as there are no such restrictions on the shareholders. They have the right to sell their shares at any time to any person without approval of the board of directors or majority shareholders. There may be problem of selling shares on the market in those cases where the market is not developed and there are no buyers. However, the right is there and shareholder can sell at any time.

¹⁰³103 Imtiaz Ahmed Khan, "The Single Member Companies" (LLM Thesis, International Islamic University, Islamabad, 2006) at 124

¹⁰⁴ Section 2 (28) (i) of the Companies Ordinance 1984

¹⁰⁵ *Ebrahimi v Westbourne Galleries Ltd* [1973] AC 360.

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The rights are provided but the important thing is their enforcement. There are different techniques of such enforcement. The first available right is to file a complaint to SECP and Stock Exchange. The other right available is to go to the court of redresser of complaint.¹⁰⁶

The Companies Ordinance 1984, SECP Act 1997 and many other laws which are administered by SECP provide powers to SECP to impose penalty on directors, chief executives, officers and on companies for default of the relevant provisions. These laws also provide powers to Commission to listen complaint of the shareholders. Similarly, Listing Regulations, Securities and Exchange Ordinance 1969 provide similar powers to Stock Exchange to take cognizance of the complaint of the shareholders and forward the cases to SECP for final decision. In Bawany Sugar Case¹⁰⁷, SECP imposed penalty on the directors for not keeping proper accounts of the company under sub section 2 and 3 of section 227 of the Companies Ordinance 1984.

The most important right of the shareholders with regard to complaint, mismanagement and oppressive conduct is with the courts. The court can take cognizance in two circumstances. First, where any provision of the law provides punishment of imprisonment, then SECP cannot take cognizance of these cases. These cases are normally tried in Court of Session; however, the High Court bench can also take cognizance of these cases. Second, where the power is delegated to the court to try offences, the courts will take cognizance of these cases and the regulator cannot take these matters. For instance, takeover, merger and acquisition cases cannot be finalized unless approved by the courts¹⁰⁸. Other instances are mismanagement and oppressive

¹⁰⁶ There are many sections which provide right to go to court for redresser of complaint. However, Section 290 of the Ordinance is important right for protection of minority shareholders to approach court.

¹⁰⁷ Bawany Sugar Mills Ltd v Securities and Exchange Commission of Pakistan

¹⁰⁸ Sections 284-288 of the Companies Ordinance 1984

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remedy¹⁰⁹, winding up by the courts¹¹⁰ etc. There are many instances where the courts have been moved in mismanagement of the company. In *Pakistan Associated Biscuits International Ltd v English Biscuits Manufacturers (pvt) Ltd*,¹¹¹ remedy was provided to the minority shareholders where company was mismanaged by the majority shareholders.

The problem of inefficiency, corruption, delay and cost is main hindrance of providing remedy to the minority shareholders.¹¹² Minority rights and their protections can be effective only when these issues are redressed. The SECP is also not free of corruption and inefficiency.¹¹³ A strong regulator can also ensure minority protections. Judiciary has been very active in recent years especially after the start of the lawyers' movement for the reinstatement of the Chief Justice of Pakistan, Iftikhar Muhammad Chaudhry, however, there are still problems at the lower level in the judiciary of Pakistan.¹¹⁴ Therefore, there is a need of reforms at lower judiciary such as to eliminate corruption and other problems. Strong and independent judiciary as well as regulator can ensure minority protections.¹¹⁵

4.3 PROTECTION OF MINORITY SHAREHOLDERS' RIGHTS

The protection of minority shareholders' rights has been considered in recent academic debate. There is almost consensus that the protections of minority shareholders' rights are important for the development of capital markets. The developed market ensures good corporate

¹⁰⁹ Section 290 of the Companies Ordinance 1984

¹¹⁰ Section 297 (i) of the Companies Ordinance 1984

¹¹¹ *Pakistan Associated Biscuits International Ltd v English Biscuits Manufacturers (pvt) Ltd*, 2003 CLD at 815

¹¹² Khan, "Role of International Organizations," at 232.

¹¹³ Sikander A. Shah, "Mergers and the Rights of Minority Shareholders in Pakistan" CMER Working Paper Series No. 04-31 (2005), Lahore University of Management Sciences, Lahore Pakistan.

¹¹⁴ Javed Chaudhry's column 'Judges restored but Justice still suspended' in nationwide Urdu newspaper 'Express' dated 23.06.2011 available at

<http://express.com.pk/epaper/PoPupwindow.aspx?newsID=1101270558&Issue=NP_LHE&Date=20110623> accessed on 23.06.2012.

¹¹⁵ Khan, "Role of International Organizations," at 232-233.

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governance. There are many ways to protect minority shareholders. The most important is the legal protection of minority rights. The corporate law and enforcement ensure minority shareholders' rights. Some scholars view that the minority rights can also be ensured by different other techniques. These include but not limited to developed market, listing rules, securities laws, judicial system, regulator and other norms which are developed in a particular system.¹¹⁶

In Pakistan, the minority shareholders rights are provided in the Companies Ordinance, 1984. However, these rights are not enforced in its spirit that is why the stock market is less attractive for investors. The main reasons for concentrated ownership in Pakistan are the lack of minority shareholders rights' protection. Once these rights are protected, this will ensure investment not only from domestic investors but also from foreign investors.

There are many issues of minority protections. Though rights are provided in the Companies Ordinance, 1984 but these are not ensured. For instance, participating in general meeting and to discuss issues and to cast votes is provided in the law but the cost factors involved in this process is the main hurdle. The shareholders who have small stakes in the equity capital of the company do not feel incentive to participate in the meeting due to cost factor. The voting is not allowed to be casted through post or by electronic voting. In modern era, the participation, discussion and casting votes is possible through internet. This process has become popular in modern world. However, in Pakistan, even if any company intends to do that will be considered as not fulfilling the conditions of the law. The Companies Ordinance, 1984 requires from companies to call general meetings of the shareholders. The objective of the meeting of shareholder, *inter alia*, is to approve any resolution or elect directors. The law does not allow this

¹¹⁶ Brian R Cheffins, "Law, Economics and the UK's System of Corporate Governance: Lessons from History", *Journal of Corporate Law Studies*, 71 (2001) at 86-89.

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process electronically. That is why if any company do this electronically, the regulator may not accept this process as this will not fulfill requirements of law. Therefore, companies do not adopt that procedure. If the voting at least is allowed through post or through emails, this will decrease the cost and may pursue the minority shareholders to cast their votes and to feel some sense of participation in the affairs of the company.

Cumulative voting system which is considered as minority right is not implemented in its true spirits because the system allows shares with enhanced voting rights which may create problem for cumulative voting system. The management of the company also do not consider in the interest of the company to allow minority shareholders to appoint director on the board. Therefore, they do not promote this method. They consider it as involvement in their family business. In a recent survey, most of the companies are not aware of the potential benefits of the cumulative voting. It is necessary to ensure that the companies follow this methodology and allow the minority shareholders to appoint director on the board. The Code of Corporate Governance 2012 in Pakistan also laid emphasis on the companies to encourage minority representative on the board.¹¹⁷ This was voluntary provision in the Code of Corporate Governance 2002 but the new version of the Code of Corporate Governance 2012 has made this provision as mandatory. So, it is duty of the companies to ensure minority representation on the board and to facilitate minority shareholders to elect their representative on the board. This is another minority protection mechanism but it will be seen as to what extent this new Code has effect on the attitude of the management of the listed companies.

¹¹⁷ Clause (i) (a) of the Code of Corporate Governance 2012

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The law also provides rights to the minority shareholders to recourse to regulator or the courts in case of any dispute or violation of rules or breach of directors' duty. The question is the cost of such proceeding which the minority shareholders have to bear in case of any litigation. The problem of such litigation is that the minority shareholders will not have evidence on the issues because they do not have access to information and records of the company. Therefore, this is problematic for minority shareholders. The other issue is the awareness of the minority about their rights. If they know about their rights and positive outcome of the litigation, then they may get benefits of such litigation. The problem of corruption, delay and expense in the litigation hinder in bringing any action. Therefore, the management does not have any fear of litigation.

There are some instances of minority shareholders rights where the courts have been moved by minority shareholders. Courts did provide remedy but in some instances they failed to get remedy from the courts. In Pakland Cement Ltd, the court held that it is not purpose of the court to indulge in the commercial merits or viability of the decisions reached by the majority and denied remedy to the minority shareholders.¹¹⁸ Remedy was provided in Pfizer Laboratories case where merger was declared unjust and oppressive.¹¹⁹ In Kohinoor Raiwind Mills Ltd v Kohinoor Gujar Khan Mills Ltd, court did not accept merger case on the objection of the minority and so remedy was provided to minority shareholders in this case.¹²⁰ In Dewan Salman case, remedy was not provided to the minority shareholders. In this case, one member did not vote for merger in the meeting and objected to the merger. The court did not accept this objection and held that the basis of objection is not valid and price determined was according to market.

¹¹⁸ Pakland Cement Ltd 2002 CLD 1392

¹¹⁹ Pfizer Laboratories Ltd and another 2003 CLD 1209

¹²⁰ Kohinoor Raiwind Mills Ltd v Kohinoor Gujar Khan Mills 2002 CLD 13

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value.¹²¹ In Brooke Bond Case, the court sanctioned the merger on the basis of the resolution of the general meeting as well as on the basis that the petitioner failed to bring on the record of the court that there were some irregularities in the merger.¹²² Similarly, in Atlas Autos case¹²³ and Lipton case,¹²⁴ the court sanctioned merger and did not accept the objections of the petitioner.

4:4 AGENCY COST AND ITS REDUCTION

The agency cost is a technical term which is not used in an economic term which means that the cost incurred by the shareholders to supervise the activities of the directors. Here the shareholders are principals as they are the owners of the company because they invested in the company whereas the directors are agents because they work on behalf of shareholders. In modern form of company this is very important to control the agency cost. The controlling of agency problem is an important factor in the survival of companies. This if uncontrolled will destroy whole organization structure of the company.¹²⁵ There are different methods of controlling agency cost. Statutory, Common law and human ingenuity in devising contracts determine the magnitude of agency cost. There always have been incentives to reduce agency cost.¹²⁶ The legislature tries to solve this problem through statutory and non statutory regulations. As discussed above, the enforcement of statutory legislations is very important to ensure reduction of agency cost. If agency cost is reduced, then this will ensure minority shareholders rights.

¹²¹ Dewan Salman Fibre Ltd v Dhan Fibres Ltd PLD 2001 230

¹²² Brooke Bond Pakistan Ltd v Aslam Bin Ibrahim 1997 CLC 1873

¹²³ Atlas Autos Ltd v Registrar Joint Stock Companies 1991 CLC 523

¹²⁴ Lipton (Pakistan) Ltd 1989 CLC 818

¹²⁵ Fama, Eugene and Michael Jensen "Agency Problems and Residuals Claims" *Journal of Law and Economics* Volume XXVI (1998): 327-349 available at < http://papers.ssrn.com/sol3/papers.cfm?abstract_id=94032 > Accessed on 11.09.2012.

¹²⁶ Michael C. Jensen and William H. Meckling, "Theory of the Firm: Management Behaviour, Agency Costs and Ownership Structure" *Journal of Financial Economics* Volume.3, No.4 (1976): 1.

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In Pakistan agency cost is very high. The reason is weak enforcement mechanism, regulator and the judiciary. The families and State is strong enough to resist any reform agenda of SECP, which could ensure the rights of the shareholders. Therefore, there are very less chances of protection of minority shareholders, unless the Regulator is given full authority which is beyond political and families influence. There is also need of judicial reforms in Pakistan. This can ensure protection of rights of the shareholders.¹²⁷

4.5 CONCLUSION

The agency cost in Pakistan is very high. Bad governance allows majority to expropriate the funds of the company at the cost of the minority shareholders. The reason is weak enforcement mechanism. The families and State is strong enough to resist any reform agenda of SECP, the objective of which is to ensure rights to the shareholders. If regulator is given full authority which is beyond political and families influence, there will be less chances of expropriation of funds and this will ensure protection to minority shareholders. There is also need of judicial reforms in Pakistan. This can ensure protection of rights of the shareholders.

¹²⁷ Khan, "Role of International Organizations," at 232-233.

CHAPTER FIVE: CONCLUSION AND RECOMMENDATIONS

CHAPTER FIVE

CONCLUSION AND RECOMMENDATIONS

The agency cost in Pakistan is very high due to many reasons. These include but not limited to private rent seeking and expropriation of funds of the company by the majority shareholders. There are many channels of expropriation of funds of the company by controlling shareholders and the managers. The controlling shareholders and managers can expropriate funds of the company by different techniques. These include but not limited to insider trading, pay and privileges of the directors and managers, appointment of irrelevant family based or politically motivated executives on heavy remunerations, self dealings, related party transactions etc. The minority shareholders are the main affectees of these private benefits by the controlling shareholders and the management. The management is normally appointed by the controlling shareholders. They work for the benefits of the controlling shareholders. The management is elected and appointed by the controlling shareholders amongst the family members in the family controlled companies and politically motivated persons in the State owned companies. The directors and managers are engaged in self dealings and therefore expropriate the funds of the companies at the cost of the minority shareholders. This enhances the agency cost of the investment. The bad governance in corporate sector cannot protect the interest of the minority shareholders. The protection of investors especially minority shareholders are necessary for investment both from local as well as from foreign investors. This can boost the economy of the country.

There has been international trend of protecting minority interests. The developed jurisdictions such as the UK and the USA have focused on more monitoring and disclosure.

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These jurisdictions have also introduced codes of corporate governances based on best practices. The developed jurisdiction took lead in this process and the developing countries piggyback on these developments.*Pakistan was not an exception to this universal trend and therefore, there were also number of developments in the corporate sector. The first major development was the establishment of the SECP under the SECP Act 1997 replacing erstwhile corporate law authority. The SECP was operative from 1st January 2000. The objective was to give more powers to the regulator to ensure good governance in the corporate sector. The SECP took number of steps for improvement in corporate governance and in particular to protect minority shareholders.

The SECP with the help of the Chartered Accountants of Pakistan and the Institute of Corporate Governance in Pakistan has been working on developing good corporate governance regime, where the investor are protected and the dominant groups can be restricted to take benefits due to their positions in the forms of private rent seeking. There are a good number of proposals that have been initiated and implemented by the Apex Regulator through Amendments in the laws, rules and regulations as well as by introducing reforms through the structure of Apex Regulator, Stock Exchanges. One of the major steps taken by the Apex Regulator was the issuance of Code of Corporate Governance in March 2002. The Code was made part of listing regulations of three stock exchanges of Pakistan. Some other powers were transferred to SECP from courts. Many amendments were made in the laws. SECP issued a number of rules and regulations.

SECP started revision of the Code of Corporate Governance 2002 after lapse of almost ten year to incorporate further developments and short comings in the previous version of the Code. It therefore issued draft Code of Corporate Governance for public opinions. The final

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revised version of the Code of Corporate Governance 2012 was issued in April 2012 with important amendments keeping in view new developments, changing governance concerns, practices and economic circumstances and international best practices and requirements since the issuance of first Code. Major steps were taken under the new Code of Corporate Governance 2012 for protection of minority shareholders. The Code of Corporate Governance provides that every listed company must have at least one independent director, and maximum executive directors should not be more than to 1/3rd of total number of directors. It also provides separation of office of chairman from chief executive officer of the listed companies. It empowers Board of Directors to appoint, remove, and fix remuneration and conditions of employment of the chief financial officer, company secretary and the head of internal Audit. Earlier this power was with chief executive officer. Objective is to provide transparency in the affairs of the companies.

The problem was, however, the implementations and enforcement of these laws, rules, regulations and Code. The judicial enforcement is another problem in this regard. A good enforcement both at the administrator and the judicial level can ensure good governance. This good governance can reduce agency cost and provide relief to minority shareholders. This will help to develop market and boost economy.

This phenomenon is not limited to Pakistan or other developing countries. A lot of work has been done on other jurisdictions including the UK, USA. They have identified different issues of the private rent seeking, safeguard of minority shareholders and abuse of powers by the controlling shareholders. They have also discussed different means to resolve the same. Pakistan can take benefits of these jurisdictions to improve good governance.

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In Pakistan agency cost is very high. The reason is weak enforcement mechanism, regulator and judiciary. The families and State is strong enough to resist any reform agenda of SECP the objective of which is to ensure rights to the shareholders. Therefore unless Regulator is given full authority which is beyond political and families influence there are very less chances of protection of minority shareholders. There is also need of judicial reforms where rights are ensured to the shareholders. The problem of corruption, delay and expenses in litigation hinder in bringing any action by the minority shareholders. Therefore, the management does not have any fear of litigation and therefore problems of mismanagement persist which cost to the minority shareholders. Good governance can ensure reduction of agency cost of the minority shareholders which can ensure market development and economic growth.

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- v. The Securities and Exchange Ordinance, 1969
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- viii. The Companies (Investment in Associated Companies or Associated Undertakings) Regulations, 2012
- ix. The Partnership Act, 1932
- x. Listing Regulations of Karachi Stock Exchange
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