

# CORPORATE GOVERNANCE IN PAKISTAN: ANALYSIS OF CURRENT CHALLENGES AND RECOMMENDATIONS FOR FUTURE REFORMS

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## INTRODUCTION

For over a decade, international attention has focused on corporate accountability and financial reporting standards.<sup>1</sup> Initially, corporations that wanted to achieve high standards of corporate governance were encouraged to voluntarily comply with non-binding corporate governance codes. These codes included provisions that governed “recognized best practices” as well as disclosure requirements such as listing regulations. Over time, however, the persistent demand for corporate accountability and transparency led to an evolution from a voluntary notion of corporate

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1. See ADRIAN CADBURY, REPORT OF THE COMMITTEE ON THE FINANCIAL ASPECTS OF CORPORATE GOVERNANCE 9 (1992).

governance to one in which corporations have a legal duty to “comply or explain.”<sup>2</sup>

To enforce standards of accountability and transparency, national governments have enacted various forms of legislation. In the United States, for example, Congress passed the 2002 Sarbanes-Oxley Act,<sup>3</sup> which is considered a legislative milestone in the formative history of corporate governance. Pakistan’s legislature, on the other hand, delegated the task of issuing a corporate governance code to the Securities and Exchange Commission of Pakistan (SECP), which enacted Pakistan’s Code of Corporate Governance<sup>4</sup> (the Code) in 2002.

The Code was met with criticism from corporations and commentators. Corporations believed that complying with the Code’s provisions would be very expensive. They also argued that there were numerous practical difficulties in implementing and enforcing the Code. Indeed, one of the legitimate problems pointed out by corporations was the lack of relevant expertise in Pakistan to enforce the Code’s provisions. In addition, some commentators believed that the Code was defective, outdated, and had “no utility to stakeholders.”<sup>5</sup>

However, despite these criticisms, the Code in many ways has been ground-breaking, ushering in a new era of corporate governance in Pakistan. The Code is continually developing and evolving through the interpretation of its provisions by the courts and the substantial revisions made to the Code itself by the SECP. Pakistan’s courts, for the most part, have not significantly criticized the Code’s provisions in the last three years.<sup>6</sup> However, the courts have shown an unprecedented concern for the welfare of minority shareholders and have been willing to annul the decisions of majority shareholders in certain cases.<sup>7</sup> In addition, the SECP

2. DEP’T OF TRADE AND INDUS., DEREK HIGGS REVIEW OF THE ROLE AND EFFECTIVENESS OF NON-EXECUTIVE DIRECTORS ¶ 1.14, at 16 (2003) (“Listed companies have to report on how they apply the Code’s principles and to state whether they comply with the detailed provisions and, if not, why not. This approach has worked well.”).

3. The Sarbanes-Oxley Act, Pub. L. No. 107-24, 116 Stat. 745 (2002) (codified in sections of 11 U.S.C., 15 U.S.C., 18 U.S.C., 28 U.S.C., and 29 U.S.C.).

4. SEC. & EXCH. COMM’N PAK., CODE OF CORPORATE GOVERNANCE (2002) [hereinafter THE CODE].

5. Khalil Ahmed, *Shortcomings in Corporate Governance Code—II*, THE BUSINESS RECORDER, Sept. 8, 2004, at 19.

6. One exception is when the Sindh High Court accepted a company’s right to continue with its external auditor, as opposed to the Code, which requires a change of auditors every five years. *See THE CODE*, *supra* note 4, at cl. xli.

7. These matters tend to arise out of minority shareholders’ objections to swap-rationing determined in schemes of arrangement for proposed mergers. *See generally* In re: Pfizer Laboratories Limited, 2003 CLD 1209; Kohinoor Raiwind Mills Limited v. Kohinoor Gujjar Khan Mills Limited,

appears to be substantially revising the Code to facilitate and complement the process of implementing capital market reforms to attract even more foreign investors.

This Paper outlines the legal superstructure governing corporations in Pakistan. It identifies problems with the current legal regime and makes recommendations for future reforms.

#### OVERVIEW OF PAKISTAN'S CORPORATE GOVERNANCE REGIME

Pakistan has a multifaceted corporate governance regime. Laws fall into one of the following six categories:

1. General corporate laws<sup>8</sup>
2. Rules and regulations made under corporate laws<sup>9</sup>
3. Stock exchanges' listing regulations and bylaws
4. Civil laws, including those that provide remedies for seeking declarations, enforcement of a claim, and recovery<sup>10</sup>

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2002 CLD 1314.

8. *E.g.*, The Companies Profits (Workers' Participation) Act, 1968; The Securities and Exchange Ordinance, 1969; The Monopolies and Restrictive Trade Practices (Control and Prevention) Ordinance (V of 1970), Gaz. Pak. Feb. 26, 1970. The Workers' Welfare Fund Ordinance, 1971; The Companies (Appointment of Legal Advisors) (X of 1974) Gaz. Pak. Mar. 5, 1974; The Companies Ordinance (XLVII of 1984) Gaz Pak. 1984; The Securities and Exchange Commission of Pakistan Act (XLII of 1997), Gaz. Pak. Dec. 26, 1997; The Listed Companies (Substantial Acquisition of Voting Shares and Takeovers) Ordinance, 2002.

9. *E.g.*, The Companies Profits (Workers' Participation) Rules, 1971; The Investment Companies and Investment Advisers Rules, 1971 Gaz. Pak. Mar. 12, 1972; The Companies (Appointment of Trustees) Rules, 1973 Gaz. Pak. May 14, 1973; The Companies (Appointment of Legal Advisers) Rules, 1975 Gaz. Pak. Apr. 2, 1975; The Monopoly Control Authority (Net Worth of Stocks and Shares) Rules, 1977 Gaz. Pak. Aug. 25, 1977; The Companies (General Provisions and Forms) Rules, 1985 Gaz. Pak. Dec. 14, 1985; The Companies (Registration Offices) Regulations, 1986; The Companies (Invitation and Acceptance of Deposits) Rules, 1987 Gaz. Pak. Sept. 26, 1987; The Companies (Management by Administrator) Rules, 1993 Gaz. Pak. Nov. 8, 1993; The Asset Management Companies Rules, 1995 Gaz. Pak. May 15, 1995; The Credit Rating Companies Rules, 1995 Gaz. Pak. Jul 26, 1995; S.R.O. No.(I)/95; The Monopoly Control Authority (Supply of Information) Rules, 1995 Gaz. Pak. Nov. 8, 1995, S.R.O. No. 75 (I); The Monopoly Control Authority (Value of Assets) Rules, 1995; Venture Capital Companies and Venture Capital Funds Rules, 2001 Gaz. Pak. S.R.O. No. 131(I)/2001; S.R.O. No. 107(I), 195; The Companies (Issue of Capital) Rules, 1996 S.R.O. No. 110(I) 96; The Employees' Provident Fund (Investment in Listed Securities) Rules, 1996 Gaz. Pak. Feb 26, 1996, S.R.O. No. (I)/96; The Monopoly Control Authority (Computation of Market Shares) Rules, 1996 Gaz. Pak. Aug. 8, 1996, S.R.O. No. 108 (KE) 96; The Companies (Issue of Capital) Rules, 1997; The Companies (Audit of Cost Accounts) Rules, 1998 Gaz. Pak. S.R.O. No. 846(I)/98; S.R.O. No.,(I)/98; The Companies (Asset Backed Securitization) Rules, 1999 Gaz. Pak. Dec. 14, 1999; S.R.O. No. 1338 (I)/99; The Companies (Buy-back of Shares) Rules, 1999 Gaz. Pak. Dec. 14, 1999; S.R.O. No. 1337 (I)/99.; The Companies (Rehabilitation of Sick Industrial Unities) Rules, 1999; The Companies Share Capital (Variation in Rights and Privileges) Rules, 2000.

5. Criminal laws for breaches of trust, fraud, etc.<sup>11</sup>

6. Special prosecution under the National Accountability Ordinance, 1999 for corporate fraud and misappropriation<sup>12</sup>

Viewing the relevant laws, along with SECP's vision,<sup>13</sup> offers the foundational perspective to understanding Pakistan's corporate governance superstructure. Isolated reforms in any one of the above categories of laws are not likely to ensure the expected results.<sup>14</sup>

### *Business Ethics—Islamic Considerations*

The SECP believes that the best way to promote the interests of all corporate stakeholders is to ensure that business is conducted in accordance with the highest prevailing ethical standards.<sup>15</sup>

[C]orporate governance does not exist in isolation but draws upon basic principles and values which are expected to permeate all human dealings, including business dealings principles such as utmost good faith, trust, competency, professionalism, transparency and accountability, and the list can go on. Corporate governance builds upon these basic assumptions and demands from human dealings and adopts and refines them to the complex web of relationships and interests which make up a corporation.<sup>16</sup>

Pakistan draws ethics principles primarily from Islamic law because the Constitution mandates that all laws conform to Islam.<sup>17</sup> The SECP's

10. *E.g.*, The Specific Relief Act, 1877; The Code of Civil Procedure, 1908; The Limitation Act, 1908.

11. *E.g.*, Pakistan Penal Code, 1860; The Code of Criminal Procedure, 1898.

12. *See* discussion *infra* text accompanying notes 19–25.

13. *See, e.g.*, SEC. & EXCH. COMM'N PAK., MANUAL OF CORPORATE GOVERNANCE ¶ 2.2, at 3 (2004) [hereinafter MANUAL OF CORPORATE GOVERNANCE].

14. *See generally id.* § III, at 12–16.

15. *Id.* ¶ 2.1, at 3.

16. *Id.* ¶ 2.2, at 3.

17. Article 2-A of the Annex to the Constitution of the Islamic Republic of Pakistan (the Objectives Resolution) and article 227 of the Constitution of the Islamic Republic of Pakistan 1973 explicitly incorporate Islam into the Constitution. Article 2-A of the Annex states:

Wherein the principles of democracy, freedom, equality, tolerance and social justice as enunciated by Islam shall be fully observed; Wherein the Muslims shall be enabled to order their lives in the individual and collective spheres in accordance with the teachings and requirements of Islam as set out in the Holy Quran and the Sunnah. CONST. ISLAMIC REPUB. PAK., Annex, art. 2-A (1985).

Article 227 of the Constitution of Pakistan states in part:

All existing laws shall be brought in conformity with the Injunctions of Islam as laid down in

position on fiduciary duties is based on Anglo-American common law and, importantly, Islamic law, which shows the significance of Islam on business ethics for the corporate governance in Pakistan.<sup>18</sup>

### *The Accountability Ordinance*

The National Accountability Ordinance (“the Ordinance”) was introduced in 1999 to eradicate corruption and corrupt practices by public officers who misappropriate public money.<sup>19</sup> Section Nine defines “corruption and corrupt practices”:

[A] holder of public office, or any other person, is said to commit or to have committed the offense of corruption and corruption practices . . .

. . . .

. . . if he dishonestly or fraudulently misappropriates or otherwise converts for his own use, or for the use of any other person, any property entrusted to him, or under his control, or willfully allows any other person so to do[.]<sup>20</sup>

Section Five defines “person”:

[I]n the case of a company or a body corporate, the sponsors, Chairman, Chief Executive, Managing Director, elected Directors by whatever name called, and guarantors of the company or body corporate or any one exercising direction or control of the affairs of such company or a body corporate.<sup>21</sup>

This definition of “person” extends the scope of “corruption and corrupt practices” to corporate frauds and misappropriations.<sup>22</sup> If corporate management is successfully prosecuted for corruption and corrupt practices, pursuant to special prosecution before the Accountability

the Holy Quran and Sunnah, in this Part referred to as the Injunctions of Islam, and no law shall be enacted which is repugnant to such Injunctions.

CONST. ISLAMIC REPUB. PAK. art. 227(1) (1973).

18. See generally MANUAL OF CORPORATE GOVERNANCE, *supra* note 13, §§ 6.19–6.26, at 32–39.

19. National Accountability Ordinance, 1999 (XVIII of 1999), pmbl. [hereinafter The Ordinance].

20. *Id.* § 9(a)(iii).

21. *Id.* § 5(o).

22. *Id.*

Courts, management may face up to fourteen years of imprisonment, pay fines, and have property that was misappropriated or obtained through corruption and corrupt practices confiscated.<sup>23</sup> Under the Ordinance, imposed fines shall not be less than the gain derived by the accused from the commission of the offense.<sup>24</sup>

The Ordinance is the first legislation in Pakistan to treat public officers the same as corporate management for prosecution purposes. The Supreme Court of Pakistan already considers a public company office to be a public office and has therefore entertained constitutional petitions for the issuance of the writ of *quo-warranto*.<sup>25</sup>

#### CURRENT CHALLENGES AND SUGGESTED MEASURES

##### *Ownership Structure, Common Law, and Civil Law*

Unlike the Berle & Means model of separation of ownership and control, Pakistan's dominant corporate ownership structure resembles a concentrated family ownership structure. Majority shareholders not only retain control of a company but also are engaged in managing it.

Because of Pakistan's common law background, the country's legal system resembles the Anglo-American model; however, Pakistan's ownership structure is the opposite of the Anglo-American structure of dispersed ownership. The issuance of the Code ignores this distinction and benefits from the U.K. and South African reform initiatives.<sup>26</sup>

Corporate governance mechanisms devised for markets with dispersed ownership may not offer the right cure for the governance issues that a concentrated ownership structure may cause. A regulatory response will be more informed if it also takes into consideration East-Asian reform initiatives, even though some East-Asian countries have civil law traditions. For instance, a regulatory analysis of family ownership structures in the capital markets of Hong Kong, Japan, and South Korea may provide insights into similar governance issues arising out of concentrated ownership structures, and may thus be helpful in devising better solutions and in achieving higher standards of corporate governance.

23. *Id.* § 10.

24. *Id.* § 11.

25. *See generally* Salahuddin v. Frontier Sugar Mills & Distillery Ltd. PLD, 1975 SC 244.

26. *See, e.g.*, MANUAL OF CORPORATE GOVERNANCE, *supra* note 13, at 1. The Securities and Exchange Commission of Pakistan acknowledged that its Code of Corporate Governance "draws upon the experiences of . . . countries with a common law tradition" and expressly referred to reports and recommendations from the U.K. and South Africa.

### *Minority Shareholders*

Under the Companies Ordinance, 1984,<sup>27</sup> the minimum threshold for seeking a remedy from the Court against mismanagement and oppression requires that at least twenty percent of the shareholders initiate a complaint.<sup>28</sup> Shareholders representing at least ten percent but less than twenty percent of the company's shares can apply to the SECP to appoint an inspector to investigate the company's affairs.<sup>29</sup> Because neither the Companies Ordinance nor the Code recognizes shareholders who represent less than ten percent of the company's shares (the minority shareholders),<sup>30</sup> no analogous provision exists for these shareholders.

Minority shareholders can enforce their claims in civil cases by suing for tortious loss in accordance with general laws.<sup>31</sup> Claimants routinely seek interim and permanent injunctive relief against management. Pending final adjudication of the matter, interim relief is invariably granted, thus hindering a company's business.<sup>32</sup>

To provide minority shareholders with an effective remedy while minimizing interference with a company's business, an internal grievance and redress mechanism should be considered for listed companies. The SECP should establish a "grievance and redress committee" consisting of executive and independent directors and formulate a list of maintainable grievances. Furthermore, the SECP should expand quasi-judicial functions of the stock exchanges by granting minority shareholders an appellate remedy before a frontline regulator, and thereafter to the SECP.

To make reports and disclosures more reliable, the SECP should encourage minority shareholders to report any noncompliance directly to an audit committee and to the relevant stock exchange. Legal protections for whistleblowers, that is, corporate managers and employees, will help establish an additional monitoring system over the controlling majority.

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27. Companies Ordinance, 1984 (XLVII of 1984).

28. *Id.* § 290.

29. *Id.* § 263.

30. *Id.* In addition, section 290 of the Companies Ordinance, 1984, maintains that minority shareholders who represent less than ten percent do not have standing to file a petition to the court for mismanagement and minority oppression.

31. For the laws that regulate the filing of civil actions in general, see sources cited *supra* note 10. For a list pertaining to special remedies for specific corporate and securities laws, see sources cited *supra* note 8.

32. Actions of this nature are ordinarily adjudicated in four to six years at the Court of First Instance. Interlocutory appeals may take longer.

*Expansion of Audit Committee—Legal Expertise*

The introduction of internal and external audit mechanisms are the most prominent achievements of the evolution and development of global corporate governance initiatives, and the SECP has tried to incorporate these international developments into the Code.

Generally, the primary function of an internal audit committee is to assist a company's Board of Directors,<sup>33</sup> while the external audit committee addresses the concerns of the shareholders at large.<sup>34</sup> In both cases, the audit committees can only offer financial and accounting expertise. Because internal and external audit committees lack legal expertise, they cannot ensure that a company's affairs are managed in accordance with the applicable laws.

The Code requires companies not only to comply with the provisions of the Code and Companies Ordinance, but also to certify that they are in compliance.<sup>35</sup> A proper certification as to compliance with the Companies Ordinance and the Code can only be done on the basis of professional legal advice.

The Code should require the certification and actual compliance with all applicable laws, not just those of the Code and the Companies Ordinance. Although such compliance would expand the scope of the corporate governance regime, this expansion would remain consistent with the purposes for which the issuance of the Code was considered appropriate.<sup>36</sup> Such certification will improve adherence to Corporate Social Responsibility (CSR) policies by companies. Accordingly, the Code will become instrumental in introducing CSR to listed companies, making them more attractive to local and international investors. In addition, compliance with a broader legal certification requirement would discourage transactions between associated companies.

To achieve these objectives, the SECP should consider expanding the scope of internal and external audits to include legal expertise for

33. The Code, *supra* note 4, at cls. xxxv and xxxvi.

34. *See id.* cls. xxxvii–xliv.

35. *Id.* cls. xxv, xlv. Clause xxv states: “The Company Secretary of a listed company shall furnish a Secretarial Compliance Certificate, in the prescribed form, as part of the annual return filed with the Registrar of Companies to certify that the secretarial and corporate requirements of the Companies Ordinance, 1984 have been duly complied with.” Clause xlv states: “All listed companies shall publish and circulate a statement along with their annual reports to set out the status of their compliance with the best practices of corporate governance set out above.”

36. *Id.* pmbl. The preamble states that the Code shall be enforced “for the purpose of establishing a frame work of good corporate governance whereby a listed company is managed in compliance with best practices.” *Id.*



evaluating a company's business and affairs from a legal perspective. In this respect, the following initiatives should be taken:

1. One of the independent, non-executive directors should be a professional lawyer. Companies may consider retaining the services of their legal advisors appointed pursuant to the Companies (Appointment of Legal Advisors) Act<sup>37</sup> and may, alternatively, be deemed to be a member of the Board;
2. One of the non-executive directors on the audit committee<sup>38</sup> should be a professional lawyer or a legal advisor;
3. With the assistance of a professional lawyer or legal advisor, the audit committee should certify each company's compliance with all applicable laws; and
4. The audit committee should be empowered to use its legal expertise to entertain and resolve grievances lodged by minority shareholders as discussed above.

#### *Additional Measures*

The Code requires directors to "carry out their fiduciary duties with a sense of objective judgment and independence in the best interests of the company."<sup>39</sup> However, the Code does not define "fiduciary duties." To clarify this provision and improve the effectiveness of its enforcement, the SECP should consider listing fiduciary duties. It could borrow from the list of fiduciary duties in the Manual of Corporate Governance,<sup>40</sup> although the SECP does not consider that document binding.<sup>41</sup>

In addition, companies should be required to draft and comply with the Statement of Ethics and Business Practices.<sup>42</sup> To ensure a uniform ethical standard, the SECP should provide a general statement setting out minimum ethical standards; companies can set higher standards to meet their particular needs. To minimize noncompliance, companies should have a duty to "comply or explain."

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37. The Companies (Appointment of Legal Advisors) Act, 1974 ¶ 3 (x of 1974).

38. The Code, *supra* note 4, at cl. xxxiii (defining the role of an audit committee).

39. *Id.* cl. vii.

40. MANUAL OF CORPORATE GOVERNANCE, *supra* note 13, at 62.

41. *Id.* at i ("[The Manual of Corporate Governance] is for reference only and does not constitute any legal requirement on companies, their officers, directors or auditors. This manual may be used for guidance and compliance must be ensured with the provisions of applicable laws and regulations.")

42. THE CODE, *supra* note 4, at cl. viii.

## FUTURE CHALLENGES

The most profound issue in corporate governance is how to weigh criminal liability for senior executives for non-compliance of mandatory disclosure and certification requirements against the constitutional right to be free from self-incrimination. For instance, the United States Supreme Court prohibits corporate custodians from successfully invoking their Fifth Amendment protection against self-incrimination when the custodians are served with a regulatory subpoena to disclose corporate records.<sup>43</sup> Since the Pakistan Supreme Court has not made a similar pronouncement, corporate representatives may appeal to the privilege against self-incrimination in this situation.

As the SECP expands its role in regulating corporate governance, the following issues should be considered for formulating future policies:

1. What are the repercussions of over-institutionalizing internal corporate structures by forming committees and sub-committees?
2. Would externalization of the Board cause cost overruns or greater administrative or organizational expenses? If so, what alternatives exist to minimize such costs without compromising effectiveness and transparency?
3. Would a good faith presumption in favor of management be revoked, and if so, under what circumstances?

The incorporation of the Pakistan Institute of Corporate Governance and the SECP's continued work to reform Pakistani markets will lead to more effective responses to the challenges highlighted above in this Paper.

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43. *See generally* *Braswell v. United States*, 487 U.S. 99 (1988).