



# The Role of Institutional Shareholders Activism in the Corporate Governance of Pakistan

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**Abstract:** This article aims at exploring the role of institutional shareholders' activism in promoting good corporate governance practices in investee companies of Pakistan. The issue of shareholders activism was addressed exhaustively in the developed countries, particularly US and UK, after the occurrence of major corporate scandals like Adelphia, WorldCom and Enron. These major corporate scandals served as an impetus to the promulgation of the Sarbanes-Oxley Act 2002, which is "considered to be the most sweeping corporate governance regulation in the past 70 years and enhancing the long standing bandwagon for increasing the shareholder power". Corporate scandals occurring in strong economies like US and UK also triggered suspicions and doubts in the corporate environment of developing countries. Pakistan being one of them also felt a need to provide the country with such a legislation and policies that could secure the rights and confidence of stakeholders. Therefore, in the year 2002, the Code of Corporate Governance (CCG) was issued by the Securities and Exchange Commission of Pakistan (SECP) "to establish a framework for good governance of companies listed on Pakistan's stock exchanges". The Securities and Exchange Commission of Pakistan made it mandatory for all the stock exchanges to incorporate the provisions of the Code in their respective listing regulations, which was done accordingly. However, the institutional shareholders owning major shares in the investee companies are still contributing minutely towards ameliorating corporate governance environment in Pakistan partly due to their passive role and partly the non-efficacy of the Code and corporate laws.

**Key words:** Shareholders, Economy of Pakistan, Business

## Introduction

Institutional shareholders can play an assertive role in promoting good corporate governance activities in the listed companies of Pakistan through actively participating in the affairs of the investee companies. In developed countries like UK and US, much has been said and much has been done pertaining to the effectiveness of the institutional shareholders activism. However, in Pakistan very less research and work has been done in this respect owing to the concentration of share ownership in the hands of individual investors; whereas in developed countries this share ownership has been transmitted to powerful institutions like pension funds, insurance companies and mutual funds etc since long.

"Shareholders are often described as owners of corporations" (Monks and Minow, 2004) meaning thereby that owning shares in corporations tantamount to owning any other property. Shareholders being owners of corporations can

discipline an unruly corporate system. Shareholders may be individual investors or institutional investors. *"Institutional shareholders can be instrumental as agents of change towards improving corporate improving corporate governance"* (Mehmood and Sharif, 2002). Institutional investors as compared to individual investors own large shareholdings in the investee companies and therefore they can have a better say in the managerial affairs of the same. Contrary to this, individual investors/shareholders owning small shares cannot influence the investee companies' affairs. The issue of shareholders activism was addressed exhaustively in the developed countries, particularly US and UK, after the occurrence of major corporate scandals like Adelphia, WorldCom and Enron. These major corporate scandals served as an impetus to the promulgation of the Sarbanes-Oxley Act 2002. The said Act is *"considered to be the most sweeping corporate governance regulation in the past 70 years and enhancing the long standing bandwagon for increasing the shareholder power"* (Pinto, 2005). Corporate scandals occurring in strong economies like US and UK also triggered suspicions and doubts in the corporate environment of developing countries. Pakistan being one of them also felt a need to provide the country with such a legislation that could secure the rights and confidence of stakeholders. Therefore, in the year 2002, the Code of Corporate Governance was issued by the Securities and Exchange Commission of Pakistan (SECP) 'to establish a framework for good governance of companies listed on Pakistan's stock exchanges'. After the issuance of the Code, all stock exchanges of the country were directed by the SECP to incorporate the provisions of the Code in their respective listing regulations, which was done accordingly.

Corporate Governance in the broader sense postulates the way in which corporations are governed in accord with 'the highest prevailing standards of ethics and efficacy upon assumption that it is the best way to safeguard and promote the interests of all corporate stakeholders'. Institutional stakeholder \ investors having an influential force can shape the corporate governance of the investee companies by demanding the implementation of these standards of ethics and efficacy. Cadbury Committee (1992) viewed the role of the institutional investors by making the following observation:

"We look to the institutions in particular (...) to use their influence as owners to ensure that the companies in which they have invested comply with the Code" (Cadbury, 1992).

Similarly, Greenbury Report (1995) observed that "The investor institutions should use their power and influence to ensure the implementation of best practice as set out in the Code" (Greenbury, 1995) On the same lines it was observed in the Hampel Report (1998) that *"It is clear (...) that a discussion of the role of shareholders in corporate governance will mainly concern the institutions"*. (Hampel, 1997). The observations made in all these three reports manifestly emphasized the influential role of institutional shareholders pertaining to the enforcement of good corporate governance standards.

In Pakistan the role of institutional investors has enhanced in the last few decades. Their role is crucial from various perspectives inter alia encouragement for institutional investor activism, shareholder monitoring, and disclosure of voting policies, proper record of resolutions at Annual General Meeting, appointment of non-executive directors and external auditors. The effectiveness of negotiations between the institutional investors and the management,

disclosure of beneficial ownership, role of nominee directors on the board, all require activism on the part of institutional investors.

### **History of Shareholders Activism**

Shareholders activism is not a novel concept. Its roots were there in the world corporate system since long, growing with slow pace. For instance in US, its origin can be traced back to 1900s when the financial institutions like mutual funds, banks and insurance companies were actively participating in US corporate governance, *“but over the next three or four decades, laws passed with the aim of limiting the power of financial intermediaries also prevented them from having an active role in corporate governance.”* (Roe, 1990). The Glass Steagall Act prohibited *“U.S. banks from owning equity directly; and the regulatory reforms that followed the stock market crash of 1929 limited the liquidity of, and otherwise raised the costs to, investors of active participation in corporate affairs. The consequence of such laws and regulations was a progressive widening of the gap between ownership and control in large U.S. public companies—a process that continued until the emergence of corporate raiders and Labor organizations in the 1980s”*. (Bhide, 1990).

The Securities and Exchange Commission was established in the US under the Security and Exchange Commission Act 1934. The main purpose of creation of the Security and Exchange Commission was to restore investor’s confidence in capital markets by providing investors and the markets with more reliable information and clear rules of honest dealing.’ The Securities and Exchange Act also introduced provisions whereby shareholders were allowed to submit their respective proposals for inclusion on corporate ballots. *“From 1942 through the end of the 1970s, shareholders activism was dominated by individual investors”* (Stuart, 2007). The role of institutional investors gained prominence in the 1980s when the public pension funds got actively involved in demanding the protection of their rights as investors. Later years witnessed the dominant role of labor union pension funds, banks, insurance companies as activist institutional investors.

Like US, in UK as well institutional shareholders activism evolved when the share ownership came to the hands of large institutions. The role of institutional investors was recognized by different corporate governance codes and reports promulgated from time to time like Cadbury Report (1992), Greenbury Report 1995 and Hampel Report 1998. The Institutional Shareholders Committee (ISC) was established in the UK in the year 1991. The ISC provides a platform to the institutional shareholding community of the United Kingdom to exchange ideas and ‘coordinate their activities in support of the interests of UK investors.’ ISC in the year 2002 issued the ‘Statement of Principles’ wherein the role and responsibilities of the institutional shareholders were defined. The purpose of issuance of the ‘Statement’ was to ensure the application of best practice to the relationship between institutional shareholders and the investee companies, with the aim of securing value for beneficiaries over the longer term. Similarly, in the year 2007 the International Corporate Governance Network also published a ‘Statement of Principles’ pertaining to the responsibilities of institutional shareholders.

In Pakistan, yester years have witnessed the concentration of equity ownership in the hands of rich families and feudal lords. The present scenario is, however, somewhat different. Large institutions are now powerful investors along with the individual investors. The Companies Ordinance 1984 and the Code of

Corporate Governance 2002 contain various provisions regarding the active participation of the shareholders in the investee companies' managerial affairs.

In the reported case of Pakistan titled '*Kohinoor Raiwand Mills Limited through Chief Executive versus Kohinoor Gujar Khan Mills and others*' the three petitioner companies filed petition under sections 284 to 288 of the Companies Ordinance 1984, seeking sanction of the court to a scheme of arrangement approved by their shareholders in general meetings. The shareholders had opposed the scheme of merger for valid reasons documented by audited accounts of the petitioner companies. It was held by Justice Jawwad .S. Khawaja of the Lahore High Court that in case of amalgamation/merger of companies, "directors cannot act arbitrarily while proposing such scheme. Directors may have discretion in selecting one of various suitable courses of action, which may come before them for consideration, but they have no discretion to choose a course of action not in the interest of shareholders" (2002 CLD 1314).

In Pakistan, activism on the part of shareholders is still under process. The investors in Pakistan prefer short term investments in order to gain quick returns while investors in the developed countries prefer long term investments. There is in fact lack of an organized level of shareholder activism in Pakistan. The level of shareholders activism can rise with the rise in the ratio of intuitional investors. Large institutions with long-term investment strategy can contribute towards stabilized markets in Pakistan.

### **Concept, Meaning and Definition of the Shareholders Activism**

Shareholder activism as a term is used frequently but defined rarely. In order to formulate a proper definition of the term 'Shareholder Activism', it is pertinent to know individually the meanings of terms 'shareholder' and 'activism'. It is interesting to note that neither the Companies Ordinance 1984 nor the Code of Corporate Governance 2002 define the terms 'shareholders' and 'activism'. However the term 'member' has been defined in Section 2(21) of the Companies Ordinance 1984 as:

"Member means in relation to a company having share capital, a subscriber to the 'memorandum of the company and every person to whom, is allotted or who becomes the holder of, any share, scrip or other security which gives him a voting right in the company and whose name is entered in the register of members, and in relation to a company not having share capital, any person who has agreed to become a member of the company and whose name is so entered" (Ahmad, 2004).

It was held in the case of "Howrah Trading Co. Ltd v. CIT" that the expression 'member', 'shareholder' and 'holder of shares' are interchangeable terms in the case of company having a share capital. Similar view was followed in the case titled '*Killick Nixon Ltd v. Bank of India*' (1985 Company Cases 831, Bombay). The expression 'member' occurring in section 2(21) of the Companies Ordinance 1984 seems to be wider in scope than 'shareholder' and signifies a person who is a member of any company whether limited by shares or guarantee. The term 'Share' as per 'section 2(35) of the Companies Ordinance 1984 means "Share in the share capital of a company". Therefore we can say that a shareholder is a person who holds some share in the share capital of a company.

The term 'activism' as defined in the Oxford Dictionary means "policy of vigorous actions in politics" (Sykes, 1976). The European Corporate Governance Institute (ECGI) defines the term as: "*Shareholder activism is the way in which shareholders can assert their power as owners of the company to influence its behaviour.*" In terms of corporate system we can say that activism means policy of vigorous actions in business. Shareholder activism can be defined as the policy of vigorous actions in business adopted by shareholders. "Activism covers a broad spectrum of activities. Activism includes 'voting with ones feet' (exit), private discussion or public communication with corporate boards and management, press campaigns, blogging and other e-ways of public 'naming and shaming', openly talking to other shareholders, putting forward shareholder resolutions, calling shareholder meetings and – ultimately – seeking to replace individual directors or the entire board'.

### **Institutional Shareholders Activism**

The International Corporate Governance Network in its 'Statement of Principles on Institutional Shareholders Responsibilities' approved in AGM dated 6th July 2007, observed that

"the terms 'institution' and 'institutional investor or shareholder' are used to refer to professional investors who act on behalf of beneficiaries, such as individual savers or pension fund members. Institutional shareholders may be the collective investment vehicles, which pool the savings of many or the asset managers to whom they allocate the funds. Examples of the former include pension funds, insurance companies and mutual funds. The investment arrangements for these institutional shareholders vary according to type and local law or regulation" ([www.icgn.org](http://www.icgn.org)).

The term 'institutional shareholders' includes financial institutions as well as non-financial corporations. Sec 2(15-A) of the Companies Ordinance 1984 defines the term 'Financial Institution' in the following words:

"Financial institution includes:-

- (a)** a company or an institution whether established under any special enactment and operating within and outside Pakistan which transacts the business of banking or any associated or ancillary business through its branches;
- (b)** a modarba, leasing company, investment bank, venture capital company, financing company, housing finance company, a non-banking finance company; and
- (c)** such other institution or company authorized by law to undertake any similar business, as the Federal Government may by notification in the official gazette, specify for the purpose".

From the above definition it is apparent that the term 'financial institution' refers to both banks and non-banking financial companies. Institutions whether financial or otherwise may be owned by the government or the private investors. Therefore, institutional ownership can be defined as the share ownership by both financial institutions and non-financial corporations. Typical examples of institutional investors are Non-Banking Finance Companies, Banking Companies, financial entities like Trusts and Non-profit Organizations, Development Financial

Institutions, Insurance Companies, International Organizations and Fund Managers.

The role of institutional investors enhanced in UK and US in the twentieth century, due to decline in the individual share ownership and increase in the institutional share ownership. Now a days, institutional investors are playing key role in the corporate governance of many developed countries .For instance , in USA *“The California Public Employees’ Retirement System (CalPERS) provide retirement and health benefits to more than 1.6 million public employees, retirees, and their families and more than 2,500 employers.”* ([www.calpers.ca.gov](http://www.calpers.ca.gov)) Similarly in UK, Hermes Pensions Management Ltd provide products which *“are aimed exclusively at institutional and professional investors.”* ([www.hermes.co.uk](http://www.hermes.co.uk)) Pension funds and insurance companies are major institutional investors in UK.

Pakistan, unlike UK and US, in the past, had an underdeveloped corporate culture, as vast numbers of companies were owned and controlled by families. Institutional investors formed a small segment of the securities market. However, in the recent years the institutional investors have grown phenomenally. As for instance, in recognition of the increased importance of mutual fund as an investment vehicle, the Securities and Exchange Commission of Pakistan made certain guidelines in the Code of Corporate Governance 2002 to be followed and implemented by both the mutual fund and Investee Company. Even after the issuance of the Code of Corporate Governance in Pakistan, the institutional investors are not playing activist role. Institutional investors can be beneficial for promotion of good corporate governance norms only when they play proactive role. Institutional investors with large shareholdings can monitor the decisions of the board. They can also assert their part by voting and raising their voices through presentation of proposals in the annual general meetings of the investee companies.

The legal environment of a particular country greatly influences the extent of activity on the part of institutional investors. In USA, the institutional investors are playing proactive role and helping in building effective corporate governance practices. Institutional investors in USA, actively participate in voting and also present proposals in AGM of the investee firms. Similarly, the institutional investors are also monitoring the decisions of the board of the investee companies. The force behind such an increased activism on the part of institutional investors was the Sarbanes-Oxley Act 2002. The Sarbanes Oxley Act was passed by the congress in USA in order to establish enhanced standards for corporate accountability. Sarbanes Oxley Act contains various provisions ensuring transparency and fairness in terms of financial statements. The institutional investors who review and study the financial statements of the companies in which they invest, benefit substantially from Sarbanes-Oxley. Section 404 listed under Title IV of the Act (Enhanced Financial Disclosures), and pertaining to “Management Assessment of Internal Controls”, requires the corporations to publish information in their annual reports as to the scope and adequacy of the internal control structure and procedures for financial reporting. ([www.sarbanes-oxley.com](http://www.sarbanes-oxley.com)) Corporations are also required to assess the effectiveness of such internal controls and procedures in such a statement. Similarly other provisions pertain to the appointment of independent directors, transparency and disclosure in terms of audit, penalties for falsifying financial records and so on. Active institutional investors in terms of Sarbanes Oxley Act 2002 can ensure the

implementation of these provisions by the investee companies, thus leading to better corporate governance.

In the United Kingdom as well the institutional investors are proactive, as the country has taken strong legislative measures to strengthen the corporate governance practices on their part. Cadbury Report 1992, Greenbury Report 1995, Hampel Report 1998 and Higgs Report made observations regarding the defined role of institutional investors in the corporate governance. Similarly the 'Combined Code of Corporate Governance' 2003 which is the amalgamation of all these reports, specifically incorporated a separate section titled 'Institutional Shareholders', wherein the main principle laid down is that the *"Institutional shareholders should enter into a dialogue with companies based on the mutual understanding of objectives"* ([www.fsa.gov.uk](http://www.fsa.gov.uk)). The Code manifestly and elaborately defines the role and powers of institutional investors in the implementation of corporate governance norms. For instance, Rule E-3 of Section 2 of the Code provides makes it obligatory for the institutional investors to make considered use of their votes. The institutional investors are bound to attend Annual General Meetings of the investee companies. Moreover, the institutional investors are further required to give due weight to all relevant factors drawn to their attention while evaluating companies' governance arrangements; particularly those relating to the board's structure and composition.

The Combined Code of Corporate Governance 2003 makes it incumbent upon the institutional investors to ensure that the investee companies have complied with its provisions and in case of non-compliance they have to furnish explanation for departure. The Code sets out guidelines and principles pertaining to the working of the board of directors, disclosure policy, accountability, corporate responsibility, role of non- executive directors and the audit committee. All these principles if applied and implemented in their true perspectives leave no ground for corrupt governance practices.

The corporate environment of UK and US was also influenced by international standards set out by international entities like the International Corporate Governance Network (ICGN). This body was constituted in the year 1995 at the instance of major institutional investors with an aim to facilitate international dialogue on the issues concerning global corporate governance practices. The ICGN is of the view that where codes of best corporate governance practices exist, they should be applied pragmatically and where they do not exist they should be developed by the institutional investors. In its statement regarding the 'Principles on Institutional Shareholders Responsibilities' the ICGN has laid down certain parameters to be observed by the institutional investors for the promotion of good governance practices.

The state of affairs in Pakistan is, however, different. Institutional investors are passive for the reason that institutional shareholder activism is still under development. In Pakistan the primary law regulating the relationship of shareholders with the investee companies is the 'Companies Ordinance' 1984. This Ordinance contains various provisions pertaining to the corporate governance. Similarly the Securities and Exchange Ordinance 1969 contains provisions for investors' protection, insider trading and market regulation. The Securities and Exchange Commission of Pakistan which is the chief regulator of capital markets and controller of corporate entities was established under the Securities and Exchange Act of 1997. The listed Companies (Substantial Acquisition of Voting shares and Takeovers) Ordinance 2002 is another legislation that provides for

additional take over and ownership disclosure rules. The Code of Corporate Governance 2002 (CCG) lays down recommendations and guidance to be followed by the listed companies of Pakistan. However, in all these legislations there are certain lacunas which require to be fulfilled in order to boost the role of institutional investors in the corporate governance.

The Companies Ordinance 1984 under section 164 provides that the shareholder owning 10 % of the shareholding can propose the resolution and furnish draft to the company. Institutional investors usually having large shareholdings can take part in the future and existing development of the investee company. However, institutional investors owning less than 10 % shareholding cannot present draft resolution for consideration in the Annual General Meetings of the investee companies. Similarly same percentage of ownership is required for shareholders in order to seek a declaration from a court of law pertaining to the invalidation of proceedings of a general meeting. Those institutions which do not own ten percent shareholdings of the investee company cannot approach the court of law even if their interests went unprotected in the AGM. This issue has not been addressed in the Companies Ordinance mainly due to passivity on the part of minority institutional shareholders.

Institutional shareholders can become a force to be reckoned and listened to by boards of directors only when they discard this passivity and actively participate in the companies affairs for the protection of their rights. Major corporate scandals that occurred in the developed countries were the result of this passivity on the part of shareholders. No doubt maladministration was the major cause of these corporate scandals but according to the 'Economist' "much occurred because owners allowed it to; they delegated their powers to managers leaving them to set pay and targets and to monitor their own performance" (Economist, 2009).

In Pakistan as well corporate scams occurred due to the lack of activism on the part of shareholders. In the reported case of "Mohummad Kaleem Rathore versus Institute of Chartered Accountants" impugning the legality of a directive issued by SECP for appointing only those persons as external auditors who have been given a satisfactory rating under the Quality Control Review Programme of the Institute of Chartered Accountants of Pakistan, Mr. Justice Tassaduq Hussain Jillani of the Supreme Court while dismissing the same observed:

"We have had our own Enron and corporate scams. But unfortunately a swift, appropriate, retributive and deterrent response has been lacking making the corporate world vulnerable to human weaknesses of greed, temptation and lack of scruples leading at times to skewed audit reports. In the ordinary course of events, company or corporation, which is responsible for its financial statements prepared by self-appointed managers appoints its own accounting firm to give a clean chit to its financial health by endorsing those statements and then these auditors\accounting firms are compensated for giving this clean chit" (2009 CLD212).

The economy of Pakistan is staggering due to political and social instability and energy crises. In the present scenario the capital market of Pakistan is overly-depressed. There is a need for domestic as well as foreign investment, in order to reboot the capital market. Institutional investors being long term investors could prove to be the riders of this positive change in the capital market of the country.

Need of the hour is that the institutional investors should organize themselves and with mutual deliberation and consultation, bring to the notice of the legislators such measures that could protect their own rights and also provide a healthy corporate governance culture. In this respect major aspect like board structure, appointment of auditors, voting rights, shareholders monitoring etc should be taken into consideration. Investee companies as well as the institutional shareholders should try to sort out those areas that need major reforms and better legislation. Together, they can lead the corporate governance culture to the zenith of good standards.

### **Influence of Shareholders Activity On the Investee Company/Firm's Performance**

Different authors have expressed different views as to the impact of institutional shareholders activism on the performance of the investee company. Some are of the view that institutional investors can achieve sufficient benefits from the investee company as they have an incentive to monitor due to large shareholdings owned by them.(Grossman and Hart, 1980) As compared to the members of the Board, the institutional investors are possessed of greater incentive to monitor the investee company's performance for the reason that the members of the Board have no substantial investments in the company.(Sheilfer and Vishny, 1986) Opportunistic behaviour of the managers can be curbed by the institutional investors as they have the power to force them to concentrate more on the implementation of corporate governance standards. (McConnell and Servaes, 1990) Large shareholding owned by the institutional investors, acts as deterrent for the managers in pursuing opportunistic goals (Chung, Firth and Kim, 2002).

Some authors are of the view that the ability to monitor the investee company's performance depends upon the size of shareholdings owned by the institutional investors. Where the institutional investors are possessed of large shareholdings in the investee company then their shares are less marketable and can last for long periods. In such a case the institutional investors have the incentive to influence the managerial affairs of the investee company. However, where the institutional investors hold small shareholding of the investee company then these investors have lesser incentive to monitor the performance of the same. Institutional investors with small shareholdings can liquidate their investments in case of poor performance of the investee company (E. Maug, 1998).

Institutional Shareholder activism bears considerable influence upon the working of a poorly performing company. Institutional shareholders participating actively in the corporate governance reduce the risk of mergers and acquisitions and enhance the asset divestitures. Activism on the part of institutional investors also curbs the abnormal increases in the share price (Bethel, Leibiskind & Opler, 1998). Institutional investors proposals pertaining to the corporate governance are likely to be voted upon more favorably as compared to those proposals rendered by individual investors (Gillan & Starks, 2000). Some authors see a positive relationship between institutional share ownership and the performance of the investee company, (Connell and Servaes, 1990) however, others hold a contrary view. According to them the institutional investors activism does not bear any substantial impact upon the performance of the investee company (Agrawal & Knoeber, 1996).

Institutional shareholder activism depends upon the pressure sensitivity and insensitivity of the investors. Those institutional investors who rely on the firm in which they invest in for business, are “pressure sensitive” and those who do not rely on the investee firm are “pressure resistant” (Rubach, 1999). Institutional investor’s preferences and motivations differ according to their size, need, location and legal and corporate culture of a particular country. They are not homogenous but rather heterogeneous. It cannot be said that all institutional investors are ‘pressure sensitive’ or all are ‘pressure resistant’. The level of activism in ‘pressure resistant’ institutional investors is higher than those who are ‘pressure sensitive’. Insurance companies and banks may be characterized as ‘pressure sensitive’ investors as they heavily rely for their business on the investee company/firm while mutual funds and pension funds are ‘pressure resistant’ investors.

An institutional investor may be described as a *“Universal owner one that ...holds in its portfolio a broad cross section of the economy, holds its shares for the long term, and on the whole does not trade except to maintain its index”* (Hawley & Williams, 2000). Institutional investors like pension funds and mutual funds prefer to make long term investments for their beneficiaries. They play an effective role in the economy of a country as a whole for the reason that the long term investments contribute towards a stable market. Resultantly *“a universal owner’s cumulative long-term return is determined not merely by the performance of each individual firm it owns, but by the performance of the economy as a whole”* (Hawley & Williams, 2000). Institutional investors could bear substantial impact upon the performance of the company/firm they invest in. Large shareholdings owned by the institutional investors pave a way for them to assert their part in managing the affairs of the Investee Company / firm. Activism on the part of shareholders include activities ranging from raising voices through proposals in AGM, passing special resolutions, voting, demanding transparency and disclosure of financial position of the investee company/ firm, fair audit and ensuring the compliance of prevalent laws by the investee company/ firm.

Institutional investors owning large shareholdings are the long-term investors. They act as intermediaries making investments on behalf of the beneficiaries. As fiduciaries of the public money they prefer to make long term investments in order to meet the needs of the existing as well as future beneficiaries. The investee companies, in which the institutional investors hold shares, are also required to act in a responsible manner in order to support a healthy and stable economy. The investing and the investee companies are expected to comply with the standards of good corporate governance for making the economy grow. Large shareholding owned by the institutional investors gave them enormous bargaining power with the management as compared to the small investors. The performance of the investee companies can be monitored by the institutional shareholders by promoting efficient allocation of resources, by offering lower transaction costs, by providing liquidity to investors etc. More expertise can be brought by active institutional investors having portfolio managers as compared to the individual investors. Shareholder activism bears co-relationship with the performance of the Investee Company/ firm. The major areas where institutional investors should participate actively are as follows:

- Annual General Meeting
- Extraordinary General Meeting
- Insider Trading
- Voting

- Board of Directors
- Auditing

### **Legal Environment in Pakistan For Institutional Shareholder Activism**

A strengthened legal and regulatory framework is pertinent for a progressive corporate sector. This framework should be devised in such a manner that it should be in accord with the requirements of the corporate structure. Promulgation of corporate laws by itself is not sufficient for a well governed corporate system but it is the implementation and enforcement of the laws that matters. A legal system can work effectively only where the system to regulate these laws is also efficient. The edifice of regulatory framework can be built upon an effective legal system. The principle of checks and balances is an important feature of sound legal system. Political pressures and weak corporate laws destroy the institutional growth of a country. A healthy environment is necessary for the flourishing of institutions.

The development of the economy depends much upon the scheme of laws and policies introduced from time to time. Law is not static but dynamic. It can change its course according to the needs and requirements of a particular governing system. The dynamism of law allows it to bring in its fold new rules, policies and procedures. Static laws and procedures stifle business expansion and economic growth. Therefore proper updating of laws, rules and procedures is must for giving impetus to the economic growth. Institutional uncertainty often results due to weak legal and regulatory laws and the institutional investors avoid making investments in such a situation. This institutional uncertainty thus constrains the market development. The countries with effective laws and procedures progress by leaps and bounds.

The implementation of corporate laws and codes depend much upon the corporate culture of a particular country. USA introduced Sarbanes Oxley Act in 2002 in order to provide stricter and efficient corporate governance standards for avoiding future corporate collapses. It also introduced major changes in the listing standards for the New York Stock Exchange (NYSE) and NASDAQ stock market. These changes fostered an environment for increased shareholder activism. Pakistan being an underdeveloped country with weak economical structure shows poor sense for adoption of good corporate governance practices. Every sector in Pakistan is being politicized and laws are made and enforced not for the protection of general public but for extending favoritism to certain groups. Corporate sector is no exception. Most companies are owned by feudalists who do not enlist their companies on the stock exchanges in order to avoid compliance of legal formalities and payment of taxes.

Corporate Governance structures are designed with an aim to provide fair return to the shareholders on their investments. The efficient allocation of capital resources is possible only where the corporate governance structure is strong. The economies with weak corporate governance structures cannot bring positive changes for the improvement of investment climate and economic growth. Pakistan being an emerging market economy lacks the proper investor protection due to weak corporate governance structures.

Foreign Institutional investors do not prefer to make investments in Pakistan due to its underdeveloped corporate structure and no protective measures for investors. War on terrorism has also moved foreign investments

away from the capital market of Pakistan. Energy crisis has also stabbed the corporate sector and most of the industries have come to a standstill. The domestic institutional investors, therefore, being an influential force can be a ray of hope in the gloomy corporate environment of Pakistan. Institutional investors can flourish only when a healthy legal environment is available to them for making investments and exercising activism. The general law prevalent and applicable to all the companies in Pakistan is the 'Companies Ordinance 1984'. Stock exchanges are regulated by the 'Securities and Exchange Ordinance 1969' and the 'Securities and Exchange Commission Act 1997'. For Banking Companies, the legislators have provided the 'Banking Companies Ordinance 1962'. Similarly other legislations include 'Modaraba Companies and Modaraba (Floatation and Control) Ordinance, 1980', 'Insurance Act 1938', 'Insurance Ordinance 2000', 'Listed Companies (Substantial Acquisition of Voting Shares and Take-overs) Ordinance, 2002' and the like.

Proper enforcement of the laws is the responsibility of all the three pillars of the State i.e. executive, legislature and the judiciary. The legislators and the Government should take such legislative measures to build up an environment for the institutional investors where they can act progressively, securely and actively. There are so many laws prevalent in the Country yet the environment for corporate governance is not healthy for the reason that many laws overlap, others lack proper amendments and implementation. Some overlapping provisions of the Companies Ordinance 1984 and the Code of Corporate Governance 2002, deficient provisions of the Ordinance, Code, Rules and Regulations are discussed as follows:

**(I) Section 160(3) of the Companies Ordinance 1984 and Para (x) of the CCG**

Section 160(3) of the Companies Ordinance 1984 requires the general meeting of a company to be presided over by the Chairman of the Board of Directors whereas CCG in Para (x) makes it mandatory upon the Chairman of the listed company to preside over the meetings of the Board.

**(II) Section 173(1) of the Companies Ordinance 1984 and Para (xii) of the CCG**

Section 173(1) of the Ordinance places the responsibility of maintaining proper record of the minutes of proceedings of AGM upon the company itself while as per Para (xii) of the Code the Chairman of the listed company is required to perform this task.

**(III) Section 187(j) of the Companies Ordinance 1984 and Para (v) of the CCG**

Section 187(j) completely debars a person to act as the director of a listed company who himself as a member of the stock exchange is engaged in the business of brokerage. Moreover he\she cannot act so if his/her spouse is a member of the stock exchange and carries out the business of brokerage. On the other hand Para (v) of the Code allows such a person to act as director of a listed company if he seeks exemption from the applicability of this rule, from the Securities and Exchange Commission of Pakistan. This provision of the Code creates confusion for the reason that the Ordinance is to be followed by all the companies compulsorily and contravention of the same entails imposition of

penalty while the SECP also requires complete compliance of the Code by the listed companies.

**(IV) Section 224 of the Companies Ordinance 1984 and Para (xxvi) of CCG**

Directors, officers, major shareholders and any person owning more than ten percent of equity securities as beneficial owner of a listed company are required Section 224 of the Ordinance to make a report of any gain made by them from sale or purchase of such securities within a period of less than 6 months. The concerned person making such gain is also required to tender the same to the company and make intimation to this effect to the Registrar and the Commission. The Code of Corporate Governance on the other hand in Para (xxvi) does not prescribe any time period and simply requires the person making such gain, to notify the same in writing along with the relevant record to the Company Secretary. The Company Secretary then has to place such notice and record before the Board of Directors in its meeting. The Code also prescribes that the listed company shall determine a 'closed period' before the announcement of results, interim or final as the case may be. During the closed period, no person shall be entitled to deal in the shares of that company.

**(V) Para (iii) of CCG**

The Code in Para (iii) postulates that a person cannot act as a director of the listed company if he is also the director of ten other listed companies. Thereby, it means that a person may act as the director of at least ten listed companies at the same time. A person acting as the director of ten listed companies cannot do justice even with the affairs of one company of the ten. The office of the director carries too much responsibilities and the person acting as director is required to show highest level of rationality and prudence in settling the affairs of the company. Such level of prudence and rationality cannot be expected of a person who holds the directorship of so many companies. The Companies Ordinance, on the other hand, is silent as to the number of companies, of which a person may act as director at the same time.

**(VI) Para (xvi) and (xvii) of CCG**

The Code in Para (xvi) while setting out the qualifications of the Chief Financial Officer, prescribes that the person so acting should be either a member of a "recognized body of professional accountants" or a graduate having experience of five years in handling financial and corporate affairs of the listed company, bank or financial institution. This provision of the Code places an ordinary graduate at par with the Chartered Accountant. The success of a company depends upon the transparency and fairness of its financial position. The Chief Financial Officer being responsible to ensure such transparency and fairness should be a professional Chartered Accountant and not an ordinary graduate.

The Code does not debar a person from acting as the Chief Financial Officer as well as the Company Secretary at the same time. A person fulfilling the criteria of qualification as set out in Para (xvi) and (xvii) may act as the Chief Financial Officer as well as the Company Secretary although propriety demands that separate persons should hold these offices. Responsibilities of one office should be exclusive and independent of the other office. Good corporate governance standards can be ensured only when every person carries out his responsibilities exclusively with

due diligence. Overburdening a person with two or more offices will result in the reduction of good quality of corporate governance norms.

**(VII) Section 190 of the Companies Ordinance 1984**

There are many provisions under the Companies Ordinance 1984 which prescribe nominal penalties for the contravention of the ordinance. Section 190 prescribes a penalty of fine of rupees ten thousand or imprisonment for two years for an un-discharged insolvent who acts as the director, chief executive or managing agent of the company. The courts usually impose fine upon such a person. Therefore the amount of fine to be imposed must not be less than 50,000 at least. The reason being that those persons who being bankrupts act as directors, managing agents or chief executives, are likely to act to the detriment of the company and its shareholders. Therefore exemplary punishments should be imposed in order to prevent such behaviour for future prosperity of the company.

**(VIII) Section 189 of the Companies Ordinance 1984**

Section 189 of the Companies Ordinance prescribes the imposition of fine of just 200 rupees for each day upon the person who is not qualified to act as director or chief executive of the company, but he acts so. The amount of fine should not be imposed on daily basis but should be a fixed amount. Whether the unqualified person acts for few days or so many days as director or chief executive he should be penalized strictly. A person not qualified to act as director or chief executive, if makes gain of huge amount of money and also acts in detriment to the interest of investors in just few days, then paying 200 rupees per day does not cost him anything.

**(IX) Section 193 of the Companies ordinance 1984**

Section 193 of the Companies ordinance 1984, postulates the quorum for a meeting of directors of a listed company should not be less than four or one third of the total number of directors. If a meeting is held without quorum then the chairman and the directors entail liability to pay fine of ten thousand rupees. 111 This amount of fine should be enhanced as the public money of investors is involved in the listed companies. Moreover, the meetings of the Board decide the fate of the investors. If the meetings are not held properly then the ultimate sufferers are the institutional investors who have invested their huge shareholdings in the company.

**(X) Section 197 of the Companies Ordinance 1984**

Companies are not allowed to make contributions to any political party or any person for political purpose under section 197 of the Companies Ordinance 1984. A fine of ten thousand rupees may be imposed upon such a company and the director or the concerned officer may be subjected to imprisonment for two years or fine. This section does not prescribe the fixed amount of fine to be imposed upon the director or the officer making contravention. The competent authority is left at liberty to impose any fine. This section clearly provides protection to politicians. Such provisions of law require to be amended and no favor should be accorded to a particular group.

### **(IX) Section 197-A of the Companies Ordinance 1984**

The company making gifts to its members in the meetings is liable to be proceeded against under section 197-A of the Ordinance. Penalty in the shape of fine of rupees five thousand may be imposed upon such a company or the officer concerned. In case of a listed company the amount of fine should be higher as compared to an unlisted company. The distribution of gifts in AGM or other meetings to the members of choice is clearly injurious to the healthy growth of capital market. It also interferes in the progress of sound corporate practices and culture.

The above mentioned provisions of the Companies Ordinance as well as many other provisions, do not prescribe adequate penalties and remedies for the contravention of laws. These sections should set out such penalties so that the contraveners as well as the persons involved in the management should not dare to exploit the legal provisions. Stability of a corporate structure depends upon strong legal environment. The weaknesses in the legal framework also weaken the corporate edifice, ultimately leading to its deterioration. Investors do not prefer to put their investments at stake if the investee company is unable to protect their investments. Therefore, for the healthy promotion of corporate governance culture, healthy, strict and up to date laws are required.

The 'Code of Corporate Governance 2002' although contains so many principles of corporate governance of international standards yet in Pakistan we see that the companies are reluctant to adopt the same. The main reason being that the manual of the Code of Corporate Governance available on the website of the Securities and Exchange Commission of Pakistan in its opening page sets out that that the manual is for guidance only and no legal action can be brought against the company that fails to comply with the provisions of the Code. This opening Para should be removed from the Code to create a sense of compliance and responsibility in the listed companies.

### **(XII) Rules and Regulations**

There are also certain Rules and Regulations that create embargo upon the institutional investors from exercising activism. For instance, Rule 4 of the 'Investment Companies and Investment Advisors Rules, 1971' prescribes the limit of not less than one hundred million rupees of capital for an investment company to commence its business. Rule 6 provides that an investment company at a time cannot hold more than ten percent of the total paid up capital of the investee company. Similarly, Rule 4 of the 'Asset Management Rules, 1995' prescribes the limit of not less than thirty million rupees of paid up capital for an asset management company for commencement of business. The investment policy as laid down in Rule 13(4) allows the investment company to invest up to twenty five percent of its net asset values in the securities of one any sector of the stock exchange. 'Prudential Regulations for Modarbas, 2000' allow a modarba company to make investment in a listed company, not exceeding ten percent of the total paid up capital of that company or five percent of its own equity. These rules and regulations create obstacles for institutional investors in making investments and playing their part in the corporate governance of the investee companies.

The Securities and Exchange Commission of Pakistan is empowered under section 34(4) of the Securities and Exchange Ordinance 1969, to direct the Stock Exchange to make, amend or rescind any regulation already made within a certain period of time. By exercising power under the said provision of law the Securities

and Exchange Commission of Pakistan may endeavor to remove confusions arising out of the overlapping provisions of various legislations pertaining to the enforcement of corporate governance standards. Moreover, outdated laws may be updated by making appropriate amendments.

### **Measures to Improve Institutional Shareholders Activism and Corporate Governance of the Investee Companies**

The Securities and Exchange Commission may take the following measures to improve institutional shareholders activism and corporate governance in the investee companies of Pakistan.

#### **(i) Supervisory Board**

The Code of Corporate Governance for listed companies in China provides for the establishment of a 'Supervisory Board'. According to clause 59 of the Code *"The supervisory board shall supervise the corporate finance, the legitimacy of directors, managers and other senior management personnel's performance of duties, and shall protect the company's and shareholders' legal rights and interests"* (Code of Corporate Governance for Listed Companies in China, 2001). In the same line the Code of Corporate Governance of Pakistan may prescribe the establishment of a supervisory board which should conduct the supervision of managers, directors and auditors. The financial matters of a company should be open for supervision and examination by the supervisory board. The supervisory board of a company should comprise of those persons as members who are well acquainted with the existent corporate laws and procedures. The supervisory board should be governed by standardized rules and procedures inculcated in the articles of association of a particular company. The supervisory board should act as a bridge between the company and its shareholders.

The supervisory board should be in a position to make consultation with the institutional as well as individual shareholders with respect to the settlement of issue creating conflict of interests. The supervisory board should be able to convene its meetings periodically. These meetings should be attended by the directors, managers and the auditors to have a liaison on important matters of the investee company and to answer queries made by the board. In Annual General Meetings the recommendations of the supervisory board should be taken into consideration. The supervisory board can improve the corporate governance of the investee companies, if it is empowered to report directly to the regulatory authority regarding any violation of law by the company or its officers. The establishment of a supervisory board will improve transparency of financial reporting and will curb corruption in the management.

#### **(ii) Corporate Strategy Committee**

The Code of Corporate Governance of China also speaks of a "Corporate Strategy Committee". Clause 53 of the code postulates that *"the main duties of the corporate strategy committee shall be to conduct research and make recommendations on the long-term strategic development plans and major investment decisions of the company"* (Code of Corporate Governance for Listed Companies in China, 2001). The establishment of a corporate strategy committee by the companies will be a novel concept in Pakistan; however, it will improve the overall efficiency of the companies. In foreign countries every governing entity has a department for the research work. The corporate strategy committee should

comprise of members from senior management of the company and professional researchers having experience in the corporate research. If every listed company also hires a professional for the research of up to date corporate laws, procedures, rules and regulations from local as well as foreign jurisdictions, then it will bear direct impact upon the improvement of corporate governance standards.

The corporate strategy committee should be able to assess the impact of prevalent corporate laws and regulations upon the working of the company. It should point out any rigidities or flexibilities in the laws. The committee should be able to propose measures that may be taken into consideration by the corporate regulators while formulating new laws and policies. The company's overall assessment as to the compliance with the corporate laws and procedures should be made by the corporate strategy committee and default on the part of the company should be reported to the regulatory authority.

### **(iii) Negotiations with the Investee Companies**

The 'Combined Code on Corporate Governance, 2008' UK emphasized the need for dialogue between the institutional investors and the investee companies in the following words:

"Institutional Shareholders should enter into a dialogue with the companies based on the mutual understanding of objectives".

There is a good example of settlement of directors' remuneration issue through a constructive dialogue between the institutional investors and the investee company in UK. In 2002, the institutional investors having large shareholdings in the Kingfisher plc (a UK based international retailer) severely criticized the directors' remuneration packages announced by the company. The company encouraged dialogue with its institutional investors and entered into a compromise with them and the remuneration terms were revised according to the demands of the institutional investors (Mallin, 2007).

Major controversies can be resolved through mutual consultation and deliberation. The Code of Corporate Governance of Pakistan does not speak of any dialogue or mutual understanding between the institutional investors and the investee companies'. Therefore, the code should specifically incorporate a particular clause to this effect in its provisions. Inserting such a clause in the Code will provide a specific way to the investors to solve their disputes and problems through negotiations instead of invoking legal provisions. The institutional investors may get aggrieved of any particular decision of the board, excessive remuneration of the directors, undue favor to some investors or lack of transparency and disclosure policies. To settle all these issues, a dialogue between the investee company and the institutional investors will be a more prudent option.

### **(iv) Responsibility of Voting by Institutional Investors**

The institutional investors in Pakistan usually do not prefer to vote and keep themselves aside from the governance affairs of the investee company. Such a practice should be discouraged and they should be made legally bound to cast their votes. Institutional investors being major shareholders of the investee company, by effectively exercising their voting power, can turn the tide of any unfavorable decision taken up by the management. Non- exercise of voting power by the

majority shareholders, in fact allows the management of the investee companies, to commit malpractices and severe irregularities by making decisions detrimental to the shareholders' interests.

In UK, the institutional investors have been encouraged specifically to exercise their rights of vote. The 'Combined Code on Corporate Governance, 2008' UK, in Section 2 clause E.3 specifically places a responsibility upon the institutional investors to use their right of vote in the following words:

"Institutional shareholders have a responsibility to make considered use of their votes (...). Institutional shareholders should take steps to ensure their voting intentions are being translated into practice. Institutional shareholders should, on request, make available to their clients information on the proportion of resolutions on which votes were cast and non-discretionary proxies lodged. Major shareholders should attend AGM where appropriate and practicable. Companies and registrars should facilitate this".

In the Code of Corporate Governance of Pakistan, the role of the institutional investors has not been defined specifically. Moreover, no such clause pertaining to the exercise of voting power by the institutional investors has been inserted by the Pakistan's Code. Active participation by the institutional investors in the investee company's affairs can be expected only when a sense of responsibility to cast their votes, is created through legal provisions. The Securities and Exchange Commission of Pakistan in order to enhance the role of institutional investors in the corporate governance of the investee companies should allocate a separate section to the 'Institutional Shareholders Activism' in the Code of Corporate Governance.

Voting by the institutional investors should be encouraged by inserting a separate clause titled 'Institutional Shareholder Voting' in the code of Corporate Governance. Non-exercise of voting power by the institutional investors should be curbed by way of imposition of penalty in the shape of fine. Moreover, electronic voting system should also be introduced instead of a paper based system, in order to ensure more transparency of the voting process.

#### **(v) Council of Institutional Investors**

The Securities and Exchange Commission of Pakistan established the 'Institute of Corporate Governance' under section 42 of the Companies Ordinance, 1984. The purpose of establishment of the institute is to promote healthy corporate governance practices in Pakistan. The Commission should also establish a 'Council of Institutional Investors' in Pakistan. In America the Council of Institutional Investors is working as a non-profit association. The council has been established there with an aim to provide information to the public, investors, and the policy makers about good governance practices. In Pakistan as well such a council should be established to rejuvenate and strengthen corporate governance practices.

In America the Council of Institutional investors is playing a significant part in enhancing the corporate governance role. The Council occasionally holds seminars, to educate investors and the public about corporate governance principles and standards. It also solves the issues concerning the investments and shareholders rights. In the same line, the establishment of a Council of Institutional Investors in Pakistan, will bridge the gap between the Board and the investors. It

will also enhance the confidence of the general public in the institutional companies. The Institutional investors owe fiduciary duties towards the public as they hold the public money. It is, therefore, incumbent upon them to protect the interests of the public by making prudent investments

The council shall act as a nonprofit association and the institutional investors foreign as well as local, making investments in Pakistani equities, must be given membership. The council should held conferences of the institutional investors periodically in order to create awareness about corporate governance system and exercise of activism by the investors. Experts in the field of corporate law should also be participants of such conferences, so as to point out weaknesses in the prevalent laws and to suggest the measures that could be taken up by the corporate regulators.

The council shall grant membership to all the institutional investors of the listed companies. The Council of Institutional Investors should encourage investments by the institutional investors local and foreign, in all the three stock exchanges of the country. The Council should call its annual meetings to discuss the problems faced by the institutional investors in the corporate sector. The Council should be empowered to collect data of the institutional companies and the investee companies and to report to the SECP any violation of corporate governance norms by the investing and the investee company. Proper record of the poorly performing companies should be maintained and they should be kept on 'focus lists'. The company giving poor performance should be held answerable through explanation and imposition of fine.

The Council, if working, effectively can arouse the passive institutional investors' souls and could lead them towards activism in Pakistan. The seminars and conferences held by the council will benefit the institutional investors in educating them about demanding the implementation of sound corporate governance practices. The Council will also help in pointing out irregularities committed by the investing and investee companies in the compliance of prevalent laws and procedures. Primary objective of the Council should be to encourage the Institutional investors to become activists in order to ensure that the shareholders interests are not put at stake while taking corporate actions.

The Council of Institutional Investors may be made empowered to observe the prevalent corporate laws and make recommendations to the Securities and Exchange Commission of Pakistan to update the laws and policies according to the market requirements. The establishment of a Council of Institutional Investors in Pakistan will give stability to the capital market thus contributing towards the robust growth of the corporate sector.

#### **(vi) Mandatory Independent Directors.**

The Code of Corporate Governance of Pakistan in Para (b) provides for the appointment of at least one independent director representing the institutional investors. The said clause of the code reads as follows:

"The Board of Directors of each listed company includes at least one independent director representing institutional equity interest of a Banking company, Development Financial Institution, Non-Banking Financial Institution (including modarba, leasing company or investment bank), mutual fund or insurance company."

The Code although provides for the appointment of an independent director by the institutional investors, however, this provision is voluntary and not mandatory. In order to ensure more transparency, it is the need of the hour that the Code shall compulsorily obligate the appointment of independent directors representing the institutional investors. Moreover, institutional investors being major shareholders of an investee company should be given more representation by appointing at least three directors instead of one. The reason being that just one independent director on the Board cannot make any decision singularly if all the other directors of the board are against him.

**(vii) Legal and Accounting Experts**

The Code of Corporate Governance 2002 should encourage the listed companies to employ legal and accounting experts. Legal and financial diligence will be expected of these experts in assessing the investee company's record in compliance with the prevalent laws, rules and regulations. These experts should be in a position to advice the investing as well as investee companies to adopt legal and accounting standards of international level in order to improve their overall efficiency.

**(viii) Mandatory Educational Qualification and Certification for Directors**

There is no minimum educational qualification for a person to act as a director of a listed company in Pakistan. Neither the Companies Ordinance 1984 nor the Code of Corporate Governance 2002 prescribes any educational qualification for the office of directorship. The office of directorship is a very responsible office and for the efficient working of the same the directors must be highly educated, experienced and men of caliber. Directors with proper educational qualifications and professional experience will be in a better position to implement the corporate governance principles and standards in their true perspective. Uneducated and non-professional persons acting on the posts of directors cannot act with rationality and prudence, resultantly putting shareholders investments at stake. Therefore, special provisions should be made in the Companies Ordinance 1984 and the Code of Corporate Governance 2002, prescribing the specific educational qualification and experience for the office of directorship.

The law should also provide for mandatory certification for directors including mandatory training and examinations with an aim to improve competency of the directors. There is a dire need for certification of the directors in order to equip them with the corporate laws and practices in Pakistan. The Institute of Corporate Governance already working in Pakistan, should strive to properly train the directors in the field of corporate laws and implementation. Non-attending of trainings and non-passing of examinations should disqualify a person from acting as the director of a listed company. Mandatory certification for the directors will help in reducing corporate failures and will strengthen the accountable and professional role of the directors. The requirement of minimum educational qualifications for the investing as well as investee companies should be the same. Institutional investors with more experienced and well educated directors will show more activism.

**(ix) Effective Monitoring by the Institutional Investors**

The effective monitoring of an investee company's performance by the institutional investors is pertinent for increased activism. This activism may be exercised by the institutional investors by periodically considering the annual accounts, board structure and audit reports of the investee company. The institutional investors should attend the meetings of the investee company regularly and should make effective exercise of voting power. They should also ensure that the independent directors are representing their true causes. They should also ensure that their proposals have been presented in the meetings of the company properly and have been taken into consideration while solving contentious issues. An effective monitoring of the investee company's performance will identify the controversies at an initial stage and will maximize the shareholders' wealth.

**(x) Effective Internal Controls**

An effective internal control system is necessary for the smooth functioning of a corporate entity. External controls can work easily when the internal control system of a company is strong. In US, the Sarbanes-Oxley Act of 2002 particularly requires in Section 404 that the companies should publish about the effectiveness of the internal control systems in their annual reports. In Pakistan as well the companies whether small or large should be made responsible for furnishing information about their internal control systems in the annual reports. Specific provisions to this effect may be introduced in the Code of Corporate Governance.

**(ix) Removing Legal Constraints**

As discussed earlier the legal environment in Pakistan is not conducive for institutional shareholders activism. In order to ensure proper representation and increased activism by the institutional investors in the corporate sector, laws and policies need to be reviewed. Legal hurdles need to be removed and laws to be made flexible to give more room to the institutional shareholders activism. The Companies Ordinance 1984 needs to be amended and updated, inserting stringent provisions for violation of corporate governance norms. Similarly various rules including the 'Investment Companies and Advisors Rules' 1971, 'Asset Management Companies Rules' 1995 and 'Prudential Regulations for Modarbas' 2000 also require necessary amendments in order to bring more investments by the institutional investors on stock exchange. The Code of Corporate Governance 2002 should be reviewed by the Securities and Exchange Commission of Pakistan and provisions relating specifically to the role of institutional shareholders in the corporate governance may be inserted.

Moreover, as discussed earlier, provisions pertaining to educational qualifications for directors and their mandatory certification, establishment of corporate strategy committee, council of institutional investors, supervisory board, effective monitoring, mandatory independent directors and responsible voting should be made in the Code. Other regulations and policies lacking in ensuring proper compliance of corporate governance policies, should be reviewed in consultation with the legal and corporate experts. Passive behavior on the part of shareholders should be discouraged. Prudent rules and procedures should be laid down to attract more institutional investments from foreign as well as domestic investors.

There should be an attitude of zero tolerance by the corporate regulators, for the violators of the Code and prevalent corporate laws. Strict actions should be taken by the Commission and the Courts, against the management and the companies concerned for any contravention of the law. Strengthening of the legal tools can bring stability to the capital market and restore the investors' confidence.

### **Conclusion**

Institutional shareholders activism has not taken its roots in the Pakistan's corporate sector. The reason is not that the corporate scandals like Enron and WorldCom have not happened here but the main reason is the lack of interest by the institutional investors in the corporate governance system. Moreover, the legal environment of the country is also not feasible for the same. The preponderance of family owned companies has also limited the scope of the institutional shareholders activism in Pakistan.

Pakistan is passing through hard times. Foreign investments have since long departed from the capital market of Pakistan due to the prevailing pathetic environment in the country. War on terror, energy crises, debt liability and other factors have brought the growth of the economy of Pakistan to a standstill. Foreign investors are reluctant to put their investments on the stock exchange of Pakistan due to prevalent instability. The only way available to the country to boost its economy is to raise capital from the domestic investors both individual as well as institutional.

Companies complying with the corporate governance norms can give greater dividend yields as compared to those companies which do not follow corporate governance principles. Substantial changes in the performance of an investee company are not possible without introducing significant changes in the legal environment along with the enforcement tools. The purpose of implementation of the corporate governance system is to monitor the market in order to make it profitable for a country's economy. The companies complying with sound corporate principles always contribute towards a well established, stable and strengthened market structure.

The institutional investors holding large blocks have the capacity to discipline an unruly corporate entity. Passivity on the part of institutional investors paves a way for mismanagement and corrupt practices by the managers of the investee companies. Institutional investors through active participation in the managerial affairs of the investee company can reduce the risk of malpractices and mismanagement. As compared to the individual investors the institutional investors having large shareholdings can exert great influence upon the investee company, by monitoring its performance.

Demanding the implementation of corporate governance practices by the investee company is a strong device in the hands of institutional investors. Active participation by the institutional investors in the meetings and voting of the investee company can ensure transparency and rationality by the Board in taking important decisions. The management of the investee company acting in detriment to the shareholders' welfare may be held accountable by the institutional investors. Such an activism is expected from the institutional investors only when the legal and corporate environment of the country is supportive of the same.

In order to enhance the role of institutional investors in the corporate sector, the SECP and the legislators are required to provide specific provisions in the prevalent laws and policies to this effect. The Companies Ordinance and other

related laws need to be amended as suggested in chapter three of this research paper. The Code of Corporate Governance also requires to be reviewed. By strengthening the role of institutional investors legally, the corporate governance practices will automatically improve. The corporate structure of a country where the corporate governance standards are complied with in letter and spirit, always contribute towards the growth of its market and attract more and more investments. Similarly, in order to inculcate corporate governance sense in the investment and investee companies in Pakistan, corporate laws and procedures have to be strengthened. Institutional investors, being major shareholders, by exercising activism, can stabilize the deteriorating economy of Pakistan by making more investments and demanding the handling of the same in accordance with best corporate governance practices.

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