PAKISTAN'S CODE OF CORPORATE GOVERNANCE 2002 re-visited by PICG

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Best practice

The Financial Reporting Council (FRC) is UK’s independent regulator responsible for promoting high quality corporate governance and reporting to foster investment. In June 2010, FRC issued the revised UK Corporate Governance Code. Given below is an extract from the opening paragraphs on Governance and the Code which are relevant considering its background of first being introduced in 1992 and undergoing revisions since in 2003, 2005, 2007 and 2009.

“The Code is a guide to a number of key components of effective board practice. It is based on the underlying principles of all good governance: accountability, transparency, probity and focus on the sustainable success of an entity over the longer term. The Code has been enduring, but it is not immutable. Its fitness for purpose in a permanently changing economic and social business environment requires its evaluation at appropriate intervals.”

The Pakistan Scene

Corporate entities in Pakistan are primarily regulated under the Companies Ordinance 1984, the Banking Companies Ordinance 1962, Securities and Exchange Ordinance, 1969, Securities and Exchange Commission of Pakistan Act, 1997, Insurance Ordinance 2000 and the various rules and regulations made there under.

The introduction of the Code of Corporate Governance in Pakistan in March 2002 (Code) by Securities and Exchange Commission of Pakistan (SECP) was a major step in corporate governance reforms in Pakistan to establish a framework for good governance of companies listed on Pakistan’s stock exchanges. This was soon followed by two reports issued by SECP in April 2003 on Harmonizing the Code of Corporate Governance with the other laws/regulations in Pakistan and in September 2003 on Impact Assessment of the Code. In keeping with recommended practice, World Bank carried out a Review of Observance of Standards & Codes (ROSC) in 2005. A pioneering effort was then made when Mr. Zaffar A. Khan in his personal capacity carried out a survey on The Effectiveness of Boards in Pakistan in 2006 and this was supplemented by the Karachi Stock Exchange Survey on Corporate Governance in the same year and with International Finance Corporation (IFC) funding a further survey of Corporate Governance Practices in Pakistan which was issued in November 2007.
The Code as it exists today is a compilation of “best practices” which was developed partly as “principle based” and partly as “code based” to provide a direction to companies listed on Pakistan’s stock exchanges with the objective of safeguarding the interests of stakeholders and promoting market confidence.

**Implementation of the Pakistan Code**

The Code is a comprehensive document, setting out the rules and guidelines to provide a better governance structure and is applicable to all listed companies through its implementation in the Listing Rules & Regulations. Additionally, the State Bank of Pakistan which is the apex regulator for banks in Pakistan has implemented Corporate Governance Guidelines as part of its prudential regulations governing banking companies. These guidelines follow a stricter observance of governance practices than in the Code itself. Subsequently, SECP which regulates Non-Banking Finance Companies has issued separate instructions requiring such companies to observe the Code.

It was noted that the Code required revision in the light of best governance practices globally to fill any gaps or loopholes that might be present and go unaddressed consequent to the voluntary nature of observance of most of the principles set out in the Code. More so as the shareholding structure of listed companies was largely controlled by single majority groups be these family, multinationals or public sector, with limited dispersal or broad-basing of shareholdings. The saving grace has been the cumulative system of voting for election of directors that was introduced in at the time of the Companies Ordinance 1984.

**Increase of awareness**

Pakistan Institute of Corporate Governance (PICG) was set up in 2004 as a public-private partnership with SECP playing a pivotal role in conjoining SBP and seventeen other associations that were all concerned with corporate governance. PICG is today a hybrid Institute of Governance and Institute of Directors. As the Institute of Governance, it increases awareness and champion the cause of good governance practices and, as the Institute of Directors, it develops professionalism and encourages engagement of corporate bodies and individuals in the role of effective oversight. This business model is unique in the IFC MENA Region and has been recognized as a success story for other countries in the Region to emulate.

PICG is indeed a leading provider of knowledge about best practices in corporate governance to all key stakeholders affected by corporate governance by improving the quality of corporate governance in Pakistan.
Regulatory buy-in for review

SECP requested IFC in November 2006 to conduct a review of the Code. SECP would provide clearance, direction and co-ordination in the process. However, IFC recommended that PICG should undertake the task since it was better equipped and already in the process of promoting good governance practices in Pakistan. The matter was taken up in the PICG board on which SECP and SBP were both represented. Additionally, the elected Chairman of the PICG Board was the then Chairman of SECP.

Project identification and approval

The first and foremost task was to identify a Chairman most appropriate for heading the taskforce that was to be constituted for reviewing the Code. The Board of Directors of PICG proposed Mr. Ebrahim Sidat –Senior Partner & Country Managing Partner of Ernst and Young - Pakistan to lead the process as Chairman. Mr. Ebrahim Sidat was one of the key representatives of the Institute of Chartered Accountants of Pakistan who was charged with developing the Code in 2002. The other taskforce members were engaged in consultation with the Chairman.

Project task force

An eleven member taskforce was set up in December 2007 to review the Code. The taskforce included a representative of SBP, the banking regulator, two professional independent directors on boards of companies, two representatives from industry, the country representative of Centre for International Private Enterprise, USA (CIPE), a senior professional accountant in public practice and the managing directors of the three stock exchanges in the country.

After developing the terms of reference, initial meetings included engaging a consultant to develop a position paper providing a gap analysis in the light of available surveys and reports to highlight the points for deliberation by the taskforce members.

The taskforce proceeded to meet on 23 occasions and covered in its deliberations:

a) The definition, number and the process of election of Independent Directors
b) Separation of the Chairman and the CEO positions
c) Need and time period for the orientation courses for directors
d) Fit and proper criteria for corporate directors and disclosure of this information
e) Non-executive directors’ remuneration
f) The two-tier implementation of corporate governance regime
g) The critical role of succession planning
h) Board evaluation
i) Whistle-blowing function in enterprises
j) Ethics policy
k) Statement of Compliance with the Code of Corporate Governance  
l) Audit Committee; appointment and removal of auditors  
m) Need for, and method of limiting the liability of independent directors  
n) Need for a standard disclosure policy  
o) Related party transactions  
p) Applicability to public interest entities & other non-listed companies

Initial draft of recommendations

In March 2009, the Taskforce had prepared the initial draft of its Recommendations for Amendments to the Code of Corporate Governance which was taken to the PICG Board for internal debate. After a couple of meetings and discussions, the amendments and changes proposed were put forward to a focus group of all the three stock exchanges of Pakistan in September 2009. Subsequent to this, a revised draft was prepared juxtaposing provisions of the Code against significant issues for recommending amendments along with the rationale for proposing the same.

Key stakeholders buy in

The revised proposed amendments to the Code were then put forward to the listed companies across the country by means of three roundtable conferences conducted in Karachi, Lahore, and Islamabad during the early part of 2010. Presentations in the roundtable conferences essentially covered the main areas of focus for the proposed amendments, these being:

- Board Composition & Structure  
- Role of the Chair  
- Board & Director development  
- Internal & External Audit  
- HR & Remuneration Committee

1 At Karachi, 60 participants were registered, out of which 50 were present. At Islamabad all 15 participants attended the roundtable. For the 3rd roundtable held at Lahore 34 participants were registered, out of which 25 attended the conference. The International Finance Corporation (IFC) acted as a rapporteur for the three roundtable conferences and provided their comments from the participants as noted by them. In addition to this, the Center for International Private Enterprise (CIPE) which is PICG’s partner in many initiatives on Corporate Governance especially amongst Family-Owned Businesses also extended complete support throughout the three roundtable conferences.
After having made the presentations, the participants were given an opportunity to voice their observations and provide feedback on the proposed recommendations. Discussions and comments mainly focused on the rationale for proposing the recommendations.

**Public Opinion**

Having reviewed the comments received at the roundtables, the next step was to collate all the comments and place these for a discussion with the taskforce members. The comments were deliberated upon and a final draft document was prepared. Once again, PICG’s Board was engaged in a final review before the document was placed on PICG’s website in May 2010 for public opinion. Appropriate notices were provided in newspapers advising public of the posting on PICG’s website and through emails to all listed companies with intended closure by May 31, 2010.

**Final review and project closure**

The last and final stage entailed meetings with the members of the taskforce in order to discuss the public comments that were received after placing recommendations on PICG’s website. Additionally, PICG’s Board was advised and the final document sent to the Chairman, SECP in June 2010 with a chronology of events setting out the rationale for the key recommendations being proposed to the Code.

Given below are the significant changes that were proposed by PICG’s Task Force.

**Applicability of the Code**

- Make the Code additionally applicable to Public Interest Entities, meaning an entity or company not being a listed company which:
  
a) is a corporation or company formed under any law in force and owned, wholly or partly, or controlled, whether directly or indirectly, by the Federal Government or a Provincial Government or the Chairman and/or the Chief Executive Officer or directors on the Board of Directors thereof are nominated or appointed by the Federal Government or a Provincial Government, as the case may be, or

b) is subject to any of the two following conditions:
   
   (i) has a paid up capital plus undistributed reserves of Rupees 500 million or more;
   
   (ii) has an annual turnover of not less than Rupees 01 billion;
(iii) has total assets exceeding Rupees 1.50 billion as per the latest audited financial statements;

- Provide an effective regulatory framework for all other non-listed companies by developing optional guidelines to supplement the existing corporate governance framework.

**Board of Directors**

- Bring about a balance of executive and non-executive directors placing emphasis on the representation of independent directors to ensure exercise of independent judgment whereby
  - Independent directors should represent not less than $1/3^{rd}$ or 3, whichever is higher of the total members of the board and their names disclosed in the Annual Report for the protection of interests of all stakeholders.
  - The proportion of the executive directors (including the CEO) should not be less than 2 or more than $1/3^{rd}$ of the elected directors to ensure effective representation of executive directors and non-executive directors including independent directors on the board.

**Qualification and Eligibility to act as a Director**

- Limit to 5 the number of directorships that an individual can hold in listed companies to allow for a materially increased time commitment from the directors which is essential for the proper functioning of the board. Directorships of listed subsidiary companies of a Group Holding Company are not to be included in this limit given certain conditions.

**Responsibilities, Powers and Functions of the Board of Directors**

- Undertake annual board evaluations (individual and collective) to provide a forum for assessing the board’s own performance, responsibilities and to improve accountability.
• Separate the offices of the Chairman and CEO with the Chairman being a non-executive director.

Orientation Courses for Directors

• Apart from Orientation Courses, directors to attain certification under the 'Board Development Series' by Pakistan Institute of Corporate Governance ("PICG") or such other organization or director education program as may be accredited by SECP in this respect.

Board Committees

• Audit Committee to have majority of independent directors with its chairman from amongst the independent directors. Also Human Resources and Remuneration Committee made mandatory with at least one independent director, and CEO (who shall not participate in proceedings relating to his own pay and performance) and the chairman being from amongst the non-executive directors. This would bring more transparency to the compensation structure of senior management and puts in place a succession plan to ensure achievement of corporate objectives/goals.

Chief Financial Officer and Company Secretary

• Removal of Head of Internal Audit to be only with the approval of the board of directors as is the case currently with CFO and Company Secretary's removal.
• CFO not to be appointed as Secretary of the Audit Committee to preserve the desired independence from executive management.

Subsequently, SECP reviewed PICG's proposals and has made available to the public through its own website, the draft of the revised Code which embodies most of the recommendations put forward by PICG. SECP allowed time till December 2010 for comments. Currently it is going over these comments before it issues the final revised Code which is expected by end March or April 2011.