

# **CORPORATE GOVERNANCE AND THE ROLE OF MANAGEMENT\***

**Dr. Tariq Hassan<sup>©</sup>**

**Dr. Ishrat Husain, Honorable Governor, State Bank of Pakistan**

**Mr. Javed Iqbal, President, Management Association of Pakistan**

**Distinguished Guests**

**Ladies and Gentlemen**

*Asalaam Aleikum:*

It is a great honour and privilege for me to be here today to address the Management Convention 2004 on the topic "Corporate Governance and the Role of Management". I would like to congratulate the Management Association of Pakistan for arranging a conference of this stature which I am sure will go a long way in creating awareness on this important issue in Pakistan.

## **Introduction**

In my speech today, I shall discuss the need for Corporate Governance and efforts undertaken by the Securities and Exchange Commission of Pakistan (SEC) to improve the corporate governance framework in the country, primarily focusing on the introduction of the Code of Corporate Governance and setting up of an Institute of Corporate Governance. I would also examine the role of management in the context of bridging the gap between best practices and corporate behaviors, with particular reference to social and cultural norms before concluding my speech.

## **Need for Corporate Governance**

The success of modern enterprises depends on the adoption and implementation of good management practices that *inter alia* seek to protect the interests of stakeholders. Sound corporate governance practices help companies to improve their performance and attract investment while enabling them to realize their corporate objectives, protect shareholder rights, meet legal requirements, and demonstrate to a wider public how they are conducting their business. These practices have become critical to worldwide efforts to stabilize and strengthen global capital markets and protect investors.

Research has shown that investors from all over the world will pay large premiums for companies with effective corporate governance. One such study

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conducted by the McKinsey Quarterly found that institutional investors in emerging markets would be willing to pay as much as 30 percent more for shares in companies with good governance. Furthermore, it showed that companies with better corporate governance had higher price-to-book ratios, demonstrating that investors do indeed reward good governance. Further, even if corporations do not rely primarily on foreign sources of capital, adherence to good corporate governance practices will help improve the confidence of domestic investors, may reduce the cost of capital, and ultimately induce more stable sources of financing.

If we take a look at the recent cases of corporate fraud, the critical importance of good corporate governance for economic development is evident. Long-term gains in job creation and incomes for the poor in developing countries depend heavily on better standards for corporate behaviour, supported by government and civil society. We can no longer afford to consider better social, labour or environmental conditions as desirable "add-ons". Rather, they are pre-conditions for sustainable economic growth.

### **Code of Corporate Governance**

It is mindful of the above that regulators around the world have promulgated codes of best practices and principles.

In Pakistan, the SEC introduced the Code of Corporate Governance in March 2002 as a first step towards systematic implementation of principles of good corporate governance. The Code has been incorporated in the listing regulations of the stock exchanges and is applicable to all public listed companies. It is a compilation of "best practices" to provide a framework by which the business and management of listed companies are to be directed and controlled.

I would like to outline here some of the salient features of the Code of Corporate Governance that deal with the role of management and directors of companies:

- ❑ The Code encourages representation of independent non-executive directors and those representing minority interests on the boards of directors of listed companies. As a further guarantee of compliance with this provision, the Code requires that the chairman of a listed company "shall preferably be elected from among the non-executive directors of the company and that the board of directors shall clearly define the respective roles and responsibilities of the chairman and chief executive, whether or not these offices are held by separate individuals or the same individual."
- ❑ The Code requires every listed company to establish an audit committee that will comprise not less than three members, including the chairman. Majority of the members of the committee, it is further directed, "shall be from among the non-executive directors of the company" To further enhance their role, it requires that the chairman of the audit committee be preferably a non-executive director.
- ❑ It reinforces the powers, responsibilities and functions of the board of directors, formalizes the corporate decision making process and requires adequate documentation of policies and decisions of directors.

- It also seeks to strengthen the corporate working of listed companies by stipulating that:
  - Appointment and removal, remuneration and terms of reference of the CFO and Company Secretary shall be determined by the CEO subject to the approval of the Board of directors.
  - New appointments of CFO and Company Secretary must be made in accordance with the prescribed qualifications.
  - The financial statements, presented to the Board for consideration, shall bear the signatures of the CEO and CFO.
  - The Company Secretary shall furnish a Secretarial Compliance Certificate as part of the annual return, to be filed with the registrar.

Furthermore, a statement of compliance with the Code of Corporate Governance is required to be published by companies to set out the extent of compliance with the Code. The statutory auditors of listed companies have been made responsible for reviewing and certifying this statement.

### **Institute of Corporate Governance**

The SEC is cognizant of the fact that an enabling environment must be created to facilitate compliance with the provisions of the Code. Subsequent to the introduction of the Code of Corporate Governance, a number of measures have been taken to improve awareness about and encourage implementation with its recommendations. In this regard, I am pleased to share with you that the SEC is at concluding stages to establish an Institute of Corporate Governance in Pakistan in consultation with other stakeholders. The Institute will be an independent entity – owned by a balanced representation from public and private sectors – to undertake various activities for education, training, awareness, communication, research and publications on good corporate governance practices and the role of various stakeholders, including management, to implement these practices in letter and spirit.

The objective of this corporate governance reform agenda is to increase the depth and efficiency of our capital markets with an aim to mobilize domestic savings and foreign portfolio investment. The SEC recognizes that growth creation in the era of global capitalism requires a corporate governance system that has the ability to efficiently raise external equity capital, to increase corporate competitiveness and to stimulate corporate growth.

### **Role of Management**

In the context of Pakistan, the need for good corporate governance assumes a more significant dimension given the corporate culture and the fact that an overwhelming number of companies are closely held. The need for reasonable representation in corporate decision-making process for all stakeholders of a

company thus assumes a striking significance in the scheme of corporate governance in Pakistan.

The board of directors in a company has the overall responsibility for management and direction of its affairs. In this regard, the directors should exercise strategic oversight of business operations while directly monitoring, measuring and rewarding management's performance. The board should also ensure the integrity of accounting and financial reporting systems and oversee the process of disclosure and communications.

The board's responsibilities inherently demand the exercise of judgment. Guiding business strategy, determining an appropriate corporate appetite for risk or selecting a chief executive from a pool of candidates involves decision-making that cannot be reduced to a mechanical series of steps. Monitoring and supervisory functions may comprise a range of reasonable approaches. In the end, healthy corporate profits do not guarantee that directors performed well, nor losses prove that directors were careless or incompetent.

The board of directors has the responsibility to ensure that corporate behaviour conforms to best governance practices. This requires directors to exhibit certain behavioral norms, including: (a) informed and deliberative decision-making; (b) division of authority (c) effective monitoring of management; and (d) even-handed performance of duties owed to the company and to shareholders as a class.

The above norms stand in contrast to business practices that often prevail in family or closely run companies abundant in Pakistan. In closely held companies, a single family or group appoints the entire board of directors. The governance of such companies often relies on private, informal decision making, deference to authority and loyalty based on long-term personal relationships; in such cases, even if legal norms clearly fix directors' duties, human nature and cultural patterns can lead to divided loyalties. The relatively large number of listed, family –run firms in Pakistan and other emerging markets makes the transition to internationalized behavioral norms particularly important and challenging.

Behavioral norms also affect shareholders and regulators. For both cultural and practical reasons, Asian shareholders often prove reluctant to litigate or to assert formally their legal rights. This reluctance places greater pressure on regulators and raises capacity and infrastructural challenges for Asian corporate-governance frameworks.

## **Conclusion**

Given the above, the Code expects the board of directors to have appropriate representation of minority interests to discharge their fiduciary responsibilities in the larger interest of all stakeholders in a transparent, informed, diligent and timely manner. Further, the Code requires the restructuring of the board of directors of listed companies allowing for broad based representation by executive and non-executive directors. This arrangement is central to the recommended theme of good corporate governance by emphasizing openness and transparency in corporate affairs and the corporate decision making process.

This would in turn reinforce the trust of the investors and other stakeholders in the corporates.

However, any good corporate governance framework cannot translate into effective practices unless corporate culture promotes and facilitates such practices. The wide discretion generally granted to directors means that behavioral norms play a particularly significant role in guiding director behavior. No legal norms, however refined, can contemplate every situation in which a director might find himself. Moreover, a director wishing to abuse his position, either for his own benefit or that of a manager or shareholder, can often mask his own misbehavior by going through the motions of proper deliberation prescribed by legal norms.

Circumstances like these call for greater awareness and education about good corporate governance practices, as being beneficial to the company, its management and directors, shareholders and investors, creditors, employees, other stakeholders and the society at large. While efforts have been initiated in this direction, we must ensure that these efforts are sustained and supported at all levels to create the necessary enabling environment for good governance practices.

Thank you!