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Enforcement of Corporate Laws and Stock Market Reforms in Pakistan

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Abstract
The objective of this paper is to examine the enforcement problems of the corporate laws in Pakistan. It critically analyses the stock market problems of enforcing corporate matters. The out-dated laws and underdeveloped and ineffective stock market are the major problems for effective enforcement corporate matters in Pakistan. There is a need to revamp the laws, enhance institutional capacity and to develop the capital market for the safeguard of the interests of the investors according to international standards keeping in view the prevailing circumstances in the country.

Keywords: Corporate Law; Corporate Governance; Minority Protections; Enforcement; Capital Market; Stock Markets; Pakistan.

I. Introduction

The concept of effective enforcement rather than merely the provision of the law in booksare not new in theory (Pound, 1910). Scholars of corporate law have been discussing the issue for quite a long time. In the new world scenario, this has become more relevant than it was before. The enforcement of laws is very important in an era of globalisation and competition (Enriques, 2002) where cross-border investment has increased. This phenomenon highlights the importance of enforcement of corporate matters not only for domestic investors, but also for overseas investors to attract foreign investment.

The judiciary is an important source for enforcement of laws. However, enforcement may also come through other means and, in fact; these alternatives are embedded in the system. The discussion in this paper is limited to enforcement of corporate matters through alternative means that is other than judiciary. The main alternative source of enforcement of corporate matters is the capital market. The capital market plays an effective role in enforcing corporate laws. The market in Pakistan has failed to implement rules and regulations. Some initiatives were undertaken by the regulator and the state but they could not produce optimum results due to the vested interests of those who did not welcome even limited reforms. Therefore, there is a need to reform market keeping in mind the prevailing circumstances of the country and international trends.

II. Enforcement issues in corporate governance

In recent years, globalisation and competition have brought about towards convergence trend in corporate governance. The transplantation of foreign corporate governance features has remained a main phenomenon. In this process the home countries tried to adapt these features according to their circumstances but a weak enforcement mechanism did not produce optimum results. La Porta et al. have discussed in detail the protection of investors, especially minority shareholder, and described them as the main reason for the development of the market and good corporate governance. They further emphasised the fact that the enforcement mechanism can be effective only when there are good laws. The 'law in books' is; therefore, important in the first phase of reform, even if there is a weak enforcement mechanism (Berglof andClaessens, 2004). In the second phase, the law in action can be ensured by enhancing institutional capacity and developing capital market (Cooter, 1998). If reforms are made without enhancing enforcement mechanism, then there are chances of expropriation of small investors. Therefore, in order to make reforms more effective, the enforcement mechanism should be improved (Pistor, Raiser, &Gelfer, 2000).

Reforms in enforcement mechanisms have been on the agenda of both developed and developing countries in the recent past. Developed countries had taken the initiative long before developing countries (Kraakmanet al., 2004).Now they have very strong enforcement mechanism as compared to underdeveloped countries. The enforcement is in fact embedded in the system. The whole system supports the enforcement mechanism which provides protection to the investors and they do not hesitate to invest. This in turn develops the system of corporate governance. For instance, in the UK supporting institutions such as the stock market, institutional investors, and a developed judicial system have provided sufficient investor protection, which has developed the system of corporate governance (Cheffins, 2001). The problem of enforcement is more severe in developing countries than in developed countries. The problem does not lie with the 'law in books' but with the 'law in action' in developing countries (Berglof&Claessens, 2004).

In Pakistan there have been some reforms during the past three decades. The reform agenda started with the enhancement of the regulator's capacity in corporate law. The establishment of the Securities and Exchange Commission of Pakistan (SECP) through the Securities and Exchange Commission of Pakistan Act, 1997 (the SECP Act 1997) was the first step on this agenda. The SECP made some laws and amended existing laws, rules and regulations to provide investors with rights and to safeguard them. Many state owned enterprises were privatised and the state disinvested some of its shareholding to the general public. This phenomenon stimulated family-owned enterprises to disinvest some of their shareholdings to the general public. These reforms caused a boom in the stock market which results in attracting small investors who were not aware of the technicalities of the market and its operations. They did get some benefits from the market boom but such benefits were only for the time being. The market crashed many times and major was in

March 2005. In this scenario small and dispersed shareholders were the main victim and they even lost their life savings. The regulator and stock market failed to avoid the market crash, and, subsequently, also failed to identify and punish the culprits. Stock brokers had manipulated the market and derived undue advantage from their position at the cost of small investors who were relatively new in the market (Khawaja&Mian, 2005).

The lack of enforcement mechanism is a basic issue in the context of Pakistan. The problem is also severe due to lack of judicial capacity to enforce investors' rights. The regulator is also not efficient enough to ensure these rights. Most officials at the SECP are not efficient, and lack knowledge about, and expertise in, the corporate sector. Other supporting institutions such as the stock markets, financial institutions and institutional investors are also not performing. Corruption, nepotism, feudalism and inefficiency are inherent in the system and the regulator, judiciary and other supporting institutions are not exempted (Shah, 2005).

III. Reforms

Corporate governance is regarded in the same way as economic and legal institutions that can be reformed but it requires political support (Shleifer&Vishny, 1997). Reforms are necessary for underdeveloped jurisdictions such as Pakistan where corporate governance institutions are weak and fail to protect investors. In order to enhance the enforcement mechanism and improve corporate governance, the system needs to be reformed. The stock market is a major actor to provide protection to the investors. The stock market in Pakistan is not developed; therefore, there is a need to reform stock market in the way that provides protection to the investors. This will enhance investor confidence, which may be beneficial to the economy in general.

IV. The Market reform

Major area of concern for effective enforcement of rights or law in action for corporate matters is the capital market in Pakistan. The market is inefficient (Ghani&Ashraf, 2005), and fails to sanction non-performing firms and managers. A weak enforcement mechanism through market forces allows market manipulation and expropriation of minority shareholders by majority shareholders and dominant business groups. In Pakistan market reform started with the establishment of a powerful regulator. The establishment of the SECP was the first stop on this agenda. The regulator, which was under direct government control, was given financial, administrative and regulatory autonomy. The SECP started improving the law in books through amendments and introducing new laws. However, failure on the part of the capital market to enforce the investor protection mechanism and sanction non-performing firms is the main concern about good governance in Pakistan.

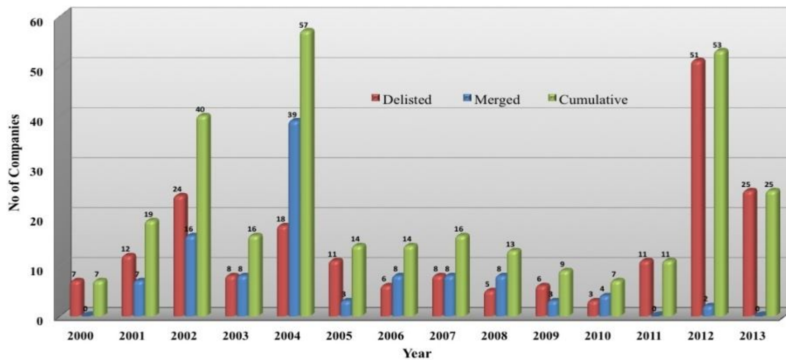
V. Stock market reform

The state and regulator undertooksome reforms in the stock markets of Pakistan.[1] In the first phase the central depository company (CDC) was formed for the central handling of securities under the Central Depositories Act, 1997 and the Central Depository Companies (Establishment and Regulation) Rules, 1996. The physical shares were transferred into electronic form to facilitate the transfer. In the second phase the stock markets were merged and integrated by converting it into one stock market known as Pakistan Stock Exchange (PSX). The PSX is corporatized and demutualised by converting it from a company limited by guarantee to a company limited by shares. It took more than ten years for completing the process as the process was to be completed by the end of 31 December 2006 (The Securities and Exchange Ordinance 1969, s. 32E (1)). In the third phase the rules for insider trading were changed. The definition of *insider trading* was enhanced and clarified in the securities law (The Securities and Exchange Ordinance 1969). The punishment for insider trading was converted from imprisonment and financial penalty to a heavy financial penalty only. The objective of this change was to convert criminal liability to civil liability. As the nature of evidence in criminal cases is stricter than in civil cases, trial courts in criminal offences require from the prosecution evidence beyond doubt, which may not be feasible in most of the cases involving corporate offences and white-collar crimes.

In a further step the SECP issued a Code of Corporate Governance and made it part of the listing regulations in 2002. This was a major breakthrough in the efforts to achieve good corporate governance. However, the business community received it lukewarmly. Many companies delisted in 2002 and in subsequent years. They had originally listed to derive certain benefits, which included tax incentives and fulfilling licensing requirements for different businesses. Many companies do not know the potential benefits of good governance and therefore do not observe the code in its true spirit. Some companies, including multinationals, do observe the code due to reputational concerns. However, the real problem was the implementation of the code in its true spirit. The SECP issued a revised version of the code in 2012 with some amendments to the first version. In 2012, the voluntary provisions of the Code were also converted into mandatory provisions which had more adverse effect than initial issuance of the Code in 2002. The following figure shows that substantial number of companies delisted during 2002 to 2004, 2012 and 2013.

[1] There were three stock markets in Pakistan: the Karachi Stock Exchange, Lahore Stock Exchange and Islamabad Stock Exchange.

Figure: Companies delisted and merged during 1999–2013[2]



To avoid resistance from the businessmen and powerful interested groups in the implementation of the reform process, one option to reform the market may be the phased implementation of the rules, regulations and the code. For this purpose, the stock market can be divided into different segments, each with its own requirements depending upon the nature of the listing. This may circumvent resistance from the families and interested groups.

The phenomenon of dividing the market into segments is already in operation in different parts of the world.

VI. London Stock Exchange

The London Stock Exchange (hereinafter LSE) is an important example. The LSE covers different segments of the market. In the main market, companies can have different types of listing: UK and overseas companies, including the European Economic Area (EEA), may have premium and standard listing, and Global Depository Receipts (GDRs) on the official list. It all depends upon the choice of the issuer and, subsequently, the different requirements have to be fulfilled according to the nature of the listing.

According to London Stock Exchange (LSE) website, there are two broad categories of listing on the main market with premium and standard listing. The premium listing is only for equity shares of trading companies, and closed and open-ended investment entities, whereas standard listing includes the issuance of shares, depository receipts, debts and securitised derivatives.

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[2] The data were taken from the Annual Reports of the Karachi Stock Exchange (Now Pakistan Stock Exchange) and the Securities and Exchange Commission of Pakistan. The data is taken for the years in which there were significant changes.

i. Premium listing

Premium listing does not mean 'first listing' or 'sole listing', rather, it means that companies are required to meet the highest standards of regulation and disclosure in Europe; in other words, they have to meet the UK's gold standards – described as 'super-equivalent requirements' that are over and above the 'directive-minimum'[3] requirements. Companies that have premium listing on the main market are potentially eligible for the FTSE UK Index Series, one of the most recognised in the world, which includes the well-known FTSE 100 Index (LSE).

The companies that have premium listing are required to comply with the following key requirements:

i) *A three-year revenue earning record, an independent audit within six month from the date of the prospectus and an unqualified working capital statement*(Listing Rules of Financial Conduct Authority, LR 6.1)

ii) *The prior approval of shareholders before the cancellation of their listing by the FCA*(Listing Rules of Financial Conduct Authority, LR 5.2.5R (2))

iii) *Compliance with six listing principles with emphasis on directors' responsibility, an adequate system, integrity towards investors, timely communication, equality of treatment of shareholders and dealing co-operatively with the FCA*(Listing Rules of Financial Conduct Authority, LR 7.2.1R*)*

iv) *The appointment of a sponsor to advise on key transactions*(Listing Rules of Financial Conduct Authority, LR 8.2)

v) *After premium listing the company remains subject to continued obligations which include the following:*

- a. *Provision of notifications to the FCA and market about changes in the company*(Listing Rules of Financial Conduct Authority, LR 9.6)
- b. *Provision in the annual report and financial statements regarding compliance with the UK Code of Corporate Governance*(Listing Rules of Financial Conduct Authority, LR 9.8.6R*)*
- c. *Application of pre-emption rights for UK companies unless dis-applied in accordance with ss. 570-1 of the Companies Act, 2006*(Listing Rules of Financial Conduct Authority LR9.3.11R & LR 9.3.12R*)*
- d. *Prior approval of shareholders regarding the disposal or acquisition of businesses or assets which reach certain thresholds* (Listing Rules of Financial Conduct Authority, LR 10.5.1R*)*
- e. *Prior approval of shareholders for related party transactions* (Listing Rules of Financial Conduct Authority, LR 11.1.7R*)*
- f. *Observance of buyback of shares rules.* (Listing Rules of Financial Conduct Authority, LR 12.1.2R)

[3] These are minimum requirements for the European directives.

ii. Standard listing

A standard listing on the LSE does not necessarily mean a company's second listing, rather, it signifies that the company has chosen to meet EU harmonised standards as opposed to the UK super-equivalent standards required for a premium listing. Overseas companies seeking standard listing were required to have a primary listing in their home jurisdictions until July 2005 but this condition has now been waived. Before 6 October 2009 standard listings were allowed only to equity securities of overseas companies but now UK companies are also given the option of standard listing.

According to London Stock Exchange, the companies with a standard listing have to meet the 'directive-minimum' standards. Also effective from 6 April, 2010, the standard listing and GDRs are required to comply with the EU Company Reporting Directive which requires, among other things, that a corporate governance statement be provided, and that the main features of the internal control and risk management systems be described.

iii. Global depository receipts

According to London Stock Exchange, GDRs are negotiable securities that represent a company's equity issued by a depository bank on behalf of a company, which is normally an overseas company. The purposes of issuing GDRs is to broaden the shareholder base, raise capital, enhance the company image globally, increase the visibility of its products and services, and to facilitate mergers and acquisitions. GDRs are intended to be purchased by sophisticated or professional investors in the primary market. Retail investors are unlikely to access them in the primary market but it is possible for them to purchase GDRs in the secondary market. It is provided in the prospectus that the securities should only be bought and traded by investors who are particularly knowledgeable in investment matters.

The GDR market is a specialist market. New admissions are often offered to institutional investors. These securities are not included in the FTSE UK index series. GDR listings are normally available to overseas companies and are required 'directive-minimum' standards. UK companies can also be GDR-listed, provided that their underlying equity is a premium listing. From 2000 onwards, overseas issuers were not required to have primary listing in their home jurisdiction (Financial Services Authority, 2008).[4]

The following are the requirements for a company with a standard listing:
The requirements for standard listing stem from the Prospectus and Disclosure and Transparency Rules (DTRs). The principal additional provisions relating to listing rules are as follows:

[4] Financial Services Authority, 'A Review of the Structure of the Listing Regime', (Discussion Paper 08/1) (January 2008), London, pp 6-12.

1. *The company must satisfy the Consolidated Admissions and Reporting Directives (CARD)*[5] *requirements*
2. *All circulars, notices, reports and resolutions must be published through the Regulatory Information Services (RIS)*[6] *in the UK.*(DTR, 6.3.2R*)*

iv. Concessions to overseas companies

Some concessions were made in the past to overseas companies with regard to premium and standard listing. Overseas companies with a premium listing were not required to 'comply or explain' the UK Code of Corporate Governance and to offer pre-emption rights. The overseas companies were only required to disclose in their annual reports and financial statements that they were complying with the corporate governance regime in their country of incorporation and also to disclose to what extent this was different from the UK code (Financial Services Authority, 2008). However, effective from 6 April 2010, the overseas companies with premium listing are now required to 'comply or explain' the UK code (Listing Rules of Financial Conduct Authority, LR 9.8.7 R) and to offer pre-emptive rights (UKLA Publications, 2010). However, effective from 6 April 2011, overseas issuers are exempted from the requirement of pre-emptive rights subject to the condition that the shareholders have allowed dis-application of pre-emptive rights equivalent to the authority given under ss. 570 or 571 of the Companies Act, 2006 or in accordance with the law of the country of incorporation, provided that it has implemented Chapter 29 of directive 77/91/EEC (Listing Rules of Financial Conduct Authority, LR 9.3.12 R (4)).[7] Furthermore, effective from 6 April 2010 overseas companies with a premium listing are exempted from the application of LR 9.3.9R which empowers the issuer to impose sanctions on shareholders who fail to respond to notice to disclose their interest in shares under s. 793 of the Companies Act, 2006 (Listing Rules of Financial Conduct Authority, LR 9.3.10 G). More concessions are made to overseas companies with a standard listing than overseas companies with premium listing.

v. Professional Securities Market

The PSM is an integral part of the LSE and is operated within the scope of its status as a Recognized Investment Exchange. The PSM enables companies to raise capital through the listing of specialist securities, including debt and depositary receipts, to professional investors.

[5] Directive 2001/34/EC of European Union deals with the admission of securities at official listing on a stock exchange and the information to be published for those securities.

[6] The companies who are subject to Disclosure and Transparency Rules require disseminating the information throughRIS. For this purpose, the FCA provides a list of RIS and a company can choose any one of them.

[7] See Listing Rules of Financial Conduct Authority LR 9.3.12 R (4).

vi. Alternative investment market

The Alternative Investment Market (AIM) is the LSE's international market for smaller growing companies. A wide range of businesses, including early stage, venture capital and more established companies join AIM seeking access to growth capital. It is a non-listed market. The companies who are admitted to trading but are not admitted to the official list can trade on AIM. This is not a regulated market and it provides companies with a different trade market. AIM does not require the UK Code of Corporate Governance. The companies that are eligible to trade on AIM are required to comply with national rules and regulations as well as certain European Commission Directive standards, where applicable, such as the DTR and the Prospectus Rules (AIM Rules for Companies, 2014').

b. Frankfurt Stock Exchange

The Neuer market is a segment of the Frankfurt Stock Exchange (FWB) in Germany. This market segment was created especially for listing new firms under the Deutsche Bourse (an operator of the Frankfurt Stock Exchange). These companies were required to follow international accounting and greater disclosure standards as compared to existing listed firms. In the early stages it proved to be very successful in Germany with many new IPOs. The German business community accepted it because it had not directly affected them (La Porta, Silanes, Shleifer, &Vishny, 2000). Later development, however, showed that this was not a successful experience. However, failure cannot be attributed to regulatory dualism, but rather to its design, management and the circumstances under which it operated (Gilson, Pargendler&Hansmann, 2011).

c. Novo Mercado (New Market) of BM&F (Brazilian Mercantile and Future Exchange) Bovespa, Brazil

The Brazilian Stock Exchange also established a separate segment of the stock exchange to facilitate new growing firms along the lines of regulatory dualism. This proved to be a stunning success as it had learnt lessons from the failure of the Neuer market. The regulator was successful in breaking the deadlock in reforms by creating a new segment of the stock exchange in which new and growing firms may adopt stringent requirement in addition to the existing lightly regulated regime in order to attract more external investment opportunities (Gilson et al., 2011). This regulatory dualism may be a successful avenue for those jurisdictions where path dependency forces resist reform. This may be a suitable case for a jurisdiction such as Pakistan where path dependency forces such as families and vested interests resist reform.

d. Stock Exchanges in Pakistan

The regulatory dualism experience can be effective in Pakistan. The stock exchange in Pakistan may be divided into segments with primary and secondary listing. Companies with primary listing may be required to follow international accounting standards, more disclosure requirementsand mandatory compliance with the code of corporate governance and related party transactions. Companies with secondary listing may be allowed to follow domestic accounting standards with

lower disclosure requirements and optional compliance with the code of corporate governance and related party transactions. This regulatory dualism may not harm families and vested interests. Families and interest groups who have reservations about compliance due to their vested interests, might not be directly affected by this kind of reform. They may carry on their listing in the secondary market and may move towards the primary market once they realise the potential benefits of primary listing with its enhanced requirements. This may be helpful in developing the market and creating good governance in the corporate sector of Pakistan.

The primary market may be attractive to multinational, big, existing and new companies. In this way, these companies can convey the message to investors that they are willing to comply with higher disclosure requirements. This may attract other companies who have a secondary listing to move towards primary listing. The bonding will play a major role in moving companies from secondary to primary listing. Small existing and new companies can enlist on the secondary market where there will be lower disclosure requirements as well as non-binding compliance with the code of corporate governance, and fewer requirements for compliance with rules and regulations. This will provide these companies with some exposure in the public sector. Compliance with fewer requirements may induce management to think about moving to the strict compliance regime of primary listing. Reputation, bonding and enhancing the shareholder base may be the stimulants for primary listing. In this way, companies may create their own culture of compliance. After maturing, companies may seek entry into a primary listing. This movement of companies from secondary to primary market will assure investors of their commitment to compliance with higher standards. This may improve the companies' share price which will help companies to raise equity finance and debt financing at lower cost. Investor confidence will be increased and good governance will be ensured. Individual investors may find it beneficial to invest in the primary market, whereas institutional investors may invest in both the primary and secondary markets. As the institutional investors have experience and expertise in investing, they can, therefore, invest in both markets. However, the primary market may be helpful for small investors as only highly reputed companies will go for primary listing.

VII. Other segments of the market in Pakistan

There are other ways to enhance the enforcement mechanism too. One may be the role of intermediaries such as institutional investors, including banks and mutual funds. These institutions can ensure company compliance with regulations (McCahery,Sautner, &Starks, 2016). They can use their position to force companies to comply with the rules and regulations through participation in general and board meetings. They can also negotiate with portfolio companies for compliance with the rules and regulations instead of participating in the management. Institutional investors are working well in advanced jurisdictions such as the UK and the US. In Pakistan the fund industry is not yet developed and that may be one reason for the underdeveloped market. The industry may play its role in enforcement, but reforms are needed in this sector as well. The UK Stewardship Code may provide Pakistan with guidelines on how to develop the fund industry. There are other benefits for

institutional investors such as safe investment for the small financier. These investments provide diversified investment through professionals. Reforming the institutional investment industry in the country may thus help to develop the market and enhance the enforcement mechanism.

VIII. Conclusion

This article discussed enforcement or 'law in action' in corporate governance in Pakistan. It sought to examine the ways in which the law in action can be effective in the country. It demonstrated that the 'law in books' was important in the first phase of reform but that 'law in action' must be improved in the second phase for better corporate governance and investor protection. This article also recommended different means of improving the law in action through reforms in Pakistan.

The other important aspect of law in action is the market in Pakistan which is underdeveloped. The capital market of Pakistan failed in compliance and enforcement. The institutional investors are passive and the takeover market is not performing due to an illiquid market. There is a need to reform the market keeping in mind the particular circumstances prevailing in Pakistan. Families are dominant and may resist any reform agenda as the *status quo*favors them. This resistance from families and vested interests can be overcome through piecemeal reforms in the market. The market can be divided into two segments: (1) the primary market and (2) the secondary market. The primary market may require more disclosure and compliance than the secondary market. International accounting standards, compliance with the code of corporate governance, controlling related party transactions and other disclosure may be mandatory features of this market. The secondary market may require less disclosure and compliance. International accounting standards, compliance with the code and related party transactions may be optional. The primary market may be attractive to multinational, big, existing and new companies. Reputational concerns will attract them to enlist on this market. This market will be useful for small and dispersed investors. Institutional investors may invest in the primary and secondary markets as they have experience in, and knowledge of, where to invest. They can also use their position and voting power to ensure compliance. The secondary market may be attractive to small, existing and new companies. Once they get exposure and know the potential benefits to be gained from the primary market, they may enlist on the primary market. The bonding mechanism will be the stimulant for them to shift to the primary market. This may ensure compliance and enforcement through the market.

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