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PAKISTAN'S DRAFT CODE OF CORPORATE GOVERNANCE 2019

PAVING THE WAY FOR
GREATER FLEXIBILITY

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FOREWORD

All over the world “Code of Corporate Governance” is issued by the regulators of capital markets to protect the interest of shareholders. As the economies, culture and companies are not stagnant and always go through an evolution phase; so does the requirements to govern the organizations.

Securities and Exchange Commission of Pakistan has recently issued a draft Code of Corporate Governance 2019. While the new draft code promises to bring certain improvements, there is and will always remain a room for improvement as for any legislation

The purpose of this publication is to educate the investors, directors, company’s management and public at large on the key changes brought about, our views on the same and suggestions for improvement. Together with this we have highlighted few areas where the Regulator can look into for enhancing the depth & breadth of the Code.

We hope that this effort will be useful for various stakeholders to develop well governed organization for creating better working lives.

Muhammad Faheem Piracha
CEO

SIGNIFICANT CHANGE OF APPROACH

Comply or Explain

One of the most significant changes introduced in the draft code is the 'Comply or Explain' Approach. This is synonymous with a principle-based approach and can be seen employed by a number of other countries namely, The United Kingdom. What this means is that companies are expected to state and explain any sort of non-compliance in case of the non-mandatory requirements of the code along with providing alternate solutions where possible.

The purpose of such an approach is to recognize that what works for one organization might not work for the other and therefore requirements should be flexible based on respective business needs.

The popularity of a principle-based approach has grown over the years as industries and businesses have evolved, so has the need for more flexibility in the way companies are run and developed.

Pakistan's code of corporate governance has long followed the rule-based approach of all its requirements being compulsory and binding to listed-companies. . While this approach might provide more clarity to companies and make it easier to verify for auditors and regulators, it is not always suitable to a company's situation. The costs might exceed the benefits especially in smaller organizations and lead to unnecessary administrative burdens. Further it gives rise to a 'box-ticking' mentality which goes against the fabrics of good corporate governance.

A principles-based approach, however, allows for a broader level of reporting, less stringent on specific requirements and more practical for a business' circumstances. This can also lead to better decision-making having considered a wider-range of factors in order to reach a conclusion on what provisions to comply with, therefore improving governance and sustainability.

SECTION 1: KEY CHANGES

Increase in Limit to the Directorship of Multiple Companies

Directors cannot have directorship of more than seven listed companies simultaneously. This was previously limited to five listed companies, however an exception was given for being a director of the listed company's listed subsidiary. Since this exception is already a part of Companies Act, 2017 hence removed from the current draft Code, to eliminating duplication.

Exemptions from Relevant Qualifications for Key Positions

Qualification criteria for key positions like CEO, CFO and Head of Internal Audit was clearly spelled out in 2017 Code with no exceptions. While the criteria is still applicable, there is now an exemption in the case where holders of such designations have 15 years or more of prior experience in their respective positions.

Remuneration of Directors

The requirement for an independent consultant to be engaged when deciding the remuneration of directors has been omitted in the draft code.

Experience Criteria for Audit Committee Members

Proposed additions in the code include the requirement for audit committee members to have 10 years of prior experience in the role or at least 20 years of experience as senior management dealing with finance & audit related matters.

Board Resolution No More Required on Certain Key Decisions

Under the 2017 Code of Corporate Governance, decision taken on material transactions like investments & disinvestment of funds with a maturity period of six months or more, determination of the nature of loans & advances made by the company were required to be documented by passing resolutions at board meetings. This is no longer a part of the new draft and removed from the "Responsibilities of Board of Directors and its members."

It is pertinent to note here that the above mentioned decisions were the only one's being singled out for approval as Board Resolution while being already covered under policy approval section. Hence, in our opinion the removal of this requirement would eliminate the anomaly.

Number of Independent / Executive Directors

There is no change in the requirement to have at least two independent directors or one-third of the board, whichever is higher.

However, draft code requires the board to explain in the director's report the reasoning for not rounding off as one any fraction contained in the one-third number mentioned above. Same explanation is required for executive directors as well, when applicable.

Highlighting Significant Policies

In 2017 code, it was recommended to disclose company's policies on its website. The same recommendation still holds however the draft code has provided further guidance by clearly spelling out the below mentioned policies for the purpose i.e.

1. Communication and disclosure policy;
2. Code of ethics;
3. Risk management policy;
4. Internal control policy;
5. Whistle blowing policy;
6. Corporate social responsibility/ sustainability/ environmental, social and governance (ESG) related policy



SECTION 2: KEY NON-MANDATORY PROVISIONS

As we have moved to the “Comply or Explain” approach through the introduction of draft Code of Corporate Governance 2019, in this section we highlight certain sections that in our opinion needs to be a given a second thought whether to keep these as it is or consider them for being mandatory.

Separation of CEO and Chairman

One of the most significant provisions, proposed as, ‘encouraged’ in the draft is the separation of the roles of CEO and chairman. It is no longer mandatory for both the roles to be held by different individuals. This essentially gives rise to a conflict of interest issue. From our perspective, these positions need to be separated since combining the two can reduce the effectiveness of the board.

One of the key roles of the Board of Directors is to monitor the performance of the enterprise. The CEO is responsible for running the show of and is therefore accountable to the board. Combining both roles allows for a self-review threat and therefore abuse of power. Because of this lack of segregation of duties, the process of accountability is comprised.

While this might not be true for most of the codes around the world, companies in United States of America are allowed to take variety of approaches based on what structure is most appropriate to their circumstances, including combining the positions of CEO and the chairman. **In such case, however, a lead director is appointed to safeguard the independence of the board for the purpose of effective corporate governance.**

Business Risk Review

Previously the Board of Directors was required to establish risk management policies in order to determine company’s risk tolerance and undertake annual reviews of business risk to ensure a sound system of internal controls. The requirement has been relaxed in the proposed draft, as it is now an ‘encouraged’ practice.

The board is in charge of ensuring the company’s long-term sustainability. In order to accomplish this, board should review and give input on the key risks and their respective treatments.

Responsibilities of the Board

In general, the responsibilities of the board, whether preparing corporate strategy, promoting ethical culture, forming specific committees or performing evaluations, all of them are paramount to successful corporate governance. The section on board's responsibilities now comes under the comply or explain approach which means the board can forego some of its responsibilities as important as they might be by providing an explanation.

Director's Remunerations

The requirement that directors shall not determine their own remuneration package is no longer mandatory.

What this essentially means is, directors can fix their remuneration themselves as long as they can explain this decision.



SECTION 3: **MANDATORY** **REQUIREMENTS**

The 'Comply or Explain' approach does not apply to issues that remain or have been changed to mandatory however. The following are all mandatory requirements of the new proposed code:



Directorship of Multiple Companies

As stated in previous section, directors of a company are not allowed to have directorship of more than seven listed companies simultaneously.

Composition of the Board

Executive directors, including the CEO cannot be more than one-third of the board of directors, while there needs to be a total of either two Independent directors in the Board or one-third, whichever is higher.

Independent directors are also required to make a declaration that they qualify for the criteria of independence, at the first meeting and then every time a change affects their independence.

Female Director

Similar to the previous code, the board of directors has to have at least one female director at the next reconstitution of the board.

Formation of the Audit Committee

The Board of Directors will oversee the formation of the Audit Committee, ensuring members have either ten years of experience serving in audit committees or twenty years of finance & audit experience as senior management.

External Auditors

Only those external auditors and firms are to be appointed that are registered with the Audit Oversight Board of Pakistan and have met the quality control requirements of ICAP (Institute of Chartered Accountants of Pakistan). They are to only provide audit services, cannot be a close relative of key management and are to comply with the International Federation of Accountants guidelines.

External auditors are also to provide a management letter to the board within forty-five days of the date of the audit report. Any other significant matter is to be sent in writing prior to the audit report.

External auditors are to be changed every five years for finance sector companies whereas the engagement partner should be rotated every five years for other listed companies.

Statement of Compliance

Listed companies are to publish a statement of compliance with the code of corporate governance after it has been reviewed and certified by external auditors.

Directors' Report

It is indicated in the 'Penalties' section of the draft, that the Directors' Report i.e. point number 34, is a mandatory provision, the non-compliance of which will result in a penalty. The word mandatory however, has not been mentioned in point number 34, indicating that this might be an error.

SECTION 4: ADDITIONAL RECOMMENDATIONS

Looking at the draft on the whole, there are some elements that should have been incorporated to a larger extent that have either been briefly mentioned or completely overlooked.

Ethics, Values and Leadership

Ethics and values are very important aspects of good company culture that should be addressed in a code of corporate governance. Pakistan's proposed code calls for the board of directors to ensure that a code of conduct is in place with supporting policies and procedures, thereby promoting ethical culture throughout the company.

While this is definitely a step in the right direction, it fails to emphasize the importance of leadership in the implementation of this culture by setting the 'tone at the top'. As an example King IV's Report on Corporate Governance for South Africa states that board should lead ethically and effectively showcasing all the required qualities of integrity, competence, responsibility, accountability, fairness and transparency. All board members and top management should individually and collectively cultivate these characteristics and exhibit them in their conduct. Similarly, the Corporate Governance Regulations of Kingdom of Saudi Arabia makes it a requirement for members of the board to set the values and standards that govern work in a company while executive management actively participates in building and developing a culture of ethical values. UK's Corporate Governance code highlights this as a 'key role' of the board.

Technology Governance

Another significant matter that should have been addressed is the governance of technology. This can include infrastructure, systems and software that generate, use or carry information and enable transactions. Looking at other codes around the world, technology governance has not yet been widely adopted but given the growing technological landscape and how integral it has become to the running of enterprises, its importance cannot be denied. King IV's report for South Africa underlines the significance of technology in revolutionizing businesses and transforming business models, giving detailed guidance on recommended practices to be followed to ensure its security. Principles of Corporate Governance for the United States also briefly speaks about technology as a means to deliver 'information' and that it should be accompanied by safeguards to protect the security of this information.

Conflict of Interest

In the Pakistani code, the same provision for a formal 'code of conduct' that deals with ethics also addresses conflict of interest but does not elaborate any further. Additionally, in case of a conflict of interest, the requirement for at least two independent directors to be present when deciding on a subsequent action relating to conflict of interest situation has also been removed.

It is pertinent to note here that corporate governance regulations in the Kingdom of Saudi Arabia call for an explicit written policy dealing with conflict of interest situations. It explains the importance of avoiding conflict of interest situations and the procedures for disclosing them, entering into contract with related parties and the course of action for violation. The UAE code draws attention to the board of directors forming a special committee to deal with any such issues and presenting their opinion before the board.



FINAL THOUGHTS

To sum it up, while the proposed draft intends to provide greater flexibility and encourage professional judgment through the new principle-based approach, it is yet to be seen whether companies can deal with this new-found freedom to comply or explain.

The broadness of principles means that guidelines might be ambiguous and difficult to correctly interpret. Constant interpretation also means more costs incurred and evidencing would also be problematic. There are also concerns with litigation in case of non-compliance, as our judicial system might lack the appropriate experience to pass judgment on accounting principle.

Having said that, the intensions are clear, as it is an effort to align Pakistan with the practices of other developed economies of the world who have already successfully implemented this approach and have benefited from it.



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We exist for creating better working lives through well-governed organizations.

Our culture is built around the values of honesty, openness and balance. These guiding principles drive us to achieve excellence for our clients and improve the lives of people.

For advisory on governance, risk and controls please contact us



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