The Role of Shareholder Activism in Corporate Governance and a Case for Legal Compulsion

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I.
INTRODUCTION

In the present corporate climate dominated by issues arising out of an increased emphasis on regulating commercial activities, shareholder activism is said to be "symbolised by the struggle between public companies and their owners"[1]. Such activism can be defined as proactive acts, which could range from large numbers of shareholders attending and voting at meetings, to just taking the time to inform themselves about the company they've chosen to invest in. The issues raised in this article shall be in context of the need for such activism, what prevents and encourages it and whether there should be a legal compulsion placed upon shareholders to become more active in the way the companies they invest are run.

"Shareholders are often described as owners of corporations"[2] and their ownership of shares is considered to be the same as owning any other property. Consequently, authors have argued that since shareholders enjoy the rights of property, therefore, they should be obliged to assert their role as owners to discipline an unruly corporate system as represented by Enron, Tyco, WorldCom and Parmalat amongst many others.

Such emphasis upon the role of shareholders as owners goes against the orthodox view, which advocated that shareholders should be allowed to conduct their affairs freely without any "unnecessary" regulatory interference and that shareholders had no business meddling with management of companies. The break from this traditional view has increasingly emerged from the recent corporate scandals that brought to light the weakness in the relationship between shareholders and board of directors, resulting in the absence of accountability of directors who prevented the owners from discovering and reacting to acts of mismanagement and corruption[3].

Hence, the advocates of corporate governance have tended to support the notion that the role of shareholders should be re-evaluated in light of what is seen to be an obligation towards common good in society. This, they believe may reinstate post-Enron corporate legitimacy along with contributing in the longevity, profitability and overall good performance of a company.

Although, such notions may appear to be vague and idealistic, nevertheless, there is presently an increased level of shareholder activism, which is increasing and being encouraged by regulatory bodies and

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[1] K. N Schacht, *Institutional Investors and Shareholder Activism: Dealing with Demanding Shareholders*, DIRECTORSHIP, Vol. XXI, Issue 5 (1995).

[2] A.G. MONKS AND N. MINOW, CORPORATE GOVERNANCE 98 (Blackwell Publishing, 2004).

[3] See R.C WARREN, THE RESPONSIBLE SHAREHOLDER: A CASE STUDY (2002) (arguing for shareholders obligations towards what is good for society when investing in industry using asbestos or other dangerous products).

governments. Such activism is predominantly located within the American and to a certain extent in the European corporate systems. It is also very much with the rise of large institutional investors and their actions regarding the corporate governance process, which have given impetus to what is being described as the awakening of the sleeping giant in the form of activists.

So how does such developments impact upon emerging markets like Pakistan? In order to address the issues that arise in relation to shareholders in such a market one should first of all take into consideration the corporate governance environment for shareholders in developed markets. The role played by institutional shareholders in such markets will be the starting point in explaining how such collective group of shareholders have been able to become effective in making their voices heard, where previously their presence was unacknowledged.

II.
RISE OF INSTITUTIONAL SHAREHOLDER ACTIVISM

According to Tortorello, N. J "it has been clear for many years that institutional shareholders wield enormous political and economic power"[4]. The rise in institutional shareholders (particularly pension funds) within America and Europe, possessing huge amounts of available capital to invest at their discretion, caused a decrease in individual holdings and to an extent made shareholders a force to be reckoned with and listened to by boards of directors. However, according to the Economist before the events of the corporate scandals "many institutional investors voted unthinkingly with management when share prices were soaring in the 1990s"[5]. Although, many of these corporate scandals were a result of maladministration, it is arguable that "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"[6].

So what made investors sit up and assert their rights of ownership? According to Leslie, G[7] it was purely a reaction to the poor returns on investments that gave investors to give rise to "the most productive season for corporate governance in the U.S, since more than 20 years ago"[8]. Institutional investors like CalPERS, Vanguard along with Fidelity, Hermes, Tweedy Browne and Standard Life made their presence felt through either

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[4] See N. J. Tortorello, *The Rising Power of Shareholders*, THE CORPORATE BOARD (2004).

[5] See *Will the Owners Please Stand up?* THE ECONOMIST dated 2002.

[6] See *Beyond Shareholder Value,* THE ECONOMIST dated 2003.

[7] See G. Leslie, *Green Light for Activism,* THE GLOBAL INVESTOR (2003).

[8] B.B. BURR, SHAREHOLDER ACTIVISM HOT IN POOR BUSINESS CLIMATE, (2002) (citing A. G. Monks).

aggressively pursuing their agenda publicly or through persuasion behind closed doors. These investors influenced changes in the decision making of such companies as Carlton television, Disney, Vodafone and others[9], which was quite unheard of in the era where the threat of hostile takeovers was considered to be the only factor which would make an impact on the decision making of the companies' board of directors.

It would seem that investors/shareholders who had acted as absentee landlords are appearing to be trying to get away from what has been described as "costly complacency"[10] and an "attention deficit disorder"[11]. Arguably such apathy may have contributed towards mismanagement by directors who decreased shareholder profits but increased their own wages. However, it is thought that investors have now begun to realise that they are the owners, resulting in voting levels in American company resolutions rising to about 80%[12].

Exercise of institutional shareholder power seems even more so when one considers that it was essentially shareholders who were responsible for the recent revolts at Hollinger, Carlton and Vodafone regarding appointments, remunerations and policy over takeovers. According to Strategic Direct Investor[13], as a consequence of activism shown by such investors as Hermes "issues of non-executive directors have become a hotly debated topic in the UK". So what has brought about this increase in the level of institutional shareholder activism, what are the obstacles in their way? and is this for real or just a momentary public relations exercise in the wake of corporate scandals.

A. *Reasons for Increased Activism*

Besides the recent corporate scandals and their repercussions for the stock market, it has particularly been the growth of large institutional shareholders which contributed towards activism. It is estimated that financial institutions in 1993 held around 62% of ordinary shares, which

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[9] Encouraged by such activism the shareholders along with fans of Manchester United Football Club showed their public displeasure with the takeover of the Club by American Glazer family. The confidence of the stakeholders in protesting when Glazer had complete management control of the Club shows how perception of who owns a company has taken hold of shareholders.

[10] See *A Full-time Occupation,* THE ECONOMIST dated 2004.

[11] See *Who is In- Charge* in THE ECONOMIST dated 2003, citing Jim Rogers the head of Cinergy.

[12] See *Will the Owners Please Stand up,* supra note 5.

[13] See *Corporate transparency---corporate reality* in STRATEGIC DIRECT INVESTOR dated 2002.

was more than double the figures since 1963[14]. Thus, institutional investors became the focus of such reforming bodies as the Cadbury and Greenbury commissions, which emphasised that "because of their collective stake, we look to the institutions in particular, with the backing of the institutional stakeholders committee, to use their influence as owners to ensure that the companies in which they have invested comply with the code"[15].

Consequently, in order to differentiate between ownership and management for good corporate governance, institutions had to accept the fact of their ownership position and not just that of a short term equity gambler. It was and is presumed that by encouraging activism, shareholders would begin to think as owners and thus begin to accept their obligation to intervene and prevent mismanagement of their property. They were are being encouraged towards such beliefs and some of them have acted on the basis of this premise along with of course the belief that their interest would be best protected in better managed companies.

Another factor that encouraged activism has been the growing interest of investors in long term investment portfolios (e.g. index investment) which resulted in the move away from the practice of investors selling their shares to escape from badly managed companies. According to estimates around 25% of American trading is done by momentum traders, which results in volatility and risk within the American market[16]. However, it's arguable that the short term investment market made up of these "momentum traders"[17] has begun to develop into one in which investors are beginning to tie into the future of investments. These so called "stuckholders"[18] are too big to sell their shares and walk away, which has given way to a "realisation that it makes better economic sense to become an agent for change" in the long term.

An increasing level of communication and information available to a diverse community of investors remedied the adverse impact from "the inability of shareholders to communicate with each other"[19]. In America the Security and Exchange Commission had made the acquisition of information harder by requiring those who were discussing a firm to inform all other shareholders. The expense involved in this exercise prevented

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[14] H. Short, and K. Keasey, *Institutional Shareholders and corporate governance in the United Kingdom*, in K. KEASEY, CORPORATE GOVERNANCE: ECONOMIC MANAGEMENT AND FINANCIAL ISSUES 18, (Oxford University Press) (1997).

[15] *Cadbury Report* , para. 6.16, 1992.

[16] C. K. Brancato, T*he Myth is the Message* in ACROSS THE BOARD, Vol. XXXV, Issue 5 dated 1998.

[17] Ibid.

[18] Rowe and Frederick, H*urrah for October 15* in FORBES, Vol. CLI, Issue 4 dated 1993.

[19] D. A. HENRY, A WAKE-UP CALL FROM INVESTORS (2004).

activism, until this problem was to a certain extent removed by the same regulatory authority.

Increased emphasis on the availability of information to investors is evident from American investors being allowed to communicate with each other without breaching the proxy solicitation rules. Further, management is required to disclose to investors the remuneration packages being offered to executives[20] and fund managers are also required to disclose their voting practices and policies to investors (an obligation also being considered in Britain). Such provisions were bound to act as an incentive for activism, through opening up of company practices and encouragement of shareholders to communicate concerns with each other about their investments.

Regardless of the reasoning for activism, an international survey[21] points to a general change in attitude of shareholders in their stance towards how, where and in whom they should invest. Out of 65% of international institutional investors surveyed, 71% said that "at some point they had declined to invest in a company due to poor governance practices". Investors "want to be better able to contribute to the new climate of corporate governance"[22], and according to another survey 70% want to know more than they use to about the running of companies they invest in.

The impact of shareholders concerns are being recognised by analysts who argue that the tendency of shareholders to speak out more often on corporate governance "is beginning to show up on sell-side analysts' reports, where typically they ignored it"[23]. This amount of interest being shown by investors should have resulted in a significant increase in the levels of activism; however, there exist certain barriers which prevent this.

B. *Barriers to Shareholder Activism*

Shareholder activism may not seem as phenomenal an occurrence as has been publicised by the media or writers on the subject. Arguably there exist barriers which prevent shareholders from exercising their monitoring of companies. Consequently, the attitude of directors towards shareholders remains as that of meddlers in business they have no knowledge of. According to Ball (1990) regardless of the fact that "there is more VOICE being exercised than is commonly supposed", yet, "nature of this VOICE is

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[20] See Rowe and Frederick at supra note 18.

[21] See *Corporate Governance is a Growing Investor Concern Worldwide,* in CORPORATE BOARDS, Vol.XIX, Issue 111 dated 1998 (citing Russell Reynolds, *International Survey of Institutional Investor).*

[22] See Tortorello, supra note 4.

[23] McGurn, Vice President of Institutional Shareholder Services Inc., cited in B.B. Burr at supra note 8.

unsatisfactory. It is not systematic. It takes place behind closed doors. The process itself is not subject to any kind of monitoring"[24].

There are a number of contributing factors which prevent shareholders from systematically making their presence felt in the board room. According to Short and Keasey[25] there is too much evidence on the attitude of shareholders not being that of owners, rather they still view shares as short term commodities. This is evident when one sees that as a group, shareholders generally do not even attend shareholders meetings[26], which are after all the forums provided to them by law to raise their concerns. This short term attitude of the shareholders breaks down the rationale underlying legal provisions for accountability of directors to the owners of the company i.e. shareholders.

The free rider issue and cost of activism are other factors which prevent investors, particularly small ones, to raise their voices more effectively. In the absence of collective action, any act of activism is still too costly for individual shareholders. Further, as Monk[27] even where an activist stand is taken, the investors risk not only expenditure but also reputation within the market place as being trouble makers. The uncertain returns on intervening may cause the investors to not rock the boat and maximise their profits through traditional short term trading of shares.

Although the rise of large institutional shareholders did result in certain amount of activism, but their diverse interests can also lead to prevention of activism. According to Black, B. S[28] institutions spend very little amount on corporate governance issues, which shows how little they are interested in the long term performance of their investments. Further, it is arguable that because institutions have diverse holdings, therefore, such investors will be facing conflicts of interest when voting on management decisions. This conflict arises from these institutional investors providing their services like insurance, pension schemes and banking to companies they invest in. According to *the Economist*[29]to such investors it makes better economic sense to not be active in the boards decision making and "act like punters not proprietors". Besides the few large investors it is argued that most institutional shareholders prefer to vote in line with the management, and intervention only occurs when it's too late. The inactiveness of investors is evident from *The Economist*[30] report, which stated that in Britain only half

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[24] See Short and Keasey, supra note 14.

[25] Ibid.

[26] See Tortorello, supra note 4 (founding that over 77% of the surveyed investors did not attend or listened into shareholder meetings in the past year).

[27] Monks and Minow, supra note 2.

[28] B.S. BLACK, DOES SHAREHOLDER ACITIVISM IMPROVE COMPANY PERFORMANCE? (1998).

[29] See *Beyond Shareholder Values,* at supra note 6.

[30] See *Will the Owners Please Stand up?* at supra note 5.

of the shares in the biggest 350 companies are voted and these are rarely anti-management.

Another factor which could have an impact upon shareholder in-activism is that of vague and inhibiting regulations. Although company law around the world place shareholders in the position of owners, whose interests are to be directors paramount concern when making commercial decisions. However, these regulations do not provide the shareholder with much assistance in becoming pro-active. In America a director can only be removed voluntarily, whilst in France the shareholder in order to vote has to be present at an annual general meeting (AGM) and Germany doesn't allow class action suit which could reduce the investors' costs for suing companies for maladministration. Such regulations make it more cumbersome for the shareholders, who to avoid the hassle and the expense, either don't attend AGMs' or don't bother to vote on issues which may not be implemented.

In an economic system which discourages collective action and places limited liability on shareholders, it's surprising to see any proactive stance being taken. Limited liability is an element which is suppose to encourage investment; however, it also provides little incentive to shareholders to make an effort to discover where and how their investments are being utilised. A sense of obligation on the part of the shareholder is missing in majority of international company regulations. Another factor which is ignored especially by institutional investors and fund managers is that of fiduciary obligation they have towards the original investor/beneficiary. According to Monks [31] the law regarding trustees acting as fiduciary for the beneficiary is not implemented in the case of institutional investors/fund managers and those individuals whose funds they invest. This results in large institutional investors acting in their vested interests rather than in the best interest of the original shareholder, when voting as proxies in AGMs.

So, it would seem that shareholder activism may not be rising as dramatically as one thought and its impact may not be as effective or revolutionary as one would like to believe. What was the purpose of the activism which did occur? A further question arises as to whether any regulations could provide a framework of not only rights but also obligations of shareholders. Can and should shareholders be made to feel like owners or will such attempts adversely effect the investment market as shareholders begin to feel more burdened by the regulations. Such questions can be addressed once one takes into consideration the rational underlying activism.

[31] A. G. Monks, *Shareholder Activism: A Reality Check,* in THE CORPORATE BOARD, Vol. XXII, Issue 129 (2001).

C. *The Purpose of Activist Shareholders*

Activism seems to be practiced by a certain type of shareholder and within a particular environment. It is the long term investor, such as pension funds, which have had to flex their ownership muscles through acts of intervention. Although, most of these shareholders do not interfere in a company's operational work, nevertheless, their intervention is thought to be required in such areas as remuneration of directors, appointment of non-executive directors, auditing and where there exists a proposal for diversifying into new businesses.

In the presence of market failures which threw up corporate scandals, it does seem that where there are absentee owners, the sense of accountability will also be absent. According to Monks[32] it was essentially the absence of an "effective ownership interest" which caused the loss incurred by Enron. Therefore, the role of activism should really be to make shareholders take their ownership more seriously and to exercise the rights they do possess in law as obligations. Responsible investment could be another outcome of shareholder activism and it could contribute towards the stability of the market as confidence in an investment would make the investment continue more than just a year.

The sheer size and investment clout of institutional shareholders leaves them with no excuse for not taking interest in decision making of the board of directors. This is evident from the words of a fund manager; "there has been a marked change in attitude. Investment managers have a responsibility to invest in well-run companies. If we don't act as a responsible shareholder then our clients will want to know why"[33]. As a result of such realisation in the UK, three of the biggest institutional investors are to form a code of principles which require fund managers to become more activist and disclose their voting record to clients.

There is evidence (known as the "CalPERS effect"[34]) that activism in any of its forms does improve a company's performance and consequently protects the investors long term interests. Another consequence which may arise from activism is that of social responsibility in the form of protection of stakeholders, which could also be interpreted in the long run as being in the interest of shareholders. Even though shareholder activists have yet to frighten the management as corporate raiders did, however, according to Black, S. B "even if institutional investor activism does not directly affect

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[32] *Ownership and Sustainability: The Case for Shareholder Activism to Promote Corporate Responsibility* in MULTINATIONAL MONITOR (2002).

[33] Cited in *corporate transparency-corporate reality*, article in The Strategic Direct Investor dated 2002.

[34] A 1994 study by S. L. Nesbitt, and one conducted by T. C Opler, and Sokobin in 1997 showed an upmarket performance by the companies being targeted for corporate governance measures.

the potential firm, it could change corporate culture, and thus the performance of all firms"[35].

It would, therefore, seem that the purpose of activism is to assist in the corporate governance of companies, so that such companies remain profitable in the future without jeopardising the investors' funds. Thus, in the absence of other market threats, the threat of practicing voting rights by well informed investors may as yet become a catalyst of change in business decision making, which otherwise may lead to corporate scandals.

What has so far been discussed referred to the developments concerning shareholder activism in developed markets. One should consider also the impact of such issues of corporate governance upon emerging markets like Pakistan, where there is an increased emphasis upon the process of privatization and where privately owned family enterprises have become listed companies on the local stock exchanges.

III.
SHAREHOLDER ACTIVISM IN CONTEXT OF PAKISTAN

According to the Economic Survey of Pakistan 2004-05 "the capital market in Pakistan have been growing by leaps and bounds" and the Karachi stock market has been referred to as one of the best five performing markets in the world. In such an environment as elsewhere the basic form of activism would be evident when a shareholder chooses to purchase shares in a particular company. Primarily the objective of the investor would be that of obtaining a good return from the investment, which should be based upon "not only risk but also on firm characteristics like growth prospects and familiarity with the business of firm. Other things like corporate governance may also matter"[36].

In the context of Pakistan, however, the selection of companies to invest in does not appear to show the maturity required for the creation of a stable market. It's a share market that does not show a widely dispersed share ownership, rather, the existing shareholdings in the listed companies are in the hands of what has been referred to as having "never gone beyond speculation activities"[37]. According to a court judgement in a notorious corporate scandal in Pakistan, the depositors/investors of the particular company were partly blamed for its losses through what was claimed to be speculative investments. The speculative behaviour arose out of the

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[35] S. B. Black, *does shareholder activism improve company performance?*, article in The Corporate Board Vol. 19 Issue 109 dated 1998

[36] Giannetti and Simonov, *Which Investors Fear Expropriation? Evidence from Investors Stock Picking,* report issued by The Department of Finance and SITE-Stockholm School of Economics Sweden (2002).

[37] A.M. Talha, *Risks in Share Business,* in The Dawn, Economic and Business Review, 2005.

depositors making the deposits in return for what was stated to be exorbitant rates of interest[38].

Such issues are not peculiar only to Pakistan; speculative behaviour and lack of diversification is infact a characteristic of even developed markets. According to Porta et al (1996)[39] small , diversified shareholders have little importance in countries that fail to protect their rights, resulting in a smaller investor base and what Merton (1987) refers to as "limited risk sharing" in companies. Question of whether Pakistani corporate environment provides the legal protection that Porta considers necessary for the existence of dispersed investment shall be reviewed later, in the mean time an overview shall be taken of what if any shareholder activism exists in the Pakistani market and what hurdles create resistance towards the development of such an environment.

The situation facing shareholders in Pakistan is evident when one considers that though the Securities and Exchange Commission of Pakistan presently has on its records 45,609 registered companies, out of which 536 are listed companies on the Karachi Stock Exchange[40], only 40% of these listed companies gave any dividend to their investors, even when the Karachi Stock Exchange was at its peak[41]. Such an alarming situation should usually have given rise to a lot of hue and cry from the investors at the annual general meetings of the particular companies, but it so far failed to raise any significant concerns, rather the investors represented by stock brokers in the three exchanges have tended to focus solely upon availability of credit financing, budgetary rumours and concerns over vague regulatory controls.

Further, it appears that although there are several companies listed on the Exchanges, yet it is few of the big public holding[42] that are being privatised, which dominate the market's interest[43]. The investors of such corporate entities appear not so much concerned with their governance as they are with government policies towards further privatisation and making short term investment in order to acquire a quick return. There does not seem to be a long term investment strategy being followed by investors nor a move towards portfolio investment, which may have assisted in developing maturity within the investor community.

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[38] *Re. Taj Company Ltd.* CLC 1994.

[39] RAFAEL LA PORTA, ET AL, LAW AND FINANCE, (1996).

[40] Lesser numbers are listed on the Islamabad and Lahore Stock Exchanges. The numbers of listed companies shown for Karachi are 2004 figures.

[41] In March 2005 it touched 10,303 points.

[42]These include PTCL, National Refinery, Pakistan Petroleum, OGDC and Muslim Commercial Bank amongst other government owned institutions whose shares are being floated on the Exchanges as part of privatisation being pursued

[43]The KSE-100 index of the Karachi Stock Exchange despite its name is dominated by the shares of PSO, PTCL and OGDC. Any problem with the shares of these companies usually ends up adversely affecting the rest of the index.

It may seem that investors in Pakistan appear to not look upon their interest in the same way as the investors in developed markets. Though their priorities do include the protection of their interest, however, the methods used towards achieving this objective tend to be based on rumours and speculation, which has tended to contribute towards destabilising of the market, as was the case in March 2005 when the Karachi Stock Exchange saw a sharp fall in its trade.

It is arguable that sudden moves towards offloading shares as has been frequently happening on the Stock Exchanges in Pakistan can be construed as a basic attempt at activism on part of investors. However, it is also arguable that such activities may also be just speculative acts in response to an environment where rumours of impending privatisation of a particular government entity creates an opportunity for speculators to make a quick profit. These persons by purchasing large numbers of shares in the particular government entity push up the share value and give the impression that it would be prudent to purchase these shares at an inflated price since the value is liable to increase further in view of the impending privatisation.

Thus, in the event that privatisation does not occur or is delayed for a considerable period, the smaller shareholders are left holding expensively purchased shares, which are no longer valuable. The situation described above is a basic form of speculative activity occurring on the Exchanges and the level of insider dealing along with other irregular speculative practices require analysis that is beyond the scope of this article. However, it is fair to argue that the large government organisations up for privatisation tend to be the focus of Pakistani investors and that any information or rumour regarding these plays a significant role in influencing the performance of the market as a whole.

The view so far presented of the Pakistani market appears to show an environment that lacks an organised level of shareholder activism (if at all) to the same extent as that of not only developed markets but also that of other emerging economies such as Brazil, where in the presence of a conservative corporate environment shareholders are "finding innovative ways to make their presence felt in corporate governance"[44], by combining their resources and influence as investors. In comparison, though, one can to a certain extent observe investors attempting to protect their interest through

[44] *The Shareholder Activist Role in Emerging Markets*, the subject of the International Corporate Governance Network Annual Conference New York, July 14 2000: Effective tactics being used by Brazilian shareholders include forming blocs of non-voting shares, which are used by them to develop committees having the powers of supervising company accounts or by having a director appointed to the board of directors to protect their interests. Brazilian investors having non-voting shares also create negotiating blocs to get a good deal in the event of a takeover happening. By taking these actions such activist shareholders have helped in creating a reform environment that insists upon reforms in the legal and regulatory setup of Brazilian corporate governance.

the Pakistani courts, particularly where there is a situation in which companies are being merged[45], however, such cases were and are not brought collectively nor are they brought on behalf of the company as derivative actions. Further, from what can be seen from the decisions given by courts in such cases, it seems that courts have tended to not share the views of the plaintiffs (which usually have been individual minority shareholders) on the basis that the point of contention had not been raised by the shareholders during any statutory meeting of the particular company.

Whether such lack of participation by shareholders in annual general meetings or extra-ordinary general meetings is a usual practice in the Pakistani corporate structure has so far not been a subject of any research, nevertheless, it does seem that absence of shareholders raising concerns regarding the impact a merger may have on their interests has been a constant issue raised within court decisions. These same courts in their deliberations, have, considered the absence of what they regard as bad faith on the part of majority shareholders as enough reason for sanctioning mergers.

At this stage it is pertinent to state that the major area of concern regarding the protection of shareholder interests within the Pakistani corporate governance paradigm is that of the conflict of interest that may exist between majority and minority shareholders. Pakistani corporate entities are dominated by three major forms of enterprises, those controlled by the government, multinationals and the most predominant type, family held companies. In the event that these organisations float their shares on the stock exchanges of Pakistan, it's never to the extent of losing majority control over the company to outside shareholders. The ultimate control rests in the hands of the majority shareholders who are the original management that existed before listing of their companies. Thus, there exists very little if any separation of ownership and control of a company and there arises a greater potential for an environment in which the majority shareholding management stands to gain at the expense of the minority outside investors.

It is the family ownership of corporate entities that provide an example of how majority shareholdings can impact upon the effectiveness of corporate governance in protecting minority shareholders. The consequences arising from this are evident when one considers the argument of La Porta et al. (1998)[46], that "the protection of minority investors

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[45] Cases that were contested by shareholders unhappy with the prospects of mergers include: *Re Pfizer Laboratories Ltd and another*, 2003 CLD 1209, *Kohinoor Raiwind Mills Ltd v. Kohinoor Gujar Khan Mills*, 2002 CLD 1314, *Re Lipton (Pakistan) Ltd. and another*, 1989 CLC 818, *Atlas Autos Ltd. and another v. Registrar Joint Stock Companies*, 1991, *Brooke Bond Pakistan Ltd. and another v. Aslam Bin Ibrahim and another*, 1997 CLC 1873, *Dewan Salman Fibre Ltd, Islamabad v. Dhan Fibres Ltd., Rawalpindi* PLD 2001 Lahore 230.

[46] La Porta, Lopez-de-Silanes Shleifer and Vishny, *Law and Finance* in THE JOURNAL OF POLITICAL ECONOMY, 101 (1998).

provided by the law is the key determinant of the corporate governance regime within a country", the absence of which will only attract investment from them if the returns are so much as to cover their loses in the event of expropriation by those in control of the company. It is arguable that unless effective legal protection is in place the possibility of creating a developed stock market would be unlikely since if one argues on the basis of La Porta's point the cost of going public would be too great for a company that cannot afford to cover the risk taken by minority shareholders.

Within the Pakistani investment scenario the legal protection afforded to minority shareholders and the encouragement such laws provide for their active participation in the investments they make, shall be discussed momentarily. In the mean time it does need to be stressed that within Pakistan the owners of listed companies protect their interests by keep their control as majority shareholders by only floating a non-controlling portion of the total shares. In such an environment it is even more necessary for the existence of laws that would protect minority external shareholders, which may provide an impetus towards the development of the stock market.

The said Pakistani company ownership structure is not unusual when one considers studies in comparative corporate governance[47], which have argued that closely controlled companies are considered to be valuable where there exists low investor protection and thus the control is less likely to be contested by the minority investors. So there arises a need to briefly discuss the Pakistani corporate legal controls in place and consider whether they are providing adequate protection to minority shareholders and if they are then why is the situation so chaotic in the stock exchanges. Further, it is pertinent to consider whether the legal rules assist the shareholders in exercising their rights as "owners" of the company they've invested in and do they place any form of compulsion that insists upon the involvement of shareholders in the governance of the company.

[47]There are several comparative studies, such as those quoted by Bebchuk (1999) in "A rent-protection theory of corporate ownership and control,"NBER Working Paper No. 7203 and in "Stock pyramids, cross ownership and dual class equity: the creation and agency costs of separating control from cash flow rights," NBER working paper 6951. These studies show that where there exists better legal protection of minority shareholders, the results are a developed stock market (La Porta et al., 1997), higher valuation (La Porta et al., 2002), greater dividend payouts (La Porta et al., 2000), lower concentration of ownership and control (La Porta et al., 1999), lower private benefits of control (Dyck and Zingales, 2004; Nenova, 2003), lower earnings management (Leuz et al., 2003), lower cash balances (Dittmar et al., 2003), higher correlation between investment opportunities and actual investments (Wurgler, 2000), and a more active market for mergers and acquisitions (Rossi and Volpin, 2004).

A. *Impact of Pakistani Corporate Laws on Activism*

It is a recognised fact that "the more legal protection minorities enjoy, the more they will want to invest. Past research has shown that stock markets as a whole are larger and more liquid when investors are better protected"[48]. A great deal of emphasis is placed upon the existence of company, bankruptcy, and securities laws that specifically describe rights of investors and their implementation by regulators and courts. This is considered to be central to corporate governance issues like shareholder activism[49].

In the Pakistani context the primary law that impacts upon the relationship of shareholders with the companies they've chosen to invest in, is that of the Companies Ordinance, 1984 (henceforth known as the Ordinance). It is pertinent to state at this point that by referring to a commercial statute as an ordinance rather than a Law or Act does give rise to connotations of non-permanency. This may appear to be a minor point, however, within the sphere of commercial relationships the perception of stability and consistency[50], can contribute towards building trust in long term effectiveness of such laws, by those who seek their protection[51].

Regardless of the apprehensions arising from its title, in regards to providing shareholders an opportunity to raise their concerns during company meetings and voting on specific elements of the agenda, the Ordinance is in line with English Company Law. This is important as one of the major methods by which shareholders can make their presence felt is through the process of voting on the agenda presented by the management in an annual general meeting or any other statutory meeting. Such occasions also provide the shareholders with an opportunity to present their resolutions on a particular matter of concern that may be included in the agenda of the meeting.

However, even though the Ordinance provides an opportunity to shareholders to take part in the future and existing developments of the company, it is arguable that it does so in an ineffective manner. If one considers the relevant provision in the Ordinance concerning this particular issue[52], it appears that in order for shareholders to bring their resolution into the agenda of a meeting, it is required for them to be holding 10% of the shares in that particular company. The same percentage of ownership is

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[48] See The Economist, December 11 1999.

[49] See La Porta, supra note 39.

[50] The use of ordinances as a means of legislating within the Pakistani political history is not un-usual; however, such methods of creating laws do raise perceptions of their being open to revocability or termination.

[51] Foreign investors who lack knowledge of local laws may be the most effected by any such confusion arising.

[52] Companies Ordinance (1984), §160 (a) and § 164.

necessary for shareholders when they apply for a declaration from the court to invalidate the proceedings of a general meeting.

Such a requirement in context of the pattern of shareholdings within Pakistan, where the original owners hold onto the controlling shares, it seems that the Ordinance gives minority shareholders protection with one provision and takes it away with another. The impact of this situation is evident to analysts who argue that "the 10 per cent ceiling might mean more than 50 per cent of shareholders other than majority plus institutional shareholders"[53]and since the minority shareholders are too thinly spread in context of their holdings, thus any likelihood of a coalition to implement their statutory rights is hardly possible.

It is arguable that such a provision of the Ordinance may curtail frivolous litigation[54] or disruptions by shareholders in the running of a company. Nevertheless, in the prevailing Pakistani pattern of shareholdings, it does provide reasoning to some extent as to why Pakistani shareholders fail to raise their concerns in meetings of companies they've invested in[55]. It should also be stressed in conjunction with the previous argument that for investors to include in a company meeting a resolution of their own is also an unlikely event as the drafting of such a resolution would be beyond the skills of many minority shareholders. The importance of acquiring the skill required for drafting of resolutions is a matter that is being addressed in even developed countries like America where at present there is emphasis being laid upon companies hiring consultants to provide their services to shareholders in drafting resolutions.

The Organisation for Economic Cooperation and Development stresses as one of the principles of corporate governance, the creation of reasonable opportunity for shareholders to raise questions and have them included on the agenda of general meetings. In line with this the availability of information regarding a company's performance is essential for a potential investor; however, there is a limited of focus on this aspect in the provisions of the Ordinance. In view of what has already been argued regarding the

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[53] Syed Aftab Haider, *Minority Shareholders Need to be Empowered* in The Dawn, December 25 2004.

[54] The Economist, dated July 2 2005 pointed out an investigation of Seymour Lazar, a well known activist shareholder in America, who was allegedly under the guise of activism and at the instigation of aggressive law firms would become the lead plaintiff in suing companies in which he held a small amount of shares. He allegedly obtained payments from such law firms to start litigation against companies. This example shows the negative aspect of shareholder activism in a developed economy.

[55] The issue of non-participation by shareholders in company meetings was pointed out by Pakistani courts when deciding upon cases concerning mergers in which an investor had raised concerns as to the benefit of such mergers for minority shareholders of the company. The case laws have been addressed earlier in this paper.

hurdles to shareholder participation, it is arguable that the Ordinance has not kept up with the reality or developments that are national as well as international.

Even when steps were taken to provide a conducive environment for minority shareholders, they did not produce the desired result. This was the case when in 1999 a 40% dividend payout rule was inserted into the Income Tax Ordinance (1979)[56] , which was reported to have provided an impetus for increasing dividend payments. However, such a requirement at the time encouraged such companies as Philips into de-listing due to what was regarded as a dislike for being "disciplined for the benefit of minority shareholders"[57]. Such a reaction from the corporate sector does give an impression of its resistance to the regulation of the relationship with its investors. This resistance thus contributed towards the particular dividend payment rule from not being included in the repealed Income Tax Ordinance (2001).

B. *The Role of Pakistani Corporate Regulators*

Besides the issues raised one must also consider how if at all are the existing legal provisions safeguarding shareholders in Pakistan are implemented. This is necessary because unless regulators and courts enforce investors rights, such as voting, there will be unwillingness on part of outside investors, big or small, to finance companies. In this context a brief examination of the regulatory authority known as the Securities and Exchange Commission of Pakistan (henceforth known as SECP) shall be made. Such regulatory Commissions exist in a number of countries and as watchdogs of commercial activity are at the forefront of protecting the interests of shareholders in particular.

The SECP draws its authority to regulate from the Securities and Exchange Commission Act (1997) as well as from the provisions of the Companies Ordinance (1984). It has unlimited legal power for the specific purpose of bringing commercial activity in line with the laws of the land and international standards. It's objective is thus to develop a conducive environment for domestic and foreign investment.

However, even with its powers, the SECP could not prevent housing securities frauds nor manipulation of the shares market that resulted in a number of small investors losing their funds in early 2005. The image of the

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[56] Income Tax Ordinance (1979) § 12-9 (A) had required a company having 50% reserves of its paid up capital to distribute 40% of its net profits among shareholders, otherwise 10% tax was levied on its reserves, which exceeded 50% of its paid up capital.

[57] Farhan Mahmood, *Corporate Governance and the Takeover Law*, in The Dawn, January 29, 2001.

SECP was further tarnished when in order to prevent future recurrence of such nature, it issued directives[58] to stock exchanges, which they adamantly resisted to implement. Furthermore, any change recommended for the existing unstable method of financing the securities market was resisted. From such resistance it is evident that unlike its American equivalent, the SECP is not feared as a regulator by the corporate sector and its powers are challenged constantly.

It is fair to stress that "the responsibility of protecting investors against market manipulation falls squarely on regulators"[59]. Although, the law provides sufficient room for the SECP to manoeuvre in pursuance of its regulatory duties, nevertheless, it does not seem to move fast enough to prevent or limit harmful commercial activities in the stock market. One of several factors contributing towards this situation may be the vaguely drafted provision of the SECP Act (1997) in regards to the selection of those who are to run the Commission. The Commission, which is the most important organ of the SECP, is suppose to be composed mainly of persons from the private sector[60], having integrity, expertise, experience and eminence and can be from any profession that is relevant to the commercial arena. Such criteria can hardly qualify a member for the regulatory work of the Commission.

Further, it is pertinent to point out that the weakness of the SECP has been argued by an analyst[61] on the subject to be its lack of reliance upon the relevant laws concerning investor protection. Rather than focus upon the domestic securities law, the SECP relies upon "general laws, executive orders or corporate laws"[62], when ever faced with investor protection. Since these laws are not meant specifically for the purpose of investor protection, therefore, reliance upon them for regulation proves ineffective. It is the securities law that form the basis of regulating the market and thus investors, however, unlike market regulators in other countries, the SECP is criticised for not focusing upon these laws. Consequently, the securities laws of Pakistan have not been developed to take into account the evolving nature of the securities market nor are clear provisions made on such issues as disclosure of information to all shareholders.

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[58] One such directive was for stock exchanges to appoint an independent, non-broker as chairman of the exchanges, in order to avoid conflict of interest as well as manipulation of the share market. The directive was given to prevent brokers having too much power in the running of the stock exchanges, particularly when the finger was pointing at them for the manipulation of the market that resulted in the March crash.

[59] Syed Mohibullah Shah, *Laws for Protecting Small Investors*, in The Dawn, Economic and Business Review, July 4, 2005.

[60] Securities and Exchange Commission Act (1997), § 5 (2).

[61] See Syed Mohibullah Shah at supra note 59.

[62] Ibid.

Thus, arguably the SECP does not stand out in the same manner as similar institutions in developed economies, nevertheless, it has got on to the corporate governance bandwagon by having listed companies compulsorily adopt the provisions of its Corporate Governance Code (Code). Such codes of governance were adopted in developed economies to allow the corporate sector to self regulate its activities rather than have further legislation encroaching upon its working. As in developed economies the focus in the Pakistani Code also emphasises upon the protection of shareholders in listed companies. However, when one reviews the Code, it is disappointing to see that its provisions do not take into consideration the Pakistani corporate structure; rather, it reproduces similar provisions to those of the code developed in England.

In the same line as the Ordinance and securities laws, the Code lays very little if any emphasis upon the dissemination and disclosure of information to all shareholders. Further, the provision for the appointment of Non-executive Directors (NEDs) does not provide any guidelines for their selection. It does not take into consideration the ground realities like the majority control of many companies being under family ownership[63], and thus the possibility of NEDs ending up being one of the members of the family. The dynamics that exist between majority and minority shareholders in such a situation is totally overlooked. This may contribute towards the ineffectiveness of the Code in protecting the interests of shareholders through the NEDs.

Essentially a shareholder is not responsible for the business activity of the company he invests in, as that is the job of the management. Nevertheless, to protect their investment, it is stressed in the Code that it is essential for shareholders to participate in General Meetings of the company. In order to participate, the shareholders must knowledge of such rights, as electing the Board of Directors along with voicing their concern about issues arising from any drastic changes like mergers or takeovers. It is evident that participation entails investor awareness and mandatory provision of information by the concerned company. Though the Code does refer very briefly to the shareholders being provided information as to the date, location and agenda of general meetings, its very ambitious in assuming that all investors will have the expertise in drafting resolutions to be raised in such meetings.

Regardless of the Code's weaknesses, it should be kept in mind that previously there was very little if any concept of protecting minority shareholders in Pakistan. Thus the presence of such a Code may provide an impetus for shareholders to develop an attitude of responsibility upon

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[63] It is arguable that since the most able member of any single family is likely to be less able than the most able member of the broader population, this means that governance is ultimately not entrusted to the most able people in a country, such as in the case of Pakistan

acquiring shares in a company. Though, there is little or no data to support this, but a need remains to develop a Code that reflects the Pakistani corporate structure rather than implant one from one of the developed economies. It should have provisions that emphasise upon ways in which minority shareholders can protect their investment from activities of the insider (family) majority shareholders, such as tunnelling[64]. The main focus of such provisions should be upon the imposition on companies to provide accurate disclosure of information simultaneously to all shareholders. Shareholders in the Code must be given the opportunity to raise their concerns in an informed manner, which is not presently the case.

IV.
IS THERE A NEED FOR LEGAL COMPULSION?

From what has so far been discussed, how can activism be encouraged to prevail in the actions of shareholders? Although, institutional investors would become more active if it was in their economic interest to do so, however, there is an argument that shareholder activism should be regulated in some way to provide a rational and consistent framework, so that investors don't just react when a crisis takes place but act to prevent this from happening.

Advocates of increased levels of activism like Monks, point towards not only creating new rules but also implementation of those that are existing. According to Monks, the fiduciary duty of institutional investors towards their clients, when acting on their behalf in such acts as proxy voting, should be paramount and they should be legally held bound to act in a manner which does not involve vested interests. In an environment where fund managers vote in proxy wars in a way not because it will benefit their clients but rather its required to maintain friendly relations with the management, then, Monks argument does bear importance.

To increase the levels of activism, one may argue for compulsory voting by shareholders. Monks and Sykes[65] argue a legal requirement for compulsory voting by those institutions with holdings of around $15 million. Although in America the rule for compulsory voting exists, however, it doesn't in many other countries. Even though, compulsory voting may not be widespread, but there are compulsions now in America and Britain for institutions and companies to release information to their investors on voting policies and remuneration packages. However, it is arguable that by making voting compulsory may not have a significant

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[64] Tunnelling refers to inter-corporate transfer of wealth amongst pyramid firms for the advantage of the controlling shareholders.

[65] See *Beyond Shareholder Value* at supra note 6.

impact, as change can only be brought about by an informed group of shareholders and not those who tick a box to fulfil a legal requirement.

Governments are increasingly encouraging shareholders to use their voting powers in making changes, rather than relying on the law to come up with solutions to purely commercial and ethical questions. Such encouragement can be seen in the suggestions of the Security and Exchange Commission in America to do away with the ordinary business exception, which prevented shareholder resolutions on a company's everyday business. It can also be seen in the Japanese revising their Commercial Code in 1993 to make it easier and cheaper to sue a company. According to the director of Hermes Focus Funds[66] UK law provides ample support to shareholders, who if holding 10% of the company can change the entire board with three weeks notice without cause.

If shareholders are choosing to ignore legal provisions then perhaps there is a need for certain amount of accountability from them in the event of a crisis or a scandal. Legal compulsion should really be there to encourage activism rather than forcing acts from those who have no knowledge of how their investment is being handled. However, institutional investors who have the resources, as suggested by Paul Myners could be placed under a legal duty to intervene in companies where it is in the shareholders interest to do so.

This is all very well in context of developed economies but as explained earlier the situation in context of emerging economies is very different. As in developed economies the shareholders in emerging markets are placed under no duty to participate in the decision making of companies they invest in. Though, as in the case of Pakistan, the Code of Corporate Governance does advice shareholders to familiarise themselves with shareholder meetings and question the consequences that may arise from their voting in such meetings. Nevertheless, it is arguable that besides such advice, laws like the Companies Ordinance lack any solid provision to give impetus for existing or potential shareholders towards the kind of activism seen in developed economies.

However, this does not mean that shareholders in Pakistan do not react at all. Even in the absence of legal compulsion the investors in Pakistan do react towards buying and selling of securities, however, their enthusiasm for taking part in the decision making of companies they invest in is not as apparent. They like any investor search for investment opportunities that will increase their wealth. In line with such an objective they react accordingly towards those companies that provide its investors with dividend payouts and those which do not. Further, the gradually increasing presence in the Pakistani stock market of institutional investors, like mutual funds and banks along with foreign portfolio investors, may create greater

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[66] Cited in M. K. Phillips, *New Rules of Engagement* in THE GLOBAL INVESTOR, Issue 156, 2002.

diversity in how shareholder react towards their investment. However, it is arguable that the growth in the Pakistani stock market[67] holds opportunities, but those who are taking up on these "are largely players with a trading rather than investment view."[68]

Therefore, potential for diverse activism is yet to be realised and the focus on solely trading shares along with the related manipulative practices is what is so far apparent. Such a situation can only develop any further, once domestic laws clearly provide for shareholder protection (the minority in particular) and the securities market is regulated according to such provisions. Additionally, there has to be legal obligation placed on companies listed in the stock exchanges to provide adequate simultaneous information to all their investors. In line with this shareholders must be educated as to their status as legal owners of companies they invest in, as well as to have the opportunity to communicate with other shareholders. The pressure placed on shareholders in this regards needs to be made particularly in view of developing a future wider domestic investor base in Pakistan.

V.
CONCLUSION

In the words of American Supreme Court Justice Louis D. Brandeis "there is no such thing as an innocent purchaser of stock" since "he accepts the benefits of a system. It is his business and his obligation to see that those who represent him carry out a policy which is consistent with the public welfare"[69]. Such is the basis for shareholder activism, being recognised by investors as a possible direct consequence of financial scandals. It is arguable that once a shareholder is viewed and accepted as an owner, there will then emerge a line of accountability. Through actively getting involved, shareholders have tied themselves to the future of the company they invested in.

The rise of large institutional investors probably gave an added advantage towards activism in an environment hostile to such "meddling". Although, it is acknowledged that a few publicised shareholder rebellions do not make a revolution, yet, it also has to be acknowledged that presently not many companies make decisions regarding remunerations, purchase of new businesses or hiring of new board members without seriously taking the views of their shareholders into consideration. This notion of activism is also seeping into countries where activist institutions have become major

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[67] As of February 2006, the market capitalization was reported to be above the 3 trillion rupee mark, which is approximately 40% of the Pakistani GDP.

[68] Naween A. Mangi, *Beyond 11,000: Where is the KSE-100 Headed?* in The Dawn, Economic and Business Review, February 13, 2006.

[69] See Monks and Minow at supra note 2.

share holders. Further, the few examples of activism have gone on to create a precedent for others to take more interest in their investment and adopt the role of owners.

To a certain extent activists as well as legal compulsions have been responsible for the demands of investors, which are based upon the concept of reasonableness. Now it is reasonable to expect clear information of policies from the management. It is also reasonable to expect the management to invest funds profitably and remove extravagant perks. Further, it is reasonable to give performance related pay. If a company is not doing every thing that is reasonable and in the interest of shareholders then it is open to these investors to hold such management liable in variety of ways, which does not necessarily involve public confrontation.

Such are also the issues that must be addressed within emerging economies like Pakistan, but these should be developed in the domestic context. A failure to address a corporate governance issue like protection of minority shareholders within the Pakistani law or through a regulatory body will cause distrust within the investment environment. On the other hand the presence of a legal framework for such protection will only create a greater opportunity for a mature level of shareholder activism, than being conducted presently. In the absence of research data, one is prevented from presenting a clearer view of such issues in the Pakistani corporate environment. Nevertheless, it shall be interesting to see whether the Corporate Laws Review Commission, reviewing the Companies Ordinance (1984), will make any effort in recognising this aspect of corporate governance in its recommendations for upgrading corporate laws.

By developing a legal framework in which shareholders may react to protect their interests would contribute towards lessening the negative effects that may arise from this. On a final note, one must stress that besides the development of laws, minority shareholders "who have always taken a beating -----will have to be vigilant and protect their own interests"[70]. Upon becoming aware of this, whether they choose to act is another matter, but their failure to do so will be on their heads in the event of another corporate crisis. This argument holds true for every economic environment.

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[70] M. Aftab, *Upgrading Company Law for the 21st Century* in The Dawn, Economic and Business Review.