AN ANALYSIS OF ASIAN AND WESTERN CORPORATE GOVERNANCE SYSTEMS: THEORETICAL AND OPERATIONAL CONCERNS

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ABSTRACT

The primary concept of corporate governance is with those who provide capital to the companies and its aim is to improve their returns by providing market stability. However, the political slogan of public-private partnership has become popular without implementation of theoretical dynamics of corporate governance. The UK has been an exporter of corporate legal concepts and innovations since the inception of corporate norms not only in continental Europe and emerging economies but also around the world. The British model of corporate governance struck a chord in many overseas countries; it has provided a yardstick against which standards of corporate governance in other markets are being measured. The ideas developed by the Cadbury Committee and its successors committees have received an ample importance in continental Europe and the rest of the jurisdictions particularly in emerging economies such as China, India, Pakistan and those countries which have old colonial ties with the UK. The variation of the corporate governance structure and arrangement appears in different models but the issue of managerial accountability is common everywhere. The corporate governance system in Pakistan including the Code of corporate governance based on 'shareholders primacy theory' that involves investors in managerial accountability of listed companies through effective and reliable disclosure to maintain good governance of listed companies and long-term market stability. In Asian economies, family dominated ownership has been playing influential role, require competitive corporate and regulatory structure. Therefore, the regulatory authority, policy makers and corporate community should also be clear that the new corporate legal framework in Pakistan should be attractive for the investors as well as provide security to the non-shareholder stakeholders through services mechanism.

Keywords: Corporate governance; Dispersed share-ownership; Regulatory Authority; Theories of corporate governance; Corporate monitoring; Family owned-corporations; Institutional shareholders.

1. Introduction

The public offering of the shares of large corporations led to the dispersion of share-ownership in the hands of individuals and institutions. The corporate reality of dispersed ownership realized the separation of control from ownership. The significant increase of corporate activities with the reality of dispersed share-ownership and separation between control and ownership raised the corporate governance issues. However, in the UK, managerial opportunism and unaccountable management opened a debate on industrial democracy with employees' participation as solution to early corporate governance issues. In 1979, the public sector reforms based upon market solution, privatization of public industry, and reforms in pension sector, health care, social welfare, removal of employment protection as well as removal of barriers of capital in-flow and out-flow changed the nature of corporate governance. These reforms replaced the industrial democracy by shareholders primacy. Therefore, on one hand, the investors as shareholders were expecting profits from the business and on the other hand, directors, as shareholders' agents, were managing the companies' business to gain profits.

The potential conflicts of interest among corporate participants led to the need for good corporate governance. The conflicts of interest in result of agency problems, as Berle and Means (1932) indicated through separation of ownership from control, arises due to corporate actors which have different objectives and imperfect information. The corporate governance mechanism has direct concern with company law that provides discretion to the company management while corporate governance shapes a framework for the exercise of this discretion by distributing powers between directors and shareholders.

Dispersed ownership, insufficient expertise and lack of professional commitment created the need for specialised and professional management that can develop and implement the corporate strategies on its own to achieve the corporate aims and objectives. However, the lack of permanent supervision on the part of shareholders gave birth to the professional and skill full independent boards of directors to run the affairs of the companies and monitor the executive. In the bigger picture of dispersed share-ownership, the professional managers run the companies' affairs with discretionary powers. Although discretionary powers may be conferred upon the management of the company through companies' legislation, in the UK they are being delegated through company's constitution, which has been taken from common law corporate practices.

In the end of 20th century the ownership structure of large corporation significantly changed and institutions became the major shareholders. Therefore, the corporate scandals such as Polly Peck, BCCI and Maxwell and financial reporting irregularities compelled the business communities, market and regulator to realize the importance of good corporate governance. They thought that an appropriate use of discretionary power could resolve the agency issues with effective system of corporate accountability and transparency through responsible corporate monitoring. Therefore the soft law practices on the bases of 'comply or explain' approach were introduced in the form of code of best practices and the combined code. The responsible monitoring of self-regulatory code was part and parcel of the British model to achieve the good corporate governance. Later on the self-regulatory code was transformed into the UK' Code and the Stewardship Code. The Stewardship Code provides guideline for responsible monitoring by putting the stewardship responsibility on the shoulders of the major shareholders.

Later on corporate collapses, stock markets' crisis, managerial opportunism and dispersed ownership forced the institutional investors who have significant shares' ownership in listed companies, to become an active monitor of their investee companies. Although individual direct-share ownership in investee companies is relatively small but institutional shareholders make their investment on behalf of individual investors. The concentration of share-ownership in the hands of a group of institutions empowers them to exercise control over management by envisaging them stewardship obligations. The stewardship theory is an alternative to the agency theory to fill the gap of stewards' obligations in existing corporate scenarios where ownership and control is concentrated in the hands of institutions.

The corporate governance system in Pakistan including the Code of corporate governance based on 'shareholders primacy theory' that involves investors in managerial accountability of listed companies through effective and reliable disclosure to maintain good governance of listed companies and long-term market stability. The primary concept of corporate governance is with those who provide capital to the companies and its aim is to improve their returns by providing market stability. However, the political slogan of public-private partnership has become popular without implementation of theoretical dynamics of corporate governance. Therefore, this is the time to formulate the policy of corporate governance that should be competitive for corporate stability and investment. The regulatory authority, policy makers and corporate community should also be clear that the new corporate legal framework in Pakistan should be attractive for the investors as well as provide security to the non-shareholder stakeholders through services mechanism.

The Security Exchange Commission of Pakistan (SECP) is a regulatory body like Financial Services Authority (FSA) in UK and Security Exchange Commission in the USA. The SECP as a 'competent regulatory authority' controls and formulates the framework for the stock exchanges of the country, laid down the listing rules for listed companies and supervise them. However, it is difficult for the SECP to monitor the governance issues of listed companies on regular basis through effective engagement with the management of the companies. The good corporate governance through effective compliance with the Code on corporate governance requires regular and day-to-day monitoring through effective engagement with the board of listed companies to resolve the agency issues and minimize the agency costs.

2. Effective Compliance with the Code's Provisions through Responsible Monitoring

The compliance with the provisions of new Code is self-regulatory except where explicitly stated otherwise. The self-regulatory compliance of the code requires responsible monitoring through regular engagement with the companies' management to examine that how did the management apply the provision of the code and what are the explanations in case of non-compliance with or depart from the code. It is pertinent to mention that without responsible monitoring the compliance of the code is considered as a formality to adopt 'box-ticking' approach for the satisfaction of Regulatory Authority. Therefore, three monitoring mechanisms to resolve the agency issue and minimise the agency cost are going to be practiced around the world.

2.1. Enlightened Shareholder Value/Shareholder Supremacy Approach

In the UK, the company Act 2006 provides innovative concept of "Social Corporation" to the corporate world that is influential around the world. In the 'enlightened shareholder value' context, the directors are responsible for promoting the success of the company for the benefit of the members as a whole. However, the British model expects that in addition to 'enlightened shareholder value' approach, the directors should have regard to pluralist factors relating to impact of companies' operation on the community and the environment[1]. The directors' duty to promote the 'success of the company' gives regard to shareholders' interest primarily and rest of the corporate constituency.

The 'shareholder supremacy approach' put the monitoring responsibility on the shoulders of shareholders who are considered either ultimate beneficiaries of the corporate stability or sufferer of the corporate failure. The shareholders are not only responsible to appoint the board of directors but also to make them accountable. In dispersed share-ownership of listed companies around the world, it was difficult for individual shareholders to monitor the management of their investee companies regularly because monitoring cost was more than their returns. Therefore, different approaches relating to effective corporate monitoring and to manage agency issues is adopted around the world financial markets.

2.1.1. Pluralist Approach

The 'pluralist approach' requires that directors are responsible to ensure that company is behaving like a 'good citizen. [2] The British model expects that in addition to 'enlightened shareholder value' approach, the directors should have regard to pluralist factors relating to impact of companies' operation on the community and the environment[3]. The directors' duty to promote the 'success of the company' gives regard to shareholders' interest primarily and rest of the corporate constituency.[4] However, the Company Law Steering Committee considered the interests of corporate constituency and therefore proposed to 'enlighten shareholder value' and to use 'pluralistic' approaches.[5] Later on, the pluralistic approach was rejected by the Committee in favour of the 'enlighten shareholder value' approach on the ground that deficiencies of the legal relationship among company

1 The Company Act 2006, s. 417
2 LE Talbot, Critical Company Law, (Routledge Cavendish 2008) 145-152
3 The Company Act 2006, s. 417
4 The Company Act 2006, s. 172
5 The 'enlighten shareholder value' approach, without altering the priority of shareholders value, requires that the interest of, and relationships with, all stakeholders should be considered by supporting corporate actions to further those interests or relationships.

and its constituency can be overcome and are made better by getting changes in other areas of the law and public policy, or in best practice, rather than by making mandatory changes in Company Act. In fact the 'pluralistic approach' recognises the role of all stakeholders in corporate sector and corporate governance. The 'pluralistic approach' or stakeholder theory is not new but successfully working in Germany, Japan and China since ages.

2.1.2. Monitoring Role of Major Shareholders

In the early 20th century, the shares of larger companies were publicly traded through the stock exchanges not only in the UK but also around the world. The trading of shares to the public listed companies increased and geographically spread. Consequently, the link between a company's shareholders and management became remote. The dispersed share-ownerships of listed companies led to the divergence between ownership and control – corporate ownership being vested in the shareholders and control in the hands of directors. The separation of ownership and control caused a divergence between owners' and managers' interests without keeping any effective check on management powers.[6] The dispersion of shares in listed companies not only led to the proxy-voting system but also gave greater power to management rather than shareholders because the proxy-voting tended to be exercised pro-management.[7] Therefore managers were monitored and made accountable in order to stop them from pursuing their own economic self-interests at the expense of others who have stakes in the company.[8]

The dispersed ownership of major public companies created a significant gap between remote individual shareholders and executive-management of the companies.[9] Therefore, the agency costs and managerial opportunism increased due to dispersion of share-ownership. The new managerial era in corporate sector started when management became powerful without the reign of corporate accountability. However, the use of managerial unfettered powers in their own interests on the cost of the company made the investors vigilant that they should monitor managerial opportunism and make them accountable for the protection of their capital.

The British model of corporate governance has an 'outsider' or 'arms-length' system of ownership and control.[10] An 'outsider' typology indicates dispersed ownership structure of corporation among institutional investors and individuals shareholders while an 'arms-length' signifies that investors hardly intervene in the day-to-day affairs of their investee companies. Therefore, an 'arms-length or outsider' corporate structure suffers unavoidable 'agency costs' that arises from self serving managerial behaviours.

The fundamental objective of corporate governance framework is to improve the accountability of corporate managers through investors.[11] In the early 1930s, individual investors had 80% of the securities traded on the London Stock Exchange but now ownership structure of public listed companies has significantly changed and institutional investors have become the dominant players of the British financial market.[12] The institutional investors by virtue of their size and power are ideal monitors of their investee companies.[13] Good corporate governance is possible by institutional investors' activism wherein their responsible monitoring behaviour can force the management to concentrate on long-term corporate performance which would not only enhance efficiency but also maintain long-term corporate stability.[14]

The overwhelming rise of institutional shareholders and their subsequent role in corporate governance have significant importance. Although they work in a very competitive environment, their duties towards their beneficiaries or clients require them to avoid risks. Today institutional investors own 88.7% equity holdings in publicly traded companies that envisaged them a significant role in corporate governance and corporate control. In the wake of the recent corporate crisis that have shaken the corporate sector, most of them believe that institutional investors can and must play their role for the improvement of their investee companies for long-term stability of financial market.[15] The main types of the institutional shareholders in the UK are insurance companies, pension funds, mutual-fund or pooled fund (unit trusts, and investment trusts), banks, and charities. Many institutional shareholders engage the services of investment managers who take investment decisions and construct portfolios on their behalf. [16]

The board of directors has a vital role in corporate governance by providing the company with leadership and drive. Their corporate actions are subject to laws, regulations, and the disciplines of the market place as well as the shareholders in general

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6 D. D. Prentice and P.R.J. Holland, Contemporary Issues in Corporate Governance, (Oxford 1993) 27 ; Helen Garten, 'Institutional Investors and the New Financial Order' (1992) 44 Rutgers Law Review 585 at 593-603
7 D. D. Prentice and P.R.J. Holland, (n. 6) 27
8 Paul L. Davies, 'Institutional Investors in the United Kingdom' in D. D. Prentice and P.R.J. Holland (eds.) Contemporary Issues in Corporate Governance (Oxford 1993) 74-75; D. D. Prentice and P.R.J. Holland, (n. 6) 27
9 The Berle and Means work (1932 & 1967) realised the significance of corporate power and drew attention of corporate community and regulators to understand the problems of corporate governance.
10 Brian R. Cheffins, 'Corporate Governance Reform: Britain as an Exporter' Corporate Governance and the Reform of Company Law, 2000 Hume Papers on Public Policy 8(1) 9-11
11 Brian R. Cheffins, (n. 10) 11
12 Brian R. Cheffins, Corporate Ownership and Control: British Business Transformed, (Oxford 2008) 344-45
13 The companies in which institutional shareholders invest are called their portfolio or investee companies.
14 Lilian Miles, 'The Role of Institutional Shareholders in Corporate Governance: Recent Developments in the UK' 2003 Scottish Law & Practice Quarterly 8(3) 204-216
15 Lilian Miles, (n.14) 204-06
16 Lodewijk Van Setten, The Law of Institutional Investment Management, (Oxford 2009) 6-20

meeting. The shareholders are responsible to appoint the directors and auditors and make them accountable. The financial reporting system requires their accountability by the shareholders for the progress of the company. Auditors report to the shareholders for company's financial matters by keeping an external and objective check on the directors' financial statement.

The corporate monitoring and accountability of management is necessary to protect members of the public who provide capital for investment with the hope of returns against certain types of wrong-doings including deliberate fraud, incompetent and unrealistic corporate decisions. The significant growth of institutional share-ownerships made them a key actor of corporate governance with concentrated holdings possessing the expertise to exercise control over corporate management. The institutional dominance of the equity market would not only force a change in the governance of public corporations but effectively monitor and resolve the arising conflicts between corporate managers and shareholders.[17]

The increased quantity of financial assets came in the hands of decreased numbers of institutional investors. Consequently, corporate control shifted towards institutions. The control of institutional clout could offer to challenge the factual basis of "separation between ownership and control" rather than remain a silent partner of corporate management. The significant shift of corporate control and ownership in the hands of a group of institutions make them the stewards of the corporate sector. The greater institutional power is regarded as the potential to be a positive force in corporate governance to improve operating efficiency, employee productivity, shareholder value and corporate stability.[18]

However, the UK played a pioneering role for the development of self-regulatory corporate governance framework.[19] The British corporate failures in the 1980s (i.e. Maxwell, Polly Peck, and BCCI) commissioned the Committee on the Financial Aspects of Corporate Governance which launched the Cadbury Report (1992) that marked the start of corporate governance in the UK. The Cadbury Report recommended a 'Code of Best Practices' that provides a corporate arrangement of company board of directors and accounting system to diminish the risks and failures of corporate governance.[20]

The Cadbury Code initiated a debate about the British model of corporate governance that subsequently commissioned the Greenbury and Hampel Committees on different aspects of corporate governance; their reports and recommended codes enabled the emergence of the Combined Code that set out self-regulatory standards for good corporate governance.[21] The Combined Code, without any amendment, was operative through the Stock Exchange Listing Rules since 1998 to 2004 and later on it was updated by the Higgs Committee Recommendations.

The British model of corporate governance provided innovative self-regulatory approach for listed companies on the basis of 'comply or explain' principle. The disclosure of compliance or non-compliance is mandatory for the companies to mention in their annual reports how they applied the provisions of the code or reasons of non-compliance by indicating the reasons of any area of non-compliance in the light of their own particular circumstance. The operational flexibility of the 'comply or explain' approach encourages the companies to adopt the general spirit of the code rather than the letters.[22]
The voluntary compliance with the code provided a unique opportunity for corporate actors to avoid a 'box-ticking' approach. This was a mandatory regime that neither provided a space for any sound deviations of the company from the rule nor did it foster investors' trust. The voluntary compliance with the code coupled with mandatory disclosure requires shareholders' monitoring through their active engagement with their investee companies for the true functioning of the British model of corporate governance. This aims to secure company assets from managerial opportunism and to provide long-term corporate stability.[23] Therefore, the Combined Code is widely regarded as an international bench mark for good corporate governance practices unlike the Sarbanes-Oxley Act 2000.[24]

Over the past two decades from the inception of the Cadbury Code, all recommendations, the Combined Code 2002 and its successor code on corporate governance such as the UK Corporate Governance Code and the Stewardship Code have continuously advocated active shareholders involvement in the affairs of public listed companies. For instance, the primary focus of the Cadbury Code was the supervision of executive decision-making through the board of directors and institutional investors wherein they are required to play a monitoring role for the improvement of corporate governance.

The Cadbury Report (1992) encouraged systematic and active engagement of institutional investors with the management of their investee companies by making positive use of their voting rights as well as taking positive interest in the composition of

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17 Helen Garten, 'Institutional Investors and the New Financial Order' (1992) 44 Rutgers Law Review 585-674 at pp. 587
18 Helen Garten, (n. 17) 589; Michael C. Jensen, 'Eclipse of the Public Corporation' (1997) Harvard Business Review at pp. 5-10 available on http://papers.ssrn.com/sol3/papers.cfm?abstract_id=146149# accessed on March 2011
19 Sridhar R. Arcot, 'In Letter but not in Spirit: An Analysis of Corporate Governance in the UK' (2006) 1-38 available on http://www.lse.ac.uk/FMGPersonalPages/sridharArcot/CGPaper1.pdf accessed on March 2011
20 Sir Adrian Cadbury, 'Report of the Committee on the Financial Aspects of Corporate Governance' (1992) available on http://www.ecgi.org/codes/documents/cadbury.pdf Accessed on January 2011
21 The Combined Code: Principles of Good Governance and Code of Best Practice (2000), Derived by the Committee on Corporate Governance from the Committee final Report (1998), and from the Cadbury and Greenbury Reports, available on http://www.ecgi.org/codes/documents/combined_code.pdf
22 Sridhar Arcot, 'Corporate Governance in the UK: Is the Comply or Explain approach working?' (Social Sciences Research Network (SSRN) on-line), (2009) 1-29 available on http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1532290&rec=1&srcabs=1511904 accessed on 2011
23 FSA Handbook 2010, Listing Rules, L. R. 9.8.6 available on http://www.fsa.gov.uk/pubs/hb- releases/rel64/rel64lr.pdf accessed on 2011
24 The Sarbanes-Oxley Act 2002, s. 302, 303, and 906, indicate the mandatory and rule based approach of the US model of corporate governance rather than principle based approach.

boards and its committees. The Hampel Committee endorsed and encouraged the Cadbury recommendations for institutional investors' engagement through dialogue between companies and major shareholders and further recommended that pension fund trustees and their fund managers should formulate long-term investment policy.[25]

The Combined Code addressed the role of institutional investors by incorporating Principle C.1 which requires dialogue between board and shareholders, and Principle E.2 sets out reciprocal guidance for the institutional investors' active engagement with their investee companies.[26] Although the Higgs Report (2003) focused on the role of outside directors, various new provisions in relation to the engagement of institutional shareholders with their investee companies also incorporated in the Combined Code as recommended by the Report.[27] For instance, the revised Combined Code 2003 required that chairman of the board should maintain sufficient contact with major shareholders to understand their concerns, and annual report should state how many steps have been taken by the board to understand the views of major shareholders.

The institutional investors are required to apply the principles issued by the ISC on the responsibilities of institutional shareholders for the monitoring of their investee companies.[28] The incorporation of these provisions in the Combined Code sponsored an initiative of institutional investors' activism in corporate governance landscape that provided an official endorsement for institutional investors' intervention in their investee companies. Paul Myners issued a government commissioned report (2001) that expressly indicated the concerns about the fund-managers' monitoring passivity and their unwillingness in relation to active engagement with their portfolio companies. Therefore, Myners proposed that a duty should be imposed on UK-based pension fund to make the use of shareholders' voting rights where appropriate as a responsible corporate monitor.[29]

The recent global banking crisis (2007-09) affected the British banking industry in which Britain's largest banks, HBOS/Lloyds TSB, and RBS received government support through a bail-out policy for survival while others such as Northern Rock and Bradford Bingley were completely nationalised. The institutional investors were identified as one of the culprits of the British corporate failure because they failed to perform their fundamental responsibility of effective scrutiny and monitoring the decisions of the boards and management. They did nothing to prevent the executive of financial institutions from making huge bonuses, and benefits. The Walker Report (2009) identified the passive and perfunctory role of institutional investors relating to the monitoring of their investee companies.[30]

The major shareholders such as pension-funds, insurance companies, investment trusts, banks, charities and unit-trusts owe stewardship obligations because they have significant share-ownership with the advantage of limited liability under company law. Resultantly, the Walker Report recommended and characterised the 'ISC's Code on the Responsibilities of Institutional Investors'[31] as a Stewardship Code that would provide guidance to the institutional investors for the effective and responsible monitoring of their investee companies. The Financial Reporting Council (FRC), which was already responsible for revision and consultation of the Combined Code, took up the responsibility of the Stewardship Code.[32] The FRC, after consultation document, issued the Stewardship Code 2010 and revised 'the UK Corporate Governance Code 2010' (i.e. new version of the Combined Code).[33]

The Stewardship Code consists of seven principles, namely disclosure policy regarding discharge of stewardship responsibilities, policy on managing conflicts of interests, the monitoring of investee companies, appropriate collective actions, voting and disclosure of voting activity, and periodic report on stewardship and voting activities, which are drafted and incorporated by the

[25] Ronnie Hampel, 'Committee on Corporate Governance Final Report'(1998) 40-48 available on http://www.ecgi.org/codes/documents/hampel.pdf accessed 2011

[26] The Combined Code 2000, Principle C.1 & E.2

[27] Derek Higgs, 'Review of the role and effectiveness of non-executive directors' (2003) 67-70 available on http://www.berr.gov.uk/files/file23012.pdf accessed on 2011

[28] The Institutional Shareholders' Committee (ISC) is a forum for interaction and cooperation for the Associations of Investment Companies (AIC), the Association of British Insurers (ABI), the Investment Management Association (IMA), and the National Association of Pension Funds (NAPF). ISC issued guidance in 2002 for Institutional investors to monitors the performance of their investee companies through regular dialogue with companies where appropriate, necessary intervention, and evaluate the impact of their own monitoring activism and report to their clients and beneficiaries. The ISC revisited and updated its principle on the 'Responsibilities of Institutional Shareholders and their Agents' in 2005 and designated it as an ISC Code. In November 2009, ISC again revised its principle and issued its promised code i.e. the Code on the Responsibilities of Institutional Investors.

[29] Paul Myners, Institutional Investment in the United Kingdom: A Review, London, HM Treasury, (2000) 14 at Para 79 available on http://archive.treasury.gov.uk/pdf/2001/myners_report.pdf accessed on January 2011

[30] David Walker, A Review of Corporate Governance in UK Banks and others Financial Industry Entities: Final recommendations, London, HM Treasury, (2009) 68-89 available on http://webarchive.nationalarchives.gov.uk/+/http://www. hm-treasury.gov.uk/d/walker_review_261109.pdf accessed on 2011

[31] Institutional shareholders' Committee Code on the Responsibilities of Institutional Investors (ISC's Code), (2009) available on http://institutionalshareholderscommittee.org.uk/sitebuildercontent/sitebuilderfiles/ ISCCode161109.pdf accessed on March 2011

[32] Financial Reporting Council, Consultation on a Stewardship Code for Institutional Investors, London, FRC, (2010) available on https://www.frc.org.uk/images/uploaded/documents/Stewardship%20Code%20C onsultation%20January%2020101.pdf accessed on 2011

[33] The provisions relating to role of institutional investors and their engagement with their investee companies by following the principles of the ISC's Code were omitted in the new version of the UK Corporate Governance Code 2010.

FRC on the similar footings of 'the ISC's Code on the Responsibilities of Institutional Investors'.[34] The institutional investors and their agents are required to perform their stewardship commitments on the bases of the 'comply or explain' approach similar to the self-regulatory approach of the Combined Code and the ISC's Code.[35]

In sum, the lack of permanent supervision on the part of shareholders gave birth to the professional and skill full independent boards of directors to run the affairs of the companies and monitor the executive. Later on corporate collapses, stock markets' crisis, managerial opportunism and dispersed ownership forced the institutional investors who have significant shares' ownership in listed companies, to become an active monitor of their investee companies. Although individual direct shareholding in investee companies is relatively small but institutional shareholders make their investment on behalf of individual investors. The concentration of share-ownership in the hands of a group of institutions empowers them to exercise control over management by envisaging them stewardship obligations. The stewardship theory is an alternative to the agency theory to fill the gap of stewards' obligations in existing corporate scenarios where ownership and control is concentrated in the hands of institutions.

2.1.3. Application of Stakeholder Theory

The German corporate governance model has significant importance due to a two-tier board, the supervisory and management boards, and employees' representation in a supervisory board on the principle of codetermination.[36] The management board is responsible to run the affairs of the company while supervisory board plays a monitoring role to ensure that the management board is managing the company in a competent and efficient manner.[37]

In Germany, the dual board and codetermination are not new. The dual-board was introduced by the General German Commercial Code of 1861. It was made compulsory in 1870 for large corporations. The supervisory codetermination was introduced in 1922 by amendment of the Works Councils Act 1920. The workers representative members of the supervisory board were elected for their reserved seats through secret ballot by the entire workforce.[38] This democratic right of employees' participation in the supervisory board was abolished in 1934 and again revived by agreement, between the British occupational forces and German trade unionist, for management and labor to work together. The system of parity employee representation in the supervisory board was introduced in the mining, iron and steel industry by the Codetermination Act of 1951 with the concept of the 'neutral person' as chairman of the board who was appointed by the shareholders meeting upon the recommendation of the supervisory board.

After 25 years, the codetermination system was required for all companies which have more than 2000 employees through the Codetermination Act 1976. The chairperson who had the casting vote was appointed by shareholders' representatives and the voice-chairman was appointed by employees' representatives. The chairman's casting vote increased the shareholders representational power and this form becomes the 'quasi-parity codetermination' rather than 'parity codetermination'. Later on, one-third of employees' codetermination in the supervisory board was prescribed through the Employees on the Supervisory Board Act of 2004 which ended the concept of parity supervisory codetermination.[39] The shareholders majority seats in the supervisory board is a step towards the UK shareholders' primacy approach. The German Supreme Court in Civil Matters held that the Codetermination Act was passed in the public interest to serve the common weal of the community and national economy.[40] Du Plessis argued that the so called 'Path dependency'[41] and political consequences are the main obstacles for the abolishment of traditional German-model.

On the other hand, Japan is a civil-law country and has less flexibility in her procedural system. The traditional corporate governance model was the *Keiretsu*[42] and was popular and prevailed in the Japanese corporate market. The *Keiretsu*'s boards were large and composed of entirely executives. In companies' governance, the 'company community' had a key role; the full-time core employees, members of board and management, who shared their identity as 'company men', were called the company community except female employees who were treated as temporary workforce. The company community ensured a life-time employment and seniority system for the promotion and incentive purposes.[43] The 'employees' ownership'[44] called relationship preserving norms and shareholders ownership is called end-game norms.[45] The corporations were usually monitored by three

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34 Financial Reporting Council, The Stewardship Code 2010, London, FRC, available on http://www.frc.org.uk/images/uploaded/documents/UK%20Stewardship%20Code%20July%2 020103.pdf accessed on 2011

35 Financial Reporting Council, Implementation of the UK Stewardship Code 2010, London, FRC, 2010, available on http://www.frc.org.uk/images/uploaded/documents/Implementation%20of%20Stewardship%2 0Code%20July%2020103.pdf accessed on 2011

36 Jill Solomon, Corporate Governance and Accountability, 2nd Ed. (Wiley, 2007) 205 - 206

37 Simon Goulding, Lilian Miles, and Alexander Schall, 'Judicial Enforcement of Extra Legal Code in UK and German Company Law' 2 ECFR 21 (2005) 20-62 at p. 41

38 Jean J. Du Plessis, 'the Rise and fall of Supervisory Codetermination in Germany?' I.C.C.L.R. 2005, 16(2), 67-79

39 Jean J. Du Plessis, (n.38) 69-70

40 Jean J. Du Plessis, (n.38) 71

41 Revolutionary theory that express the idea; history matters-choices made in the past can affect the feasibility of choices made in future.

42 Keiretsu are networks of companies in Japan connected through cross-holding of shares and with interlocking directorships. Member companies including financial institutions tend to inter trade extensively.

43 Zenichi Shishido, 'Japanese Corporate Governance: The Hidden Problems of Corporate Law and Their Solution' (2000) 25 Del. J. Corp. L. 189-233 202-204

44 The employees being human capital have a long term contractual relationship with corporations.

45 End-game consists of inside shareholders exercising their voice in the corporation and outsider shareholders have the option of exit by selling their shares.

ways: First, in-house monitoring conducted by the 'company community'; second, monitoring by inside shareholders; last, monitoring by outside-shareholders through exit.[46] Therefore, it could be argued that the Japanese Model of Corporate Governance based on stakeholder theory rather than shareholder primacy theory.

2.1.4. Monitoring through Company Auditors and Creditors

The Japanese corporate law also provided the concept of statutory-auditors like Italian model of corporate governance.[47] They were not the board's members but they could attend board meeting and express their opinions. Both boards of auditors and the out-side auditors monitored the illegal action of the directors. They prepared company reports regarding companies' financial matters, infringement of the commercial code and articles of the company.

In Italy, Partnerships with unlimited liability and limited liability companies are the main form of business. Families, state, and block holders (i.e. coalition of different companies) are dominant shareholders of listed and unlisted companies.[48] The uniqueness of the Italian-modal is tri-part governance system: board of directors, executive committee including Managing Director (MD) and board of statutory auditors.[49] The statutory audit board acts autonomously, and represents and protects the interests of the generality of the shareholders. The principal responsibility given to the board of auditors is to monitor the directors' performance in the discharge of their duties, which is similar to the British non-executive directors.[50] The internal auditing staff, internal control committee and external audit firm that were appointed by the shareholders are supposed to co-operate and share the relevant information with the board of auditors.

3. Possibility of Responsible Corporate Monitoring in Emerging Economies Like Pakistan

Corporate governance has received wide attention of policy makers in the developed and developing countries during the last decade. The significant dimension of corporate governance issues in a developing country like Pakistan, are underdeveloped nature of corporate culture, family dominated business group, regional instability due to war and terror, and ineffective regulatory mechanism. This is a fact that family dominated corporate ownership structure prevails in Pakistan wherein the majority of companies or large number of business groups are held and controlled by family networks. Minorities' interests neither find a reasonable representation in corporate decision-making process nor corporate frame work protect them in form derivate-actions which are provided in British Company Act 2006. The behavioral patterns of corporate governance, such as, the actual conduct of corporations in terms of performance, efficiency, growth, financial structure, treatment of shareholders, role of institutional shareholders and corporate social responsibility are not yet well established. The laws and regulations under which firms are operating, the functioning of the board of directors in relation to ownership structures, the responsibility of executive dispensation in determining and deciding firm performance, the relationships between labor policies and firm productivity, the role of multiple shareholders, and lack of transparent and accountable corporate and financial reporting frameworks are some of the issues confronting the corporate sector in Pakistan.[51]

However, the Government of Pakistan established the Securities and Exchange Commission of Pakistan (SECP) in 1997 to lay down and improve the structure of good corporate governance as well as build the regulatory framework for effective management of the corporate sector. The SECP in pursuance of its policy of regulation has enacted and enforced various laws and regulations including the Code of Corporate governance to create and strengthen an "enabling business environment" for smooth and sustained functioning of corporate and economic development.

The shareholder primacy theory is attractive for the investors but it requires active corporate monitoring for which the institutional shareholders can play important role. However, the free and fair functioning of institutional investors requires comprehensive review of their legal framework because the institutional shareholders (such as pension funds, insurance companies, investment companies and unit-trusts) in Pakistan are working under the shadow of federal government. Their functioning should be independent without bureaucratic interference for healthy functioning of major shareholders. However, the stakeholder theory may also be applied to provide job security to the corporate employees through services laws as well as to the general community through consumers' protection laws. The fiduciaries duties of the corporate directors and right of derivative actions for the protection of minority shareholders should also be incorporate in corporate law to protect the investors and to save them from managerial opportunism and agency issues.

The western institutional investors in contrast to major investors of the developing economies work independently in the best interest of their beneficiaries. For instance in the UK, institutional investors have more than 87% equity ownership in their investee companies listed in the London Stock Exchange.[52] They have significant role in the corporate governance of their investee companies being a steward of their companies. They are responsible to actively involve and monitor their companies

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[46] Zenichi Shishido, (n.43) 208
[47] Zenichi Shishido, (n.43) 206-207
[48] Christine A. Mallin, Corporate Governance, Ed. 2nd (Oxford 2008) 167-180
[49] Raffaele Lener, 'The New Rules on Corporate Governance of Banks issued by the Bank of Italy and Milan Stock Exchange' J.I.B.L. R. 2008, 23 (7) 387-391
[50] Andrea Melis, 'On the Role of the Board of the Statutory Auditors in Italian Listed Companies' 2004 Corporate Governance 12 (1) 75 at pp. 77
[51] Rasul Bakhsh Rais, Regulatory Impact Assessment of SECP's Corporate Governance Code in Pakistan, CMER Working Paper no. 05-39 at (2007 & 2008) 1-25
[52] The UK, ONS Share Ownership Structure, < http://www.statistics.gov.uk/pdfdir/share0110.pdf > (8 September 2011)

while in emerging economies, the major shareholders are absentee landlord of their investee companies and that is detrimental to the minority shareholders and corporate stability. However, the perfunctory monitoring behaviour of institutional investors is beneficial for corporate families to keep their complete control on their business firms and to run them in their own best political and economic interests. The ineffective monitoring of domestic institutions increased the agency cost. The management exercises their powers and utilizes corporate resources without the fear of accountability.

In the existence of family domination in corporate sector, political interference and ineffective monitoring of the domestic institution, the creditors and professional auditors can play responsible monitoring role. Their responsible monitoring can manage and mitigate the agency problems and provide corporate stability. The high quality of auditors monitoring would not only enhance the confidence of domestic and foreign investors but also ensure the minority shareholders that their interest would be protected.[53] The relationship between auditor choice and ownership structure is evident among firms frequently raising equity capital wherein auditors play a governance role to mitigate agency problems and issue of minority shareholders in emerging markets. The role of auditors would allow using these quantifiable measures to capture the quality of a corporate governance mechanism used by a firm.

On the other hand, both the company's shareholders and creditors finance the company, but shareholders will often be more than merely finance providers in a company because they have role in corporate decision making and control of the board as monitor through their vote. However creditors who are first and foremost providers of finance have limited role in the operation of the company, though their financial interests are clearly prejudiced and they seek to exercise their contractual and proprietary protection. The creditors' role during insolvency proceedings is not enough to protect the corporate stability and their own financial interests.[54] The family owned corporations exercise their political and bureaucratic influence in financial institution to take the overvalued heavy loans for their companies and utilize this credit money for their personal benefits and take the shield of corporate personality as a legal entity in case of insolvency to protect them from personal liability.

Secondly, in concentrated financial markets the directors cum shareholders such as family members run the company to protect their own financial and political interests at the cost of the company. The managerial opportunism increases the agency cost. Therefore, the creditors as capital providers should be in a position to play their significant role in corporate governance during solvency. Creditors may have a monitoring role, as a result of their contractual relationship with the company.[55] The finance is a life-blood for corporate sector; therefore the relationship between shareholders and creditors should be understood in the dynamics of company financing decisions in both solvent and insolvent scenario.

The creditors should protect themselves against two dangers through possible monitoring: firstly, the borrower should deplete the assets either by diminishing their value or by substituting its safe assets for more risky ones and secondly, it should dilute the value of the creditor's debt by adding more liabilities without correspondingly increasing the asset pool.[56] The unsecured creditors should be required to have extensive covenants which give them the ability to monitor the entire business of the borrower and, in conjunction with that monitoring, to stop the borrower depleting the asset pool or increasing liabilities. The creditors' monitoring should be focused on the asset that is given as security. The responsible monitoring can be effective through creditors with a security interest over all the assets of the company.[57]

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[53] Joseph, P.H. Fan and T.J. Wong, "Do External Auditors Perform a Corporate Governance Role in Emerging Markets? Evidence from East Asia," Journal of Accounting Research, Vol. 43, No.1(March 2005): 35-72

[54] Louise Gullifer and Jennifer, *Corporate Finance Law Principle and Policy*, (London: Hart Publishing, 2011) 80

[55] Gullifer and Jennifer, (n.54) 14

[56] Gullifer and Jennifer, (n.54)294

[57] Louise and Jennifer, (n.54)294-295