Over the past few decades, role of institutional shareholders in the listed companies has expanded manifold. It is also believed that institutional shareholders can be instrumental as agents of change towards improving corporate governance. Various studies have been conducted to explore the effectiveness of institutional shareholders in developed countries notably USA and UK. Using data for listed companies, this research work explores the institutional ownership pattern in Pakistan for both the government-owned and privately owned institutions. This paper specifically investigates the role of institutional shareholders in promotion of Corporate Governance. We explore the role of institutional shareholder activism for two particular aspects: appointment of non-executive directors and appointment of external auditors. The paper then goes on to investigate role of nominee directors on the board. The paper concludes by discussing the how the Code of Corporate Governance of Pakistan can facilitate/support institutional shareholders.

Introduction: Institutional shareholding has increased rapidly during the past few years. According to an estimate equity holdings increased in the US from 24% in 1980 to approximately 50% in 1994 (Sias and Stark, 1998). It implies that role of institutional investors as equity holders has gained significant importance. Consequently, this has led to considerable increase in shareholder activism. The purpose of this paper is to analyze the institutional ownership pattern and role of institutions in promotion of good corporate governance practices in the investee companies. It specifically investigates these issues from Pakistan’s perspective. This is a pioneering research work in this direction as no prior research work has been done on this issue. The paper is structured as follows: in Section 1, we explore the concept of institutional ownership and issues involved. It also discusses the conditions necessary for shareholder activism. Section 2 discusses the pattern of institutional ownership in Pakistan. In Section 3, we explore whether legal environment is conducive for institutional shareholder activism. Section 4 investigates the level of institutional activism in Pakistan and how the Code of Corporate Governance can help promote institutional shareholder activism. Finally we give conclusion of our findings in Section 5.

SECTION 1

Institutional Ownership

Institutional ownership is defined as share ownership by financial institutions (both banks and non-bank financial companies) and non-financial corporations. These include both the public-owned as well as privately owned institutions. Typically institutions are categorized as follows:

1. Non-banking Finance Companies (NBFC): insurance companies, mutual funds, investment companies, leasing, venture capital companies etc
2. Banking Companies: These include the commercial banks
3. Non-financial Corporation
4. All other non-financial entities including trusts and non-profit organizations
5. Development Financial Institutions and International organizations/fund managers

The scope of this paper is limited to only local financial institutions, which includes both banking and non-banking institutions.
Issues involved in Institutional Shareholding

The objectives of both bank-based and market-based financial systems are to promote efficient allocation of resources, lower transaction cost, provide liquidity to investors and efficient project monitoring. Market based system provides greater incentives to gather information because trading takes place on the basis of that information. This information is also indicated in the share price (according to efficient market hypothesis). Another advantage is that this market-based system provides means for efficient risk sharing and diversification. In this way, risk return preferences of all categories of investors can be satisfied. With poor corporate performance, share price will fall which can result in takeover and expulsion of management. Therefore efficient market based systems maintain managerial incentives to maximize profit.

The distinguishing characteristics of the large shareholders include:

1. Substantial investment
2. Non-homogenous grouping

Apart from controlling shareowners and directors, individual stockholders usually have smaller level of investment. Financial institutions can have different investment objectives for example some institutions have short-term investment objective and have therefore higher liquidity preferences.

Financial institutions invest and manage funds on behalf of other investors. These institutions have the voting authority of the investors. These institutions have professional portfolio managers who bring more expertise than individual investors. Since the financial institutions are block holders, their monitoring can reduce the shirking behavior of managers and induce them to maximizing shareholder wealth. However, Institutional investors have been criticized for not investing sufficient resources in monitoring corporate managers. They are usually either voting with managers or abstaining from voting. This reluctance to vote against management stems from conflict of interest caused by their other business relations with corporations.

Shareholder Activism

Institutional investor activism is defined as monitoring of performance and corporate governance of portfolio companies by institutions, which include both banks and non-bank financial companies. But the scope of activism also includes attempts made to bring about changes in a company’s behavior for adoption of good governance practices. Generally there can be two modes of institutional shareholder activism:

1. Block holders who buy shares in a company and are determined to bring about changes in decision-making policies of the firm
2. Market for Corporate Control

Conditions for Shareholder Activism

1. Large Shareholder: For institutional shareholder activism, significant shareholding is the most important factor. This is comparable in two ways: higher shareholding as compared to others or holding of greater than a minimum amount as percentage of total equity. This means that bargaining power of institutions with management increases and thus reduces the problem of collective action. Small investors have no incentive to undertake management monitoring activities because of the costs involved and free-rider problem (benefit to all shareholders from the action of just one shareholder). On the other hand,
for institutions with significant holding, the increased return from monitoring can cover the cost.

2. Conflict of Interest: There can be conflicts of interest, which may lead to institutional passivity. Agency problems arise due to separation of ownership and control. Managers are given responsibility of running a company by shareholders who are also the owners: managers have tendency to make decisions on the basis of self-interest e.g. managers might focus on short-term gains at the expense of long-term gains which is not prudent. When the board of directors does not act according to satisfaction of some shareholders, shareholder activism becomes imperative. A clear conflict of interest arises if the institution provide services to the company e.g. investment banking and consulting etc. This is why institutions are pushing for proxy voting at Annual Shareholder meeting (in case of Pakistan, this is called Annual General Meeting AGM).

3. The institutions are more active when they co-ordinate with each other. In this way the benefits can be taken by all at the same time costs can be shared. This could be achieved by two ways:

   i) Each institution taking a lead role in monitoring of a company where it has significant shareholding

   ii) All the institutions acting collectively

The first option seems to be more prudent since the significant shareholder will reap maximum benefits and so there are strong incentives for it to be active.

SECTION 2

Institutional Investors in Pakistan

In this section we examine the ownership structure of institutional investors in Pakistan for a selected group of companies for the year 2001. Our sample consists of 244 non-financial privately-owned companies. The total number of listed companies on Karachi Stock Exchange is 713, out of which financial and government owned companies are 208. Our sample therefore represents approximately 50% of the total population of non-financial and privately owned companies.

Data was collected from various Divisions within the Securities and Exchange Commission of Pakistan. The Commission is making every effort to adopt state-of-the-art procedures for data collection and analysis, which will facilitate future research work.

We observe the pattern of institutional investors. For this purpose, we divide the institutional investors into following categories:

   1. Government-owned Financial Institutions
      a) Banks
      b) DFI
      c) National Investment Trust (NIT)
      d) Investment Corporation of Pakistan (ICP)
Private-owned Financial Institutions

e) Banks
 f) DFI

g) Insurance Companies
 h) Leasing Companies

i) Modarbas
 j) Mutual Funds

2. Foreign Institutional Investors

Pakistan like other developing markets has certain characteristics, which differ from developed countries. These include:

1. Family-owned business: Many listed companies especially in the textile sector in Pakistan are family-owned. This leads to insider control and concentrated ownership.

2. Less developed Capital Market. The capital market in Pakistan is less developed. Active trading is done in only a few companies. Also there have not been many new listings which means that there is less reliance on market for raising capital.

3. Absence of market for corporate control: Market for corporate control does not exist. There is hardly any incident of corporate control and takeovers. The reason again is that controlling ownership lies with Directors.

4. Heavy reliance on Bank financing

5. With the Initial Public Offering, share distribution is done in such a way that majority of the shareholding lies with directors directly or indirectly. The Directors of the company endeavor to spread the remaining share ownership making it as diverse as possible so as to avoid possibility of corporate control.

<table>
<thead>
<tr>
<th></th>
<th>Bank</th>
<th>Insurance</th>
<th>Leasing</th>
<th>Mutual Fund</th>
<th>Modaraba</th>
<th>DFI</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Domestic</td>
<td>7.64</td>
<td>2.26</td>
<td>0.02</td>
<td>0.75</td>
<td>0.02</td>
<td>8.33</td>
<td>19.22</td>
</tr>
<tr>
<td>Foreign</td>
<td>3.87</td>
<td>0.37</td>
<td>0.23</td>
<td>0.41</td>
<td>0.00</td>
<td>0.24</td>
<td>4.91</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>11.51</td>
<td>2.63</td>
<td>0.25</td>
<td><strong>1.16</strong></td>
<td>0.02</td>
<td>8.56</td>
<td>24.13</td>
</tr>
</tbody>
</table>

Source: Based on authors' own calculations

Table 1 above shows pattern of ownership in Pakistan. As we can see, total financial institutions' ownership in the manufacturing sector of Pakistan is 24%. Apart from financial institutions, other major shareholders can be directors and sponsors. It is pertinent to mention here that the sample for this study excludes financial institutions ownership in financial and government-owned companies. Banking sector turns out to be the most significant equity holder with around 12% holding. This is because there is no restriction currently on bank investment in equity and banks tend to diversify their portfolio by investing in equity. There is also a conflict because banks are also lenders and are interested in timely loan payment. Stock market responds positively to improvement in credit rating of a company. So banks can also gain benefit if they give loan to a
company. One interesting aspect from this data is that Development Financial Institutions (DFI) have turned out to be significant equity holders with 8.56% holding. In Pakistan like many other developing countries DFIs usually play a very important role in term-financing. However, it is evident from the table that financial institutions holding becomes insignificant if we remove bank holdings. One striking feature is that Mutual Funds have very low equity holding. This is probably due to market volatility, less developed mutual fund industry and lack of fund management skills. Lack of sophisticated financial instruments and price discovery mechanism in the market are also major deterrent for non-bank institutional investors.

We now examine investment of government-owned financial institutions namely National Investment Trust and Investment Corporation of Pakistan. Both are currently going through the process of privatization but these were government owned for the sample period. Therefore we treat ICP and NIT as government-owned financial institution as well. It turns out that ICP has 0.61% equity holding while stockholding of NIT is around 5%. NIT has high holding because according to Capital Issues Act it was mandatory for all companies to offer 20% of the paid up capital to NIT during IPO. This act was, however, repealed in 1995.

The pattern of shareholding for financial institutions (both government owned and privately-owned) across the sectors is as follows:

**Table 2: Pattern of Shareholding in Different Sectors**

<table>
<thead>
<tr>
<th>Sector</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Auto and Allied</td>
<td>16.43</td>
</tr>
<tr>
<td>Cables and electrical</td>
<td>20.4</td>
</tr>
<tr>
<td>Cement</td>
<td>17.26</td>
</tr>
<tr>
<td>Chemical and pharmaceutical</td>
<td>8.49</td>
</tr>
<tr>
<td>Engineering</td>
<td>25.16</td>
</tr>
<tr>
<td>Food and allied</td>
<td>57.97</td>
</tr>
<tr>
<td>Fuel &amp; energy</td>
<td>45.32</td>
</tr>
<tr>
<td>Glass and ceramics</td>
<td>22.36</td>
</tr>
<tr>
<td>Jute</td>
<td>29.05</td>
</tr>
<tr>
<td>Leather and tanning</td>
<td>23.92</td>
</tr>
<tr>
<td>Miscellaneous</td>
<td>8.58</td>
</tr>
<tr>
<td>Paper &amp; board</td>
<td>26.58</td>
</tr>
<tr>
<td>Sugar &amp; allied</td>
<td>24.69</td>
</tr>
<tr>
<td>Synthetic &amp; rayon</td>
<td>7.51</td>
</tr>
<tr>
<td>Textile composite</td>
<td>20.37</td>
</tr>
<tr>
<td>Textile spinning</td>
<td>21.73</td>
</tr>
<tr>
<td>Textile weaving</td>
<td>22.26</td>
</tr>
<tr>
<td>Tobacco</td>
<td>6.18</td>
</tr>
<tr>
<td>Vanaspati and allied</td>
<td>7.02</td>
</tr>
<tr>
<td>Woolen &amp; textile</td>
<td>16.8</td>
</tr>
</tbody>
</table>

*Source: Based on authors’ own calculations*

Food and allied sector has the highest institutional shareholding. In Fuel and Energy sector, financial institutions hold 45% of equity. Textile sector as expected has on average 20% shareholding. This may be because most of the companies in textile are family-controlled.

The pattern of holding in individual companies is given as follows:

**Table 3: Number of Companies in Different Categories of Shareholding**

| Less than 1%                         | 11 |
| Greater than 1% and less than 10%    | 70 |
| Greater than 10% and less than 20%   | 52 |
| Greater than 20% and less than 30%   | 48 |
| Greater than 30% and less than 50%   | 49 |
| Greater than 50%                     | 14 |

*Source: Based on Authors’ own calculations*
As we can see institutional holding is greater than 20% for 45% of the sample companies. High stockholding by institutional investors means that scope for institutional shareholder activism is present as benefits from the activism will outweigh the costs.

In order to measure firm performance for different categories of institutional holding, we estimate Return on Equity (ROE) and Return on Asset (ROA) for selected number of companies in the sample and take average for each group. The results are presented in table 4 below:

**Table 4: Performance Indicators**

<table>
<thead>
<tr>
<th>Institutional Holding</th>
<th>ROE (%)</th>
<th>ROA (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than 1%</td>
<td>13.17</td>
<td>1.62</td>
</tr>
<tr>
<td>Less than 10%</td>
<td>19.28</td>
<td>8.05</td>
</tr>
<tr>
<td>Less than 20%</td>
<td>45.39</td>
<td>4.05</td>
</tr>
<tr>
<td>Less than 30%</td>
<td>45.43</td>
<td>4.27</td>
</tr>
<tr>
<td>Less than 50%</td>
<td>68.54</td>
<td>3.7</td>
</tr>
<tr>
<td>More than 50%</td>
<td>98.93</td>
<td>9.54</td>
</tr>
</tbody>
</table>

*Source: Based on Authors’ own calculations*

The results show that return on equity and return on asset increase from 13% and 1.6% for companies with less than 1% institutional ownership to 99% and 9.54 for companies with greater than 50% institutional holding respectively. It is thus evident that performance indicators improve with increase in institutional holding.

**SECTION 3**

**Legal Conditions in Pakistan**

There have been various changes brought about in the legal governance of the financial institutions. Limitations on total equity holding as percentage of total equity are as follows:

<table>
<thead>
<tr>
<th>Company Type</th>
<th>Limitation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Associated Company</td>
<td>30%</td>
</tr>
<tr>
<td>Modaraba</td>
<td>20%</td>
</tr>
<tr>
<td>Leasing Upto</td>
<td>30% of its total assets</td>
</tr>
</tbody>
</table>

It is however pertinent to mention here that investment companies (closed-end mutual funds) are allowed to hold in a company an amount not exceeding 10% of the total paid-up capital of the Fund or the investee company as per investment companies and investment advisors rules 1971. According to Asset Management Companies Rules of 1995, open-end companies cannot invest more than 25% of its net asset value in securities of any one sector. Further Modaraba cannot make an investment in the shares of a listed company of an amount exceeding 5% of its own equity or 10% of paid up capital of that company whichever is less (Prudential Regulations for Modarabas, 2002). As we can see that law in Pakistan imposes limitations on Institutional shareholding. For Institutional shareholder activism this can be deterrent. This also means that corporate control market has no incentives to develop. However, recently promulgated ordinance on take over and acquisition states that prospective acquirers have to disclose information regarding their intention to acquire within the range of 25% to 50% holding. It is mandatory upon the company to give proportionate representation to these shareholders according to their controlling shares. Most financial experts believe that 25% holding is too high and does not give teeth to law.
There is no requirement on shareholder proposal. Neither is there any compulsion on attendance of Annual Shareholders meeting except for special resolution, which has to be passed by not less than 75% of members entitled to vote. However, proxy voting is encouraged. Right to demand voting confidentiality is given to the shareholder.

Companies ordinance in Pakistan (1984) gives description of the way voting shall be carried out at AGM. Section 165 states “At any general meeting, a resolution put to the vote of the meeting shall, unless a poll is demanded, be decided on a show of hands.”

Furthermore the law has clear provisions for proxy voting. It says that all the members may participate in the meeting (AGM) either personally or through proxy. Section 161 states “Any member of a company entitled to attend and vote at a meeting of the company shall be entitled to appoint another person, as his proxy to attend and vote instead of him, and a proxy so appointed shall have such rights as respects speaking and voting at the meeting as are available to a member.” It further states “Every notice of a meeting of a company shall prominently set out the member’s right to appoint a proxy and the right of such proxy to attend, speak and vote in the place of the member at the meeting and every such notice shall be accompanied by a proxy form.”

So the law is not discouraging proxy voting. This law is protective for minority shareholders in particular. However according to section 167, demand for poll may also be made subject to discretion of the chairman by following persons:

a) In the case of a public company, by at least five members having the right to vote on the resolution and present in person or by proxy.

b) In the case of a private company, by one member having the right to vote on resolution

c) By any member present in person or by proxy and having not less than one-tenth of the total voting power in respect of the resolution

d) Also if shares confer right to vote on the resolution

From the law, it is obvious that institutional shareholders can demand poll. They may do so if they have other conflicts of interest e.g. if they have other business with the company as well.

The board of directors sends proxy forms to the shareholders. This proxy form allows for two-way voting on all resolutions which are to be proposed i.e. shareholders has the choice to vote for or against any resolution. If a shareholder does not specify how the proxy should vote on the different issues, the proxy will be free to vote as he pleases.

**SECTION 4**

**Institutional Activism in Pakistan**

During the course of this research work, efforts were made to study the voting behavior of the financial institutions at Annual General Meeting for two aspects of Corporate Governance: appointment of directors and of auditors. This could not be done because of two reasons:

1. Lack of complete data
2. Improper way of recording minutes of Annual General Meeting
During the scrutiny of the available data on recorded minutes of AGM, it was found that because of the lack of proper methodology for recording minutes of the meeting, this exercise couldn’t be carried out. The minutes are recorded in a vague and unclear way. For example, it could not ascertained whether financial institutions have submitted any resolution at AGM of a company for appointment of external auditor. It is only mentioned in the AGM that an auditor has been appointed.

It has been generally observed that financial institutions tend to remain passive and do not exercise the votes attached to their shares. This increases the already significant power of directors. It is obvious that if financial institutions do not vote actively at AGM, then the directors will be able to get all resolutions passed in their own favor. Since majority of directors on the board are executive directors, it means that management of company gets stronger which leaves lesser scope for shareholder monitoring.

We now look at representation of nominee directors of financial institutions on the board of directors of the companies with significant shareholding. It has been found that in nearly 65% of such companies, nominee directors are present on the board. However, their active participation on the board could not be ascertained. This is because data for board meeting attendance was not available for the year 2001. Moreover, many industry analysts have criticized nominee directors for their passive behavior. During the informal discussion with Directors of public listed companies, it was observed that nominee directors just played the role of rubber-stamp on the board. It is therefore imperative to develop capacity building mechanism for nominee directors particularly in non-bank finance companies. In this regard, SEC is planning to establish an Institute of Corporate Governance.

A country’s legal and judicial system is vital for well-functioning financial sector. Legal and judicial institutions of a country are associated with broader equity markets. Stock market returns have been found to be positively correlated with judicial efficiency and sound legal system\(^\text{[3]}\). Countries with poorer investor protections, measured by both the character of legal rules and the quality of law enforcement, have smaller and narrower capital markets\(^\text{[4]}\).

In Pakistan, judicial system lacks capacity to keep pace with market developments. This could also be one of the reasons that benefits owners and undermines rights of other stakeholders.

Recently powers of mergers and amalgamation and appointment of administrator for non-bank finance companies have been transferred to Securities and Exchange Commission of Pakistan (NBFC Ordinance 2002). However, these decisions can be challenged in the courts so that judiciary still retains powers. Moreover, some of the powers like liquidation still lie with the courts. Judicial and legal system in Pakistan has to adapt to changing economic demands in order to satisfy investors. Pakistan needs to reform its judicial system focusing on following areas: protection of rights of investors, efficient decision-making, contract enforcement.

**Code of Corporate Governance and Institutional Shareholder Activism**

In Pakistan, the Securities and Exchange Commission of Pakistan (SEC) introduced the Code of Corporate Governance (“the Code”) in March 2002, which was subsequently incorporated in the listing regulations of the three stock exchanges. At present, this basic code is applicable to listed public companies. The objective of the code is to create an institutional system, which protects various stakeholders and thus provides an environment, which is conducive to investment.

The Code of Corporate Governance encourages effective representation of independent non-executive directors on their Boards of Directors. According to Section (b) of Clause (i) of the Board of Directors:
“The Board of Directors of each listed company includes at least one independent director representing institutional equity interest of a banking company, Development Financial Institution, Non-Banking Financial Institution (including a modarba, leasing company or investment bank), mutual fund or insurance company; and the independent director representing an institutional investor shall be elected by such investor through a resolution of its Board of Directors and the policy with regard to selection of such person for election on the Board of Directors of the investee company shall be disclosed in the Directors’ Report of the investor company”.

It is clear from the above-mentioned clause that the Code is pushing for increased representation of institutional shareholders. This is again in order to promote the monitoring role of these shareholders.

In addition, minutes of board meetings are to be recorded. If a Director does not agree with the minutes, he may send the matter first to Company Secretary and then to SEC. Here again nominee directors of financial institutions can express their views freely during the meetings. Attendance of Board meeting is now required to be attached with the Annual Accounts report of the company so that this information is available to all shareholders.

The Code lays down issues to be decided by the Board as well responsibilities powers and functions of Board of Directors in order to formulate corporate policies. The Code has made it mandatory upon all listed companies to disclose the whole shareholding pattern including shares held by financial institutions (both government and privately owned), associated companies and directors and management of the company and their spouse and their minor children. Details of beneficial ownership i.e. shareholders holding ten percent or more interest in the listed company are also required to be disclosed.

Also the Code focuses on formation of Audit Committee, which shall ensure that appropriate internal control systems are effective and that appropriate measures are being taken to safeguard company’s assets. The Code requires that majority of the members of the Committee and preferably its Chairman is from among the non-executive directors of the listed company. Here again nominee director can play a vital role.

SECTION 5

Conclusion

Financial Institutions are block-holders in Pakistan. We find that 45% of companies have holding greater than 20%. Therefore stakes are high and incentive for shareholder activism is present. Also nominee directors of these block holders are present on 60% of sample companies’ Board of Directors. Although the legal conditions in Pakistan are not helping to flourish the market for corporate control particularly for non-banking financial sector, proxy voting is allowed and there is no restriction on co-ordination among institutions. The Code of Corporate Governance also highlights the role of nominee director as independent non-executive directors. Based on our results we recommend that institutional investors be encouraged for activism.

Institutional investors should be encouraged to submit resolutions at Annual General Meeting. Also nominee directors need to adopt a more proactive role as the Code of Corporate Governance lays emphasis on the role of non-executive directors.

It is also recommended that institutional investors be encouraged to establish Council of Institutional Investors, which will provide a forum for institutional shareholder activism. Investors’ activism can be expressed in follow ways: shareholder proposal, negotiations with management and public targeting. It is envisaged that this Council will perform all these functions.
For the financial year ending 2002, all the listed companies are required to submit with their annual reports, the statement of compliance with Code of Corporate Governance. This will further help to improve transparency and disclosure policies of the companies and provide vital information related to corporate governance practices to various shareholders including institutional shareholders.

Most of the banks’ nominee directors lack expertise. In addition, there is always conflict of interest involved as bank are only interested in quick recovery of their loans. It is therefore imperative to develop non-bank financial companies as fund managers possess skills and knowledge to monitor. As these non-bank finance companies develop, potential for institutional shareholder activism will increase in Pakistan. In this regard SEC has been taking various steps for market deepening and introduction of sophisticated financial instruments. With T+3 system in place, it is expected that price discovery mechanism will also improve. Moreover, two private pension funds have also been approved. It is expected that these steps will help in development of non-bank institutional investors and their activism.

For comments and queries, please contact cgc@secp.gov.pk

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[2] Modaraba is an Islamic corporate system that is similar to a two-tier fund structure.
