

**Corporate Governance and Principles-based market rule exploitation  
by Public listed companies in Pakistan, proposing a Solution model to  
overcome issues to have the effective enforcement of practices**



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Islamabad, Pakistan

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A thesis submitted to the National University of Sciences and Technology, Islamabad,

in partial fulfillment of the requirements for the degree of

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Supervisor: Dr. Muhammad Shariq

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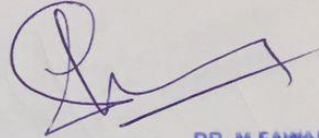
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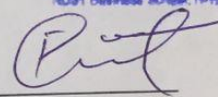
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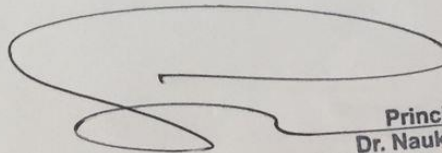


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I Nouman Ahmed hereby state that my MS thesis titled “Corporate Governance and Principles-based market rule exploitation by Public listed companies in Pakistan, proposing a Solution model to overcome issues to have the effective enforcement of practices” is my own work and has not been submitted previously by me for taking any degree from National University of Sciences and Technology, Islamabad or anywhere else in the country/ world.

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## **ABSTRACT**

This project investigates corporate governance practices in Pakistan, specifically focusing on the flexibility exploited by public listed companies under the "comply or explain" approach mandated by the Securities and Exchange Commission of Pakistan (SECP). The research highlights how this approach allows companies to evade full compliance with the Code of Corporate Governance (CCG) and opens avenues for agency conflicts, where majority shareholders often dominate decision-making at the expense of minority shareholders. Through case studies of Suraj Cotton Mills and High-Noon Laboratories, this project identifies critical shortcomings in board composition, related party transactions, and audit committee independence, emphasizing how these gaps weaken corporate governance. The research also draws comparisons with rule-based governance models used globally, advocating for a more stringent enforcement mechanism in Pakistan. Recommendations include increasing board independence, improving audit committee standards, and ensuring transparency in related party transactions to protect shareholders' rights and restore investor confidence. The project concludes that a hybrid model combining principles-based flexibility with rule-based rigor is essential to mitigating corporate governance challenges in Pakistan. This solution aims to align managerial actions with shareholder interests while fostering a transparent and accountable corporate environment.



# Chapter 1: Introduction

Collection of control mechanisms that an organization adopts to prevent or dissuade potentially self-interested managers (and majority shareholders) from engaging in activities detrimental to the welfare of shareholders (minority shareholders) and stakeholders.

## 1.1. INTRODUCTION TO RESEARCH

Collection of control mechanisms that an organization adopts to prevent or dissuade potentially self-interested managers (and majority shareholders) from engaging in activities detrimental to the welfare of shareholders (minority shareholders) and stakeholders. Here's an overview of the importance of corporate governance in ensuring transparency, accountability, and investor confidence.

### *1.1.1. Transparency*

Corporate governance promotes transparency by requiring companies to disclose relevant information about their operations, financial performance, and decision-making processes to stakeholders. It builds trust and confidence among investors, creditors, regulators, and other stakeholders by providing them with access to accurate, timely, and reliable information to make informed decisions. Transparent corporate governance practices help prevent fraud, corruption, conflicts of interest, and unethical behavior by promoting openness, honesty, and integrity in business operations.

### *1.1.2. Accountability*

Corporate governance establishes mechanisms to hold company management and directors accountable for their actions and decisions. Accountability ensures that executives and board members act in the best interests of shareholders and fulfill their fiduciary duties to protect shareholder value. By defining clear roles, responsibilities, and performance metrics, corporate governance helps mitigate agency conflicts between management and shareholders, reducing the risk of managerial opportunism and self-dealing.

### *1.1.3. Investor confidence*

Strong corporate governance practices enhance investor confidence by providing assurance that companies are managed responsibly and ethically. Investors are more likely to allocate capital to companies with robust corporate governance frameworks, as they perceive lower risk and higher potential returns associated with transparent and accountable organizations. Improved investor confidence leads to lower costs of capital, higher stock valuations, increased liquidity in financial markets, and greater access to capital for companies to fund growth and expansion initiatives. Corporate Governance Plays an imperative role by defining their codes depends upon the practice being taken place either it's comply/explain approach or Rules based market practices are being followed. However, there is not any universality in it but there are certain steps and sets of procedures that ensure accountability and transparency.

## **1.1 AGENCY CONFLICTS**

### *1.1.1 Type 1 (Tier 1)*

Conflicts between management and shareholders

- Self-interested executives take actions to benefit themselves (agency-problem)
- Shareholders and stakeholders bear the cost of such actions (agency cost)

### *1.1.2 Type 2 (Tier 2)*

Conflicts between majority and minority shareholders

- Majority shareholders with greater control rights influence the management to take actions to better themselves (agency problem)
- Minority shareholders and stakeholders bear the cost of these actions (agency cost)

## **1.2 Agency Costs**

- Insufficient time and effort on building shareholder value Inflated compensation or excessive perquisites
- Manipulating financial results to increase bonus or stock price.

- Excessive risk taking to increase short-term results and bonus.
- Failure to groom successors so management is "indispensable."
- Pursuing uneconomic acquisitions to "grow the empire."
- Thwarting hostile takeover to protect jobs.

### 1.3 INTRODUCTION TO CG APPROACH/REGIMES

#### 1.3.1 Rules-based approach

instills the code of governance into law with appropriate penalties for transgression.

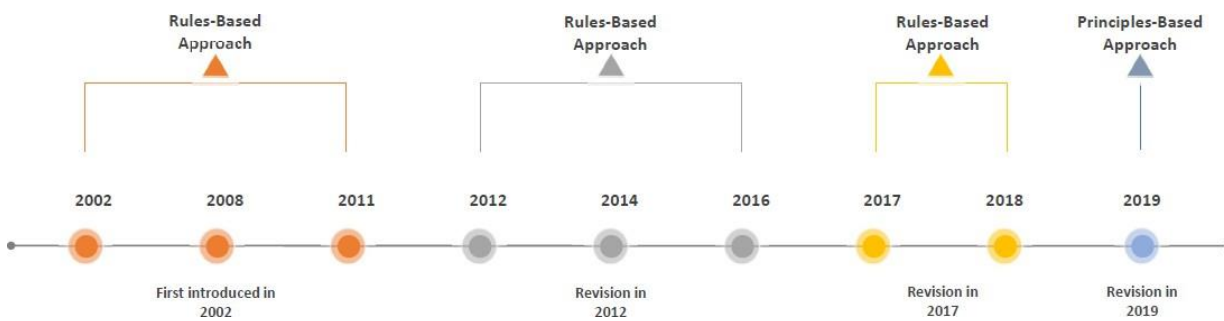
#### 1.3.2 Principles-based

requires firms to adhere to the spirit rather than the letter of the code. Firms must either.

- Comply with the code
- OR**
- Explain why it has not

### 1.4 GOVERNANCE STANDARDS IN PAKISTAN

#### 1.4.1 Evolution of Code of Corporate Governance in Pakistan



The evolution of the Code of Corporate Governance (CCG) in Pakistan has been a dynamic process influenced by various factors, including regulatory reforms, market developments, global best practices, and corporate scandals. Here's an overview of the key milestones in the evolution of corporate governance codes in Pakistan

#### 1.4.1.1 Securities and Exchange Commission of Pakistan (SECP) Guidelines (2002)

- The SECP, the regulatory authority overseeing capital markets in Pakistan, introduced the first comprehensive guidelines on corporate governance in 2002.
- These guidelines aimed to improve transparency, accountability, and investor protection in listed companies by setting out principles and recommendations for corporate governance practices.

#### 1.4.1.2 Code of Corporate Governance (CCG) (2002)

- Building on the SECP guidelines, the Institute of Chartered Accountants of Pakistan (ICAP) and the Institute of Cost and Management Accountants of Pakistan (ICMAP) jointly issued the first Code of Corporate Governance (CCG) in Pakistan in 2002.
- The CCG comprised principles, recommendations, and best practices covering various aspects of corporate governance, including board structure, disclosure requirements, audit oversight, and shareholder rights.
- Listed companies were required to comply with the CCG or provide explanations for non-compliance, following the comply or explain principle.

#### 1.4.1.3 Revisions to the CCG (2005, 2012)

- The CCG underwent revisions in 2005 and 2012 to align with evolving global standards, address emerging governance issues, and enhance regulatory oversight.
- The revisions introduced stricter requirements on board composition, independence, committees, internal controls, risk management, and corporate disclosures.

#### 1.4.1.4 Introduction of SECP's Listed Companies (Code of Corporate Governance) Regulations (2017)

- In 2017, the SECP introduced the Listed Companies (Code of Corporate Governance) Regulations, which replaced the earlier guidelines and incorporated key provisions of the CCG.
- The regulations strengthened corporate governance requirements for listed companies and imposed stricter penalties for non-compliance.

#### 1.4.1.5 Review and Updates (Ongoing)

- The SECP conducts periodic reviews and updates of the corporate governance framework in Pakistan to keep pace with international best practices, regulatory developments, and market dynamics.
- Stakeholder consultations, regulatory reforms, corporate governance assessments, and benchmarking against global standards inform the continuous improvement of the corporate governance regime.

## 2.1 Research Abstract & Code of Corporate Governance

This Project's research or assessment would be revolving around the Code of Corporate Governance issued by SECP 2019 how this is being practiced and adapted by the public listed companies since Pakistan is following comply or explain approach it has a lot of Gaps which need to be bridged to get the shareholder's confidence. There are advantages however disadvantages of comply or explain approach as well which only fulfils the spirit of the code rather the letter of the code which gives space to the dynastic businesses to exploit the flexibility. we will be comparatively analyzing the company holistically what is happening worldwide where rules-based market exists and how Pakistan market behaves under this 2019 SECP comply/explain approach.

### 2.1.1 Short Title and Commencement

- (1) These Regulations shall be called the Listed Companies (Code of Corporate Governance) Regulations, 2019.
- (2) These Regulations shall apply to the listed companies based on "comply or explain approach" except the requirements for which it is explicitly stated as "mandatory" and it shall be the responsibility of the board of directors (the "Board") to use this approach wisely and of investors to assess differing company approaches thoughtfully.
- (3) These Regulations shall come into force from the date of its publication.

### 2.1.2 Definitions

In these Regulations, unless there is anything repugnant in the subject or context, "**Annexure**" annexure means annexure appended to these Regulations.

- a. "**Comply or explain approach**" means discretion of a company with respect to non-mandatory provisions of these Regulations either to comply or provide appropriate explanation as to any impediment in its compliance in the compliance report along with the financial statements.
- b. "**Mandatory**" in relation to these Regulations, means such provisions that are construed to be strictly complied with by the company and non-compliance of such Regulations leads to penal proceedings under regulation 37

## **2.2 DISADVANTAGES OF PRINCIPLES-BASED APPROACH**

### *2.2.1 Lack of Enforcement*

Relies heavily on voluntary compliance and self-regulation, which may lead to inconsistent adherence and a lack of meaningful consequences for non-compliance.

### *2.2.2 Potential for Abuse*

Companies may exploit the "explain" option to justify non-compliance without genuine reasons, undermining the spirit of transparency and accountability.

### *2.2.3 Investor Confidence*

Inconsistent adherence to governance standards may erode investor confidence, particularly if explanations for non-compliance are perceived as inadequate or insincere.

### *2.2.4 Regulatory Oversight*

Requires effective monitoring and enforcement mechanisms to ensure companies provide meaningful explanations and to address instances of non-compliance effectively.

### *2.2.5 Complexity*

Companies may find it challenging to navigate the complexities of the "comply or explain" framework, particularly if there are ambiguities or inconsistencies in governance codes or reporting requirements.

## 2.3 Suraj Cotton Case – Thorough Analysis

2.3.1 *What is the percentage (and number) of independent directors on the board? Is the company compliant with the independence requirements set forth by the regulator?*

*Code for independent directors* It is mandatory that each listed company shall have at least two or one third members of the Board, whichever is higher, as independent directors.

25% and 2 independent directors of the total board have been appointed and compliant with the code.

- Ms. Maheen Hisham Adam-Jee (independent)
- Mr. Shams Rafi (independent)

They could have appointed 3 as well but they explained the reason below in compliance statement.

“The two elected independent directors have requisite competencies, skills, knowledge and experience to discharge and execute their duties competently, as per applicable laws and regulations. As they fulfill the necessary requirements as per applicable laws and regulations, hence, appointment of a third independent director is not warranted.”

2.3.2 *What is the percentage (and number) of executive directors on the board? Is the company compliant with the related regulation in the Pakistan Code of Corporate Governance 2019?*

*Code for Executive Directors* It is mandatory that the executive directors, including the chief executive officer, shall not be more than one third of the Board. Has to explain the fraction to one.

The percentage of executives including CEO is 37.5% or 3 have been appointed which should not be more than 33.33%. They have explained the reason for fraction rounding in order to have compliance, yes, they are compliant to the code.



### 2.3.3 *Comply/Explain as per report*

“Executive directors, including the chief executive officer on the Board are three out of total eight directors. One third of the Board i.e. 2.67 has been rounded up as 3 directors as the manufacturing units of the Company are geographically spread and the Company needs executive directors for effective management of operations.”

- Mr. Nadeem Maqbool (CEO)
- Mr. Ahsan Bashir (Executive)
- Mr. Adil Bashir (Executive)

### 2.3.4 *The number of female directors and compliance with the code.*

*Female Director Code* Subject to section 154 of the Act, it is **mandatory** that the Board shall have at least one female director when it is reconstituted after the expiry of its current term.

Yes, they have appointed one female Director to compliance with code.

- Ms. Maheen Hisham Adamjee

### 2.3.5 *Is the chairman of the board and the CEO the same person?*

CEO duality is not into practice rather both the persons are separate.

**Chairman:** Mr. Khalid Bashir (Non-Executive Director)

**CEO:** Mr. Nadeem Maqbool

2.3.6 *How is the audit committee constituted? Is it in compliance with the code?*

Audit Committee consists of three Members including one independent director, Executive and non-executive director.

- Mr. Shams Rafi (independent) Chairman
- Mr. Ahsan Bashir (executive) Member
- Mr. Humayun Maqbool (Non-executive) Member

They have appointed one of the executive directors which does not meet the Code guidelines, nor the financial literate appointed which could have met the definition of the term.

Independence with financial literacy is recommended to be followed.

2.3.7 *Does the company have an HR & Remuneration committee?*

Yes, company does have an HR & Remuneration committee which is also partially overseeing and performing the function of nominating committee

- Ms. Maheen Hisham Adamjee (chairperson)
- Mr. Adil Bashir (Member)
- Mr. Ahsan Bashir
- Mr. Nadeem Maqbool

2.3.8 *How many other committees (name and number of committees) does the company have?*

as mentioned above it has Audit Committee, HR & Remuneration Committee the other Committee of Risk management has also been comprised of three members.

Risk Management Committee:

- Mr. Humayun Maqbool
- Mr. Nadeem Maqbool
- Mr. Ahsan Bashir

*2.3.9 Who is the external auditor of the company?*

Riaz Ahmad & Co Chartered accountants are the external auditors of Suraj Cotton.

*2.3.10 What is the auditor's opinion on the financial reports?*

We have reviewed the enclosed Statement of Compliance with the Listed Companies (Code of Corporate Governance) Regulations, 2019 (the Regulations) prepared by the Board of Directors of Suraj Cotton Mills Limited (the Company) for the year ended 30 June 2022 in accordance with the requirements of regulation 36 of the Regulations. The responsibility for compliance with the Regulations is that of the Board of Directors of the Company. Our responsibility is to review whether the Statement of Compliance reflects the status of the Company's compliance with the provisions of the Regulations and report if it does not and to highlight any non-compliance with the requirements of the Regulations. A review is limited primarily to inquiries of the Company's personnel and review of various documents prepared by the Company to comply with the Regulations. As a part of our audit of the financial statements we are required to obtain an understanding of the accounting and internal control systems sufficient to plan the audit and develop an effective audit approach. We are not required to consider whether the Board of Directors' statement on internal control covers all risks and controls or to form an opinion on the effectiveness of such internal controls, the Company's corporate governance procedures and risks. The Regulations require the Company to place before the Audit Committee, and upon recommendation of the Audit Committee, placed before the Board of Directors for their review and approval of its related party transactions.

We are only required and have ensured compliance of this requirement to the extent of the approval of the related party transactions by the Board of Directors upon recommendation of the Audit Committee.

Following instance of non-compliance with the requirement of the Regulations was observed which is not state in the Statement of Compliance:

(a). Composition of the audit committee is not as per the requirements of the regulation 27(1) of the Regulations

as one of the members of the audit committee is executive director and except for him other members of the audit committee do not fall under the definition of “financially literate”. Based on our review, except for the above instance of non-compliance, nothing has come to our attention which causes us to believe that the Statement of Compliance does not appropriately reflect the Company’s compliance.

*2.3.11 What is the percentage of common stock outstanding (%CSO hereafter) by insiders?*

Common stock outstanding of insiders is totaling **76.84%** including the associated companies **47.53%** and Directors, CEO, their spouses, and minor children are having **29.31%** CSO respectively.

Associated companies: Crescent Powertec LTD 44.19% and Premier insurance is 3.33%

*2.3.12 Percentage of CSO by all institutional investors?*

2 institutional investors mainly in total clubbed. **9.13%**

- NIT & ICP **2.16%**
- Banks, NBFCs, DFICs, Takaful **6.97%**

*2.3.13 What is the total number of institutional investors?*

2 institutional investors Mainly categorized, whereas individual institutional investors are sub-categorized are 5 in total. Which are mentioned below.

- NIT & ICP
  - NBP
  - CDC Trustee National investment (unit) Trust
- Bank, NBFCs, DFIs, Takaful, Pension Funds
  - Modarabas
  - Insurance companies
  - Other Companies, Corporate bodies, Trust etc.

*2.3.14 Percentage of CSO by all institutional block holder investors?*

Total percentage of all institutional block holder investor's CSO is (2.16% + 6.70=**8.86%**)

2.3.14.1 NIT & ICP 2.16%

- a.** CDC-Trustee National investment **2.16%** (Major)

2.3.14.2 Banks, NBFCs, DFICS, Takaful 6.97%

- b. Modarabas 0.27%
- c.** Other Companies, Corporate Bodies, Trust 6.70% (Major)

*2.3.15 What is the total number of all institutional block holder investors?*

2 block holders have been found beyond 1%

2.3.15.1 NIT & ICP

- a.** CDC-Trustee National investment **2.15%**

2.3.15.2 Banks, NBFCs, DFICS, Takaful

- b.** Other Companies, Corporate Bodies, Trust **6.97%**

*2.3.16 perceived quality of corporate governance in Suraj Cotton.*

Annual General meetings were held as per the report. Committees have been formed except the Auditing committee which was formed inclusive of executive director neither they have financially literate personnel on the committee panel that undermines little compliance code. Since Financial literacy is Important equally the independence in the committee so that financial reporting guidelines and reporting can be met or followed rightly to show the true and fair value of the company to the investors. Furthermore, if we see it insider's perspective 'Bashir' family has secured more percentage of investment in that including their spouse it crosses 22% stake. Independent directors need to be appointed for more transparency and independence true standards must be defined. These are the recommendations that should be followed to strengthen and be more aligned with corporate code to achieve common of organization to increase shareholder's wealth and protect stakeholder's stake as well.

## **2.4 High-Noon Laboratories Case of Related Party Transaction, non-independent Audit Committee member, and conflict of interest**

### *2.4.1 Related Party Transactions*

In the business realm, companies commonly engage in transactions with one another, such as supplying raw materials for manufacturing or procuring goods and services. When two or more companies share ownership, management, or significant voting power, they are categorized as associated companies, according to the Securities and Exchange Commission of Pakistan (SECP). These interconnected relationships can influence decision-making and require enhanced scrutiny of transactions to prevent any potential conflicts of interest. In simple terms, these are two companies which are owned and controlled by the same people and as these people have a say in the operations of both the companies, these companies are associated with each other. The decision making at one company can have an impact on the other and they need to be qualified as such.

Suppose there is Company A, serving as a raw material supplier for the paper manufacturing industry, and engages in transactions with Company B, which shares common shareholders or management, these transactions fall under the category of related party transactions. Given the intertwined nature of these dealings, they warrant heightened scrutiny due to the absence of external oversight or formal mechanisms for determining fair pricing. This close association between the two entities raises concerns about the potential for one company to exploit the relationship to the detriment of the other, highlighting the importance of ensuring transparency and fairness in such interconnected business interactions.

The situation becomes even more complicated when there is a private limited and public limited company involved. A private limited company has investors and owners who have put up their own money and investment and would look to make sure that they profit from any and all transactions that are being carried out.

In a public listed company, the owners are not only the individuals who own most of the shares but also investors who have bought shares in the company. If the private limited company is transacting with the listed company, there is potential that the private company will end up selling their raw material at an inflated price which will mean that the listed company will end up paying more. This will reduce the profit earned by the listed company while the private company will end up earning more.

But is it really that simple? Won't the substantial shareholders at the public listed company also make a loss? Wouldn't they be disadvantaged as well? Yes, they will be disadvantaged but as they have ownership in the private company as well, they will still end up making a profit from these transaction. So, it is obvious that this can be an avenue where shareholders can lose out. There is a clear conflict of interest, and shareholders need to be protected in such a case.

The best course of action would be to disclose these transactions and to inform the market about all the aspects of the trades to let the market decide on the objectivity and accuracy of these transactions. By giving this information to the investors, the company can give a more holistic view of the company to everyone.

So, what is done to not allow this to happen?

SECP has given out rules and regulations that dictate the area of related party transactions.

#### 2.4.1.1 Section 208 of the Companies Act 2017

Section 208 of the Companies Act 2017 mandates that a company can only enter into a contract with a related party based on a board-approved policy. The law requires the board to justify such contracts to shareholders and maintain detailed records as per SECP regulations. Approval from the board or members at an AGM must be obtained within ninety days of entering into the contract.

Failure to secure approval renders the contract voidable, and the director involved must indemnify the company for any losses incurred. This regulatory framework aims to prevent conflicts of interest and ensure transparency in related party transactions, allowing shareholders to address concerns through formal channels if necessary.

So, what exactly happened at High noon Laboratories?

#### 2.4.1.2 High noon Laboratories

High noon Laboratories is a pharmaceutical company which was founded by Ghulam Hussain Khan in 1968 as a partnership. It was incorporated in 1984, was publicly listed in 1985, and had its shares listed on the PSX in 1994. The company is involved in the manufacturing, sale and import of pharmaceutical and related consumer products. The company recently featured in Forbes magazine's Asia's Best Under a Billion List for the fourth time. The company also received the Pharma Export Award at the 6th Pharma Export Summit & Awards 2023.

In its latest notice of AGM, the company announced that they were looking to ratify and pass all related party transactions that it had carried out with its associated companies. Considering the hundreds of companies which announce their AGMs and their agenda items show that it is a normal course of action for a company to ratify these transactions.

“The Company be and is hereby authorized to enter into arrangements or carry out transactions from time to time including, but not limited to, for the purchase and sale of goods and material with different related parties to the extent deemed fit and/or approved by the Board of Directors. The members have noted that for the aforesaid arrangements and transactions there may be interested directors. Notwithstanding the same, the members hereby grant an advance authorization and approval to the Board Audit Committee and the Board of Directors of the Company, including under Section 207 and/or 208 of the Companies Act, 2017 (to the extent applicable) to review and approve all related party transactions as per the quantum approved by the Board of Directors from time to time,” read the resolution.

#### 2.4.1.3 So what was out of the ordinary?

The first sign that something is not normal is the fact that the policy of the company has been to approve these transactions through its board. The annual reports of the company state that the Audit Committee working under the Board of Directors approves any related party transactions based on their set policy and once that is done, the board approves these transactions as well. The company has been pursuing this policy and this meets the requirements of the SECP. Looking at any previous agenda items set for the AGM shows that no approval from shareholders was sought before the one in 2023. Why this change in policy? Has the company finally started to follow the precedence of the market and start to get all of these transactions approved by the board and the shareholders?

Another fact that is out of the ordinary is that the approval is being taken from the shareholders for not only 2023 but the agenda item also states that any future transactions which will be carried out have been approved already as well. As per the resolution, “The related party transactions, for the period ending December 31st, 2024, shall be deemed to have been approved by the members, and shall subsequently be placed before the members in the next Annual General Meeting for ratification and confirmation.” Why the urgency to get future transactions approved a year before? Why is the company looking to get transactions that it will carry out with its associates till 31st December 2024 before they have even occurred? Lastly, in its agenda item, the company is stating all the past transactions that have been carried out from 2018 to 2022 when they are getting the recent ones approved. There is little



evidence that shows that these transactions were approved in previous AGMs. If the board has already approved them and a minimum obligation to the laws has been met, then why are these transactions being stated again? When reached to get a reply to these exact questions, the company secretary at the company failed to reply or provide any justification. The transactions that have been highlighted by the company pertain to transactions carried out between High noon and Route2Health (Private) Limited. From 2017 to 2023, the values presented by the company itself state that they have purchased materials worth Rs 4.1 billion with Route2Health (Pvt) Limited. For the 1st quarter of 2024, no transactions have been carried out, but the approval already exists from the shareholders as the special resolution was passed by the shareholders. So why not file a case against the company and its directors?

#### 2.4.1.4 Case is filed at Lahore High Court

Well that is exactly what has happened now. Ghulam Hussain Khan, the initial founder of the company, filed a case against Tausif Ahmed Khan, the current chairman of the board. The case alleges that Tausif Ahmed Khan has transferred value from High-noon to Route2Health which is a company where Tausif Ahmed Khan holds directorship and shares. Even though this can seem like a victimless crime, the loss of profitability, cash reserves and retained earnings of High-noon is hurting the shareholders who bought the shares of the company thinking that its owners and directors will work for the betterment of the company. The case alleges that the chairman has gotten his family members elected on the board and is now transferring wealth from High-noon to his other venture. A huge point of contention in the case is the fact that the transactions are being approved by the Audit Committee. Two of the members on the Audit Committee in the past were Nael Najam and Zainub Abbas. These individuals were also shareholders at Route2Health while Zainub Abbas was a director at Route2Health simultaneously. Zainub Abbas is still part of the Audit Committee while she has served as a director and a shareholder at Route2Health. Nael Najam was in the board and the Audit Committee till December 2022 after which she resigned. Nael Najam is no longer a board member at Route2Health but still holds shares of the company.

Essentially, the same people were approving the transactions at High-noon while they were benefiting from these same transactions on the other side. Despite an active conflict of interest, they were able to vote on these issues and get these resolutions passed when they should have

recused themselves. In addition to that, once these transactions were passed, no evidence or documents relating to these related party transactions was given to the directors of the company which shows mala fide on the part of the committee and the remaining board members. For example, for 2022, board resolutions were passed in the board meeting held in April of 2022. When the minutes were to be confirmed in the next meeting, Hussain Khan raised the issue that he had not been provided the necessary documentation for the approval from the last meeting. These documents were not given. This was a common occurrence at the company where the Company Secretary did not provide the documentation on time to all the directors. The company secretary at High-noon is also the company secretary at Route2Health (Pvt) Limited. The petitioner kept raising the fact that transactions were being approved by the board with related parties and no documentation was being provided to all the directors, which was against the rules and regulations. From April 2022 to December 2022, the petitioner was stonewalled and not given rationale and reasoning for the transactions being approved.

Hussain Khan also raised the issue that Nael Najam, an independent director at the company, was not independent as she was a shareholder at Route2Health and was approving trades with the associate company. Based on this objection, Najam resigned from the board in December 2022. After this, multiple attempts were made to check the share register, record their protest to the affairs at the company and raise concerns to the appropriate authorities but it seems that all pleas fell on deaf ears.

#### 2.4.1.5 Why the change in policy?

While the court deliberates on the case and High-noon does not respond, the recent policy change can be hypothesized. Up until December of 2022, the audit committee was made up of Nael Najam, Zainub Abbas and Ghulam Hussain Khan. Before this, Hussain Khan had raised Hue and Cry over the fact that all related party transactions that would be approved by the Audit Committee and then would be ratified by the Board of Directors. As the board was taking the onus, these were not presented to the shareholders in the AGM. After Hussain Khan started to question the transactions being approved and started to ask for rationale and justification of these transactions, the company started to stonewall any attempt of becoming transparent. As the objectivity of Nael Najam was also questioned, she had to resign as an independent director. A new director was appointed in the form of Tariq Wajid.

Again, the company has classified him as an independent director even though he holds shares

in the company. Regardless, the new audit committee is now made up of Zainub Abbas, Ghulam Hussain Khan and Tariq Wajid. Due to the recent tensions at the company, the audit committee might not act like a rubber stamp for the company. The audit committee would want these transactions to be highlighted and presented to the shareholders for their interest and better understanding. Even though these transactions would be approved by the shareholders, there is still a release of this information into the public which was not carried out before. The recent vote results showed that the measure was approved in a landslide of more than 95%. Still, the fact that these transactions were even put forward by the company shows that a step in the right direction has been taken by the new audit committee and board.

#### 2.4.1.6 Management's response

In response to inquiries from Profit, the company has clarified its commitment to strict compliance measures as mandated under the Companies Act, 2017, especially concerning transactions involving related parties. Management explained that these transactions undergo a thorough review process, initially scrutinized by the Audit Committee before being forwarded to the Board of Directors for final approval. The company maintains transparency throughout this process, with detailed minutes that clearly outline the nature of the transactions, ensuring they are conducted as part of normal business operations and on an arm's length basis.

Further elaborating on its practices, the company disclosed its interests in its associate company, Route 2 Health (Private) Limited, and its wholly owned subsidiary, Curexa Health (Private) Limited. It was emphasized that all transactions with these entities are fully disclosed to Board members and comprehensively reported in the company's quarterly and annual financial statements for public scrutiny.

To reinforce their transparency, the management also mentioned that these transactions were presented to shareholders at the most recent AGM held on April 29, 2024, confirming adherence to applicable laws. Additionally, in addressing suspicions regarding its profit growth, the company highlighted that its significant growth amidst an industry facing diminishing returns demonstrates the integrity and efficiency of its operations and financial management. This consistent and significant profit growth not only reflects the company's robust performance but also its unwavering commitment to ethical business practices.

Further, as per the management, all the related party transactions have contributed to increasing the margins/profitability of High noon.

## 2.5 Literature Review

### 2.5.1 Introduction

In financial regulation, the debate between rules-based and principles-based approaches is prominent. This literature review explores the advantages, disadvantages, and impacts of both regulatory frameworks on markets.

#### 2.5.1.1 Rules-Based Markets

Rules-based regulation relies on detailed, specific rules and guidelines. This approach provides clear instructions and leaves little room for interpretation, which can enhance compliance and reduce ambiguity. Key studies highlight the following:

1. **Clarity and Predictability:** Research by Black (2008) indicates that rules-based systems offer clear, precise directives that can reduce uncertainty for market participants.
2. **Enforcement and Compliance:** According to Armstrong (2013), the specificity of rules-based regulation simplifies enforcement and compliance monitoring, leading to more straightforward legal and regulatory processes.
3. **Rigidity and Complexity:** However, studies such as those by Baldwin (2012) argue that the inflexibility of this approach can result in regulatory arbitrage, where firms exploit loopholes, and increased complexity as rules multiply.

#### 2.5.1.2 Principles-Based

Principles-based regulation (PBR) is often praised for its flexibility and adaptability. However, it also faces significant criticism and presents several challenges. This literature review highlights the negative aspects of principles-based regulation, drawing from key studies and expert opinions.

### 2.5.1.3 Ambiguity and Uncertainty

- **Interpretive Challenges:** One of the primary criticisms is the ambiguity inherent in broad principles. Black and Hopper (2007) argue that the lack of specific guidelines can lead to varied interpretations, creating uncertainty for market participants who may struggle to understand compliance requirements.
- **Inconsistent Enforcement:** The flexibility of PBR can result in inconsistent enforcement, as regulators and firms may interpret principles differently. Baldwin (2012) notes that this inconsistency can undermine regulatory effectiveness and fairness, leading to legal disputes and market confusion.

### 2.5.1.4 Implementation Difficulties

- **Complexity in Application:** Applying broad principles to specific situations can be challenging. Braithwaite (2013) points out that without clear rules, firms may find it difficult to develop concrete compliance strategies, potentially leading to over-compliance or under-compliance.
- **Training and Expertise:** Effective implementation of PBR requires regulators and market participants to possess a high level of expertise and judgment. Ford (2010) highlights that inadequate training and varying levels of expertise among regulators can exacerbate interpretative challenges and enforcement inconsistencies.

### 2.5.1.5 Compliance Costs

- **Increased Costs for Firms:** While PBR can reduce the need for constant updates to specific rules, it may increase compliance costs for firms. Posner (2014) suggests that firms might incur higher costs in interpreting and applying broad principles to their unique circumstances, requiring extensive legal and advisory services.

- **Regulatory Burden:** The burden of interpreting principles often shifts from regulators to firms, which can be particularly onerous for smaller companies with limited resources. Jackson (2015) finds that this shift can create an uneven playing field, where larger firms with more resources can better navigate the complexities of PBR.

#### 2.5.1.6 Risk of Regulatory Arbitrage

- **Exploitation of Flexibility:** The broad and flexible nature of PBR can be exploited by firms seeking to engage in regulatory arbitrage. Armstrong (2013) warns that firms might take advantage of the leeway provided by principles to engage in risky or unethical practices that comply with the letter but not the spirit of the law.
- **Enforcement Challenges:** Detecting and addressing regulatory arbitrage under PBR can be difficult. Black (2008) notes that without specific rules, regulators may find it challenging to pinpoint and prove non-compliance, allowing some firms to evade regulatory scrutiny.

#### 2.5.1.7 Erosion of Trust

- **Perceived Lack of Transparency:** The subjective nature of PBR can lead to a perception of regulatory opacity and favoritism. Baldwin (2012) suggests that stakeholders may view principles-based systems as less transparent and more susceptible to regulatory capture, undermining trust in the regulatory framework.
- **Stakeholder Confidence:** Trust in regulatory systems is crucial for market stability. Ford (2010) argues that the perceived unpredictability of PBR can erode confidence among investors and other stakeholders, potentially affecting market participation and investment decisions.

## **2.6 Conclusion of Literature Review**

While principles-based regulation offers flexibility and adaptability, it faces significant challenges related to ambiguity, high compliance costs, risk of regulatory arbitrage, and erosion of trust. On the other hand, rules-based regulation provides clarity, ease of enforcement, cost efficiency, mitigation of loopholes, and enhanced stakeholder confidence. Therefore, the choice between PBR and RBR should consider the specific regulatory context and the balance between flexibility and predictability.

## 3

## Chapter 3: Recommendations & Conclusions

### 3.1 Recommendations

We have analyzed thoroughly that each approach has its different significance whether its principles-based or rules-based. But it's better to have the Balance below elements in order to have complete prevalence over the approaches that are being enforced. Since principles-based approach has more flexibility and enforcement issues this can only be enforced for a shorter period to enhance the exposure of the market. But there are high chances of volatility associated with this since only the spirit of the code is to be fulfilled and easy escape for the companies to explain in the compliance report without any concrete evidence. As we have discussed multiple cases above, how independence of an audit committee member was smartly compromised. Furthermore, related party transactions were completely framed in such a manner to save the board members as well as to ratify the current and future related party transactions. Here are below elements which need to be fine-tuned and should come into practice for have less agency problems to be faced.

#### 3.1.1 *Efficiency of local capital markets*

The efficiency of a local capital market in overcoming agency problems hinges on its ability to reduce information asymmetry and align the interests of managers and shareholders. Efficient markets provide transparent, timely, and accurate information, which helps investors make informed decisions and monitor management actions. Regulatory frameworks and corporate governance practices play a crucial role by enforcing disclosure requirements and protecting minority shareholders' rights. Additionally, mechanisms such as performance-based incentives, independent board oversight, and active participation by institutional investors can mitigate agency conflicts. Overall, the more robust and transparent the market infrastructure, the better it can address and resolve agency problems.



### 3.1.2 *Protections afforded by legal system*

The legal system provides several protections to overcome agency problems, ensuring that managers act in the best interests of shareholders. Key protections include:

1. **Fiduciary Duties:** Laws impose fiduciary duties on corporate executives, requiring them to act with loyalty and care towards the company and its shareholders.
2. **Disclosure Requirements:** Securities laws mandate regular and detailed disclosure of financial and operational information, enhancing transparency and reducing information asymmetry.
3. **Shareholder Rights:** Legal provisions protect shareholder rights, allowing them to vote on crucial corporate matters, including the election of directors and major corporate decisions.
4. **Board Independence:** Regulations often require a significant portion of the board to be independent, ensuring objective oversight of management.
5. **Legal Recourse:** Shareholders can sue for breaches of fiduciary duty or fraud, holding management accountable for misconduct.
6. **Regulatory Oversight:** Agencies like the SEC enforce compliance with financial regulations and can impose penalties for violations.
7. **Auditor Independence:** Legal frameworks ensure that auditors are independent, providing unbiased financial reviews and protecting against managerial manipulation.

These protections collectively enhance accountability, align interests, and mitigate agency problems, fostering a more reliable and fair corporate governance environment.

### 3.1.3 *Reliability of accounting standards*

The reliability of accounting standards is crucial in overcoming agency problems by ensuring transparency, consistency, and comparability of financial information. Key aspects include:

- **Consistency:** Accounting standards, like GAAP or IFRS, provide a consistent framework for financial reporting, allowing stakeholders to

compare financial statements across different periods and companies.

- **Transparency:** These standards mandate comprehensive disclosure of financial information, reducing information asymmetry between management and shareholders.
- **Accuracy:** Rigorous accounting rules and principles ensure that financial statements accurately reflect the company's financial position, preventing managerial manipulation.
- **Accountability:** By adhering to established standards, managers are held accountable for their financial reporting, which enhances trust among investors.
- **Regulatory Compliance:** Compliance with accounting standards is legally enforced, deterring fraudulent activities, and ensuring reliable financial disclosures.
- **Auditor Verification:** External auditors review financial statements for adherence to accounting standards, providing an additional layer of verification.
- **Investor Confidence:** Reliable accounting standards bolster investor confidence, as they can make informed decisions based on accurate and consistent financial data.

the reliability of accounting standards plays a vital role in mitigating agency problems by promoting a transparent and trustworthy financial reporting environment.

#### *3.1.4 Enforcement of regulations*

Enforcement of regulations is vital for overcoming agency problems by ensuring that corporate managers act in the best interests of shareholders. Key aspects include:

- **Regulatory Agencies:** Bodies like the SEC enforce compliance with financial regulations, conducting investigations and imposing penalties for violations.
- **Legal Framework:** Laws mandate disclosure, fiduciary duties, and governance practices, setting clear expectations for corporate behavior.
- **Penalties and Sanctions:** Violations of regulations result in fines, sanctions, or imprisonment, deterring managerial misconduct.

- **Audits and Inspections:** Regular audits and inspections by regulatory authorities ensure ongoing compliance with financial reporting standards.
- **Whistleblower Protections:** Laws protect whistleblowers who report unethical practices, encouraging internal reporting of agency problems.
- **Market Surveillance:** Continuous monitoring of market activities helps detect and address irregularities promptly.
- **Transparency Requirements:** Regulations enforce strict disclosure of financial information, reducing information asymmetry and enhancing accountability.
- **Corporate Governance Codes:** Adherence to governance codes is often legally required, promoting independent oversight and ethical management practices.
- **Investor Protections:** Regulations safeguard investor rights, providing mechanisms to challenge managerial decisions and seek redress.
- **Judicial Enforcement:** Courts uphold regulations by adjudicating disputes, ensuring that legal standards are applied consistently.

Effective enforcement of these regulations strengthens the corporate governance framework, aligning managerial actions with shareholder interests and mitigating agency problems.

### 3.1.5 *Societal and cultural values*

Societal and cultural values play a crucial role in overcoming agency problems by shaping ethical behavior and corporate practices. Key aspects include:

- **Ethical Standards:** Societal norms and cultural values that emphasize integrity and ethical behavior promote honesty and accountability in corporate management.
- **Transparency Culture:** Cultures that value openness encourage transparency in business operations, reducing information asymmetry between managers and shareholders.
- **Corporate Social Responsibility (CSR):** Societal expectations for CSR drive companies to act responsibly and consider the interests of all stakeholders,

aligning managerial actions with broader societal goals.

- **Trust and Reputation:** Societies that prioritize trust and reputation incentivize companies to maintain high ethical standards to build and sustain trust with investors and the public.
- **Whistleblowing Acceptance:** Cultural support for whistleblowing encourages the reporting of unethical behavior, enhancing internal controls and accountability.
- **Stakeholder Engagement:** Societal values that promote stakeholder engagement ensure that companies consider the interests of various parties, not just shareholders.
- **Educational Emphasis:** Societies that emphasize business ethics in education foster a generation of managers and executives who prioritize ethical decision-making.
- **Regulatory Support:** Cultural respect for rule of law supports strong regulatory frameworks and compliance, ensuring that corporate behavior aligns with legal and ethical standards.
- **Community Pressure:** Societal pressure from communities and advocacy groups can drive companies to adopt more ethical practices and improve governance.
- **Collective Responsibility:** Cultural values that emphasize collective responsibility over individual gain encourage management to align their actions with the long-term interests of the company and its stakeholders.

These societal and cultural values help create an environment where ethical behavior is the norm, thereby mitigating agency problems and fostering better corporate governance.

## 3.2 Conclusion

a rules-based market practice is more effective in ensuring consistency, transparency, and enforceability across the corporate landscape. Unlike principles-based approaches, which can lead to varying interpretations and potential loopholes, rules-based systems provide clear, specific guidelines that minimize ambiguity and enhance compliance. By setting definitive standards, a rules-based approach helps prevent managerial opportunism and aligns corporate actions with regulatory expectations, thus mitigating agency problems more effectively. This method ensures that all market participants operate on a level playing field, fostering a stable and predictable environment for investors and stakeholders alike. While flexibility is valuable, the inherent clarity and uniformity of a rules-based framework make it the superior choice for robust corporate governance and reliable market practices. Both school of thoughts have their own advocacy arguments but solution to the agency problems cannot entirely be cured rather protected through a vigorous controls and mechanisms to mitigate. Further solution proposed does not have universality, but recommended elements can reduce agency problems to much extent including the efficiency of capital markets, adherence to the societal and cultural values which create environment in a company, robust accounting standards, protections afforded by legal systems and should make sure the enforceability of regulations.

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