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PICG ADVISORY UPDATE - 21

PICG

Pakistan Institute of Corporate Governance

The Update

Corporate governance refers to the way in which corporations are directed, administered, and controlled. It is concerned with both the relationship between internal and external stakeholders as well as the governance processes designed to help a corporation achieve its goals. Good corporate governance contributes to sustainable economic development by enhancing the performance of companies as well as striking a balance between both economic and social goals and between individual and communal goals.

Compliance with applicable laws and regulations is fundamental to good governance. PICG's Advisory Update, therefore, aims at keeping our members updated with regards to the latest local and international governance-related changes to regulations, practices and corporate reporting.

The Update consists of a Summary Table (with links to relevant information) followed by a Synopsis of the changes.

A. Summary Table

Pakistan

Sr #	By	Reference	Date	Topic / Update link
1.	**Guidelines**			
i	SBP	BPRD Circular No. 02 of 2019	Apr 3, 2019	Guidelines on Internal Audit Function- Banks, MFB's & DFIs
2.	**Regulations**			
i	SBP	PSD Circular No. 01 of 2019	Apr 1, 2019	Regulations for Electronic Money Institutions (EMIS)
ii	SECP	SRO 372 (I)/2019	Mar 14, 2019	Draft Amendments to the Securities Brokers (Licensing and Operations) Regulations, 2016
3.	**Circular**			
i	SBP	BPRD Circular Letter No. 05 of 2019	Mar 22, 2019	Revised Format of Interim Financial Statements-Banks/ DFIs
ii	SBP	IH&SMEFD Circular No. 07 of 2019	Mar 19, 2019	SBP Social Responsibility Scheme for Special Persons
iii	SBP	IBD Circular No. 01 of 2019	Mar 1, 2019	Adoption of (AAOIFI) Shariah Standards 2, 5, 14, 18, 24 & 38

Sr #	Issued by	Reference	Date	Topic / Update link
4.	**Others**			
i	SECP	Press Release	Mar 28, 2019	Closure of Unlawful Companies by SECP

International

Topic	Links
Corporation Code revised - Philiipines	Revised Corporation Code of the Philippines
IFC Study on the Link Between Performance and Corporate Governance of IFC Investment Clients	Governance and Performance in Emerging Markets
UK's House of Commons' - Business, Energy and Industrial Strategy (BEIS) Committee's 18th Report of Session 2017–19	Executive Rewards: Paying for Success

B. Synopsis of changes

Pakistan

1. Guidelines

a. Guidelines on Internal Audit Function

State Bank of Pakistan (SBP) has issued Guidelines on the Internal Audit Function (IAF) of financial institutions to provide a standardized framework for the establishment and implementation of robust internal audit governance in line with international standards and best practices. The purpose of the guidelines is to ensure that financial institutions have a dynamic governance and internal audit process to tackle the ever-changing business environment and evolving risk exposures. The guidelines are applicable to all FIs irrespective of their size and/or complexity of operations.

Some of the salient features are as follows:

i. All FIs shall have a Board Audit Committee (BAC) comprising:
   - at least 3 non-executive directors, including a minimum of 1 independent director.
   - chairperson shall be an independent director & shall not be the chairperson of the board.
   - Majority of the members to have a good understanding of accounting, finance and audit related matters – with at least 1 member with relevant qualification and experience in the field of audit, accounting and finance.

ii. The BAC shall be governed under the board-approved 'Audit Committee Charter (ACC)/ Terms of Reference (ToRs)

iii. The BAC shall review and approve 'Internal Audit Charter' (IAC) and annual 'Risk Based Audit Plan' (RBAP). The BAC/board shall approve a budget for IAFs that is sufficient to carry out planned audit activities.

iv. Chief Internal Auditor (CIA) shall develop an 'Internal Audit Strategy' (IAS) to be reviewed by BAC and approved by the board.

v. The CIA, in consultation with BAC, shall devise a comprehensive plan to adopt 'Risk Based Internal Audit' approach (if not adopted already) in line with 'Institute of Internal Auditors' (IIA) Standards and the best practices by December 31, 2020.

vi. BAC to ensure that the IAF remains equipped with necessary financial, human, operational, physical and technological resources to carry out its mandated responsibilities as per the Charter; and internal auditors receive necessary trainings to remain updated on auditing competencies, methodologies, tools and techniques including FI's products and services.

vii. The BAC shall ensure: a) independence of IAF in the organizational structure; b) independence and objectivity of internal auditors; c) optimal utilization of audit resources; d) effectiveness of IAF in FI's overall governance and internal control framework; e) constructive engagement of IAF with the senior management and auditee units etc.

viii. BAC to approve the appointment/re-hiring/renewal of contract and removal of CIA and other terms of employment. Further, CIA should be a professional having at least 15 years of experience in the field of finance (10 years for DFIs), with at least 5 years of aggregate audit experience in banks/financial institutions at the time of appointment – this being in addition to the minimum qualifications mentioned in relevant code/rules/regulations [Note: Applicable for all future appointments/re-hiring/renewals with immediate effect].

ix. The BAC shall formulate and document 'Key Performance Indicators' (KPIs) for CIA and evaluate his/her performance against them. The CEO shall have no role in performance evaluation of CIA including determination of any performance-based bonuses, increments, cash awards or other financial and non-financial benefits, which are to be approved by BAC.

x. The FI may conduct an internal assessment to identify gaps vis-a-vis the requirements of IIA Standards and IAF instructions/guidelines, in order to prepare an action plan to bridge identified gaps.

xi. The FI shall have its IAF assessed, after every 5 years, from an independent external professional firm/consultant to ensure compliance with IIA Standards. The first such assessment shall be completed within 6 months of the implementation of these guidelines, i.e. June 30, 2020.

xii. In order to maintain independence, the CIA must functionally report to BAC, administratively report to CEO and shall be exempted from rotation requirements as stipulated in BPRD Circular No. 5 of 2015. Moreover, to maintain the stature, the CIA shall be a senior executive with hierarchal position equivalent to business heads.

xiii. FIs shall put in place an audit system solution capable of handling complete audit process/lifecycle - data collection, risk assessment, audit planning, execution, reporting, and follow-up (not mandatory for DFIs). The system should be capable of supporting every type of audit i.e. operational audit, IT audit, management audit, etc. The required system shall be implemented by December 31, 2020.

xiv. The CIA must establish a robust follow-up, validation and escalation mechanism for audit findings and corresponding recommendations and regularly report a summary of compliance status to BAC. Control breaches of critical nature that occur in at least 2 audit periods despite repeated audit recommendations shall be tagged accordingly and submitted to BAC on a regular basis.

FIs have been advised to comply with requirements of the guidelines by December 31, 2019, except where otherwise specifically mentioned.

2. Regulations

a. Regulations for Electronic Money Institutions (EMIS)

The SBP has issued Regulations for Electronic Money Institutions (EMIS) primarily aimed at removing entry barriers for non-banking entities by providing them with guidance as well as an enabling regulatory framework for the establishment and operations of EMIs in Pakistan. The regulations also address potential risks in order to ensure consumer protection in line with the legal framework in Pakistan while promoting digital payments and financial inclusion.

Electronic Money Institutions (EMIs) are entities that offer innovative, user-friendly and cost effective low value digital payment prepaid instruments like wallets, prepaid cards, and contactless payment instruments including wearables. Globally, these innovative payment instruments have been instrumental in promoting cashless payments like merchant checkouts, e-commerce, transportation and toll payments etc. Traditionally, payment instruments in Pakistan are issued by banks without participation of non-banking entities New technological innovations are now enabling the non-banking sector to deliver innovative and efficient payment services to consumers at much lower cost.

The objectives of the regulations are to:

i. Provide regulatory framework for EMIs desirous of offering innovative payment services to the general public.
ii. Prescribe minimum service standards and requirements for EMIs to ensure delivery of payment services in a safe, sound and cost effective manner.
iii. Outline the permissible activities that can be carried out by an EMI and its agents' network.
iv. Provide a baseline for protection of EMI's customers.
v. Achieve the SBP's objective of digital payments and financial inclusion.

The regulations also specifiy the governance arrangements required including compliance with Fit and Proper criteria and various roles and responsibilities of the Board given therein. EMIs shall maintain a clear organizational structure with well-defined, transparent and consistent lines of responsibility to ensure integrity of its e-money business.

EMIs shall follow the Code of Corporate Governance issued by SECP as far as the provisions thereof do not conflict with any provisions of the Payment Systems and Electronic Funds Transfer Act, 2007 and other relevant regulations issued by SBP.

b. Draft Amendments to the Securities Brokers (Licensing and Operations) Regulations, 2016

SECP has proposed draft amendments to the Securities Brokers (Licensing and Operations) Regulations, 2016, inviting public comments thereon within 14 days of placement on their website.

Proposed amendments include:

i. A securities broker shall advertise its business publically only in accordance with the guidelines issued by the securities exchange under its regulations.
ii. Ensure compliance with guidelines for Internal control system and compliance function for securities brokers as specified by the Commission from time to time.
iii. The auditor shall also make out a limited assurance report of the securities broker stating whether, during the period, the securities broker has, in all material respects:
    - maintained systems and controls adequate to identify with reasonable accuracy the assets held on behalf of customer and distinguish such assets from the proprietary assets of the securities broker;
    - implemented an adequate internal control system and compliance function commensurate with the size and nature of services performed by the securities broker; and established a compliance function which performed its functions with efficiency.

3. Circulars

a. Revised Format of Interim Financial Statements - Banks/ DFIs

The State Bank of Pakistan has revised the format of interim financial statements (ie. quarterly & half-yearly), together with the notes forming part thereof, substituting the existing format that was prescribed in May 2004, in order to bring it in line with the annual financial statements format, issued vide BPRD Circular No. 2 of 2018.

Consequently, all banks/DFIs have been directed to prepare their quarterly & half-yearly financial statements on the revised format effective from the accounting year starting from 1st January, 2019. However, taking into consideration the lack of time available for preparing the 1st quarter financial statements of 2019, the timeline for the 1st quarter has been extended from April 30, 2019 to May 31, 2019.

b. SBP Social Responsibility Scheme for Special Persons

SBP has launched a 'Small Enterprise (SE) Financing and Credit Guarantee Scheme for Special Persons' in line with the governments aim to improve the socio-economic life of special people in the country and SBP's measures to improve access to finance for this vulnerable segment of the economy.

Under the scheme, Banks and DFIs will be required to provide financing facilities to special persons (holding CNIC with the disability logo/symbol) to meet credit needs for setting up of new business enterprises or for expansion of existing ones and claim refinance from SBP of up to 100% of finance extended by them.

c. Adoption of (AAOIFI) Shariah Standards 2, 5, 14, 18, 24 & 38

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) has adopted a number of shariah standards with immediate effect, subject to certain clarifications/amendments as given by SBP, in order to standardize and harmonize Shariah practices in the Islamic Banking industry.

The AAOIFI Shariah Standards adopted are as follows:

i. No. 2 - Debit Card, Charge Card and Credit Card

ii. No. 5 - Guarantees

iii. No. 14 - Documentary Credit

iv. No. 18 - Possession (Qabd)

v. No. 24 - Syndicated Financing

vi. No. 38 - Online Financial Dealings

SBP has clarified that the adoption of the above Standards is in addition to current regulations, other instructions and directives issued by SBP from time to time and is not replacing them by any means. Further, failure to comply with these instructions may invoke penal action under the provisions of the Banking Companies Ordinance 1962.

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4. Others

a. Closure of Unlawful Companies by SECP

The SECP has initiated legal proceedings to wind up at least 9 companies dealing in cryptocurrencies and offering Ponzi/MLM, referral marketing, pyramid business/schemes and has advised the public not to be misled by any schemes/deals/plans being offered by such companies. In this regard, legal proceedings have been initiated for winding up in terms of section 301 read with section 304 of the Companies Act, 2017.

Further, the SECP has issued notices to some companies involved in businesses which are prohibited and contrary to their object clauses of the Memorandum of Association. These include unlawful activities such as collecting unauthorized deposits from the public, leasing of cars, houses, electronic alliances and other goods and materials without lawful authority.

> **"If you exclude 50% of the talent pool, it's no wonder you find yourself in a war for talent."**
>
> **- Theresa J. Whitmarsh, Executive Director of the Washington State Investment Board**

International

a. Revised Corporation Code of the Philippines

A Revised Corporation Code (RCC) became law in the Philiphines on receiving the assent of the President, thereby amending the previous 38-year-old Corporation Code in an effort to improve the ease of doing business in the Philippines. Under the amended Code, it is now possible to form single member companies and companies will enjoy, unless the articles provide otherwise, perpetual existence (as opposed to the previously set limit of 50 years).

Following are some of the notable changes made in the RCC:

- **Incorporators :** allows 1 person to register a business as a corporation by oneself, thus, removing the requirement of a minimum of 5 incorporators. While the old Corporation Code required incorporators to be natural persons, the RCC provides that incorporators may be any person, partnership, association or corporation.
- **One-Person Corporation (OPC)**: allowance for a single person – whether natural or judicial, to organize and put up a corporation, subject to a minimum capital stock of php1,000,000.00. However, banks and quasi-banks, trusts, insurance, public and publicly-listed companies, and non-chartered government-owned and –controlled corporations may not incorporate as an OPC.
- **Board of Directors/Trustees:** Corporations vested with public interest are now required to have independent directors constituting at least 20% of the board. Trustees shall be elected for a term not exceeding 3 years.
- **Corporate officers** : Chief Executive Officer is made the alternative title to president and Chief Financial Officer is made the alternative title to treasurer. Also, the inclusion of Compliance Officer as a mandatory Corporate Officer on top of the President/CEO, Treasurer/CFO, and Corporate Secretary.
- **Board meetings:** allowance of remote communication methods in attending board meetings subject to provisions of corporate by-laws.
- **Removal of a member of the board of directors or trustees**: empowering the Securities and Exchange Commission (SEC) to remove disqualified members of the board of directors or trustees.
- **Compensation of Directors/Trustees:** The RCC now requires the submission to the shareholders and SEC of an annual report on the total compensation of each director or trustees.
- **Dealings of Directors, Trustees or Officers with the Corporation:** Limitation on the dealings of directors, trustees or officers with the respective corporation now includes contracts with the corporation of their spouses and relatives within the 4th civil degree of consanguinity or affinity[1]. Such contracts are voidable unless all the requirements and conditions set forth in Section 31 of the Revised Corporation Code are complied with.
- **Digital means:** the new code introduces provisions that permit the electronic filing of reportorial requirements and attendance in meetings via remote communication or in absentia, among others – practices that were not recognized in the old law.

[1] Two people are related to each other by consanguinity if one is a descendant of the other or if they share a common ancestor. The 1st degree of consanguinity is a parent-child relationship; 2nd degree: a sibling relationship; 3rd degree: an uncle/ aunt with a niece/nephew; while 4th degree: first cousins.

b. **Governance and Performance in Emerging Markets: Empirical Study on the Link Between Performance and Corporate Governance of IFC Investment Clients**

The International Finance Corporations (IFC's) Governance and Performamce in Emerging Markets Report investigates the extent to which having good CG policies and practices—as defined by the CG Index specifically developed for this study based on IFC's CG Methodology—is associated with better financial and non-financial performance of IFC's portfolio clients during the investment period.

The report reflects the success of an investee company, defined not only in financial terms but also by its contributions to a broader set of stakeholders and the economy in general, including environment and social aspects. For the purpose of this study, IFC created a 'Core CG Index', consisting of the most important CG indicators selected based on a consensus of IFC corporate governance specialists prior to undertaking the empirical analysis.

The report stated that companies from the top CG quartile exhibited an average Return on Equity (ROE) which was about 3 times higher than that of the bottom CG quartile (ie. 18.56% versus 6.91%). The results indicate that the most material indicators of CG performance demonstrate a stronger correlation with financial performance.

Moreover, the study identified specific CG practices that have the highest correlation with financial performance, namely:

- Having a dedicated internal audit function with its own charter or terms of reference;
- Following internationally recognized standards on internal controls;
- Having financial statements audited by a recognized independent auditing firm;
- Having a written code of ethics/conduct;
- Having a board that has an audit committee;
- Having a written policy for the approval of related party transactions.

These indicators show that the broad spectrum of CG improvement actions available to a firm can be narrowed down to a key set of actions that make value creation a priority for the benefit of investors.

c. **Executive Rewards: Paying for Success: BEIS Committee's Report - UK**

The Business, Energy and Industrial Strategy (BEIS) Committee is a select committee of the House of Commons in the Parliament of the United Kingdom. The remit of the committee is to examine the expenditure, administration and policy of the Department for Business, Energy and Industrial Strategy, and any departmental bodies.

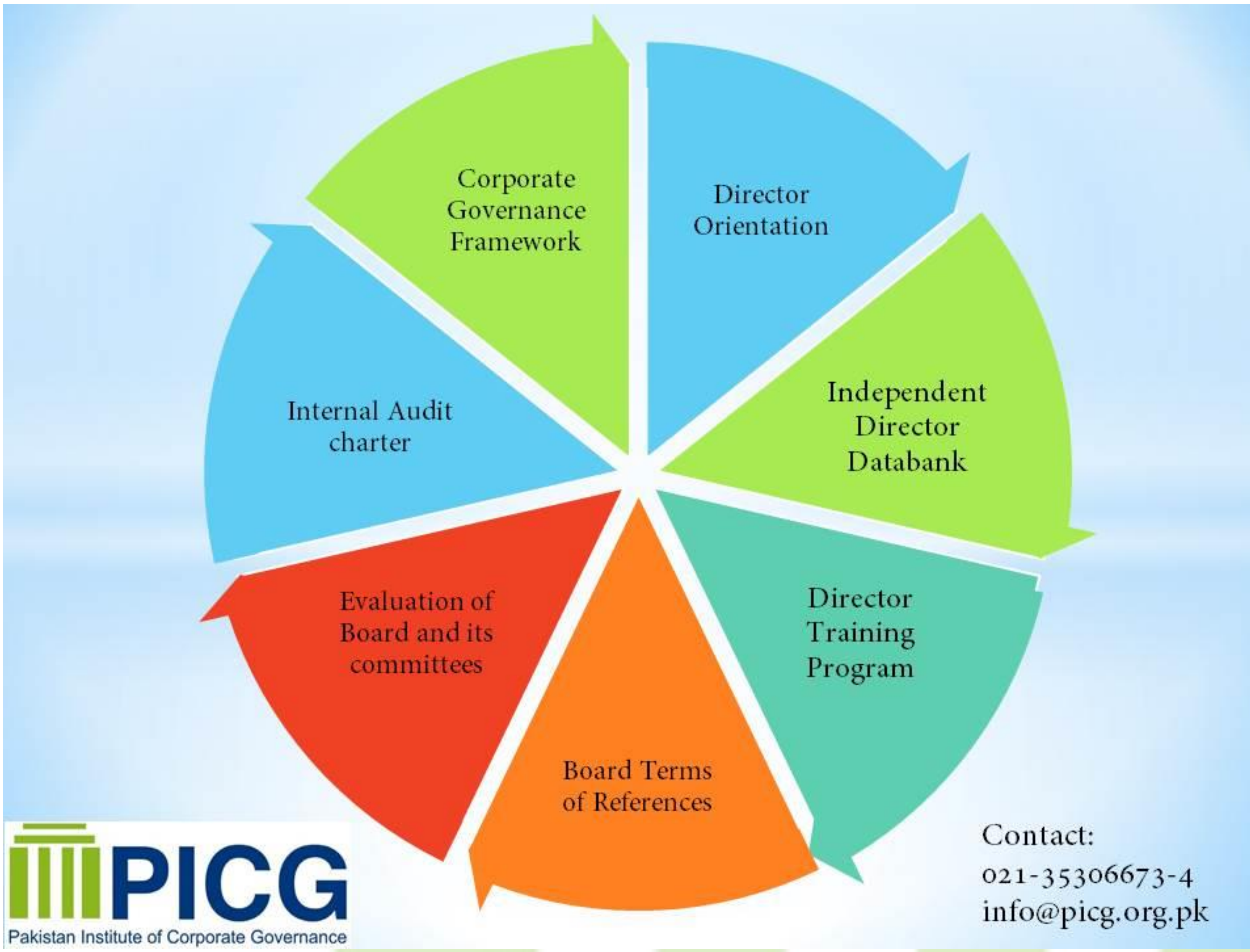
The BEIS Committee has recently released a report on its investigation into executive pay. The report forms part of the Government's scrutiny of corporate governance and examines the progress being made in addressing the gap between executive pay and company performance, on the one hand, and employee pay on the other. This is the eighteenth report of its 2017–19 session.

Some of the matters reported are as follows:

- The "say on pay" reforms introduced in 2014 have had some impact in curbing levels of new pay awards, which have remained fairly flat over the last decade. However, there continue to be regular examples of excessive payments, which are reputationally damaging and serve to fuel a perception of institutional unfairness
- Over the last decade chief executives' earnings in the FTSE 100 have increased four times as much as national average earnings. FTSE 100 chief executives earn around £4 million per annum while average pay is under £30,000. These huge differentials have been baked into the pay system, in part by a heavy reliance on over-generous, incentive-based pay and partly by the weakness of remuneration committees which design complicated and opaque pay packages for their peers.
- Structure of executive pay has become too dominated by incentive-based elements that do not effectively drive decision making in the long-term interests of the company.

The report also argues for a much stronger link between executive and employee pay, for example by the greater use of profit-sharing schemes and the Committee recommends an 'employee representative' on the remuneration committee to strengthen this link. As per the report, a tougher, more proactive regulator is needed because of the lack of confidence in remuneration committees, or institutional investors in exercising their stewardship functions, in a way that consistently bears down on executive pay.

Greater transparency, accountability and responsibility are required throughout the investment chain if the gap between pay at the top and the bottom is to be reduced and companies are compelled to pay their whole workforce reasonably and responsibly.



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