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Colombia

The Role of Institutional Investors in Promoting Good Corporate Governance Practices in Latin America: The Case of Colombia

Colombia's report was elaborated by the Financial Superintendency (Superfinanciera).

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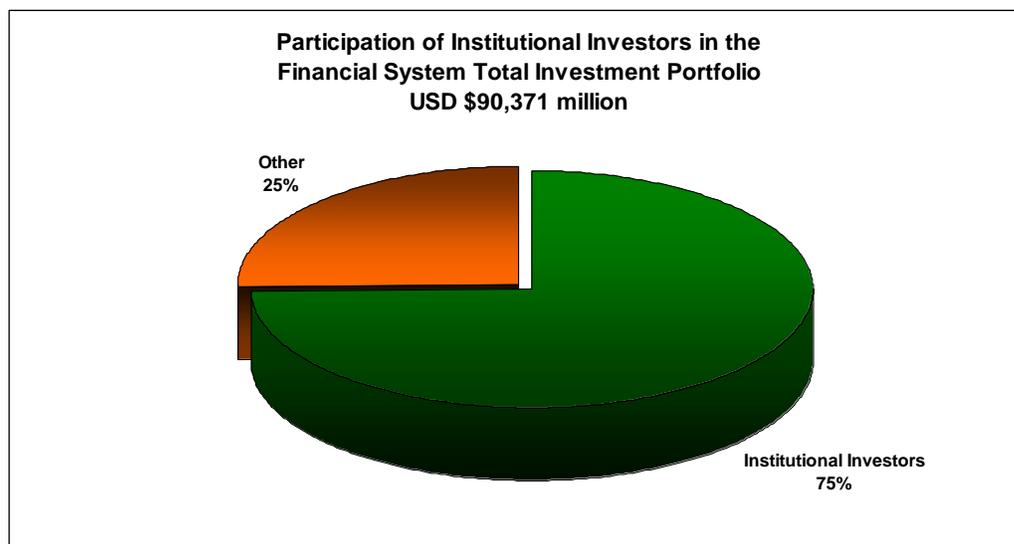
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Introduction

The following report was prepared by the Financial Superintendence of Colombia (FSC) on the basis of several interviews conducted during the first semester of 2007, with the relevant entities supervised by the Superintendent Delegate for Pension Funds and Fiduciary Entities, the Superintendent Delegate for Insurance Companies and the Superintendent Delegate for Issuers and Collective Investment Schemes was. Some information and the figures have been updated in October/November 2008, prior to the 2008 Latin American Roundtable on Corporate Governance. The information about market share and portfolios is based on the information reported to the Financial Superintendence of Colombia

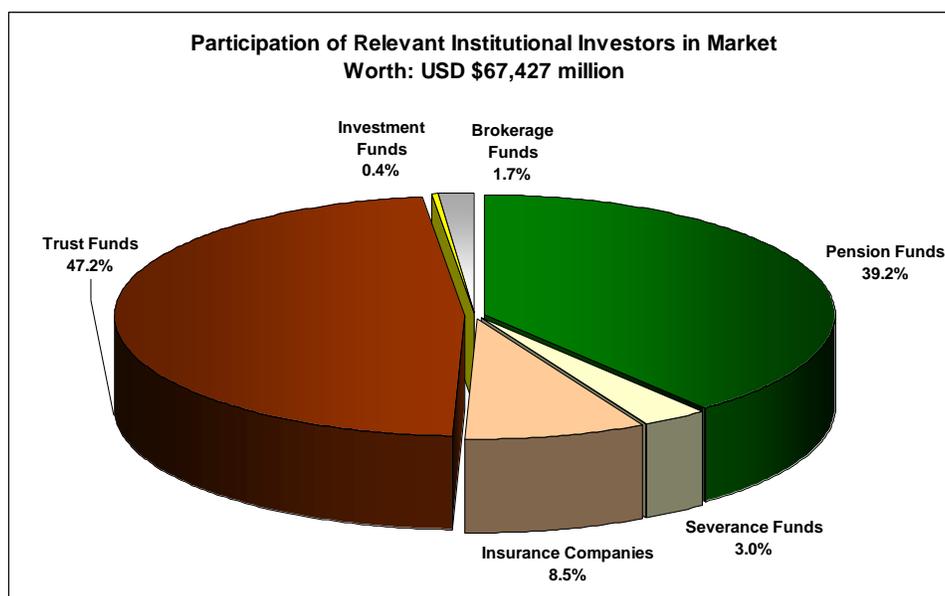
I. Background

Several institutional investors (IIs) participate in the Colombian financial market. For the purposes of this report they will be classified in the following categories: pension funds, severance funds, insurance companies, trust funds and investment funds. In the case of trust funds, their assets are managed by trust companies or brokerage firms. The total amount of Investments in Colombia as of June, 2008 was USD \$90,371 million that amounted to 45.4% of the estimated GDP.



1. Institutional Investors Participation in the Colombian Financial Market as of June, 2008

The total amount of investments under the management of institutional investors as of June 2008 was USD \$67,427 million that amounted to 33.8% of the GDP.



The total amount of investments managed by Institutional Investors as of June 2008 is shown in the following table:

Institutional Investors	Investments (In USD million)
Pension Funds	26,416
Severance Funds	2,004
Insurance Companies	5,755
Trust Funds	31,859
Investment Funds	266
Brokerage Funds	1,127

II. Evolution of the Role of IIs in Promoting Good Corporate Governance Practices

Colombia understood the importance of promoting good corporate governance practices very early on. Rules regarding general assembly of shareholders, shareholders rights, disclosure of information, board of directors, etc, have been in place in corporate law since 1971, when the current Commercial Code was enacted. It is still recognised amongst the most advanced in the region.

However, in light of the different episodes that took place in international markets at the end of the last century related with corporate governance malfunctions, the Securities Superintendence enacted Resolution 275 of 2001. This Resolution established a number of corporate governance areas that needed to be regulated by issuers wanting to attract the investment of mandatory pension funds. Pursuant to this Resolution, mandatory pension funds were restricted to invest only in issuers that had

complied with it and have developed corporate governance rules regarding the various aspects contained in the Resolution.

The eagerness of most issuers to attract the investment of these pension funds, led to a widespread adoption of corporate governance codes by most issuers. Furthermore, good corporate governance became a matter of great interest in the securities market and different projects have been developed to promote good corporate governance practices between the Government and the private sector. However, the codes that were approved by each of the issuers were considerably different and not all of them embodied best practices, some merely reflected the general legal standards that were already mandatory.

In light of this outcome, in 2005 the new Securities Act (Law 964 of 2005), established mandatory corporate governance practices for issuers in general. These practices covered topics such as board member elections, proposals submitted by minority shareholders to the board of directors, disclosure of shareholder agreements, independent directors, and audit committees, among others.

During 2006, the Financial Superintendency led a working group comprised of the representatives of the most important groups of issuers. This working group had the duty to agree on a Colombian Corporate Governance Code (Código País). After several discussions, the group decided to promote a code with 41 measures that were suggested to all issuers. The purpose of the Code is to encourage issuers to adopt the suggested measures on a “comply or explain” basis. Issuers are asked to disclose whether they comply or not with each of the measures of the Code. If they are complying with the measure, they are required to provide an explanation describing the manner and mechanisms by which compliance is ensured. If they are not complying with the measure, the issuers are free to explain why that is. The code was finally enacted in 2007 and the first report took place between 15 and April 30, 2008 describing the situation of the issuers in the period from the date of entry into force of the C.E. 56, 2007 and December 2007.

Código País is used as a standard for issuers to provide the market with relevant and adequate information regarding their corporate governance. This information will become an important tool for the decision-making process leading to investments. In turn, the FSC is verifying the veracity of the information reported by the issuers in order to ensure its reliability.

III. Future Development of the Role of Institutional Investors in the Promotion of Good Corporate Governance Practices

In order to understand the development of the role of Institutional Investors in the promotion of Good Corporate Governance practices in Colombia, it is important to understand the system that was in place, Resolution 275 of 2001, and the new structure that is being implemented, Código País.

As it has been briefly described, the previous model rested on the existence of a mandatory statute (Resolution 275 of 2001) that described a series of measures that should be observed by those issuers who wished to be eligible for investment from pension funds. Although this model was very effective in

promoting good corporate governance practice among issuers, the Financial Superintendence considered convenient to modify this approach in order to rely on the voluntary adoption of good governance practices by issuers together with placing a much heavier onus on Institutional Investors to incorporate the corporate governance considerations into their investment decision making process.

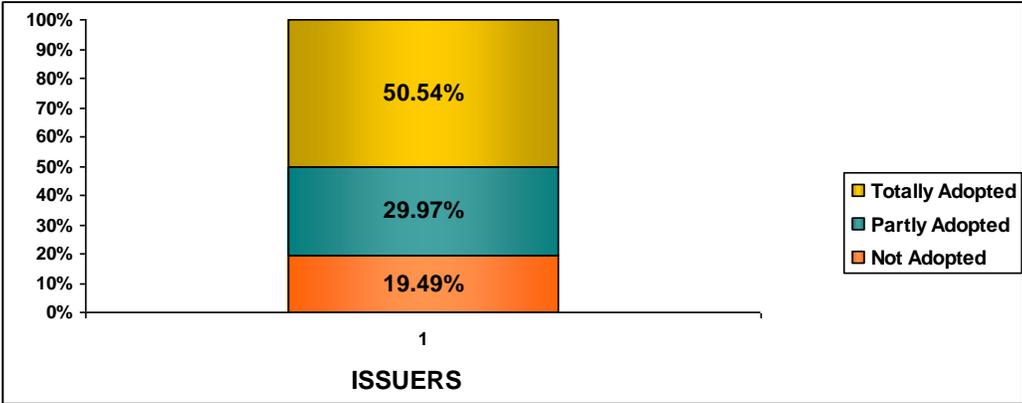
The current model is based on the Código País, the strengthening of disclosure requisites for issuers regarding their corporate governance system and the strengthening of the responsibilities of Institutional Investors during the investment decision process.

The new structure requires issuers to provide a detailed Corporate Governance Report that covers the main aspects of their corporate governance system. The report is made on the basis of open-ended questions. Also every question requires the issuer to provide evidence of the practices that it says it is putting into place. The questions cover general topics as well as particular practices included in the Código País.

On the other hand, pursuant to Circular Externa 55, 2007 Institutional investors are legally required to expressly decide and disclose the importance that they place on the evaluation of the corporate governance system of the issuer. However, this requisite does not in any manner imply that a poor evaluation of the corporate governance system of the issuer will limit the investment in all cases. Furthermore, institutional investors are required to maintain evidence of the analysis made of the corporate governance system of the issuer.

Analysis degree of adoption measures suggested by Código País

169 issuers completed and sent the survey. Of the 41 measures that comprise the survey a 50.5% were fully adopted, 22% partly adopted, and 19.5% were not adopted by the issuers, as the next graph shows:



The Código País does not require explanation for measures not adopted. If a measure is adopted, the issuer must explain how, as well as the mechanisms by which adoption is ensured.

Circular 55 states that pension funds, in making their investment decisions, must establish discretionary criteria based on the Código País recommendations and other practices of Corporate Governance adopted by issuers recipient of their investment.

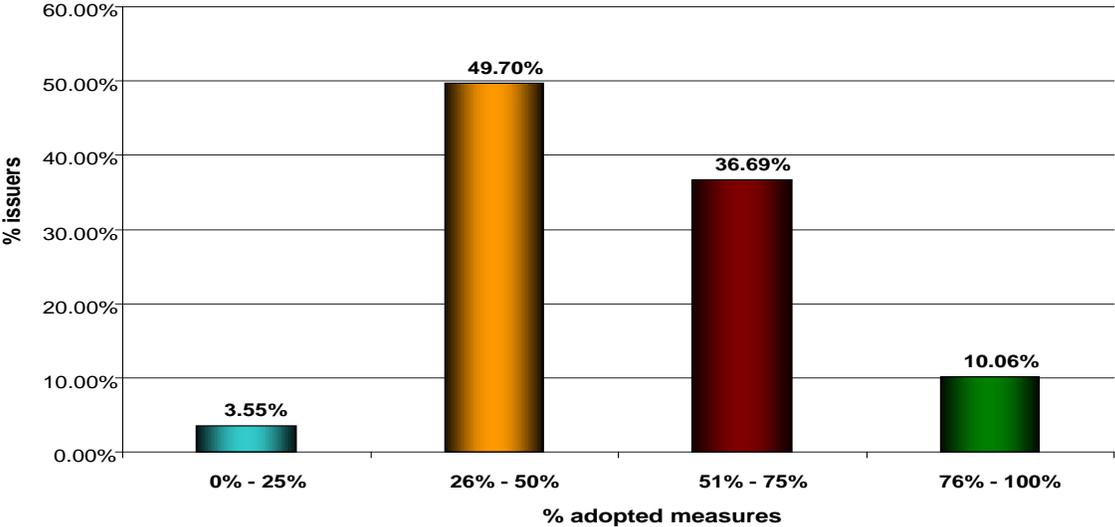
It is natural that investors in capital markets bear the financial risk of the investments they make. But it is not reasonable that, in addition, investors must assume the risk of undue transparency or lack of risk management by the issuer or even fraud.

Good corporate governance practices contribute to the development of capital markets as they contribute to the elimination or at least mitigation of non-financial risks.

In this sense, regarding the first report undertaken by issuers, the FSC concluded:

- Issuers accepted the commitment to adopt corporate governance practices on a voluntary basis.
- Entities with high marketability of shares have adopted a higher number of measures of best corporate practices in relation with entities with low stock marketability.
- Within the real sector, issuers of the sub-sector of trade reported the largest percentage of measures adopted and within the financial sector, the credit establishments reported the largest percentage of measures.
- It was observed that the reason for the non-implementation of several measures was that Assemblies did not meet during the reporting period.
- It expects a higher level of implementation of measures in the next transmission period of the Código País survey.

The degree of adoption of measures suggested by Código País is depicted in the following graph:



IV. Pension and Severance Funds

Colombia has six private pension funds in charge of managing the resources that are subtracted from the employees' salary according to the law. These financial entities are also able to manage voluntary pension funds and mandatory severance funds.

As mentioned before, the investments under management of pension funds amount to 45% of the total investments of Institutional Investors. Therefore, their activity in the capital market is quite important.

1. Investment Regime

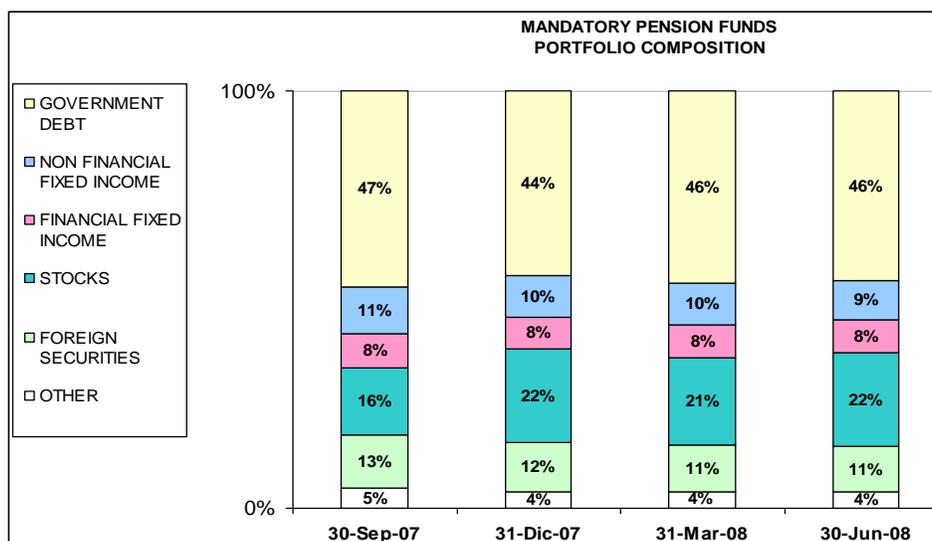
Current regulation provides for certain limits to the portfolio of the mandatory pension funds. These limits may be summarised as follows:

Type of Investment	Limit
Government Bonds	Up to 50% of the portfolio
Financial Institutions fixed income securities	Up to 30% of the portfolio
Non Financial Institutions fixed income securities	Up to 30% of the portfolio
Securitisations different from mortgage securities	Up to 40% of the portfolio
Stocks	Up to 40% of the portfolio
Foreign Securities	Up to 40% of the portfolio

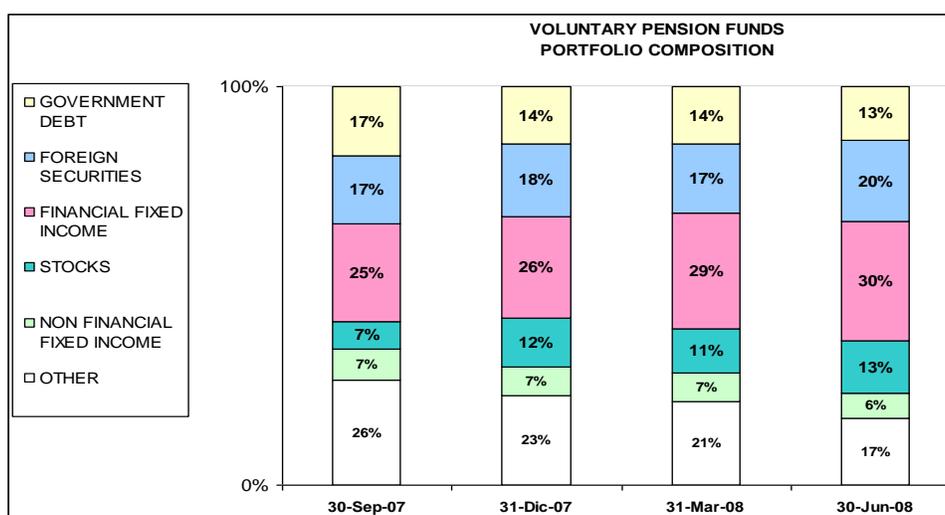
There is also a limit on the investment placed on the same issuer or its subsidiaries equivalent to ten per cent of the total value of the fund. If the issuer is related to the pension fund manager, this limit decreases to five per cent of the total value of the fund. However, this limit is not applicable to government issued securities.

Furthermore, there is a limit on the amount of securities issued by the same issuer that may be held by the same fund equivalent to thirty per cent (30%) of the total number of securities issued. If the issuer is related to the pension fund manager, the limit is calculated over the amount of securities effectively placed in the market. Government issued securities are not covered by this limit.

For the second semester 2007 and first semester of 2008, the composition of the portfolios managed by mandatory pension funds is described in the following graph:



On the other hand, the voluntary pension funds portfolio composition during the second semester 2007 and first semester 2008 was:



2. Specific Role Played by Pension Funds in the Promotion of Good Corporate Governance Practices

Since 2001, pension funds have played a very important role in the promotion of good corporate governance practices in issuers of securities. Thanks to Resolution 275 of 2001 enacted by the former Superintendence of Securities, they are compelled to invest the resources they manage only in issuers that have incorporated and follow good corporate governance practices on the following topics:

- Management evaluation
- Conflict of interests

- Risk identification and disclosure
- Transparent election of the external auditor
- Information disclosure
- Specialised audits determined by minority shareholders
- Equal treatment for shareholders and
- Enforceability of corporate governance codes.

Although this approach was very important in the promotion of good governance practices among issuers, since May 2007 Colombia adopted a voluntary approach based on a Corporate Governance Code that is applied by all issuers. This Corporate Governance Code provides measures on the following topics:

- Shareholders Assembly. Summon procedure, decisions that must be reserved for the Shareholders Assembly, authorisations of relevant related parties' transactions and rights of shareholders.
- Board of Directors. Number of directors, qualifications, independence, frequency of the meetings and responsibilities.
- Disclosure and Transparency. Disclosure of material findings of the external audit, transactions between the company and senior managers and their relatives.
- Dispute Resolution.

Under this new approach, pension funds would be required to rate the corporate governance system of each issuer according to their own standards and attribute a certain importance to this rating within the investment decision making process.

There is no specific legal rule that requires pension funds to exercise their voting rights in the meetings of the Shareholders Assembly. However, it may be construed that there is an obligation to determine the need to exercise voting rights as a consequence of the fiduciary duties that Pension Funds must observe.

The current commercial legislation states that board members are elected in accordance to the electoral quotient. This method implies that in order to ensure the possibility of appointing a member of the board the shareholder must have a number of shares at least equal to the number of votes divided by the number places to provide. However, minority shareholders may elect board members if they have enough shares that represent the largest residue in any given election.

There is no legal incentive or obstacle for pension funds to coordinate their efforts and act jointly in shareholder meetings.

As a result of the adoption of *Código País* at the end of 2007 the Superintendence ordered some entities, among them pension funds, to have discretionary criteria and policies to analyse their investments incorporating into their decision making process the corporate governance practices of companies invested in.

The first review carried out by the Superintendence of pensions funds use of *Código País* in their decisions confirmed that they have adopted specific criteria to value issuers' situation and that they make decisions based on this whether to keep their investment or sell it. We see this as an important advance in corporate governance practices.

Following the provisions of the Circular 55, 2007 each fund manager has adopted its own criteria for evaluating the corporate governance of the investee company and has incorporated his/her evaluation into models used for investment analysis. The rating value established by the new model of analysis must be taken into account in the evaluation of the risks of the issuer and is assigned a specific weight at the time of allocating the quota of investment.

All fund managers have as a source of information for the analysis of the issuer's corporate governance: the answers to the *Código País* Survey (Regulation 028/07). Additionally, some of them take into account the evaluation of additional practices of good corporate governance as defined by themselves.

The most common criteria employed by fund managers are:

- The issuer has codes of good governance, Internal Control Manuals and Codes of Conduct.
- The weighting of the results of the Survey of Country Code on the following topics: General Assembly of shareholders, board of directors, information disclosure and dispute resolution. In each of these topics is given a specific weight.

The previous factors determining the risk level of the issuer and its investment quota is determined by the final result of the financial evaluation set with the score on corporate governance practices.

More details on the answers to the survey "Código País" can be found on the Superintendence's web page, link "Gobierno Corporativo- Código País"., including specific result of pensions funds.

3. Major Obstacles to Improving the Role of Pension Funds in the Promotion of Good Corporate Governance Practices

According to the answers given by all the pension funds, the most important corporate governance risks are related with transparency and disclosure, shareholder rights, control environment and family business issues.

Due to the current regulation, pension funds are used to incorporating an evaluation of the corporate governance standards of the issuers in their investment decisions. Furthermore, they actively exercise their voting rights and are inclined towards nominating certain board members when their participation allows them to do so. However, just one third of the pension funds have a policy regarding exit whenever corporate governance risks materialise.

According to pension funds the most important obstacles for them to improve their position as corporate governance activists are the following:

- High ownership concentration
- Insufficient offer of securities
- There are no incentives for them to be more active

- Existing rules are not enforceable
- Current regulation is insufficient

Regarding their suggestions for improving their role as corporate governance activists, they mainly supported the development of good corporate governance standards that should be observed by the issuers and identified by the pension funds within their evaluation process.

4. Corporate Governance of Pension Funds

Current legislation provides for specific requisites related to the corporate governance structure of pension funds. These requisites may be summarised as follows:

- Participation of beneficiaries in the management of the pension funds. Currently, the law provides for a representative of the employees and a representative of the employers to be part of the board of directors of the pension funds. However, difficulties related to the election of these representatives and their actual contribution to the board of directors may lead to a redefinition of the involvement of beneficiaries in the management of the fund.
- External auditor. The external auditor of the fund is currently elected by shareholders and beneficiaries.
- Pension funds have a control committee mainly composed by affiliates to its funds.
- Managers of pension funds are subject to specific restrictions related to other activities that they are not allowed to perform while being managers.

Furthermore, due to recent experiences and to the importance placed on corporate governance risks by the Financial Superintendence, there is an ongoing process that will lead to the adoption of certain corporate governance standards by pension funds. These standards are related to the following topics:

- Prohibition to appoint as managers or directors of the issuer, persons who work for the pension fund or any of its related parties
- Conflict of interest rules related to the conflict that may arise between the fund or any of its related parties and the issuer¹
- Exercise of shareholder rights vis a vis the issuer².
- Rules for the selection of the external auditor (The external auditor is an additional organism of control with functions similar to those of the auditor. Having an external auditor for the pension funds is voluntary.)
- Enforceability mechanisms for Corporate Governance Codes. (Adopting a corporate governance code is not mandatory since the recommendations of corporate governance in Colombia are based on the principle of self regulation.)

There are no further legal rules related to the conflict of interests that may arise within Pension funds.

¹ The OECD submitted a follow up question: “What are the mechanisms to prevent or make conflicts of interest apparent?” **Answer:** There is not specific mechanism the rules of corporate government are based on the principle of self regulation. These rules should be incorporated in the code of conduct of the pension funds.

² The OECD submitted a follow up question: “What rights? How are they exercised? What is required, what is voluntary?” **Answer:** The exercise of the rights mentioned above is always voluntary (e.g. vote in the General Assembly of shareholders; inspect the documents of the issuer in the opportunity provided by law, etc)

V. Mutual Funds Managed by Trust Companies

Trust companies in Colombia are conceived as entities that render financial services to customers. One of those services is the management of collective investment schemes (CIS) known as mutual funds.

Before the enactment of Decree 2175 in June 12, 2007, there were two main types of such mutual funds: Open funds where investors are free to join or leave the fund at any time and closed funds where investors can only join or leave the fund during the periods set forth in the corresponding document.

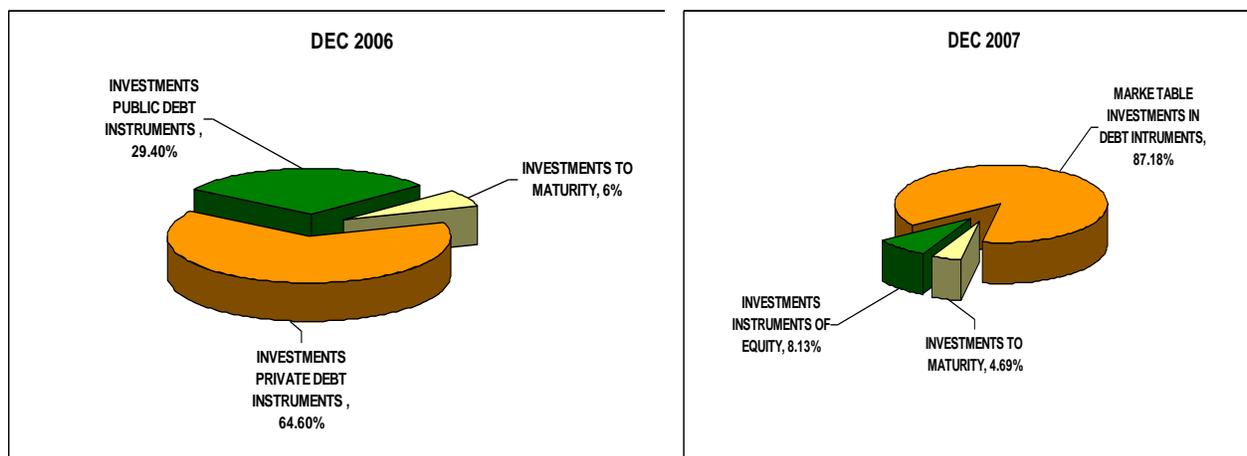
The main purpose of the new legal rule is to unify the law applicable to Collective Investment Schemes in Colombia. In fact, before Decree 2175 of 2007, trust companies and brokerage firms were able to manage CIS. Although the product was substantially the same, each type of entity had different regulation applicable to the CIS that they managed. Decree 2175, overcame this arbitration and updated the rules governing CIS.

Considering that the new rules governing collective investment schemes is quite recent, the figures shown below describe the portfolios as they were composed based on the previous regulation³.

1. Open funds Investment Regime⁴

Open funds are CIS in which participants can leave the fund at any time, consequently their portfolios have to be constituted with highly liquid assets.

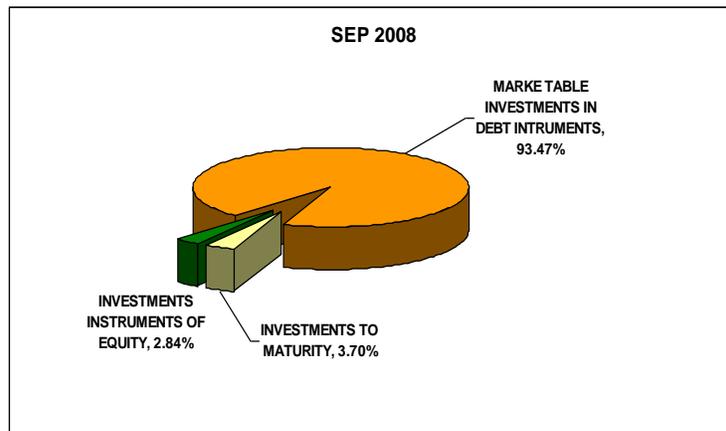
The evolution of portfolio of open mutual funds as of December 31, 2006, December 31, 2007, September 30, 2008, is depicted in the following pies:



³ At the time of the study the current regulation of collective investment schemes had not entered into force, with the exception of data for September 2008.

⁴ All graphs were made with the old regulation in mind, except the last chart for September, 2008

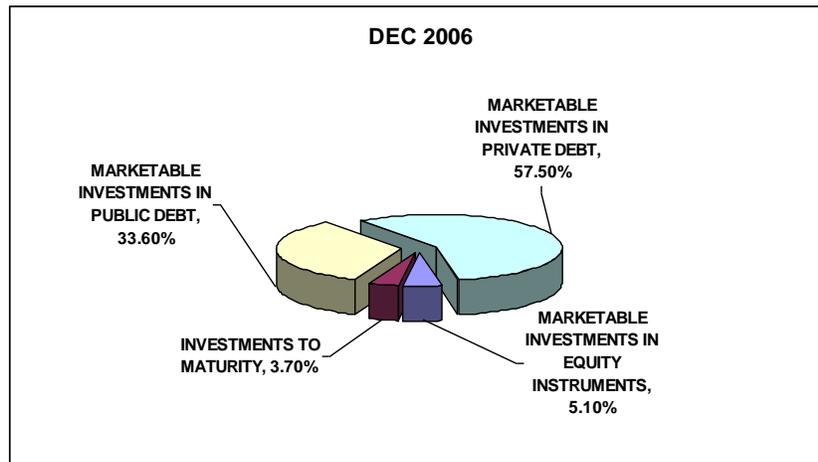
(this graph is based on the new regulation)

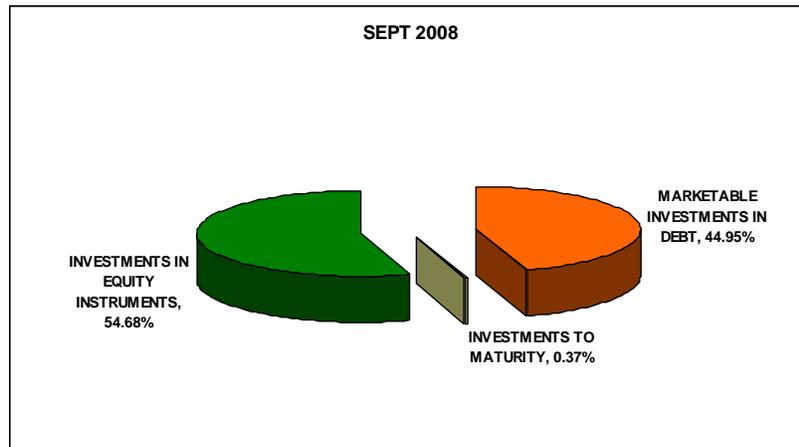
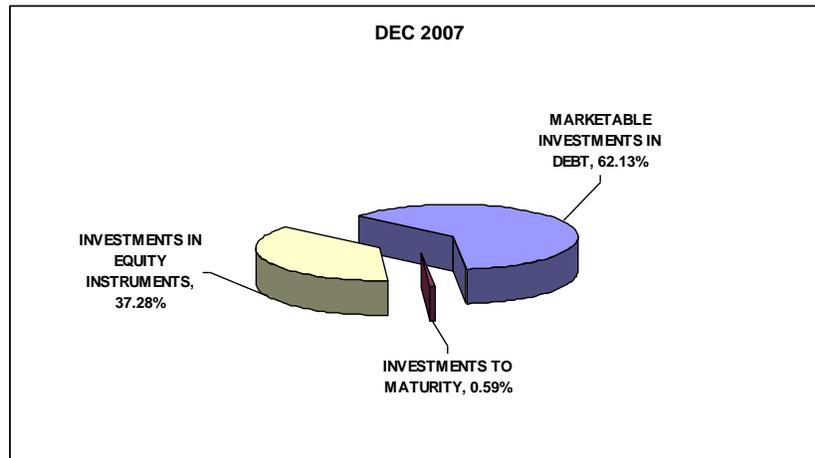


2. Closed Mutual Funds

Closed mutual funds are CIS in which the participants are not able to enter or leave the fund at any time but only whenever the corresponding prospectus states that they can do so. Consequently, their investment regime allows their portfolios to be more heterogeneous than open funds.

The evolution of portfolio of closed mutual funds as of December 31, 2006, December 31, 2007, September 30, 2008, is depicted in the following pies:





3. Collective Investment Schemes Governed by Decree 2175 of 2007

According to Decree 2175 of 2007, collective investment schemes may assume any of the following types:

- a. Money market CIS
Their portfolio may only be composed of short term debt instruments
- b. Real Estate CIS
60% of their portfolio should only be composed of i) real estate located in Colombia or abroad, ii) Securities issued in real estate securitisation processes, iii) foreign collective investment schemes with similar characteristics.
- c. Margin Account CIS
These CIS are constituted to manage margin accounts.

d. Speculative CIS

These CIS are constituted to manage speculative operations and there is a minimum amount established for participants to join the CIS.

e. Market Index CIS

The portfolios of these CIS mirror the securities used to determine a national or international market index.

Taking into account that Decree 2175 of 2007 has been so recently enacted, and that there is some further regulation pending, there are no statistics available regarding the behavior of the portfolios of the CIS described above.

4. Specific Role Played by Mutual Funds in the Promotion of Good Corporate Governance Practices

There are no specific rules that limit in any way the investment that mutual funds may place on any given issuer. Any rules on this matter should be contained in the prospect prepared by the fund manager. There are no requirements for mutual funds to exercise their voting rights in shareholder assemblies. Also there are no specific conflict of interest rules applicable.

Although there has not been any legal rule that provides guidance as to what should be the role of mutual funds in promoting good corporate governance, during the course of this research, some of the trust companies that were interviewed showed considerable interest in corporate governance issues.

Furthermore, there is evidence of certain securitisation operations in which trust companies have acted as issuers and have observed higher standards of corporate governance rules with the purpose of differentiating such issues from other competing ones.

5. Major Obstacles to Improving the Role of Mutual Funds in the Promotion of Good Corporate Governance Practices

According to the answers given by all the trust companies that were interviewed, the most important corporate governance risks are related with transparency and disclosure, and control environment.

Nevertheless, mutual funds have not developed methodologies that include the evaluation of corporate governance aspects of the issuer, for their investment decision. Furthermore, one third of the companies interviewed stated that they actively exercised their voting rights.

According to the mutual funds the most important obstacles for them to improve their position as corporate governance activists are the following:

- High ownership concentration
- There are no incentives for them to be more active
- Insufficient offer of securities

- Current regulation is insufficient

In terms of their suggestions for improving their role as corporate governance activists, they mainly supported the development of good corporate governance standards that should be observed by issuers. They would devote a part of their evaluation to the analysis of how those standards are implemented in the issuer in order to decide about their investment. They also supported the idea to develop voluntary standards for Institutional Investors on their fiduciary responsibilities to their beneficiaries. Also, they emphasised the possibility of increasing the communication between issuers and mutual funds.

6. Corporate Governance of Mutual Funds

In a manner consistent with the process of the evolution of corporate governance standards of pension funds, there is an ongoing process that will lead to the adoption of certain corporate governance standards by mutual funds. In this case the process is supported by a specific requirement to provide Corporate Governance Rules for entities that manage mutual funds, imposed by Decree 2175 enacted in June 12, 2007.

On October 30, 2007 the FSC enacted Circular 54 that requires mutual fund managers to adopt corporate governance codes that will ensure that these managers will focus their efforts on the efficient organisation and operation of the collective investment schemes. Also the corporate governance codes must include rules that shall preserve investors' rights, rules that will allow an adequate performance control and rules that will prevent and manage any potential conflict of interest that may arise on behalf of the manager or its employees.

Also Circular 54 establishes that managers of mutual funds shall consider in their investment policies the relevant corporate governance regulations, in particular the adoption of Código País by the corresponding issuers.

Therefore, it is expected that mutual funds will follow a similar path as pension funds and increase their role in the promotion of good corporate governance standards in Colombia.

VI. Issues to be taken into account for the white paper on the role of II's in the promotion of good corporate governance

In light of the Colombian experience regarding Institutional Investors and their role in the promotion of good corporate governance practices, we believe that the following issues must somehow be addressed in the drafting of a white paper on this topic:

1. Differential treatment for mandatory and voluntary pension funds

As it has been portrayed in this report, in Colombia both mandatory and voluntary pension funds coexist. They have a different legal treatment, especially regarding obligations related to the promotion of good corporate governance practices. Indeed, due to the need to establish further protection for investors in mandatory pension funds, Colombian legislation has required these pension funds to take into account specific corporate governance standards that must be met by issuers in order to be eligible as investment objectives. These requirements are not imposed on voluntary pension funds.

2. Importance of including corporate governance diagnostics within the investment decision process

Colombia made the transition towards a system in which institutional investors are required to disclose the importance that they give the corporate governance environment of the issuer in their investment decision. We believe that special importance must be placed on the obligations that institutional investors must observe in reviewing the corporate governance environment of the issuers they invest in, on the aspects that should be taken into account in such assessments, and the need to disclose to the market the importance that such analysis has in their investment decisions.

3. Disclosure obligations on behalf of the issuers

There is a necessary link between further importance attributed to the corporate governance analysis and the information that must be available in order to perform such analysis. Thus, we believe that it is very important to provide some guidance as to what kind of disclosure obligations issuers must observe in order to ensure that Institutional Investors have enough resources to perform their evaluations.

VII. The Colombian Rating Agencies: corporate governance scores

To start with, it is necessary to explain the current situation of the Colombian CRA's Industry in order to measure the real impact of the existing corporate governance scores on the market.

Currently, there are three CRA's authorised to operate in Colombia with significant differences in terms of market share. While Duff and Phelps have 67.4% of the ratings' market, the two remaining agencies (BRC Investor Services and Value and Risk) issue 32.4% and 0.20% of all ratings respectively.

Despite BRC's minor participation in the market, it is the only CRA that has developed an index to measure corporate governance performance.

BRC does not issue a Corporate Governance Rating but a Corporate Governance Score. According to BRC the score highlights the significance of good governance and allows investors to compare and assess a company's policies and practices with similar companies.

The score was designed to complement their financial scoring systems with corporate governance ones. The corporate governance score reflects the extent to which companies' corporate governance practices and policies serve the interests of investors, shareholders and other stakeholders.

Furthermore, the score is based on the evaluation of the compliance to regulation, codes and guidelines and governance best practices. The score ranges from 1 to 5 and its components are divided into four main points:

Component 1: Ownership structure and influence

Component 2: Financial stakeholder rights

Component 3: Financial transparency and information disclosure

Component 4: Board structure and process

Like other CRA's, BRC evaluates companies only upon their request, hence the companies pay for the rating. BRC's governance scoring and its credit ratings are different forms of analysis that complement each other.

In order to avoid any conflict of interest both, the rating activity and the governance scoring, are developed by different and independent members of the CRA. Indeed, the scores are analysed and proposed to the CRA's Technical Committee by external analysts, with different and independent procedures.

Finally, it is important to point out that despite the relevance of the good corporate governance practices, the score given by the CRA remains private unless the company or the CRA decide otherwise.