LATIN AMERICAN COMPANIES CIRCLE

Corporate Governance Recommendations
for
Company Groups
Based on Experiences from the Latin American Companies Circle
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I. **INTRODUCTION AND BACKGROUND**

These set of corporate governance recommendations for group of companies has been developed by the Latin American Companies Circle. The Circle is a group of Latin American firms that have demonstrated leadership in advocating and practicing governance improvements for companies throughout Latin America. The Circle is sponsored by the International Finance Corporation (IFC) and supported by the Organization for Economic Cooperation and Development (OECD), and is presently composed of 14 companies: Los Grobo from Argentina; Grupo Algar, CPFL Energia, Embraer, Natura and Ultrapar from Brazil; Grupo Argos, Carvajal and ISA from Colombia; Florida Ice & Farm Co. from Costa Rica; Grupo Gentera from Mexico; Buenaventura, Ferreycorp and Grupo Graña y Montero from Peru.

This document is based on experiences of the Circle member companies and takes into consideration limited analysis of the companies’ own practices and covers areas related with wholly- and partially-owned subsidiaries.

The objective of these recommendations is to share a set of best practices for companies in Latin America to consider while developing or improving their respective policies and practices for company groups. These best practices derive primarily from the experiences of members of the Circle, most of which are listed companies, and therefore may be relevant for other publicly-listed companies of the region. At the same time, many of the practices might be relevant and could be adopted by non-listed companies as well. Furthermore, this document does not imply that all Circle members follow these practices or suggest that companies should follow all of the suggested practices – each company is unique and should consider its own facts and circumstances such as domestic laws and regulations, ownership structure, history and culture, market practices, needs and requirements of its relevant stakeholders, either local or foreign, governmental or private.

The Companies Circle views these recommendations as non-exclusive that eventually may be updated to reflect changing realities and emphasize additional points and developments in the corporate governance field as an evolving area. At the same time, members consider that companies in Latin America could benefit from this document and gradually improve their relevant practices where such improvements are necessary.

II. **CHALLENGES OF COMPANY GROUPS**

Company groups have numerous decision-making levels and, therefore, a number of challenges may arise with respect to strategic objectives, implementation and monitoring of strategies, dissemination of corporate culture, management of corporate risks, corporate reporting and mitigations of potential conflicts of interests, among other matters. Company groups may also have various shareholders in different instances. A common structure for a company group includes a listed holding company that owns several subsidiaries, each with different business lines. Therefore, in this environment where the decision-making process is more complex than in stand-alone companies, it is of great importance to adopt minimum standards of corporate governance in order to align interests and create an adequate setting for the sustainable development.

The benefits of adopting a governance framework for company groups are multiple. In the view of the Circle members, a governance framework for a conglomerate creates value for holding companies, their affiliates or subsidiaries, as well as for their shareholders.
A governance framework for company groups allows the global integration of the business in accordance with the group’s business model, maximizing operational efficiency at the subsidiary companies and providing the dissemination, implementation, and compliance with the general strategy, through the exchange of best practices among subsidiary companies and ensuring their decision-making autonomy.

A number of jurisdictions across Latin America have not promulgated laws and regulations governing conglomerates¹ and therefore, setting forth an applicable framework is a decision which lies at the shareholder level, which could provide for clearer shareholder rights, allocation of Board authority at the subsidiary level, adequate oversight, control and disclosure of information by subsidiary companies.

Moreover, in the case of partially-owned subsidiaries, the adoption of clear governance rules results fundamental in order to permit shareholders not related with a corporate group to understand the applicable decision-making process and the relationship among a holding and its subsidiaries, especially with respect to payment of dividends, intercompany transactions, access and use of information from subsidiary companies.

III. General Practices

The chief executive of a holding company, appointed by the Board of Directors, usually takes overall responsibility for the organisation and strategic coordination within a group through the dissemination, implementation, and monitoring of the global strategy and basic management guidelines established by the Board.

Control of a subsidiary is achieved through the implementation of different measures, which generally include: (i) the establishment and clear communication of a group’s general strategy; (ii) requiring shareholder vote or consent rights for specific matters; (iii) establishing corporate policies and procedures for key matters (i.e. branding, environmental and social concerns, internal controls, compliance and accounting); (iv) having regular monitoring meetings among representatives from holding company and from its subsidiary to follow-up on the implementation of directives and performance; (v) setting a corporate-wide independent² internal audit function with a direct reporting line to the parent company’s Board and appointment of an external auditor; (vi) implementing risk management practices; and (vii) establishing an efficient management information system to monitor key strategic indicators.

a) Related Party Transactions

As related party transactions present potential for abuse whereby a related shareholder may obtain an undue benefit at the expense of shareholders, directors, creditors, providers and the securities market, related party transactions are generally recommended to be entered into in an arm’s-length basis.

The requirement to have related party transactions entered into on an arm’s-length basis could be set as a provision within the shareholders agreement or under the corporate by-laws. A specific related party transactions policy could also be issued. As to procedure, it is common to

¹ Colombia has issued an applicable law for conglomerates. Additionally, Mexico has recently issued a new law governing financial groups to replace its prior law on this same subject-matter. From a best practice perspective, the Development Bank of Latin America has recently issued a set of guidelines for company groups

² Independence refers to the absence of subordination of the internal auditors vis-a-vis the management of the audited company.
subject these types of transactions to the prior approval of the subsidiary company’s Board of Directors based on a qualified (supermajority) or unanimous vote. Moreover, to ensure a degree of objectivity, the prior opinion of a committee comprised by uninterested directors (qualifying as non-executive or, preferably, independent) is suggested. Alternatively, conflicted parties should recuse themselves or be prevented from voting in this matter so as to have an uninterested vote.

a.1) Shared Services

A usual arrangement in company groups to reduce administrative costs and eliminate redundancies is to set shared services functions or centers (which commonly may handle accounting, human resources and IT matters). The rendering of these types of administrative services by an affiliated company constitutes a related party transaction and, therefore, to avoid an undue benefit these should be on an arm’s-length basis. For instance, when establishing a shared service center, a shareholder should not be compensated as a service provider and, instead, payment could be made in a cost-based manner (on a reimbursement basis) to the extent permitted under applicable law and regulation. Such costs should be fairly borne by all group companies involved in accordance with services provided. In addition, consideration should be given to applicable tax implications.

IV. WHOLLY-OWNED SUBSIDIARIES

a) Incorporation or acquisition

Incorporating or acquiring a subsidiary would usually require from Board approval (generally supported by the opinion of a Board-level committee) in the event it is material such as strategic acquisitions or the entry into a new business line. Finally, when these types of investments are immaterial, the respective approval process could be handled at the managerial level.

As a general recommendation for purposes of establishing an approval system, the involvement of corporate bodies or functions should be set in accordance with the materiality of the transaction, typically setting approval instances and procedures for this type of transactions in accordance with investment thresholds.

b) Control

Depending on the degree of flexibility and operational autonomy that a holding company intends to grant upon its wholly-owned subsidiary, a parent company should be in a position to add value, ensure effective control and align interests. Various governance mechanisms exist that permit a holding company maintain an adequate level of control over its wholly-owned subsidiaries.

b.1) Reporting Framework

In addition, an adequate information reporting framework is generally recommended. While a parent company holding a 99.99% ownership interest in a subsidiary would practically have full access to subsidiary information (as it participates in shareholder meetings and it appointed the subsidiary’s Board members), it is important to ensure that communication is permanent and provided in an organized manner. To set appropriate internal reporting procedures

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3 This is the common limit for a single shareholder in joint-stock companies in the jurisdictions in which Circle companies operate where a minimum of two shareholders is generally required.
to ensure timely and accurate disclosure, a holding company should previously identify material information (including key performance indicators and its frequency for reporting purposes) that has to be provided by the subsidiary.

b.2) Appointment of Directors

Another widespread practice to ensure control by the parent company over its wholly-owned subsidiary is the appointment of directors from the holding company at the subsidiary’s Board. In addition, this practice ensures a higher degree of communication. An additional practice is to appoint senior management members from the parent company as Board members of the subsidiary or to executive positions at the subsidiary (as Chief Executive Officer or Chief Financial Officer). For purposes of appointing a Board member to a subsidiary, a holding company should initially consider if a Board of Directors is necessary for its subsidiary and whether it should replicate the entire Board composition from the parent company or just appoint certain directors.

While the entire replication of a parent company’s Board at the subsidiary level would certainly provide a full alignment of corporate objectives and strategies, appointing non-executive or independent Board members at a wholly-owned subsidiary could add professional skills suitable for the specific business in which the subsidiary is engaged in and may provide an external perspective. In particular, diversified business groups may have a need to set different Board profiles with specific industry knowledge and experience.

Non-executive or independent directors could provide a different perspective and a critical analysis of a subsidiary’s management. Typically, these types of appointments are made based on the professional qualifications of the director nominee. However, finding non-executive or independent directors with very specific technical skills, sector and business experience may sometimes impose a practical challenge across the Latin American region. To address this practical concern, in certain jurisdictions (particularly Brazil and Peru) companies may rely on databases or lists of directors (sponsored by specialized organizations) to find suitable candidates.

An appropriate balance between the benefits of appointing non-executive or independent directors and maintaining control of a subsidiary could be obtained by appointing and maintaining a majority of related Board members (i.e. those qualifying as non-executive or independent directors) at the subsidiary’s Board, in which control is ensured by a majority vote while an external perspective is obtained through the participation of non-executive or independent directors.

b.3) Internal Controls

A group-wide internal control system should be set by the parent company so as to control its subsidiary’s financial and business operations. The holding company’s executives are responsible for ensuring that the guidelines and controls (in particular limits of authority) established by its Board are properly implemented, including internal controls and procedures. In particular, a holding company should provide guidelines as to implement an independent internal audit function with a reporting line to the parent company’s Board or its audit committee. These internal audit responsibilities should include overseeing a subsidiary’s activities.

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4 For instance, a sole administrator (instead of a Board of Directors) would suffice for a special purpose vehicle/entity.
To ensure consistency and formality among group practices, the establishment of Board-approved corporate policies for the entire group is recommended. Matters usually addressed through group-wide corporate policies set by a parent company include limits to the selling of fixed assets, limits of indebtedness, rules for related party transactions, fixed and variable compensation, managerial evaluation, environmental commitments, social responsibility and ethical conduct. The corporate policies should apply for all subsidiaries with eventual necessary adjustments as approved by the holding’s Board of Directors (for example, limits of indebtedness for start-up companies or for specific business segments).

However, corporate policies should not negatively impact the development of a subsidiary. The scope of policies should depend upon the business needs of a group. For instance, in the event subsidiaries engage in different businesses, having a sole group policy could prove complex and impractical to address specific business concerns of subsidiaries. Therefore, it is also recommended that subsidiaries establish their own set of operational policies and procedures. A good example is state-owned companies that compete in the markets and have a private structure – a completely different situation from the rules and requirements applicable for its owner (the state).

According to the different business segments that a conglomerate may have and its related risk exposure, it is recommended that the Board of Directors of a parent company considers whether it should address risk management on a group-wide basis or have it overseen by each group company separately. Based on best practice, for a conglomerate-wide risk oversight a Board of Directors of a holding company should at least (i) conduct ongoing mapping and monitoring of risks across all group companies; (ii) establish risk appetite for the entire corporate group; and (iii) ensure an effective risk management system has been implemented across the conglomerate. Should a Board deem it convenient, it could delegate these functions in a Board-level risk management committee.

V. PARTIALLY-OWNED SUBSIDIARIES

a) Incorporation or Acquisition

As in the case of incorporating or acquiring a wholly-owned subsidiary, participating in a partially-owned subsidiary requires a diligent analysis, in particular of the investment convenience. As in the case of wholly-owned subsidiaries, it is recommended that an approval process (based on investment thresholds) be followed at the parent company level in order to decide whether to participate in a partially-owned subsidiary. In addition, for co-investments, a company should understand the culture of its fellow shareholders (preferably when these are to hold significant ownership interests in the subsidiary). A due diligence review process (particularly with respect to compliance matters of the potential business partner) is required when acquiring a stake in an existing company in order to mitigate reputational risks to the group.

b) Shareholders Agreement

Alignment of interests with respect to partially-owned subsidiaries could be complex as a result of differences among fellow co-investors. Under this scenario, a negotiation process among shareholders is suggested. To provide for a clear understanding among different shareholders in partially-owned subsidiaries, the entry into a shareholders agreement is a customary practice. Under a co-control scenario a shareholders agreement ensures the governance of the subsidiary.
Shareholders agreements help prevent or solve conflicts between shareholders, protect certain rights and give transparency to the roles of a partially-owned subsidiary’s Board of Directors and managers. Moreover, a shareholders agreement could include detailed provisions in which applicable corporate law may be insufficient. It is recommended that shareholder agreements at least include provisions for (i) shareholders’ consent rights or qualified voting requirements for shareholder meetings; (ii) Board composition, authority, procedures and voting requirements on specific subjects (election of senior management, veto or golden shares); (iii) procedures to solve voting deadlocks (tie-breaking vote or requiring a binding external expert opinion); (iv) exit rules (tag along, drag along, put options and call options); (v) investment rules and limits for indebtedness; (vi) reporting procedures and information disclosure; (vii) procedures to follow in case of conflict of interests; (viii) approval procedures to enter into related-party transactions; (ix) the adoption of minimum compliance standards by the subsidiary; and (x) applicable compensation for the rendering of shared services (in the event a contracting shareholder provides these types of services).

c) Shareholder Activism

Depending on the scope of influence that a holding company intends to exercise over its partially-owned subsidiary, a parent company should evaluate whether it should assume an active or passive shareholder role. As a way to assure its investment, it is generally recommended that a holding company acts as an active shareholder. However, if a parent company only has a limited economic or financial interest, it could adopt a more passive shareholder role. Nevertheless, a holding company should be mindful of respecting minority shareholder rights and interests, avoiding the creation of conflict situations.

c.1) Share Voting

An informed exercise by a parent company of its right to vote could add value to its subsidiary. A share voting policy is recommended to provide guidance and consistency with respect on how a shareholding company (or a proxy with discretionary authority) should exercise its voting rights on partially-owned subsidiaries. However, co-investors should be mindful that an appropriate share voting policy may provide general guidelines and that agenda matters may require the consideration of specific factors. Usually, these specific factors could be related with applicable domestic laws, governance arrangements and business-specific considerations.

c.2) Appointment of Directors

As in the case of wholly-owned subsidiaries, it is recommended that nominee directors appointed at the Board of subsidiaries provide industry knowledge and experience. In the case of partially-owned subsidiaries, an external voice at the Board level is generally recommended so as to balance perspectives from directors related with their nominating shareholders. To ensure an external perspective from co-controlling shareholders and management at a subsidiary’s Board level, the appointment of a non-executive or independent director is recommended.

It is important to clarify that a general perception exists that nominee directors act as “representatives” of their nominating shareholder. In principle, nominee directors generally owe their duties to the company in whose Board they serve and are required to act in the best interests of all of its shareholders (i.e. not solely for the benefit of their nominating constituency). In this regard, shareholders should always be mindful of requirements for directors deriving from applicable fiduciary duties.
c.3) Reporting

For an efficient monitoring by co-investors of a partially-owned subsidiary, shareholders should agree among themselves minimum information requirements and the frequency of reporting from a partially-owned subsidiary. It is paramount that all shareholders be provided with the same disclosure, reporting and access to information from a subsidiary so as to ensure an equal treatment among shareholders and avoid selective disclosure. Key points for reporting should be defined by all shareholders, identifying material information to be obtained from the subsidiary as an excess of immaterial information through reporting could prove exhausting.

A partially-owned subsidiary shall not be required by any of its shareholders to disclose confidential information such as price-sensitive information, industrial secrets or know-how, but all other information should be readily available or reported. Disclosure and/or reporting of confidential information shall exclusively be provided to shareholders or the public in accordance with applicable laws and regulations.

Commonly, reporting of monthly financial performance is suggested. The Board of Directors of each co-investing shareholder should be informed on the financial performance on a monthly basis and quarterly performance should be presented at Board meetings, emphasizing budget gaps and the actions to perform. Quarterly budget review meetings could be held to obtain information on financial performance and situation, risk management status, update on strategic initiatives, human talent development, among others.

Maintaining subsidiary reporting as a fixed agenda item at the shareholders’ Board levels could allow subsidiaries to constantly present results of their activity to its shareholders. Likewise, permanent monitoring and evaluation could be achieved via reporting from the subsidiaries Board (usually through the preparation of reports or the delivery of meeting minutes to all shareholders).

VI. **Final Comments**

The adoption of company group practices is an evolving dynamic process that has to be in accordance with the context of the respective group. To the extent that each company group is distinct, for purposes of ensuring formalization of these practices, it is nevertheless recommended that a parent company’s relationship and interaction with its subsidiaries and affiliates should be documented, particularly with respect to those companies that are listed. Adequate communication is paramount to ensure transparency and, therefore, for listed companies public disclosure of group policies is suggested. Therefore, a Board should consider establishing the group’s policies, basic guidelines for the management of affiliated and subsidiary companies as well as the general supervision of the development of these guidelines and decisions on strategic issues at the company group level.