**Organisation for Economic Co-operation and Development**
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# The Legal and Regulatory Framework – A Comparative Overview

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## Purpose of this Session

Session 3 looked at patterns of corporate ownership and control in the major markets of Latin America. This panel will examine what the discussants see as some of key legal/regulatory issues that are on the agenda in most or all of the major markets in this Region.

Let me begin by a saying a few words about how we came to select the five issues on the agenda for this session. Over the course of the last year or so, most of the participants in this panel have been involved in a project sponsored by the World Bank and IFC to look at the law and practice of corporate governance in their respective countries. Each of the panelists is a recognized expert in the field, with extensive practical experience as well as legal expertise. Each has produced a paper outlining the legal framework and, more importantly, actual practice of corporate governance in his or her country. Versions of these papers are included in the background materials for this roundtable.

In preparation for today's event, the panelists and I have looked again at each of the country studies, along with the outputs of the various national corporate governance events that have been held in this Region over the last few months. We have chatted about the various scandals that have occurred, and discussed the set of policy responses, including code drafting and legislation, that have been proposed. The result is this list of five issues which we feel are common to the four major markets in the region and probably also many of the rest of the countries in the Region. Other topics are also no doubt of great importance. But we feel that the five we have selected are, if not the most timely, then at least among the most timely issues that are currently under discussion.

**Reasons for Commonality**

I believe that it should not come as a surprise to any of us that this set of distinguished practitioners was able to arrive at some sort of consensus on the most salient current topics. The major markets in the Region, as well as most of the remaining countries, share a common historical experience, including a common legal heritage. Undoubtedly, this is a time of important transition in terms of market structure and ownership and control of private industry. I think it is also an important period in the evolution of the civil law in the Region. Every economy in the region has special characteristics and is being affected differently by the critical forces of technological change, privatization and economic globalization. But the Latin American corporate sectors still share enough key characteristics that we can perceive common patterns that make cross-country comparison a potentially valuable exercise for market participants and policymakers.

Key characteristics of the corporate sector shared by most or all countries of this region, and which are today shaping the response of the corporate sector to rapid technological change and economic globalization include:

1. Privatization. The late 1980s and the 1990s clearly marked a shift in the division of responsibility between the public and private sectors. There is now greater consensus that the private sector is simply better placed to deliver most of the goods and services demanded by citizens. Public policy and especially the legal framework for corporate activity is still adjusting to this dramatic realignment of responsibilities.

2. Concentration of control of industry and finance and need for additional capital. As most of us are painfully aware, Latin America has among the most unequal patterns of income distribution of any region of the world. One reflection of this concentration is the continued dominance of industry and finance by family-owned and family-controlled companies. However, even the largest family-run companies can rarely rely on retained earnings to meet the huge investment requirements of modern industry. They need to tap local and international sources of capital, and adapt their governance practices in accordance with the demands of these outside sources of finance. The day when board meetings were held around the Sunday dinner table is drawing to a close. (Though let's hope this doesn't mean that the quality of meals served at board meetings needs to decline!)

3. Internationalization, Regionalization and the growing importance of Multinational enterprises. Since the Spanish and Portuguese conquests, Latin America has been an integral part of the international division of labor referred to as the "Atlantic Economy." Even during the period of import substitution in the last century, economic links with Europe, North America and Japan remained important and Multinational companies continued to maintain an important presence. Today we are witnessing a new round of economic integration across borders, both within the Region and without. Mercosur and NAFTA are important realities and it is hard to think any longer of their member countries as discrete economic units. The effects on industrial organization are still "shaking out." One dramatic aspect of this "shake out" is the series of take-overs of major energy, telecoms, utility and financial institutions by international companies.

4. Limited Domestic Capital Markets and Growing Importance of Foreign (NY) Listings. One important aspect of the buying spree by foreign multinational that I just mentioned, is that it seems to be resulting in further shrinkage in the number of companies listed in domestic

markets. This comes at a time when domestic trading volumes were already under pressure as transactions in shares of the larger regional companies continued to shift to the deeper depositary receipt markets in New York and London. So, to a degree that has come as a surprise to many, the relevant capital market for major Latin industries has already probably irreversibly moved abroad. The transparency standards and substantive corporate governance practices expected by international markets are now also those germane to Latin companies dependent on such markets to raise new capital or maintain liquidity in their securities.

5. Privatization of Social Security. In comparison with Europe, the US and Japan, Latin America markets lack a base of large domestic institutional investors to provide steady demand for securities and leadership in defending the rights of minority investors. The mutual fund and insurance industries are growing, but they remain small. The one set of domestic institutional investors that does carry some weight in the Region is privately-managed pension funds. Chile's social security privatization in the early 1980s and similar systems established elsewhere in the region (including Argentina, Peru, and more recently Mexico) are, of course, the best known examples. But non-mandatory schemes, like those found here in Brazil are also emerging as important players. Today, the assets of the Chilean system are close to 100% of GDP. Argentina, Peru and Mexico's systems are far behind this figure (particularly when you consider just equity investments), but there can be little doubt that industries that absorb and invest 5-12% of salaries will be key players in local capital markets. The degree to which pension fund managers view promoting transparency and corporate governance as part of their mandate to maximize return for their clients will be an important determinant of the pace of improvements in both respects in the coming years.

I hope my foregoing remarks don't make it sound like I believe critical differences do not exist among Latin American countries in respect of corporate governance. They clearly do. While the Region (thankfully) shares a common legal heritage, history has treated each country in a unique fashion, and this is reflected in sometimes dramatic differences in the rules applicable to corporate activity. An attorney with experience in Mexico (like me) cannot arrive in Brazil and expect the legal framework for companies to be entirely recognizable.

Differences in economic realities are perhaps even more important than differences in the legal framework. Income and savings levels vary dramatically across the continent. The patterns and pace of privativization have been distinct. Different countries have so far experienced differing degrees of regional and international integration. And, of course, the size of the domestic economies and the mix of goods and services produced will always have important effects on how the corporate sector is structured, and on how relations among the various interests with a stake in the corporation are handled.

So I don't want my remarks today to be understood as implying that in developing policy responses to the critical challenges of corporate governance "one size fits all" in this Region. It will not be that easy, I am afraid! But by comparing economic patterns across the region, as the discussants in Session 3 did, and by looking at the policy responses that have been proposed and implemented in different countries in recent years, as this sessions will do, we should be able to reach some judgments about what has worked, what has not worked, and what sorts of policy interventions can have the most "bang for the buck."

## The Topics

Since each discussant will be in charge of starting off discussion of one of the topics on the agenda, I will provide only a very brief introduction at this point to each of the five topics.

### Status and Treatment of Non-Voting Shares

Issuing non-voting shares, particularly non-voting common shares, can be an attractive option for controlling shareholders. Non-voting shares permit the capital base to grow without diluting the legal powers of controlling shareholders. But non-voting shares also dilute the community of interest between controllers and the remaining equity stakeholders. If we think of corporate governance as the challenge of aligning the interests of controlling and outside shareholders, then the treatment of non-voting shares presents a special cause for concern to market participants and policymakers.

I believe the issue of non-voting shares is clearly most salient here in Brazil, although it is clearly an important topic of discussion in Mexico as well. As Henrique Lang will discuss, non-voting shares have a special history in Brazil. Many were issued during a period when distortions in the capital markets prevented normal discounting of their prices. Under current Brazilian law, a listed company can have as much as two thirds of its equity represented by non-voting, so-called "preferred shares". In the extreme case, this means that it is possible to control a Brazilian company with only 16.5% of the equity. Particularly when you consider that preferred shares are entitled to a 10% premium on dividends, it is easy to see how far the interests of the controllers and the rest of the shareholders may diverge under such circumstances. What approach should markets and policy makers take to the issuance of new non-voting shares? And what should be the response when, as in Brazil, non-voting shares proliferated due to now-removed policy distortions? These are important questions for today's panelists.

### Changes of Control (Tender Offers)

Until recently, changes of control among public listed companies in the region were relatively rare. But no longer. As major industrials, utilities and financial sector companies in the region have grown, they have become increasingly attractive to regional and multinational companies looking to expand. The last few years have witnessed a shopping spree by European and American telecommunications companies, power companies and banks. In some cases, most dramatically the Endesa-Espana take-over of Chile's Enersis, the difference in treatment of controlling and outside investors has been so great as to engender shareholder rebellion, public outcry and eventually legislative responses.

I think it is clear that in today's environment, many controlling shareholders are preparing for the ultimate sale of their companies to larger national, regional and multinational conglomerates. In some countries, family control is passing to the third or fourth generation, and the controllers sense that the old ways of running and financing the company are not viable in the new environment of global competition. Assuring themselves that they are able to capture all or most of the control premium figures prominently in their current planning.

The question of the treatment of minority interest in changes of control is also of increasing importance as more and more Latin companies become wholly-owned subsidiaries of multinational companies. Increasingly, a stake in a major Latin company is a play on an eventual take-over by a multinational firm – and hence sharing of the control premium at that point is a critical issue. This

importance of this topic seems to have become apparent first in Chile and Argentina, but is now a critical part of the discussion here in Brazil, as it will be no doubt throughout the continent. Analia Cuervo of the CNV will introduce this topic from the Argentine perspective, with particular discussion of Repsol's take-over of the one of Region's more broadly-held companies, YPF. I am hoping that those with experience in the recent changes of control of more tightly-held companies in Chile and Brazil will join the discussion and give us the benefit of their insights.

**Role of Pension Funds**

As I mentioned earlier, institutional investors who can serve as champions of minority interests are scarce in Latin America. The one exception is private pension funds. While still in their infancy in some countries, they already play important roles in those with more established schemes. Obviously, the country where these are most salient in Chile, where funds sometimes together control up to 35% of the voting shares of public companies. But even in Chile, the record of pension fund vigilance of company management is mixed. Indeed, one of the goals of the recent legislative proposals in Chile is to impose greater responsibility on directors appointed by pension funds to oversee management.

Shareholder activism by pension funds and other institutional investors is a relatively new phenomenon even in the more advanced markets. The temptation in such markets is to vote with your feet rather than take a costly, and perhaps ultimately unsuccessful stand against management. When should funds sell and when is it appropriate for pension funds to take a stand against management? Given that local markets are generally relatively illiquid, is there an even stronger case for activism by Latin pension funds? What has been the experience with pension fund activism so far in Chile, and elsewhere in the Region? Ricardo Escobar, who advised the Chilean Ministry of Finance on its reforms, will introduce this topic and hopefully set us off in the right direction to look for answers to these important questions.

**Co-Investment of Companies in Ventures of Controlling Shareholders**

The problem of co-investment by publicly-held companies in private ventures of controlling shareholders is a special case of the related party transaction problem. Related party transactions are a particularly unavoidable issue for corporate governance in this Region, because of the high concentration of corporate control, and the prevalence of industrial and industrial/financial groups. As in the general case, the challenge here is to assure that the benefits of the any synergies of cross-ownership are shared among all shareholders, and not unfairly appropriated by the controlling parties.

The Financial Times has put the issue more pointedly in reference to the case of Ricardo Salinas Pliego and his use (some would say abuse) of Mexico's TV Azteca to finance his privately-held telephone ventures. Controllers have a duty to all shareholders, they must be prevented from "running a public companies like private investment." In countries where financial markets are thin, the temptation can be strong to get your financing wherever you can, even when it may lead to a lot of unhappy minority shareholders.

The history of the last ten years is, sadly, rife with examples of controlling shareholders using public companies to support their private ventures. The 1992 purchase of Bancomer, Mexico's second largest bank, by the VISA group was possible only with hundreds of millions of dollars of co-investment by other public companies controlled by VISA I have already mentioned the TV Azteca case. What should be the rules in such cases? What special procedures need to be in place? How can

market discipline be reinforced? How practical is some sort of corporate purpose rule, particularly in a civil law system? Ms. Zaldivar and the panel will look at some possible answers to these questions.

**Sindicos, Comisarios, Conselhos Fiscais**

The final issue to be examined by this panel is the role of special organs of corporate governance, variously known as sindicos, comisarios, or, as here in Brazil, conselhos fiscais. The corporate laws of some, though not all, countries in the Region, provide for an institution independent of the board of directors charged with oversight of the company's accounts and the conduct of management. The specific powers and responsibilities of such organs vary, and the methods of their appointment also differ. Sometimes such organs are uni-personal, sometimes pluri-personal. They can be mandatory or optional, and the rules for when minority shareholders can insist on their presence vary.

The one fairly uniform characteristic of the such organs of vigilance and oversight is that they have been historically ineffective. Some countries have eliminated them entirely from their corporate laws. However, here in Brazil there has been a resurgence of interest in conselhos fiscais, largely in response to the problem of non-voting shares. Joao Camargo, who has looked at this issue both as an investor at BNDES and as a private lawyer, will discuss whether there is a new role for such entities in the current Brazilian context. Do entities such as sindicos, comisarios and conselhos fiscais hold any promise for "keeping management honest" when controlling shareholders can appoint a solid majority of directors? Can they be natural allies of minority-appointed or independent directors? If so, are there changes that need to be made to the legal/regulatory frameworks to make them more effective instruments of good corporate governance?