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Institutional Investors and Corporate Governance in Latin America:

Challenges, Promising Practices and Recommendations

This overview report was developed by **Daniel Blume** and **Felipe Alonso** of the OECD Corporate Affairs Division, based mainly upon country surveys prepared by Roundtable country task forces and consultants for Argentina, Brazil, Chile, Colombia, Mexico, and Peru. The co-authors wish to thank the many contributors involved (see par. 4 for details) in preparing each of these reports, to be made available separately at the Roundtable and at http://www.oecd.org/daf/corporate-affairs/roundtables.

Roundtable participants will be invited to discuss the report's findings and recommendations as well as to submit written comments to Daniel.Blume@oecd.org as a first step toward developing a *Latin American White Paper on Institutional Investors and Corporate Governance* for consideration at the

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Introduction

1. The *White Paper on Corporate Governance in Latin America* (*White Paper*) identified the issue of "encouraging the emergence of active and informed owners" as an important recommendation to achieve better overall corporate governance in the region. Particularly within an environment of concentrated ownership, institutional investors (IIs) represent an important potential lever for influencing better governance because of the positive impact that governance improvements have on company (and share) value and on ensuring the protection of minority shareholder interests. As the *White Paper* puts it in its chapter on reform priorities, "Institutional investors that in many cases have taken too passive a role should be encouraged to exercise their ownership rights in a more active and informed manner."

2. Subsequent to the *White Paper's* issuance in 2003, the sessions of the Latin American Roundtable on Corporate Governance (Roundtable) in Rio de Janeiro in 2004 and in Buenos Aires in 2006 that addressed this topic found that, while some positive practices have emerged, more should be done to identify emerging good practice and encourage more active and informed ownership. As a result, the Roundtable decided to develop a more intensive and broad-reaching effort to take stock of current practices and challenges identified across most of the actively participating Latin American countries concerning the current state of institutional investor activism on corporate governance, with a view towards developing new "White Paper" recommendations on this subject.

3. The approach taken was to invite leading Roundtable participants from each interested country to convene country "task force" meetings or discussion groups involving institutional investors and other key players in the debate, such as stock exchanges and securities regulators.[1] A questionnaire (Annex 1) was provided to guide discussion, but task forces were given flexibility to focus on those issues of greatest relevance in their particular country context.

4. Reports prepared and provided for this Roundtable and the lead institutions and consultants involved in preparing them included: **Argentina -** the Center for Financial Stability; **Brazil -** the Capital Markets Investors Association (AMEC), National Association of Investment Banks (ANBID) and Brazilian Institute of Corporate Governance (IBGC); **Chile –** the Superintendency of Securities and Insurance, the Superintendency of Pension Funds and Alvaro Clarke as moderator; **Colombia –** The Financial Superintendency (Superfinanciera) **Mexico -** the Center for Excellence in Corporate Governance; and **Peru -** the Association of Private Pension Funds with Carlos Eyzaguirre as moderator The authors also wish to thanks Mike Lubrano and Davit Karapetyan of the IFC for their review and valuable input, as well as Waldo Tapia from the OECD's Financial Affairs Division.

5. In view of differing institutional investor contexts, the country task forces addressed differing priorities in their reports, which limited the comparability of data and ability to provide consistent comparisons across all countries. The reports from Argentina, Chile, and Peru all devoted greater detail to the role of pension funds, which in those countries are far more prevalent than other institutional investors, whereas Brazil's report addressed mainly the practices of its dominant mutual funds sector, and Colombia's and Mexico's report focused on both categories, which are of roughly equal significance.

[1] Reports from Brazil, Chile, and Peru were based on task force discussions supplemented by additional research, while the reports from Argentina, Colombia and Mexico were based on research without task forces *per se.*

Box 1. The purpose and structure of this report

This report provides a brief overview of 1) consensus recommendations on the role of institutional investors as active and informed owners already agreed by the Roundtable and in the *OECD Principles of Corporate Governance;* 2) the Latin American context, including market characteristics and the size and make-up of the institutional investor sector in each of the participating countries; 3) country legal and regulatory frameworks impacting on how Latin American IIs behave; 4) challenges and promising practices identified in the country reports; 5) issues for further recommendations; and 6) conclusions. This overview report, along with individual country reports, was prepared to serve as background for the Roundtable's discussion of these issues in Medellín, Colombia on 10-11 October, and as the starting point for a proposed *Latin American White Paper on Institutional Investors and Corporate Governance* to be developed in 2008.

1) THE CURRENT CONSENSUS: LATIN AMERICAN ROUNDTABLE AND OECD RECOMMENDATIONS ON THE ROLE OF INSTITUTIONAL INVESTORS

6. Although individual country contexts differ, it should be noted that the Roundtable has already achieved consensus around a number of key recommendations set out in its *White Paper*. Relevant recommendations are excerpted for reference in Box 2:

7. Since the Roundtable's adoption of the *White Paper* in 2003, the OECD has also issued a revised version of the *OECD Principles of Corporate Governance (2004),* which provides reinforcing recommendations supporting corporate governance frameworks that protect and facilitate the exercise of shareholder rights (Chapter II). While *the OECD Principles* "do not seek to prescribe the optimal degree of investor activism," they nevertheless suggest that many investors are likely to conclude in considering the costs and benefits of exercising their ownership rights that positive financial returns and growth can be obtained by undertaking a reasonable amount of analysis and by using their rights (Principle II.F).

Box 2. White Paper recommendations to encourage the emergence of active and informed owners

32. Legal provisions intended to provide minority shareholders with the opportunity to elect directors should be workable in practice.

33. Where legislation provides for proportional director nomination, cumulative voting or other mechanisms to promote minority shareholder participation, voting systems should function in practice in a way that provides non-controlling shareholders with a realistic opportunity to collectively achieve a voice by influencing the composition of the board of directors. When the legal framework does not include provisions that provide minority shareholders with the opportunity to influence the board composition, other means, such as listing requirements and voluntary commitments among shareholders to achieve a proper diversity among board members could be considered.

34. Governments, regulators and beneficiaries should insist that pension funds and other institutional owners have the incentives and governance structures that encourage them to exercise their ownership functions in an informed and effective way.

35. The right regulatory environment and good governance practices encourage institutional investors to: (1) make investment decisions that are intended to maximise returns for shareholders; and (2) effectively exercise their fiduciary duties as shareholders in the companies in which they have invested the funds entrusted to them. The pension system regulatory regime and its supervisory system should provide pension managers with the appropriate incentives to maximise returns on fund investments. The priorities in this area may vary from country to country, but in each case policy makers, regulators and supervisory authorities should be vigilant to protect against the potential for conflicts of interest on the part of fund managers, or fee structures that set inappropriate benchmarks, or other aspects of the regulatory framework that cause managers to act in ways that do not maximise returns for investors.

Box 2. White Paper recommendations to encourage the emergence of active and informed owners *(cont.)*

36. Likewise, special attention needs to be paid to the management of investments of state-owned development banks (and their multilateral counterparts, such as International Finance Corporation, Inter-American Investment Corporation, Andean Development Corporation, etc.) and the effects of government-controlled finance allocation on governance. While direct state ownership of industry has declined, in several countries state-channelled resources and multilateral development bank financing remain important sources of long-term financing. Governments and multilateral development banks need to ensure that such sources of financing and guarantees insist on the highest standards of governance and transparency demanded in the capital market. Co-investment strategies, where public and private sector entities invest on the same terms, can provide a mechanism for ensuring a level playing field while encouraging the broader adoption of common governance standards by institutional investors of all types.

37. Objective evaluations of governance and transparency practices should be factored into the investment decisions of state-owned and multilateral development banks and affect pricing. State-owned and multilateral development banks should therefore consider policies that recognise the risk mitigation accorded by good governance practices by progressively improving the financing terms for clients as they meet objective benchmarks outlined in national codes or articulated in bank-specific or collectively-developed programmes.

38. With a view to encouraging active and informed shareholder participation by pension funds and other institutional investors, outdated and unnecessary restrictions on the ability of such investors to exercise their shareholder rights should be removed.

39. Pension funds, both private voluntary and privately managed mandatory schemes, are potentially the most powerful group of domestic investors with an interest in good corporate governance. Given the mandatory nature of some schemes, and the critical social function they perform, regulators need to be particularly diligent that companies that issue securities eligible for investment by pension funds are sufficiently transparent and well-governed.

40. At the same time, legislators, regulators and beneficiaries should recognise that existing shortcomings in pension fund governance and regulations that discourage competition in portfolio management (such as requirements that explicitly or implicitly require fund portfolios to mimic an index) limit the incentives for fund managers to put a high enough premium on transparency and governance. An appropriate policy response in such circumstances (and one with which there are a number of recent experiences in the region) may be to modify the legal investment regime – i.e., by permitting proportionally greater investment in companies that meet certain objective corporate governance and disclosure requirements.

41. Institutional investors who act as fiduciaries should articulate their approach to the corporate governance of investees and their policies on voting shares held in such companies and disclose these on a regular basis to the public and their beneficiaries.

42. Institutional investors should provide as much detail as possible in the disclosure to their beneficiaries and the public regarding their standards for corporate governance of portfolio companies and their general policy concerning the execution of key rights, such as pre-emptive and tag-along rights. The disclosure on voting practices should set out the institutional investor's assessment of the costs and benefits of actively participating in corporate governance as a shareholder, and, for example, identify on what specific types of General Meeting agenda items it would ordinarily exercise its vote. Institutional investors should also disclose the process and procedures that they have in place to make decisions on how to exercise their voting rights, including their reliance on proxy advisory services and co-operation with other institutional investors to nominate board members. The purpose of this information should be to provide beneficiaries with an adequate basis upon which to make an informed judgment about whether the institutional investor is taking into account the risks of poor corporate governance in portfolio companies, and whether the institutional investor takes the opportunity to reduce risk and maximise return for beneficiaries by actively participating in governance as a shareholder.

8. As in the *White Paper*, the *OECD Principles* recommend that "Institutional investors acting in a fiduciary capacity should disclose their overall corporate governance and voting policies with respect to their investments" (Principle II.F.1).

9. However, the *OECD Principles* also go a step further with two recommendations that the *White Paper* did not address:

1) **"Institutional investors acting in a fiduciary capacity should disclose how they manage material conflicts of interest that may affect the exercise of key ownership rights regarding their investments"** (**Principle** II.F.2). This recommendation seems particularly relevant in the Latin American context, as the *OECD Principles'* annotations note that conflicts of interest "are particularly acute when the fiduciary institution is a subsidiary or an affiliate of another financial institution, and especially an integrated financial group," which is a common occurrence in the region.

2) "**Shareholders, including institutional shareholders, should be allowed to consult with each other on issues concerning their basic shareholder rights as defined in the Principles, subject to exceptions to prevent abuse" (Principle II.G).** The *OECD Principles'* annotations state that shareholders by themselves may have too small a stake in the company to warrant the cost of taking action or monitoring performance. Even if they do invest resources in such activities, others would also gain without having contributed (i.e., the "free riders" gain the benefits). Institutional investors may have policies of investment diversification in order to spread risk, increasing the likelihood that at an individual level, costs of playing an active role will be too high. The *OECD Principles* suggest that "To overcome this asymmetry, institutional investors should be allowed, and even encouraged, to co-operate and co-ordinate their actions in nominating and electing board members, placing proposals on the agenda and holding discussions directly with a company in order to improve its corporate governance. More generally, shareholders should be allowed to communicate with each other without having to comply with the formalities of proxy solicitation." The *OECD Principles* also warn, however, that co-operation among investors could be used to manipulate markets and to obtain control over a company while circumventing takeover regulations or competition law. In this respect it notes that some countries limit or prohibit institutional investor co-operation, or closely monitor shareholder agreements. Yet, it is suggested that "if co-operation does not involve issues of corporate control or conflict with concerns about market efficiency and fairness, the benefits of more effective ownership may still be obtained. Necessary disclosure of co-operation among investors, institutional or otherwise, may have to be accompanied by provisions which prevent trading for a period so as to avoid the possibility of market manipulation."

10. With this overall international consensus on desirable steps forward for institutional investors, the remainder of this report focuses more closely on Latin American experience.

2) THE LATIN AMERICAN CONTEXT: MARKET AND INSTITUTIONAL INVESTOR CHARACTERISTICS

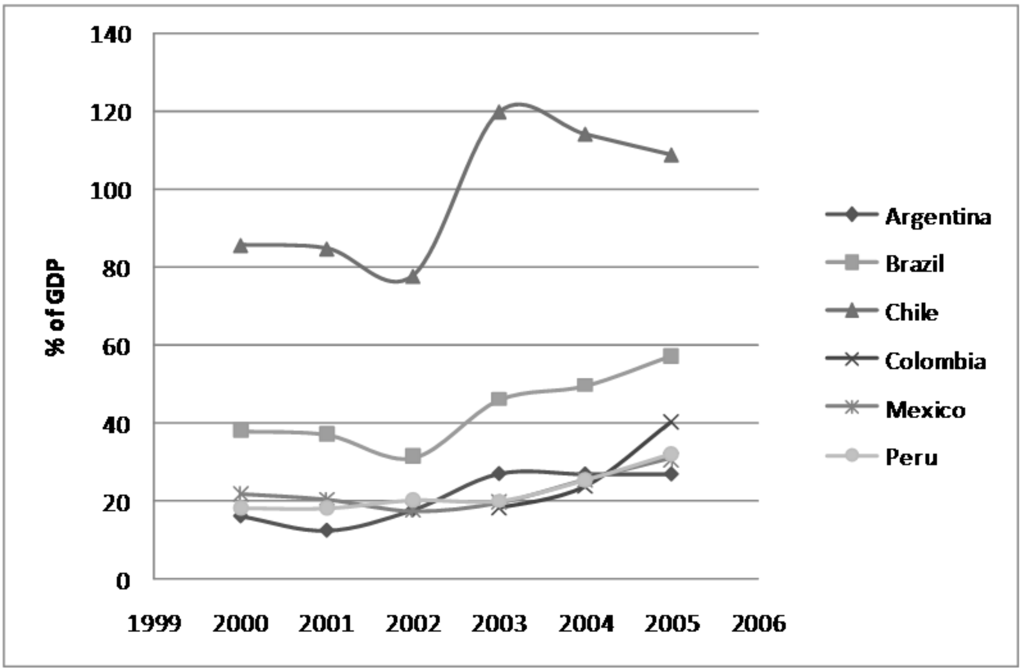
Growth and limitations of the Latin American market

11. Almost five years of uninterrupted economic growth in Latin America[2] -- although modest when compared to booming economies in Asia -- has brought relative economic stability to a region previously characterized by frequent financial crises. This stability, accompanied by global economic growth and liquidity in the financial markets, has also attracted increasing amounts of foreign investment. Most Latin American financial markets have grown significantly during this period, while the demand for local equity now comes from both local and international investors.

12. The stock markets of the largest Latin American economies have shared in this growth, with most stock markets expanding faster than their overall economies Gross Domestic Product (GDP) (Figure1 below) during this decade. Brazil is the most dynamic Latin American equities market, as the Brazilian report indicates: as of July 2, 2007, Bovespa (the Brazilian stock exchange) reported the listing of 30 new companies, against 26 companies for all of 2006, 9 in 2005 and 7 in 2004. By value, the total volume of stock issues jumped from US$4.7 billion in 2005 to US$12.6 billion in 2006, by the end of June 2007 reaching the sum of US$12.9 billion.

13. While Brazil and Mexico, the first and second largest economies in the region, have the correspondingly two largest stock markets, Chile had the highest market capitalization ratio as a percentage of GDP -- 109% in 2005. The Chilean market size to GDP is well above Latin American standards, and comparable to those of the most developed markets in the world.

Figure.1 Market capitalization as % of GDP for selected Latin American countries (2000-2005)



Source: World Federation of Exchanges

2. According to the *"Estudio económico de América latina y el Caribe 2006-2007"* of the CEPAL (United Nation's Economic Commission for Latin America and the Caribbean), the region's economy has been growing by at least 3% every year since 2003, including 5.6% in 2006. This year it is projected to grow at 5%, and 4.6% in 2008.

14. While the overall growth in these countries' stock markets has been positive, there remains an important concern that, apart from Brazil's more recent success, the markets have not developed sufficient levels of liquidity to sustain a healthy market for investors, including institutional investors. Table 1 provides a wider set of indicators against which to assess the current state of activity in the market, showing limited IPO activity in most markets.

15. Market liquidity in Latin America is relatively low in comparison to more developed OECD as well as some emerging markets. Value traded as a percentage of market capitalization ranged from 6.4% in Argentina to 38.8% in Brazil among the studied Latin American countries, whereas countries such as Thailand (72%), Turkey (137%), Spain (145%), the UK (113%) and the US (155%) all experienced far higher stock trading levels. This low liquidity leaves IIs with relatively tight investment options in terms of number of companies in the market and amount and class of stock to invest in. In addition, the scope of companies in which the regulator allows Pension Fund Administrators (PFAs) to invest is even narrower. This limits competition among institutional investors for companies to invest in, reduces the opportunities for exit from the investment, and increases the vulnerability to financial downturns. Hence, long-term IIs such as PFAs have heavily oriented their portfolios towards government and corporate debt, since bond markets have also been "complacent" in terms of performance.

Table.1 Domestic market cap, value of local shares traded, number of local listed companies and IPOs

	Market Cap USD bn (2006)	Value Traded USD bn (2006)	Value Traded as % of Market Cap (2006)	Listed comp. (2006)	Newly listed comp. (2006)
Argentina	$ 51.2	$ 3.3	6.4%	101	4
Brazil	$ 710.2	$ 275.6	38.8%	347	30
Chile	$ 174.4	$ 28.9	16.5%	244	7
Colombia	$ 56.2	$ 14.8	26.3%	94	4
Mexico	$ 348.3	$ 81.1	23.2%	132	4
Peru	$ 40	$ 4.8	12%	189	3
Australia	$ 1,095.8	$ 824.4	75.2%	1751	n/a
India	$ 818.8	$ 214.4	26.1%	5952	248
Spain	$ 1,322.9	$ 1,915.9	144.8%	n/a	n/a
Thailand	$ 140.1	$ 100.9	72%	518	18
Turkey	$ 162.3	$ 222.7	137.2%	316	15
UK	$ 3,794	$ 4,283.5	112.9%	2,913	544
US[a]	$ 19,286.1	$ 29,901.3	155%	4,641	235

a) Aggregated data from Nasdaq and NYSE.

Source: World Federation of Exchanges.

Characteristics of institutional investors in Latin American markets

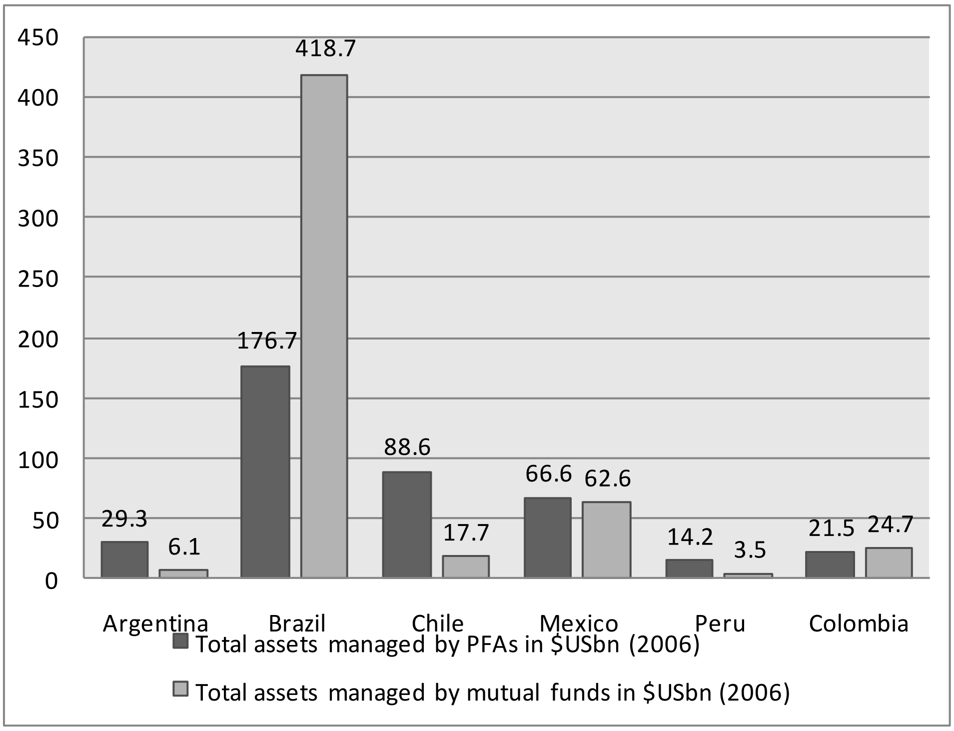
16. Despite these limits on investment opportunities in Latin America, institutional investors are no doubt playing a role in stock market growth, as the largest and most influential minority shareholders in many listed companies. The *White Paper* noted the particular importance of pension funds in Latin America in its chapter on key regional characteristics:

> *"The one set of domestic institutional investors that typically carries the most weight in the region is privately managed pension funds. The degree to which pension fund managers view promoting transparency and corporate governance as part of their mandate to maximise return for their clients will be an important determinant of the pace of improvements in the coming years. But the interest of fund managers in maximising returns for investors cannot be taken as a given. Whether an individual*

fund manager takes an active interest in the good performance of individual investee companies depends on the set of incentives the fund manager faces, including the regulatory framework and the character and efficiency of the funds' own governance. Pension fund governance and accountability therefore remains an important public policy priority for the region."

17. Indeed, pension system reforms starting with Chile in 1981 and continuing in the 1990s with many other Latin American countries, moving from a pay-as-you-go to an individual account privately-managed system, have provided an important contribution to growing pools of domestic investment. Pension fund assets under private management in the region have grown by an average of 16 percent annually since 1999, reaching US$390 billion by the end of 2006.[3] These funds are the most dominant institutional investors in the market in most Latin American countries (Figure 2 below), with the exception of Colombia and especially Brazil, where mutual funds make up a bigger share.

Figure 2: Privately managed pension funds and mutual funds assets



PFAs data source: International Association of Pension Fund Supervision Organs, AIOS- and Secretaria de Previdência Complementar -SPC- for Brazil. Mutual funds data source: 2007 Investment Company Factbook, ICI (www.ici.org) provides net asset figures, except for Colombia and Peru whose figures are based on country reports providing slightly higher gross asset figures.

18. Differing legal and regulatory frameworks also have an important influence on the activities of different institutional investors. To ensure risk diversification and guard against the effects of potential economic downturns, Latin American pension funds face regulatory limits on how much of their funds can be invested in stocks (in contrast to the US and UK, where such limits are not established – see Table 2 below). Some countries report variable limits on the amounts that can be invested in stocks, with maximum percentages differing depending on the risk strategies of different funds (e.g., "conservative" vs. "aggressive"). At the same time, there tend to be even stricter limits on investment in foreign securities, due to a public policy objective of having these domestic funds directly support the domestic economy.

3. See the Latin American Economic Outlook, Chapter 2, "Pension Reform, Capital Markets and Corporate Governance," published by the OECD Development Centre (forthcoming).

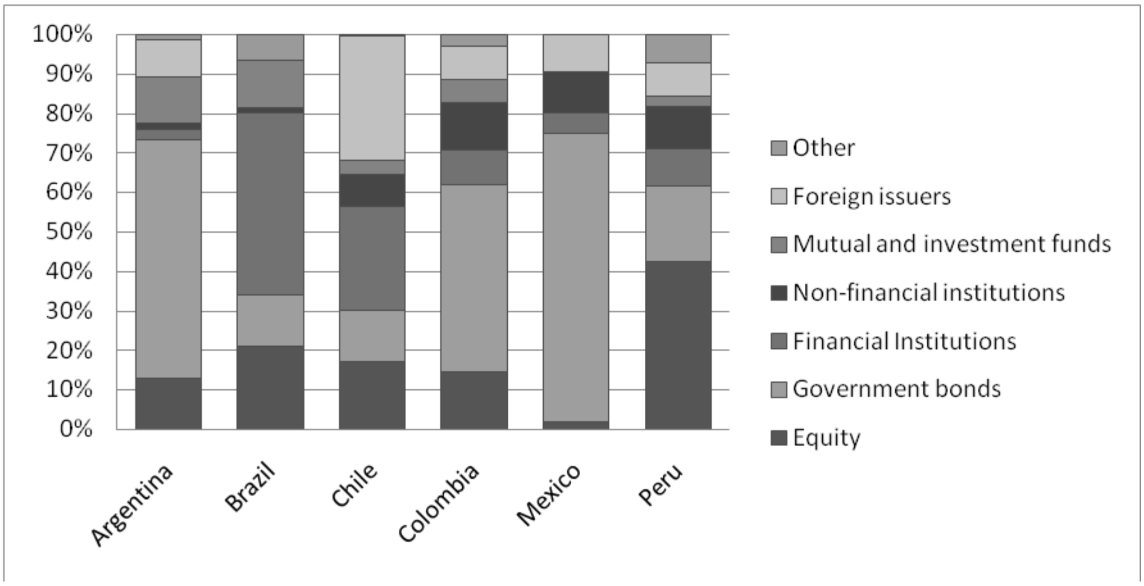
Table 2. PFAs portfolio ceilings by main asset classes in Latin American and OECD countries

	Government securities	Financial institutions	Stocks	Corporate bonds	Investment funds	Foreign securities
Argentina	80 %	40 %	50 %	40 %	20 %	10 %
Brazil	No limit	20 %-80 %	35% - 50%	20 %-80 %	20 %-80 %	10 %
Chile	40 %-80 %	40 %-80 %	0 %-80 %	30 %-60 %	0 %-40 %	35 %
Colombia	50 %	30 %	30 %	30 %	5 %	20 %
Mexico	None	10 %	15 %	5 %-No limit	-	20 %
Peru	30 %	40 %	10% - 80%	40 %	15 %	10.5 %
UK	No limit	No limit	No limit	No limit	No limit	No limit
United States	No limit	No limit	No limit	No limit	No limit	No limit

Source: OECD, 2006

19. Despite these limits, a significant share of pension fund portfolios is being invested in the equity market, with Peru leading all Latin American countries at close to 40%, and Mexico on the opposite end of the scale with just 2% of their pension funds invested in local equities. While government bonds are in several cases the largest form of pension fund investment, equities are often the second biggest category.

Figure 3: Portfolio Composition of PFAs (2006)[a]



Source: AIOS and *Secretaria de Previdência Complementar -SPC-* for Brazil.
a) equity for Brazil includes local and foreign.

20. Data on mutual fund investment portfolios and percentages invested in equities was available only in a few countries. Mexico reported 19% of its US$70 billion invested in equities, while 15% of Brazil's near US$500 billion in mutual funds was invested in equity. Interestingly, in Argentina, where mutual funds do not face restrictions on investment in foreign equities, the share of mutual funds' equity investment was 52%. However, 90% of these investments are in foreign equity, particularly in securities from Brazil and Mexico (while Brazilian and Mexican mutual funds invest far lower percentages of their portfolios in their own countries' equity).

21. The growth of assets managed by IIs, especially those of PFAs, as well as the important stakes in equity that they're acquiring, has provided support for the view among many regulators and the market that they should play an active role in promoting corporate governance practices among the companies in which they invest. As a range of studies have shown that higher corporate governance standards lead to higher share values and cheaper access to capital, and as this has been confirmed in the Latin American context in Brazil through the experience of the Novo Mercado and the higher-than-average performance, there is a public policy interest in using government-regulated pension funds as a lever for encouraging such good governance practices.

22. The interest of IIs to promote corporate governance practices in the companies in which they invest is further underscored in high ownership-concentration markets, to provide an informed counterbalance to controlling shareholders and to safeguard against the company's board and management working for interests other than those of the company and its shareholders as a whole. In the case of pension funds, it is further suggested that because PFAs manage compulsory saving, the social role and vigilance exercised by pension funds to protect the future benefits of retirees should be correspondingly stronger. With low liquidity limiting options for exit, pension funds, which have a long-term stake in the market, also have a particularly strong reason to consider corporate governance practices as a way to improve company value over the longer term, supporting longer-term strategies for their funds' growth.

23. However, active ownership also carries costs involved in the exercise of shareholders rights and company monitoring. These costs may include shareholders' meetings representation, proxy services, company and market monitoring, and the possibility of litigation, among others. The decision of IIs to become active owners and assume these costs depends on many variables, among which the amount of stock held and the investment period may be the most relevant. In this regard, IIs with large stock holdings -- and their respective voting rights -- associated with long investment periods have a cost-benefit reason to become active shareholders and procure share value sustainability. Long-term strategies of PFAs put them in this group.

3) LEGAL AND REGULATORY REQUIREMENTS IMPACTING ON INSTITUTIONAL INVESTORS' CORPORATE GOVERNANCE ACTIVISM

24. Latin American countries have taken differing legal and regulatory approaches to the question of how best to influence institutional investors to actively promote good corporate governance in the companies in which they invest. A quick overview of some of the highlights of these legal approaches gives an overall sense of the level of institutional investor activism in each country.

25. ***Variable limits on investments in equity***, previously highlighted in Table 4, can provide one means of promoting better corporate governance when the limits are linked in some way to corporate governance standards. This is the case in **Brazil,** where Brazilian regulators allow PFAs to invest up to 50% of their portfolio in equities listed on one of the three corporate governance listing segments of the stock market, Bovespa's Novo Mercado initiative, on which companies are required to commit to higher corporate governance standards than legally required.. These PFAs may only invest up to 35% of their portfolios in the regular market segment. With figures of individual Brazilian pension fund portfolio allocations not available, it was unclear whether these variable limits have any impact in practice, especially considering that the overall share of pension fund investment in equities was just 20% on average (including

foreign equities), well short of either the 35% or 50% limits. Nevertheless, it remains clear that the corporate governance listing segments provide an important signal of higher corporate governance commitments to which investors are responding. Indeed, companies in Novo Mercado's corporate governance listing segments have outperformed those listed in other market segments by 25% in terms of share value.[4]

26. Lacking a Novo Mercado-style corporate governance benchmark which enables companies to make binding commitments to higher than legally required standards, other countries have not followed suit with such incentives for PFAs to invest in better governed companies. Yet, several other countries have taken active measures to promote pension fund activism on corporate governance.

27. **Peru,** whose pension funds have invested the highest proportion of their portfolios in equities of any Latin American country, seeks to promote active pension funds by defining their ***fiduciary duties to require activism***. According to Peru's country report, the law requires that its PFAs (known as AFPs) "appoint representatives of the funds, which must exercise the rights (and comply with the duties) that are attached to the securities held in the portfolios of the funds… [R]epresentatives of the funds will defend the rights of the funds with independence of the interests of the AFPs, will comply with corporate governance practices and promote their adoption by the investee companies… [R]epresentatives of the funds must voice their points of view on the topics that are discussed, cast their votes and see that it is reflected in the minutes. They must report to the AFP on the result of their endeavors… In the election of members of the board, the representatives are forbidden to vote for candidates that are shareholders, directors, managers or workers of an AFP[5]… Resolution 680 of the SBS…[requires PFAs] to invest in those companies and funds that follow good corporate principles. They have to promote good corporate governance in those companies and good investment practices… No rules require disclosure of their policies and practices regarding corporate governance of the companies in which they invest."

28. **Chile** has also taken a step to mandate active ownership by ***requiring both its pension funds and its mutual funds to vote*** on all matters in the shareholders' meetings, with the exception of votes for directors who have a direct relationship to the pension fund or its controlling shareholders, in which case they must abstain. While this has ensured that Chilean institutional investors play an active role, some analysts have noted a potential weakness in the law in that IIs can have other conflicts of interest. For example, an II's controlling shareholder could be involved in a takeover bid or in acquiring a significant stake in a company in which the II holds shares, and could seek the pension fund's support in agreeing that shares be offered at a low price, even though the pension fund's affiliates have an interest in obtaining as high a price for shares as possible. In Chile, a pension fund could not abstain in such a case.

29. **Colombia** took a different approach with its Resolution 275 of 2001 ***mandating listed companies to adopt corporate governance codes in order for their securities to be eligible for purchase by PFAs***. However, with the Resolution offering little precision regarding a common standard for such codes, the Colombian report suggested that the quality of the company codes varied widely and some of them ended up merely replicating already legally-mandated provisions. More recently, with the issuance of a new, Colombian voluntary corporate governance code in 2007, listed companies will be required to submit an annual corporate governance report addressing the code's recommendations, following a comply or explain approach. Likewise, institutional investors will be required to take into account and provide a detailed report on the corporate governance structure of each company, and to disclose the importance of this review within the investment decision-making process. However, this requirement does not imply that a poor evaluation of the company's corporate governance system will limit the investment in all cases.

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4. Guerra, Sandra, *"Brazil, the Virtuous Circle";* Governance, September 2007 - Issue 167.
5. Article 94, Regulation of The Unified Text of the Private Pension Fund Law, enacted by Supreme Decree Nº 004-98-EF, modified by, Article 2, Supreme Decree N ° 182-2003-EF, 12-12-2003.

In Colombia, there is a limit on the investment placed in the same issuer or its subsidiaries equivalent to ten per cent (10%) of the total value of the fund. If the issuer is related to the pension fund manager, this limit decreases to five per cent (5%) 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.

30. **Argentina** ***compels a pension fund to attend general shareholder meetings*** of companies in which it holds 2% or more of the voting rights. When the pension fund's stake is below 2%, the decision to attend or not must be made explicit in the pension fund's board records and based on the best interests of the pension fund's affiliates. Nevertheless, Argentina's pension funds are free to abstain, even when attending the annual shareholder meetings. The Argentina country report suggests that pension funds in practice refrain from voting on most measures, "focusing on maximizing portfolio returns subject to (among other factors) avoidance of potential claims coming from their beneficiaries due to the funds' activism as shareholders." In sum, the report states, "available evidence suggests that [PFAs] are focused on full compliance with the existing regulatory framework rather than devoting efforts and resources to improve corporate governance of firms in which they invest."

31. Finally, **Mexico** has adopted recent changes in its Securities Market Law of 2006 to ***strengthen the rights of minority shareholders generally***, allowing shareholders with 10% of voting and limited voting shares the right to appoint a board member and his/her alternate, the right to appoint a comisario, the right to call a shareholders' meeting, and the right to delay a vote for three days when they believe that not enough information has been provided. The new Law has also expanded the right of shareholders to initiate civil lawsuits against members of the board, lowering the ownership threshold for voting to 5%, while with 20% they can challenge the resolutions of the shareholder meetings in court.

32. While these changes can have an important impact on private sector institutional investors, Mexico's pension funds face a crucial restriction undermining the incentive to play an active role on corporate governance -- ***they are not permitted to invest in individual listed companies in Mexico***, but only in instruments which replicate selected share indexes. Given the quite low percentage of pension fund portfolios allocated to equities (just 2%) and the absence of voting rights associated with individual companies due to their investment in combined funds, it is unrealistic to expect that under current circumstances pension funds can influence corporate governance of Mexican companies.

33. While mutual funds are not restricted from investing in Mexican equities, they do not face any requirements to monitor corporate governance practices or serve as active owners. The Mexican report suggests that "Mutual funds have not been active and effective monitors of corporate activities mainly due to the limited monitoring capabilities, given large portfolios, limited staff, and limited ability to engage in active management activities; and the need or desire to maintain liquid portfolios, which results in the acquisition of small blocks without significant voting power; but mostly by the prevailing institutional culture of 'passivity'… No one on their behalf is assigned to overview any type of governance or proxy analysis. They are only doing financial analysis (technical and fundamental)."

4) CHALLEGES AND PROMISING PRACTICES

34. Although legal and regulatory requirements cited above point to some of the most significant public policy measures taken to promote active and informed ownership in the region, further investigation is needed to fully understand practices in the market. An attempt is made in this section to address some of the more practical issues and incentives impacting on actual practice. The discussion is organised around the recommendations of the *White Paper* referenced in section 1 of this report.

Electing Board Members

35. The election of board members independent of the controlling shareholder is an important preoccupation of institutional investors in most of the country reports, with particularly active attention reported in **Peru** and **Chile**. Pension funds in these countries use their board member nominations to try to positively influence governance practices of investee companies.

36. In the case of **Peru**, as mentioned above, representatives of the funds are required to exercise their rights attached to the securities held in their portfolios. This has been translated into promoting good governance in their investee companies through the nomination of independent directors. These directors, in turn, have played a role in modernizing the boards through the introduction of board committees like the audit committee. A number of companies in which PFAs have invested had gone from having board meetings three times a year to having board meetings every month. PFAs have elaborated a handbook for directors to help guide them on governance issues. The quality of the information provided to the directors has also improved.

37. It´s useful to remember that Peruvian PFAs have the largest portfolio percentage invested in equities in the region (about 40%), giving them more power and visibility than the mutual funds or insurance companies. With higher stakes than other IIs, PFAs are able to vote together in electing directors, and can join forces when a particular problem arises. The Peru country report cites several examples of such cases.

38. For example, the Peru report points to cases in which the controlling group withheld information from the directors elected by the pension funds. "A parallel meeting would be held without the participation of said directors. Also, a company reduced the number of directors so as to block the access of any independent director to the board. [However], with the passage of time, the AFPs [PFAs] have reached some agreements among themselves and with the issuers on the way to elect directors. Also, current legislation allows the AFPs to vote for the list presented to the shareholders meeting by the board."

39. **Chilean** IIs, especially PFAs, have enough shares collectively to be able to elect directors in most of the listed companies. For example, minority shareholders holding up to 30% of the voting shares (collectively) are able to appoint 2-3 directors to the board out of 7-9 in total. "Moreover, those directors are considered independent in accordance with the law and must also be part of the Directors Committee (auditing committee), which is in charge of overseeing related party transactions, selection of auditors and rating agencies, and executive compensation schemes, among other things. Once elected, the directors should represent the company independently, in other words all shareholders, rather than either the pension funds or controller groups that elected them."

40. The Chilean report also asserts that since most corporations are controlled with a proportion of equity of around 60% to 70%, the role of IIs as minority shareholders is quite relevant: "To the extent that they are active they also produce positive externalities for the entire market." In this sense, important initiatives regarding the boards of directors have been supported by some of the largest PFAs such as the rotation of directors after six years of being appointed in order to preserve their independence (Provida and Habitat), or the selection of directors by a professional entity (i.e., Provida, Habitat and Santa María hired Egon Zender International, a headhunter firm, to propose candidates supported by pension funds to be presented before shareholder meetings)."

41. Evaluation of director performance has also been a concern in Chile, however, without satisfactory results so far, since it is hard to find concrete variables to make such an assessment and board minutes generally don´t reflect the opinion of each director but only the final decisions. The Chilean report recommends facilitating the process of gathering information about board candidates by enacting regulatory mechanisms to require that shareholders be informed of which candidates are independent in accordance with the law. "If by regulatory mechanisms this information could be formally released, it should help foreign investors to

determine how to vote and to create a wider base of active minority shareholders," the report suggests.

42. **Brazil's** pension funds also play an active role in electing board members. **Previ,** one of Brazil's largest pension funds, has taken this practice a step further by organizing annual meetings with all of the board members that it has elected to educate them on playing an active and informed role with respect to corporate governance issues.

43. **Argentina's** PFAs usually do not nominate directors, but may informally suggest potential candidates for the board as independent directors, and may vote in favor of certain candidates. A broader concern in Argentina is the perception that independent directors with appropriate background are difficult to find. This issue has become one of the main concerns of Argentina's institutional investors, particularly pension funds that in many cases have sufficient voting rights to notably influence directors' nomination and appointment. Furthermore, these investors have a concern about the costs of searching for and finding capable candidates to be nominated (and eventually elected); again, the potential benefits for investors are not as clearly perceived as the costs, while the free-riding of other investors is another element of concern.

In **Colombia**, 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. According to current corporate legislation, 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. Finally, there is no legal incentive or obstacle for Pension funds to coordinate their efforts and act jointly in shareholder meetings.

Due to the current regulation, Colombian pension funds are used to incorporate an evaluation of the corporate governance standards of the issuers in the decision making process that leads to the investment decision. 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 some kind of policy regarding the liquidation of the investment whenever corporate governance risks materialize.

Incentives and Governance Structures to Encourage Informed and Effective Exercise of Ownership Functions

44. Section 3 on the "Legal and Regulatory Requirements Impacting on Institutional Investors Corporate Governance Activism" sets out some key legal and regulatory initiatives aimed at establishing incentives to encourage informed and active institutional investors, as well as significant differences in approach taken by different Latin American countries.

45. One additional point raised in the *White Paper* is the role and importance of state-owned development banks (and their multilateral and bi-lateral counterparts, such as the IFC, Inter-American Investment Corporation and the Andean Development Corporation). In this respect, the IFC took a positive recent step with Netherlands' Development Finance Company (FMO) to convene their sister institutions from throughout the world to develop an agreed statement of objectives to promote better corporate governance (See Box 3). The Brazilian National Development Bank (BNDES) also has established corporate governance policies to take into account good corporate governance in their investments.

Box 3. Excerpts from the "Statement of International Development Finance Institutions on Corporate Governance Objectives"

IV. Why an Approach Statement on Corporate Governance by DFIs

[Development Finance Institutions] DFIs can be leaders in the promotion of good corporate governance practices because of their emphasis on sustainability in their role as providers of financing and advisory services to emerging market companies. Good corporate governance is a public good and can be considered a pillar of sustainable economic development on par with good environmental and social practices.

Considering the linkages between good corporate governance and access to capital, company performance, and sustainable economic development, improving corporate governance practices has become an important element of the development mission of DFIs.

V. Approach Statement

Each DFI that adopts this Approach Statement will endeavor to:

1. Develop or adopt guidelines, policies or procedures on the role of corporate governance considerations in its due diligence and investment supervision operations; these could cover aspects such as: commitment to good corporate governance, the rights and equitable treatment of shareholders, the role of stakeholders, disclosure and transparency, and the composition and responsibilities of the Board of Directors.
2. Provide or procure training on corporate governance issues to its investment and supervision staff
3. Encourage companies where it invests in (whether directly or indirectly) to observe local codes of corporate governance in the spirit of best international practice. Engage company management and board members in a dialogue to foster improvement in those cases where corporate governance practices are weak.
4. Promote the use of internationally-recognized financial reporting standards and encourage investee companies to adopt or align their accounting principles and practices to such standards.
5. Collaborate with other DFIs on an ongoing basis, and when appropriate with its partners, to further advance the cause of good corporate governance.

Eliminating Unnecessary Restrictions on Pension Funds and other Institutional Investors to Exercise Their Shareholder Rights

46. Lack of tradable shares in the Latin American markets has generated what the Chileans call the *"manada"* effect, which means that PFAs end up structuring almost identical portfolios due to limited supply of stocks in the market as well as investment limits set by the regulator. PFAs tend to replicate the "average" portfolio, which is often based on following the practices of one or more of the largest PFAs. In **Chile**, this effect is also caused by a requirement of minimum return that has induced pension funds to choose similar portfolios: "These measures have meant that pension funds have diminished their freedom to allocate resources and, to the same extent, their responsibilities for the outcomes. In accordance with formal research, these restrictions also have resulted in lower returns for pension funds."

47. Similarly, in **Peru**, the "minimum return policy" for pension funds, as well as the very short list of companies in which PFAs are allowed to buy stock, has contributed to portfolio replication. Previously, the detailed portfolio of each PFA was made public every month, but since most of them were identical, the requirement was extended to every four months; a development that the Peruvian report says has diminished transparency. **Argentina's** report

cites a similar concern about "minimum return policies" and portfolio replication due to limits on the number of companies they can invest in.

48. While the problem of portfolio replication reflects wider liquidity problems (i.e., low free float and value traded, few IPOs, few PFA investible companies, tight limits on foreign equities investment, etc.), it also underscores the importance of PFA co-ordination in order to monitor and be active owners in companies where they share risks and fiduciary duties.

Articulating Corporate Governance and Sharevoting Policies

49. As is common in well-known, active pension funds from OECD countries (described in greater detail in the concluding "Recommendations" section), a number of Latin American pension funds, notably in Brazil and Chile, have issued corporate governance statements that include a set of benchmarks and principles upon which PFAs guide their investment decisions and base their sharevoting policy.

50. The issuance of such policies or statements brings certainty and clarity to the market regarding investment and voting policies, and may reduce the scope for discretionary decisions by PFA managers that could involve conflicts of interests. In addition, these statements may be valued by the market as a competitive advantage, since corporate governance-guided investments may contribute to higher value and portfolio sustainability.

51. In **Chile**, AFP Cuprum, the third largest PFA, recently released a corporate governance statement aimed at guiding investment and voting decisions named *"Buen gobierno corporativo es buen negocio para todos."* This statement covers issues such as board composition, role of the chairman, election of board members, rotation of board members, conflicts of interest, role of board committees, information disclosure, executive compensation, shareholder protection in cases of mergers and acquisitions, and corporate social responsibility. The AFP Cuprum governance statement is particularly important in the Chilean context because Chile lacked until very recently a national voluntary corporate governance code.

52. While in Chile only one pension fund has adopted a corporate governance statement, **Brazil's** largest pension funds, including Previ, Petros and Funcef, have all adopted such statements. **Peru's** "Handbook for Directors," issued by its Pension Funds Association, also serves this purpose.

53. Beyond the pension funds, ANBID, **Brazil's** National Association of Investment Banks, has launched an important, new self-regulatory initiative in this regard. *"ANBID's Self-Regulation Code for Investment Funds,"* to be released in 2008, will incorporate minimum acceptable practices with respect to the exercise of ownership rights, eliminating the possibility of "not exercising voting rights under any circumstances." This document will include a set of *"Guidelines for a representation policy of funds in meetings,"* elaborated by ANBID Funds' Self-Regulation Committee. These Guidelines will include subjects such as: its applicability for the funds and their activities, a set of corporate governance principles, a set of parameters and requirements under which funds will elaborate their voting policy as well as best practices. The Guidelines will define the benchmark under which funds will be committed to draft a voting policy.

54. In relation to ANBID's initiative, the Brazilian report says: "…self-regulation will also begin covering Proxy voting at General Meetings of Publicly Held Companies, but not only restricted to these assets – the policy will cover any asset class in the fund where there are voting rights, including debentures, fund quotas and other assets… [T]he rules on Proxy voting shall be compulsory to Funds which have as their investment policy the application in financial assets such as, but not limited to: (i) rights, share participations and stock splits; (ii) investment fund quotas; (iii) debentures, commercial papers, promissory notes, contracts, certificates and private bonds in general and (iv) other securities, should these assets be eligible for discussion in shareholders' meetings…"

5) ISSUES FOR FURTHER RECOMMENDATIONS

55. Section 1 of this report sets out internationally agreed recommendations on institutional investors and corporate governance, first from the Latin American *White Paper,* followed by additional recommendations agreed by OECD countries in the *OECD Principles of Corporate Governance.* Sections 3 and 4 above show that Latin American countries have a mixed record in actually implementing the *White Paper's* recommendations.

56. This section sets out additional issues not addressed in the 2003 *White Paper* in the institutional investor context, supported by country-specific examples as relevant, that the Roundtable may wish to consider developing into additional *White Paper* recommendations.

Disclosure of Conflicts of Interest

57. Mutual funds and PFAs in the region are often owned by other financial institutions, and in such cases, usually banks. Likewise, listed companies in which these IIs invest – which in the case of PFAs tend to be among the largest companies in each country – can also be one of the bank's main clients. In this sense, II managers may resist – or be pressured against -- adopting an active ownership strategy that could eventually challenge the board and its management, as the company may then complain to the bank/PFA owner, which could compromise its commercial relationships. It may also be the case that due to particular holding structures, IIs and companies in which they invest are fully or partially owned by the same financial institution.

58. While sound regulation and supervision on conflicts of interest may tackle abuses arising from these relationships, regulating activism or assuring that the rights of IIs are exercised in the best interests of all of their shareholders or affiliates is a more difficult task. In this sense, transparency in the II's decision-making processes is essential. However, the country reports provided very little detail on how institutional investors actually handle or report on such conflicts, so further research may be necessary in this regard. Additionally, disclosure of a comprehensive corporate governance statement and voting policy may provide a way in which mutual fund investees and pension fund beneficiaries can hold managers accountable on voting every issue to the best benefit of the fund and in accordance with such policies, rather than in accordance with the wider commercial interests of certain owners.

Co-ordination among Institutional Investors to Promote Active and Informed Ownership

59. As mentioned previously, low liquidity and scarcity of investible shares have caused long-term investors, especially PFAs, to have similar portfolios and therefore own shares in the same companies. While this similarity of portfolios is to be discouraged from the standpoint of providing pension beneficiaries with a range of choices and a competitive market from which to choose a pension plan, the reality of having relatively few listed companies to invest in also presents an opportunity for pension funds to have a greater impact as minority shareholders, by coordinating and pooling their votes to pursue common goals. Likewise, co-operation between mutual and pension funds from the same group could be facilitated.

60. At the same time, the *OECD Principles* note the importance of taking precautions to avoid using such co-operation to manipulate the markets or to obtain control over a company while circumventing takeover or competition regulation. In the case of pension funds, for which investment limits generally preclude taking of ownership control, the concern about circumventing takeover regulations would seem to be less significant, but the potential for abuse related to conflicts of interest, as referred to above, remains an important consideration.

61. The country reports tend to support this active, co-ordinating approach among institutional investors, but with similar reservations concerning the potential for abuse. The active and coordinated actions taken by **Peru's** and **Chile's** pension funds in electing board members has already been described in the previous section. **Argentina's** report also

advocates such coordination, noting that because pension funds have similar portfolio compositions, “better performance of stocks would benefit them all across; additionally, pension funds face a similar profile of future disbursements for beneficiaries that should lead them to focus on the long-term performance of companies. In sum, their interest seems to be aligned and should facilitate the coordination of their actions as shareholders.” However, the report also stresses the main obstacles for II coordination: (i) material conflicts of interest originating from the ownership structure of many IIs; (ii) regulations on activism, e.g., the rules prohibiting PFAs to communicate prior to GSMs, and (iii) the free-rider problem.

62. Another approach to coordination, more focused on ensuring that minority shareholder rights are respected more generally, has been launched in **Brazil** by the Capital Markets Investors Association (AMEC), a body made up of representatives of several independent portfolio management companies as well as those linked to financial institutions. AMEC was established within the last year in order to represent the interests of fund investors as minority shareholders. They have kept a close eye on market transactions and, for example, requested information from the boards and investor relations department of several listed companies and an investment bank involved in a corporate restructuring that was believed to infringe on minority shareholders rights.

Establishing Better Functioning Market Mechanisms

63. A common concern raised in almost all the country reports was the lack of an objective rating system or platform under which better-governed companies can make clear their higher standards to obtain a competitive advantage over less well-governed companies, in order to be better valued by the market.

64. The special corporate governance listing segments of Bovespa, as mentioned previously, have emerged as the most successful objective corporate governance standard of the region. Companies voluntarily choose to list in the corporate governance segments and therefore comply with higher governance standards than those prescribed by law, which is giving them higher market value, since investors are willing to pay a premium for better governed firms. The corporate governance listing segments today account for approximately 60% of the total market capitalization and daily volume traded in Bovespa. Likewise, virtually all IPOs in Brazil are listings in one of the three corporate governance segments.

65. Voluntary codes of corporate governance applied through a regulatory-mandated comply or explain mechanism also have the potential to become an objective standard by which IIs could take into account governance considerations. Currently, these types of codes exist in several of the region’s countries. However, enforceability has been a main issue in order for investors to actually pay a premium on those companies implementing the code’s recommendations.

66. Added to this, **rating agencies** could play a stronger role by considering corporate governance issues in their equity and bond ratings, especially in a region in which low liquidity and concentrated control represent a higher financial risk for minority shareholders. While in a wider context some rating agencies such as Standard & Poor’s have developed corporate governance analytical criteria to be applied in its credit analysis and rating, most country reports specified that rating agencies do not or have only just started to take into consideration corporate governance issues in their analysis. However, the effort cannot come from rating agencies alone, since the demand for these services from the investors’ side is also crucial. Regarding these subjects, the country reports express:

> **Argentina**: “The lack of a valid and objective benchmark against which institutional investors can measure whether good or bad governance practices are put in place at listed companies and then be more active, is another element that prevents them from demanding implementation of those alleged as better practices. The CNV [the regulator] has recently issued for public discussion a proposal for the adoption by listed firms of a code of good corporate governance practices… Although the CNV proposal could be a first step in the right direction, some market participants consider that it may

not work well as an objective benchmark for investors… There are four rating agencies…in Argentina… little or no attention is paid to corporate governance practices at firms when rated… The reports reflect that the rating is basically based on the balance sheets (current and historical), on the income statements and on the perspectives for the industrial sector in which the company operates."

Chile: "...the [PFAs] system has been thought to operate under a competitive market, in such a way that best performers should be able to attract more affiliates doing more profitable business. From this point of view, corporate governance should be another variable to compete… Rating agencies have been including corporate governance assessments as part of the risk assessment of issuers. This trend is just beginning and there is no explicit result up to now. Issuers are reluctant to pay for this extra service without being totally convinced of its usefulness; neither are institutional investors asking for this kind of rating."

Mexico: "Rating agencies should play a significant role in providing information about the governance of companies involved in debt and equity emissions…in order to use them as promoters in the region for obtaining a stronger focus on good governance from IIs. Currently mutual funds and pension funds rely mainly on these ratings for their investment considerations. The unfavorable cost-benefit ratio for mutual and pension funds for analyzing corporate governance is one of the main reasons why they rely on other assessments and supervisory agencies."

67. Some country reports also pointed out the lack of ***proxy services*** in their markets, and how these could help IIs exercise their ownership rights without having to spend resources in developing their own research and surveillance teams. The cost of monitoring companies and exercise of ownership rights was raised repeatedly in the country reports as one of the main obstacles to active ownership. However, just as with rating agencies, the scarcity of proxy services in the region may also be due to the lack of demand for such services.

68. The idea of implementing a system similar to Novo Mercado was also dealt with in some countries' reports. While a certain level of liquidity and market dynamism will be necessary for such a system to work effectively, a growing number of Latin American countries appear to be open to considering it. In this respect, the country reports say:

Chile: "The first model discussed was the implementation of a 'code of corporate governance and best practices', focused on complementing the regulatory framework, containing principles and practices, and backed by the major business associations and authorities. Two problems were pointed out: the capacity to enforce the code and the risk of the code ending up as a law… The second model discussed was a 'Prime Market' in the legal framework similar to the 'Novo Mercado'… The major advantage is the voluntary listing, meaning that corporations believing that this segment adds value would be leaning to participate… We [the task force] lean more towards a self-regulatory approach or an incentive-based model such as the 'Novo Mercado'".

Mexico: "Mutual funds and insurers are passive shareholders in their investments, so one idea from the BMV [Mexican Stock Exchange] would be to generate an index or scale generated by the BMV or other organizations that would differentiate companies with better governance. Another recommendation would be that Investment Committees of these II's design investment policies that take corporate governance into account."

69. The Brazilian report also recommends voluntary mechanisms to improve the functioning of the market. To tackle passivity of investment funds, the Brazilian report recommends: the dissemination of proxy voting mechanisms to stimulate activism in GSMs; raising awareness among portfolio managers that exercising voting rights is part of their fiduciary duty to the fund's investors (the regulator can play an important part here); defining and disclosing voting policies; transparency to the funds' investors, which doesn't mean revealing their strategies (i.e. composition of the portfolio), but disclosing how they fulfill their fiduciary duties, among others.

Eliminating Unnecessary Investment Limitations

70. The Argentina report suggests that because the PFAs' portfolio limit of 10% in foreign equity generally has been reached since the 2001-2002 crisis, PFAs have been prevented from voting with their feet to move from local securities, when they are unresponsive to governance concerns, to foreign ones. In **Mexico**, as mentioned before, the most important constraint on PFA activism was the restriction on PFAs to invest directly in shares of listed companies, rather than just being allowed to invest in equities through indexes.

71. Moreover, **Peru's** report suggested a series of country-specific changes to enhance the impact of institutional investors on corporate governance: (i) elevate limits that PFAs can invest in each issuer, since the current ones may limit the ability of PFAs to elect directors; (ii) increase the percentage of the fund that can be invested abroad; (iii) lower the percentage of voting rights required to exercise some rights; (iv) lower the costs of exchanging investment shares or non-voting shares for shares with voting rights; (v) specify who can belong to the investment committee; (vi) public disclosure of the members of the investment committee and the risks committee; (vii) public disclosure of investment policies; (viii) public disclosure of codes of conduct; (ix) more coordination between the mutual funds and PFAs watchdogs to supervise related party transactions and conflicting interests of funds belonging to the same economic group.

Overcoming a Culture of Passivity

72. In some of the countries of the region, activism is perceived by IIs as a risk for potential claims from beneficiaries and investors, since they might blame such activist strategies in the event that equity investments do not deliver sufficient returns. In this sense, some II managers prefer to refrain from interfering with a portfolio company's management or board, or even to vote in the shareholders meetings, which reinforces a culture of passive ownership.

73. Likewise, the sanctions that may result from PFA mismanagement may sometimes deter managers from having a larger equity portfolio, and encourage them to rely on "complacent" fixed-income instruments with lower risk of default such as government bonds. However, this practice could be countered by more competition and especially better disclosure mechanisms required by the regulator in order to inform pension fund beneficiaries about the real performance of their retirement savings, since a well-managed and risk-controlled portfolio with a larger exposure to equities will often perform better than one with a smaller equity portfolio.

Learning from International Experience

74. While this report focused on Latin American experience as a first step towards understanding the current state of practices in the market and the potential for improvement, additional examples and possibilities for strengthening institutional investors' role in the region could be developed through a more active exchange with other international investors. The Roundtable discussion planned in Medellín will provide a first step in this direction with the participation of some international investors. A more extensive solicitation of international (OECD country) investor and government policy input could be sought to complement Latin American input to further develop and refine the recommendations in this report.

75. For example, the California Public Employees' Retirement System (CalPERS) and the Teachers Insurance and Annuity Association - College Retirement Equities Fund (TIAA-CREF) have recognized their role as long-term investors and active owners in their portfolio companies, and assumed a responsibility for monitoring the activities and promoting best practices therein. CalPERS has issued its *"Core Principles of Accountable Corporate Governance,"* covering several subjects from board independence and processes to audit integrity. These principles call for a one-share one-vote policy and for the adoption of a corporate governance code in each of the markets in which they invest.

76. TIIA-CREF issued its *"Policy Statement on Corporate Governance"* along with a set of *"Proxy Voting Guidelines."* In both cases, CalPERS and TIIA-CREF recognize that there in not a one-size-fits-all approach to the exercise of ownership rights and that each voting decision has to be considered separately within its context. However, these documents provide a set of benchmarks and principles that guide both funds' investment and ownership decisions and can give a detailed description of how they will most likely vote on a several range of issues. Drawing upon its Principles, CalPERS has publicly issued a *"black list"* of companies considered to be underperforming in the market, aiming to exert pressure to promote corporate change and increase their share value.

77. Likewise, on July 6th 2007 the members of the International Corporate Governance Network (ICGN) approved *International Corporate Governance Network: Statement of Principles on Institutional Shareholder Responsibilities.* ICGN brings together some of the largest institutional shareholders – its members are estimated to hold assets exceeding $10 trillion. The Statement sets out the ICGN's view of the responsibilities of institutional shareholders both in relation to their external role as owners of company equity, and also in relation to their internal governance. The Statement also claims that "Institutions that comply with the enlarged principles will have both a stronger claim to the trust of their end beneficiaries and to the exercising of the rights of equity ownership on their behalf."

78. Another example of institutional investor self-regulation is in the UK, where the Institutional Shareholders' Committee published its Statement of Principles on the Responsibilities of Institutional Shareholders and Agents in October 2002, updated in 2005. Endorsed by the Association of British Insurers, the Association of Investment Trust Companies, the National Association of Pension Funds, and the Investment Management Association, this Statement of Principles sets out best practices for institutional shareholders and/or agents concerning their responsibilities with respect to investee companies. They will: set out their policy on how they will discharge their responsibilities; monitor the performance of, and establish, where necessary, a regular dialogue with investee companies; intervene where necessary; evaluate the impact of their engagement; and report back to clients/beneficial owners.

6) CONCLUSIONS

79. The *White Paper on Corporate Governance in Latin America* provides a starting point for the Roundtable to consider development of further recommendations to encourage active and informed ownership among Latin American institutional investors. Among some of the preliminary conclusions are the following:

- Recent economic developments in Latin America coupled with the growth of capital markets have been the basis for the ever increasing importance attached to institutional investors. These IIs are currently managing significant amounts and have a real opportunity to influence the development of capital markets.
- Among the various types of institutional investors present in Latin America, pension funds appear to be key players in almost all major markets (while in Brazil, asset management firms have a much larger share of the market than pension funds).
- In parallel with market developments, corporate governance is being increasingly recognised as an indispensable feature for the success of companies and creation of long-term value. Some institutional investors, especially those with long-term investment horizons and those that have a social purpose (i.e., pension funds), have developed policies and practices to integrate corporate governance considerations in their investments.
- Some examples of active and informed ownership by IIs in Latin America include actively voting their shares, nominating directors to boards (in particular independent directors), requesting additional information from companies, disclosing their corporate governance policies on investment and share voting, alerting the markets when negative corporate governance practices are identified, and requiring investee companies to develop their own codes of best practices.

- At the same time, there remain many barriers to IIs playing a more active role in promoting better governance practices in their investee companies. Some of these barriers are: legal restrictions (e.g., limits on investments, lack of proper/enforceable proxy voting mechanisms), market shortcomings (e.g., short-term investment horizons, ownership patterns prevalent in the market, portfolio replication due to limited scope of investible securities, free-rider problems, lack of a clear governance benchmark, conflicts of interests, internal governance problems of IIs, weak/incomplete market infrastructure) and cultural passivity.
- Finally, leading institutional investors and IIs' associations in the region are following in the footsteps of their counterparts in developed markets by focusing more attention on self-regulation, addressing both their internal corporate governance and best practices for institutional shareholders and/or agents concerning their responsibilities with respect to investee companies.

ANNEX 1

THE ROLE OF INSTITUTIONAL INVESTORS
IN
PROMOTING GOOD CORPORATE GOVERNANCE PRACTICES IN LATIN AMERICA
A DISCUSSION FRAMEWORK FOR COUNTRY WORKSHOPS

I. Background Questions[6]:

1. What types of institutional investors (IIs)[7] are there in your market? (To the extent possible, please provide an indication of their relative impact on your country's securities market)
    a. Foreign:
        i. Pension funds;
        ii. Mutual funds;
        iii. Private equity firms;
        iv. Insurance companies;
        v. Other.
    b. Domestic:
        i. Pension funds (mandatory schemes, private pension funds, etc.);
        ii. Mutual funds;
        iii. Private equity firms;
        iv. Insurance companies;
        v. Other.

2. What kind of investment strategies do IIs tend to employ most commonly?
    a. Minority or majority stakes?
    b. Acquisitions in the market or direct negotiations?
    c. Active or passive shareholding?
    d. What types of companies do IIs invest in?
        i. Listed;
        ii. Non-listed;
        iii. Family-owned;
        iv. Privatisation projects;
        v. SOEs;
        vi. Other.
    e. What exit strategies are used commonly?

3. What is the equity ownership share of IIs in the domestic capital market? Are there any ownership limitations imposed by legislation? Please indicate any legal investment rules, including the kinds of companies (listed, non-listed…), investment limits (% of the II's total portfolio), and type of securities (shares, bonds, convertible shares…) in which Pension Funds are allowed to invest.

4. What laws and regulations exist in the country with regard to IIs' duties to its beneficiaries? Are there any voluntary documents addressing the role of IIs in promoting good governance, such as in the country codes of best practices, corporate governance statements/standards promulgated by associations of IIs or the regulators of IIs?

5. What laws and regulations exist in the country with regard to corporate governance rules for various types of IIs? Are IIs required to disclose their policies and practices regarding

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6 . Section 1 is aimed at obtaining written background on the context and is not intended for discussion. The project co-ordinator(s) are also asked to provide any relevant background material, including laws, regulations, voluntary guidelines, articles or other pertinent documentation on these subjects.

7. Organisations that invest, including insurance companies, depository institutions, pension funds, investment companies, mutual funds, and endowment funds.

corporate governance of the companies in which they invest, including share voting, nomination of directors, etc.?

II. For Discussion: The Role of IIs in Promoting Good Governance:

1. Are IIs in your country in a position to influence/promote good governance in their investee companies? Which types are potentially most influential? Are IIs different from other minority shareholders? Are IIs perceived as effective agents of good governance in your country?

2. What are the key risks and main corporate governance problems in your country from the IIs' perspective?
    a. Board practices;
    b. Control environment (internal controls and risk management);
    c. Disclosure and transparency;
    d. Shareholder rights;
    e. Family business issues;
    f. Other.

3. How can IIs influence/promote good governance practices in your country? Are IIs active in promoting good governance practices on the level of:
    a. Individual companies they invest in;
    b. Supporting the development of a public policy/regulation on corporate governance (public events promoting good governance, participating in working groups on laws and voluntary codes, etc.).

4. What is being done/not done in practice?
    a. Considering corporate governance risks and opportunities before investing;
    b. Actively exercising ownership rights through:
        i. One-on-one meetings;
        ii. Voting;
        iii. Focus lists ("black lists") – negative market exposure;
        iv. Using corporate governance rating systems;
        v. Board representation (nomination of directors);
        vi. Putting issues on the AGM agenda;
        vii. Other.
    c. Selling shares when governance-related problems occur;
    d. Combination of shareowner activism and exiting from the investment.

5. How do these approaches to promoting good governance vary among different types of IIs - foreign vs. domestic, pension funds vs. mutual funds?

6. What barriers exist for IIs to better utilize their position as a key governance activist in your country?
    a. Shortcomings of existing regulation;
    b. Weak enforcement of existing rules;
    c. No incentives for IIs to be active shareholders (exit is more cost-effective than voice);
    d. Concentrated ownership patters which precludes IIs from having significant influence over companies in which they invest;
    e. Lack of proxy advisory services;
    f. Other.

7. What should be done to improve the contribution of IIs to bettering corporate governance practices in your country?
    a. Improve legislation/regulation;
    b. Improve enforcement;
    c. Develop voluntary standards for IIs on their fiduciary responsibilities to their beneficiaries regarding…;

d. Develop standards of good governance practices that IIs should seek their investees to follow;
e. Improve IIs' accountability to their beneficiaries and the regulators;
f. Improve voting rules and procedures to enable IIs to actively vote their shares (AGM notification deadlines, relevant information in accessible language, proxy rules, electronic voting, etc.);
g. Improve the dialogue between the IIs and their investee companies;
h. Initiate/broaden the public debate about the role of IIs in promoting good corporate governance in the country;
i. Provide incentives to encourage IIs' activism;
j. Other.

8. What measures have been undertaken or should be further implemented to address the following reasons why IIs may not always be active and effective monitors of corporate activities?
   a. Free-ridership – the efforts of institutional investors to increase corporate value will benefit other shareholders and may benefit the institution's rivals;
   b. Co-option by management/conflict of interest – the pension plan of a service provider may vote with management for fear that if it does not, it will lose the corporation's business;
   c. Political pressures on public pension funds – pension funds may be pressured to make certain investments to support the local economy or for other political reasons;
   d. Limited monitoring capabilities, given large portfolios, limited staff, and limited ability to engage in active management activities;
   e. The need or desire to maintain liquid portfolios, which results in the acquisition of small blocks without significant voting power;
   f. Legal restraints on institutional monitoring activities;
   g. An institutional culture of "passivity";
   h. Fear that approaching other shareholders with concerns about management will trigger a "race to exit" which will cause the share price to fall;
   i. When fund managers become corporate directors, whose interests should they promote – the interests of the fund or of the investee company, especially when these interests conflict;
   j. Difficulties in identifying other shareholders.

III. Corporate Governance of IIs: Issues and Risks:

1. What are the key issues and risks in corporate governance of IIs?
   a. Board composition (independence);
   b. Qualifications of Board members;
   c. Disclosure of policy on activism (The policy would need to address the following areas: how investee companies will be monitored; the policy for requiring investee companies' compliance with certain corporate governance standards/guidelines; the policy for meeting with an investee company's board and senior management; how any conflicts of interest will be dealt with; the strategy on intervention; indication of when and how further action may be taken; and the policy on voting.);
   d. Focus on short-term results;
   e. Conflicts of interest;
   f. Access to insider information;
   g. Other.

2. Are all types of IIs (pension funds vs. mutual funds) facing similar corporate governance issues? Should these be treated the same way? Should their governance be the same as governance of the private sector (commercial) companies?

3. What measures have been taken and should further be implemented to improve corporate governance of IIs?

a. Improve legislation/regulation;
b. Improve enforcement;
c. Develop voluntary standards/best practice guidelines for corporate governance of IIs;
d. Improve the Board composition;
e. Improve how IIs deal with conflicts of interest and insider information;
f. Have public debate about corporate governance practices in IIs;
g. Other.