

Foreword

This Review of Corporate Governance in Chile is part of a series of reviews of national policies undertaken for the OECD Corporate Governance Committee. It was prepared as part of the process of Chile's accession to OECD membership.

The OECD Council decided to open accession discussions with Chile on 16 May 2007 and an Accession Roadmap, setting out the terms, conditions and process for accession, was adopted on 30 November 2007. In the Roadmap, the Council requested a number of OECD Committees to provide it with a formal opinion. In light of the formal opinions received from OECD Committees and other relevant information, the OECD Council decided to invite Chile to become a Member of the Organisation on 15 December 2009. After completion of its internal procedures, Chile became an OECD Member on 7 May 2010.

The Corporate Governance Committee (the "Committee") was requested to examine Chile's position with respect to core corporate governance features and to provide Council with a formal opinion on Chile's willingness and ability to implement the recommendations laid down in the OECD Principles of Corporate Governance (the "Principles") and the OECD Guidelines on Corporate Governance of State-Owned Enterprises (the "SOE Guidelines").

This report, prepared as part of the Committee's accession review, highlights some of the key corporate governance challenges facing Chile. A major feature of Chile's corporate governance landscape is the concentrated ownership structure and limited liquidity that characterises its capital market, with most firms controlled by conglomerates or business groups. As in other jurisdictions with similar corporate structures, concerns arise that minority shareholders may be vulnerable to irregular practices by controlling shareholders to extract private benefits at their expense through practices such as abusive related party transactions or self-dealing.

Chile has made considerable progress in improving its corporate governance framework, first through laws adopted in 2000 on Public Tender Offers and on Corporate Governance, and more recently through a significant Corporate Governance law approved by Congress in September 2009, just prior to the conclusion of this review. The law established new protection for minority shareholders through enhanced transparency standards and mechanisms to address use of privileged information, related party transactions and conflicts of interest, and provisions to improve the definition of independent directors and to strengthen their role in reviewing sensitive issues. In addition, the new law approved by Congress in October 2009 to strengthen governance of Chile's largest state-owned enterprise, the copper mining company Codelco, is an important reform that may give momentum to further reforms of other Chilean SOEs.

The review also found that Chile should continue to pursue corporate governance improvements in a number of areas. For example, concerns were raised about the need for additional checks and balances to strengthen the independence of the Superintendency of Securities and Insurance and protect against the risk of political intervention in enforcement decisions. While Chile has taken positive steps to improve the governance of its pension funds and to guard against conflicts of

interest in their investment decisions, further improvements are desirable in relation to other institutional investors such as mutual funds and insurance companies. In addition, further SOE governance improvements, not yet addressed by the Codelco reforms, remain on the reform agenda.

This review of corporate governance in Chile was conducted on the basis of a comprehensive self-assessment by the Chilean authorities and Chile's answers to a detailed questionnaire on state-owned enterprises, supplemented by information gathered from Secretariat fact-finding missions, interviews with public officials, market participants, academics and relevant literature. Successive drafts of the report were discussed with Chilean representatives at joint meetings of the Corporate Governance Committee and its Working Party on State Ownership and Privatisation Practices in November 2008 and April and November 2009. This final version of the report reflects the situation as of November 2009. It is released on the responsibility of the Secretary General of the OECD.

The review was prepared by Daniel Blume and Cuauhtemoc Lopez-Bassols under the overall supervision of Mats Isaksson, Grant Kirkpatrick and Robert Ley of the Directorate for Enterprise and Financial Affairs. The analytical framework is explained in Annex A and detailed information on Chile's state-owned enterprises is provided in Annex B.

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Chapter 1

Assessment and Recommendations

1. Corporate Governance Framework

Chile's Santiago Stock Exchange constitutes the third largest equity market in Latin America, behind the stock exchanges of Brazil and Mexico, with a relatively high market capitalisation of USD 213 billion for 238 listed firms at the end of 2007 – equivalent to 124 percent of GDP. The market is characterised by low liquidity and quite high ownership concentration of individual firms, usually in the hands of conglomerates or business groups that are also concentrated in number. As of 2002, some 50 major conglomerates had ownership control of more than 70 percent of non-financial listed companies, and 91 percent of total equity in the Santiago Stock Exchange. While liquidity is low, it has been improving, with annual trading volume rising from about 10 percent of GDP in 2002 to about 30 percent by 2007. The free float within the 138 largest and most actively traded firms was estimated at 36 percent in 2007, with virtually all companies having a controlling owner or group.

The predominance of company groups, high ownership concentration and low liquidity in Chilean markets are characteristics that may weaken the effectiveness of market mechanisms, leading to the Chilean authorities' self-review conclusion that "the central corporate governance challenge in Chile is the risk of minority shareholder expropriation at the hands of controlling shareholders".

A particular characteristic of the Chilean market is the importance of pension funds as minority shareholders, whose transactions accounted for 52 percent of trading volume in the Chilean stock exchange in 2007. Chile's five privately-owned pension funds held equity in 113 listed companies as of 2007, with sufficient ownership to elect independent directors to many of these firms. Pension governance reforms enacted in 2007 require them to report on how they address conflicts of interest and to establish Directors' Committees with independent members to review investments and conflicts of interest.

The Corporations Law and Securities Market Law, both enacted in 1981 and amended several times since, are the principal pieces of legislation bearing on corporate governance in Chile. Key amendments have included laws enacted in 2000 on Public Tender Offers and on Corporate Governance, which moved to strengthen minority shareholder rights by, among other things, enhancing disclosure and establishing Directors' Committees which serve a role similar to Audit Committees. Chile's Superintendency of Securities and Insurance (SVS) is responsible for overseeing the securities and insurance markets, while separate regulators oversee pension funds and banks.

In the course of the review, Chile has taken major steps to improve its corporate governance legal framework through passage of two key laws – one to reform the governance of its largest SOE, Codelco, and the second addressing listed companies. The new Corporate Governance law, passed by Congress in September 2009 and signed into law on 13 October 2009, strengthens protection for minority shareholders through enhanced

transparency standards and mechanisms for addressing use of privileged information, related party transactions and conflicts of interest, and through provisions to improve the definition of independent directors and to strengthen their role in reviewing sensitive issues relevant to minority shareholder protection through the Directors' Committees.

The SOE sector is small in comparison to the overall economy, representing a book value of USD 3.3 billion or just 1.5% of market capitalisation, but it includes several that play a major and strategic role in the economy. Among its most visible SOEs are Codelco, the world's largest copper producer and a major source of government revenue; ENAP, which is active in oil exploration, refining and more recently the production of natural gas, playing a key role in ensuring Chile's energy security and stability; ENAMI, a minerals processor with an economic development mission aimed at supporting small and medium-sized mining companies in the country's mining regions, and its state-owned bank, Banco Estado. Twenty-six of the 32 SOEs are entirely state-owned, while six have some private shareholders.

The Public Enterprise System (SEP) is the main state institution responsible for exercising the state's ownership function for most SOEs (23 out of 32), but separate legal and institutional arrangements are in place for many of the larger or more prominent SOEs. Chile has been taking important steps to make these supervisory arrangements more uniform by establishing a new SEP Code of Conduct and new procedures for appointing independent directors in the 23 SOEs under its supervision. Legislation was proposed in 2008 that would establish these discretionary measures under law and increase the number of SOEs under SEP supervision from 23 to 28, while strengthening requirements related to disclosure and the role, qualifications and independence of board members. This bill did not advance in Congress which gave higher priority to the October, 2009 passage of the bill to strengthen the governance of Codelco and to remove ministers from its board. This represents an important, precedent-setting reform that may give momentum to further reforms to other SOEs.

2. Assessment

The following section assesses Chile's corporate governance in terms of five core corporate governance features:

- Ensuring a consistent regulatory framework that provides for the existence and effective enforcement of shareholder rights and the equitable treatment of shareholders, including minority and foreign shareholders.
- Requiring timely and reliable disclosure of corporate information in accordance with internationally recognised standards of accounting, auditing and non-financial reporting.
- Establishing effective separation of the government's role as an owner of state-owned companies and the government's role as regulator, particularly with regard to market regulation.
- Ensuring a level playing field in markets where state-owned enterprises and private sector companies compete in order to avoid market distortions.
- Recognising stakeholder rights as established by law or through mutual agreements, and the duties, rights and responsibilities of corporate boards of directors.

Ensuring the Enforcement of Shareholder Rights and Equitable Treatment. Overall, Chile has a framework in place that broadly provides for the existence and enforcement of shareholder rights and the equitable treatment of shareholders. But the Chilean authorities have also recognised weaknesses that they have attempted to address through their recent corporate governance legislation. The new law includes significant measures to require disclosure of material information to the market aimed at combating insider trading and mis-use of privileged information. Certain additional steps discussed below should also be considered to further address these weaknesses.

While Chile's new Corporate Governance law strengthens ex-ante review mechanisms at board level, questions remain as to whether these mechanisms can be fully effective in companies with weak minority shareholders and consequent weak functioning of market incentives. Strong ex post review by the regulator may be equally important in this context. Chile's proposal to create a Securities Commission with a two-board structure aimed at strengthening its independence may be an important step in this regard. Chile could also enhance its enforcement capacities on cross-border cases by taking the steps necessary to become a full signatory to the Multilateral Memorandum of Understanding of the International Organization of Securities Commissions (IOSCO) concerning consultation and co-operation on exchange of information.

Chile has taken some steps to minimise the impact of mechanisms that allow certain shareholders to maintain disproportionate control, and in cases where such disproportionate control exists, to ensure their transparency and safeguard against abuse. Nevertheless, further steps should be considered, such as requiring disclosure of all governance-related requirements of shareholder agreements, and requiring a clearer explanation of how different companies in a group are related that is easily available to market participants, rather than merely listing their various components.

Chile's corporate governance framework has established a set of standards to facilitate exercise of shareholder rights, to encourage disclosure of voting policies and to address conflicts of interest among the largest class of institutional investors – the pension funds. But it has not applied such requirements to less important investors in the Chilean market. Disclosure of voting policies would be addressed for domestic mutual and investment funds through Chile's proposed capital market reform legislation, known as MKIII, submitted to Congress in September 2009, but these proposed reforms do not address conflicts of interest, nor insurance funds.

Timely and Reliable Disclosure In Accordance with Internationally Recognised Standards. Chile has taken significant steps over the last several years to strengthen the quality of its financial and non-financial disclosure, notably in adopting and implementing International Financial Reporting Standards (IFRS). Its new Corporate Governance law achieves significant additional improvements by strengthening auditor independence requirements, requiring them to attend shareholder meetings to respond to questions raised by shareholders, strengthening SVS oversight of the auditing profession, refining the definition of related party transactions in accordance with IFRS standards and enhancing the role and independence of Directors' Committees in reviewing such transactions. Similarly, the SOE corporate governance legislative proposal to expand the number of SOEs subject to SEP and SVS supervision would extend the application of international accounting and audit standards to nearly all SOEs.

One of the issues that Chile has considered during the review period is the recommendations of the 2004 Accounting and Auditing Report on Observance of Standards

and Codes (ROSC) carried out by the World Bank. Chile has taken action on several of these recommendations. Questions were raised during the review concerning the clarity of the division of responsibilities between Chile's Institute of Auditors, which self-regulates the implementation of auditing technical standards consistent with international norms, and the role of SVS, which in turn ensures that minimum standards are respected. However, the Chilean authorities maintained that SVS should continue to play an active role, which would be strengthened further by the new corporate governance law, in light of the fact that Chile's Institute of Auditors has only recently begun playing a more active role and that regulatory safeguards are needed to ensure that both play their roles as required.

Review of disclosure, auditing and accounting provisions applying to SOEs show that Chile is making an effort to harmonise standards applying to most SOEs, with further progress achieved in April 2009 through the enactment of the Transparency Act, requiring all SOEs to disclose the same information as corporations are required to provide to the SVS. There may be scope to clarify the division of responsibilities between different auditing functions for SOEs in Chile, with a view towards reducing the degree of overlapping external auditing responsibilities between external auditors, the Comptroller, and in exceptional cases such as in the mining sector, specialised review bodies.

Effective Separation of the Government's Role as Owner and its Regulatory Role, and Ensuring a Level Playing Field. Chile's recent actions to establish an SOE code that draws substantially on the *OECD SOE Guidelines* and to begin appointing board members following certain criteria aimed at promoting their independence represent significant improvements in their SOE governance framework. Proposed legislative reforms would enhance these initiatives and increase their application from 23 to 28 of Chile's 32 SOEs. The SOE legislation would also subject all SOEs co-ordinated by the SEP ownership entity to SVS regulatory oversight, and strengthen the appointment of independent directors and their role in reviewing related party transactions and conflicts of interest.

The Codelco legislative reform adopted by Congress in October 2009 has established an important precedent for further SOE reforms by eliminating Ministers from Codelco's board, increasing the number of independent directors to be elected through competitive and open processes, providing the board with increased authority in relation to the CEO, establishing professional qualification requirements for board members, and stipulating that Codelco and its board are subject to the same requirements as private sector companies.

Chile is encouraged to continue in this direction by enacting its SOE bill and by ensuring, as soon as possible, that similar requirements will apply to all SOEs. It is especially important to address the case of Ministers serving on the boards of the oil company ENAP and mining company ENAMI, because of the risk this poses to the separation of ownership and regulatory roles, and to political interference in day-to-day management of these SOEs. Chile should build on the Codelco precedent to adopt similar reforms for ENAP and ENAMI, and by ensuring that all SOEs are subject to similar oversight and regulatory requirements.

Chile has taken several important steps to ensure that SOEs do not receive preferential treatment that would undermine the maintenance of a level playing field. Company law applies equally to SOEs, and Chile is gradually moving to harmonise its regulatory and institutional structure for enforcement to ensure that the law is applied in an even-handed manner to both SOEs and private companies. In the cases of state guarantees or budget transfers to cover losses, government support is transparently justified and approved in terms of achieving non-commercial public policy objectives related to "net social

profitability”. Market observers have not raised significant concerns about SOEs receiving unfair advantages *vis-à-vis* competitors. However, further progress could be achieved in this regard through passage of the proposed SOE corporate governance reforms and their application to all SOEs, as noted above.

Recognising Stakeholder Rights and the Duties, Rights and Responsibilities of Boards.

Stakeholder rights are established by law or through mutual agreement through a range of legal provisions and enforcement mechanisms. However, some potential weaknesses were identified in the course of the review. For example, explicit requirements or mechanisms to provide safeguards to “whistle-blowing” employees who wish to complain at company level may be lacking, but employees do have an outlet to register complaints anonymously with SVS. In addition, lengthy court processes may not facilitate stakeholder redress when they feel that their rights are not respected. However, the review did not encounter complaints concerning violations of such rights, and several market observers suggested that awareness and recognition of such rights have improved. The same framework for addressing stakeholder rights is applied to SOEs through company law, and in addition through explicit provisions in the new SEP Code.

The issue of how effectively the rights, duties and responsibilities of board members are implemented is complex. Independent reviews and surveys of Chilean board practices and perceptions suggest weaknesses in the functioning of boards, particularly in smaller companies, but some progress in awareness and professionalism of board members as well. Pension funds and other institutional investors’ election of independent board members, and their role in reviewing sensitive transactions at Directors’ Committee level, provides an important safeguard in relation to the protection of minority shareholder rights. SVS enforcement, however, is largely limited to reviewing meeting minutes to ensure that various provisions are formally respected.

The new Corporate Governance law includes important measures to enhance the effectiveness of board practices through its emphasis on independent and *ex ante* scrutiny at board level to prevent abusive related party transactions and ensure protection of all shareholder interests. The law reinforces the role of the Directors’ Committee and adds important improvements, including strengthening the role of independent directors and more clearly defining the economic and relational criteria that such directors must meet, and expanding their responsibilities to review, recommend and report on a range of sensitive issues. However, the Directors’ Committee structure will only be applied to companies with at least 12.5 percent free float and a minimum of USD 58 million in market capitalisation, focusing such requirements on those companies that are most actively traded.

3. Recommendations

While Chile has made positive progress in its implementation of the *Principles* and the *Guidelines*, the Committee identified a number of areas where further improvements are recommended:

- Currently, the Superintendent of Insurance and Securities is directly appointed and removable by the President without cause. Chile is encouraged to provide adequate checks and balances to protect against the risk of political intervention in enforcement decisions. The need for independence will take on added importance if, as proposed, SVS is put in charge of regulatory oversight and enforcement of SOEs.

- Chile is called upon to use its regulatory and enforcement structure to give ongoing attention to the question of corporate groups, and to ensure that the nature of the relationships among companies within conglomerates is well understood by the market.
- Building on its pension fund governance reforms, Chile should take further steps to enact governance reforms for mutual and insurance funds to address conflicts of interest and disclose voting policies. Furthermore, requirements for disclosure of shareholder agreements should be extended to cover provisions not strictly related to control of the company, for example including the agreements whose object is the exercise of voting rights, the election of board members, block voting and right of first refusal.
- Chile should build on the precedent of Codelco governance reforms to work towards further SOE reforms, including expanding the number of SOEs subject to the SEP Code of Conduct and to SVS regulatory oversight and requirements, along with reforms to strengthen the appointment of independent directors and their role in reviewing related party transactions and conflicts of interest. It is especially important to address the case of ministers serving on SOE boards (i.e. ENAP and ENAMI), because of the risk this poses to the separation of ownership and regulatory roles, and to political interference in day-to-day management of these SOEs.