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Country Report: The Role of Institutional Investors in Promoting Corporate Governance in Colombia

To provide background for the development of an overview report on Institutional Investors and Corporate Governance in Latin America, the OECD asked consultants and task forces to elaborate country reports on current practices, challenges and prospects for improvement. These country reports are provided to the Roundtable participants as background for the meeting's discussion, and will be made available at <http://www.oecd.org/daf/corporate-affairs/roundtables>.

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

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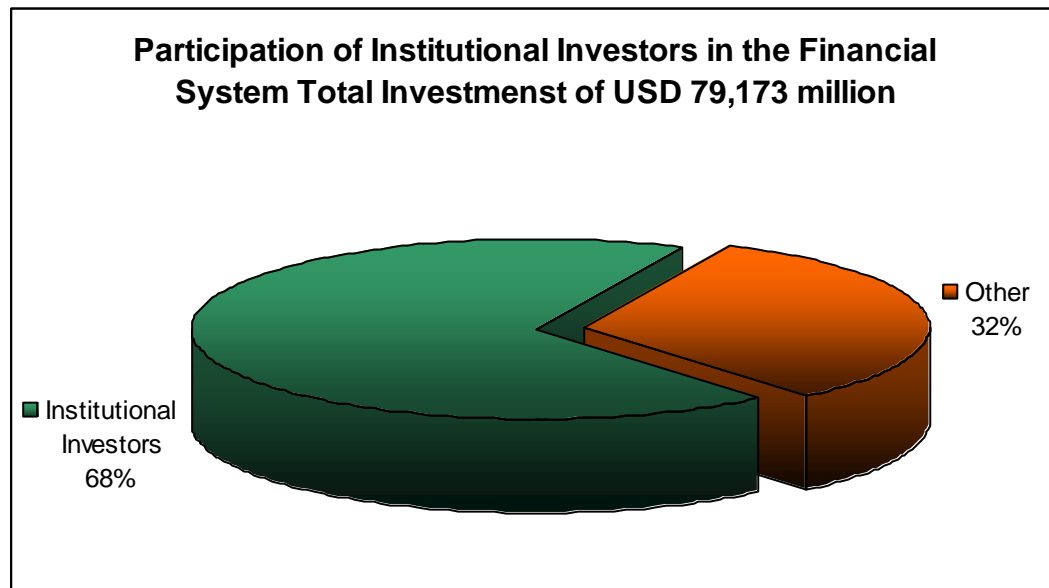
**THE ROLE OF INSTITUTIONAL INVESTORS
IN
PROMOTING GOOD CORPORATE GOVERNANCE PRACTICES IN COLOMBIA
A DISCUSSION FRAMEWORK FOR COUNTRY WORKSHOPS**

I. INTRODUCTION

The following report has been prepared by the Financial Superintendence of Colombia (FSC) on the basis of several inquiries made to the relevant entities supervised by the Superintendent Delegate for Pension Funds and Fiduciary Entities, the Superintendent Delegate for Insurance Companies and the Superintendent Delegate for Issuers and Collective Investment Schemes conducted during the first semester of 2007. The information provided regarding market share and portfolios is based on the information reported to the Financial Superintendence of Colombia

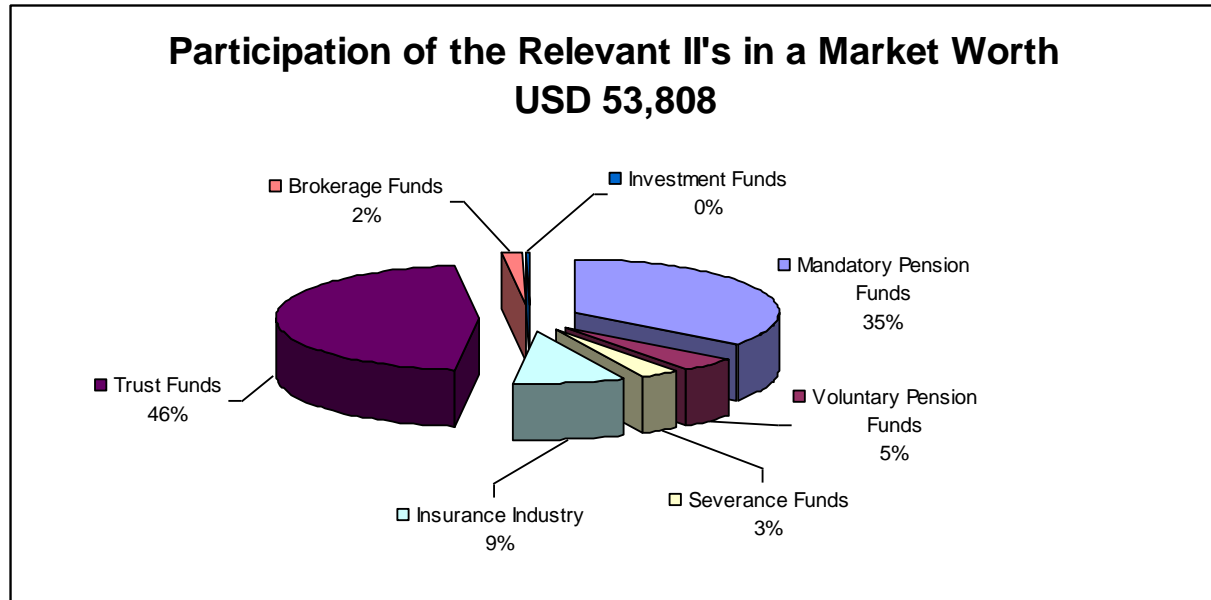
II. BACKGROUND

Several kinds of institutional investors (IIs) participate in the Colombian financial market. For the purposes of this report it is possible to classify such institutional investors in the following categories: Pension Funds, Severance Funds, Insurance Companies, Trust Funds and Investment Funds. In the case of trust funds, the assets are managed by Trust companies or Brokerage firms. The total amount of Investments in Colombia as of December, 2006 was USD 79.173 millions that amounted to 55% of the GDP. The relevance of institutional investors within the Colombian financial market may be depicted in the following pie:



1. Institutional Investors Participation in the Colombian Financial Market as of Dec, 2006

The total amount of investments under the management of institutional investors as of December, 2006 was USD 53,808 million that amounted to 37.6% of the GDP. The distribution of said investments assets among Colombian IIs, is shown in the following pie:



The total amount of investments managed by Institutional Investors as of December, 2006 is shown in the following table:

Institutional Investor	Investments (In US millions)
Mandatory Pension Funds	19.012
Voluntary Pension Funds	2.506
Severance Funds	1,657
Insurance Industry	4,831
Trust Funds	24,792
Brokerage Funds	819
Investment Funds	191

As it is evident, the main Institutional Investors in Colombia are Pension and Trust Funds.

III. EVOLUTION OF THE ROLE OF IIS IN PROMOTING GOOD CORPORATE GOVERNANCE PRACTICES

Colombia has understood the importance of promoting good corporate governance practices since the earlier legislation on corporate law. Indeed, rules regarding general assembly of shareholders, shareholders rights, disclosure of information, board of directors, etc, have been in place since 1971, when the current Commercial Code was enacted and are still recognized amongst the most advanced in the region.

However, in light of the different episodes that took place in international markets at the end of the last century related with corporate governance malfunctions, the Securities Superintendence enacted Resolution 275 of 2001. Said Resolution established a number of corporate governance topics that had to be regulated by those issuers that wanted to attract the investment of Mandatory Pension Funds. Pursuant to this Resolution, Mandatory Pension Funds are restricted to invest only in issuers that have complied with it and have developed corporate governance rules regarding the various aspects contained in the Resolution.

The eagerness of most issuers to attract the investment of the aforementioned Pension Funds, led to a widespread incorporation of corporate governance codes in most of the issuers.

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Furthermore, good corporate governance became a matter of great interest in the securities market and different projects have been developed to promote good corporate governance practices between the Government and the private sector. However, the codes that have been approved by issuers are considerably different amongst themselves and not all of them embody best practices but, unfortunately, some merely reflect the general legal standards that are already mandatory.

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

During 2006, the Financial Superintendency led a working group comprised of the representatives of the most important groups of issuers. This working group had the duty to agree on a Colombian Corporate Governance Code (Código País). After several discussions, the group decided to promote a code with 41 measures that were suggested to all issuers. The purpose of the Code is to encourage issuers to adopt the suggested measures by a type of “comply or explain” method. In this case, issuers are asked to disclose if they are complying or not with each of the measures of the Code. In case they are complying with the measure, they will be required to provide an explanation describing the manner in which they are complying. If they are not complying with the measure, the issuers can choose if they want to explain the reason for not complying or not. The code was finally enacted in 2007 and the first report must be filed before the next general shareholders’ meetings that will take place in 2008.

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

IV. FUTURE DEVELOPMENT OF THE ROLE OF INSTITUTIONAL INVESTORS IN THE PROMOTION OF GOOD CORPORATE GOVERNANCE PRACTICES

In order to understand the future development of the role of Institutional Investors in the promotion of Good Corporate Governance practices in Colombia, it is important to understand the system that is currently in place and the new structure that is going to be implemented in the near future.

As it has been briefly described, the current model lays on the existence of a mandatory statute (Resolution 275 of 2001) that describes a series of measures that should be observed by those issuers who wish to be eligible by pension funds to invest their resources. Although this model has been very effective in promoting good corporate governance practice among issuers, the Financial Superintendence has considered convenient to modify this approach in order to rely on the voluntary adoption of good governance practices by issuers together with placing a much stronger responsibility on behalf of Institutional Investors of analyzing the corporate governance structure as one of the criteria used in the investment decision making process.

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

The new structure will require issuers to provide a detailed Corporate Governance Report that will cover the main aspects of their corporate governance system. The report would be made on the basis of open questions. Also every question will require the issuer to provide evidence of the practices that they have put into place according to their answers. The questions will cover general topics as well as particular practices included in the Código País.

On the other hand, Institutional investors will be legally required to expressly decide and disclose the importance that they will place on the evaluation of the corporate governance system of the issuer within the decision making process that leads to the final investment decision. However, this requisite does not in any manner imply that a poor evaluation of the corporate governance system of the issuer will limit the investment in all cases. Furthermore, institutional investors will be required to maintain evidence of the analysis made of the corporate governance system of the issuer.

V. PENSION AND SEVERANCE FUNDS

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

As it was established before, the investments under management of Pension Funds amount to 45% of the total investments of Institutional Investors. Therefore, their activity in the capital market is quite important.

1. Investment Regime

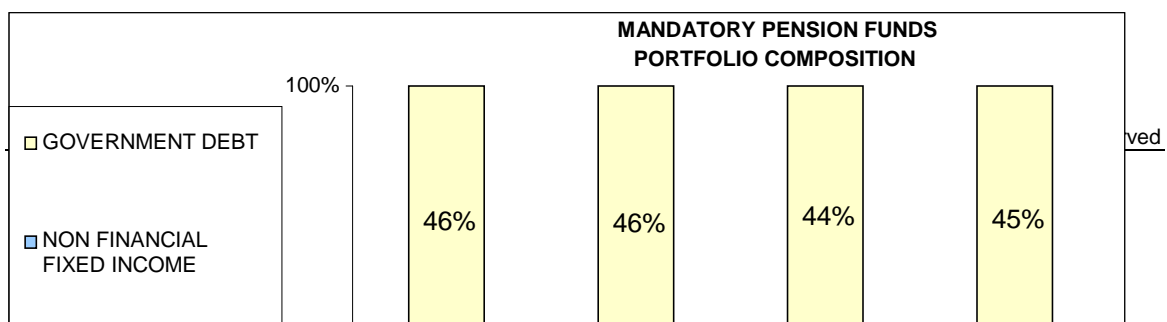
Current regulation provides for certain limits to the portfolio of the mandatory pension funds. Said limits may be summarized as follows:

Type of Investment	Limit
Government Bonds	Up to 50% of the portfolio
Financial Institutions fixed income securities	Up to 30% of the portfolio
Non Financial Institutions fixed income securities	Up to 30% of the portfolio
Securizations different from mortgage securities	Up to 40% of the portfolio
Stocks	Up to 30% of the portfolio
Foreign Securities	Up to 20% of the portfolio

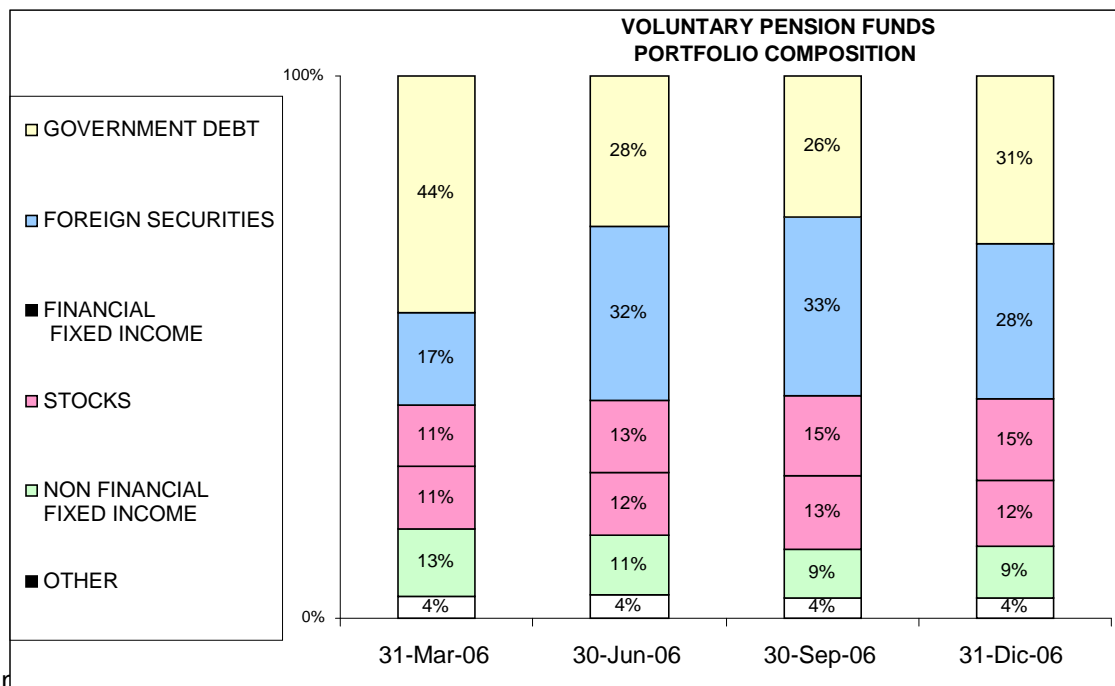
There is also a limit on the investment placed on the same issuer or its subsidiaries equivalent to ten per cent (10%) of the total value of the fund. If the issuer is related to the pension fund manager, this limit decreases to five per cent (5%) of the total value of the fund. However, this limit is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

For the year 2006, the actual composition of the portfolios managed by Mandatory pension funds is described in the following graph:



On the other hand, the voluntary pension funds portfolio composition was the following during the year 2006:



governance practices among issuers of securities. Due to Resolution 275 of 2001 enacted by the former Superintendence of Securities, they are compelled to invest the resources they manage, only in issuers that have incorporated and follow good corporate governance practices on the following topics:

- Management evaluation
- Conflict of interests
- Risk identification and disclosure
- Transparent election of the external auditor
- Information disclosure
- Specialized audits determined by minority shareholders
- Equal treatment for shareholders and

- Enforceability of corporate governance codes.

Although this approach has proven to be very important in the promotion of good governance practices among issuers, Colombia is currently changing towards a more voluntary approach based on a Corporate Governance Code that is suggested for all issuers to adopt. This Corporate Governance Code provides measures on the following topics:

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

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

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

According to current commercial 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.

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

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

According to the answers given by all the pension funds, the most important corporate governance risks are related with Transparency and Disclosure, Shareholder Rights, Control Environment and Family Business Issues.

Due to the current regulation, pension funds are used to 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.

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

- High concentration of property
- Insufficient offer of securities
- There are no incentives for them to be more active
- Existing rules are not enforceable
- Current regulation is insufficient

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

4. Corporate Governance of Pension Funds

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

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

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

- Prohibition to appoint as managers or directors of the issuer, persons that work for the pension fund or any of its related parties
- Conflict of interest rules related to the conflict that may arise between the fund or any of its related parties and the issuer
- Exercise of shareholder rights vis a vis the issuer.
- Rules for the selection of the external auditor
- Enforceability mechanisms for Corporate Governance Codes.

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

VI. MUTUAL FUNDS MANAGED BY TRUST COMPANIES

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

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

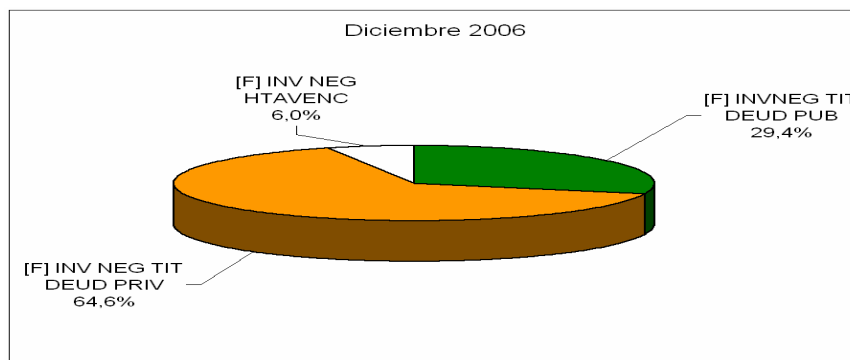
The main purpose of the new legal rule is to unify the law applicable to Collective Investment Schemes in Colombia. In fact, before Decree 2175 of 2007, trust companies and brokerage firms were able to manage CIS. Although the product was substantially the same, each type of entity had different regulation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

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

1. Open funds Investment Regime

Open funds were CIS in which a participant could leave the fund at any given time. Consequently their portfolio had to be constituted by highly liquid assets.

The portfolio of open mutual funds as of December 31, 2006 is depicted in the following pie:

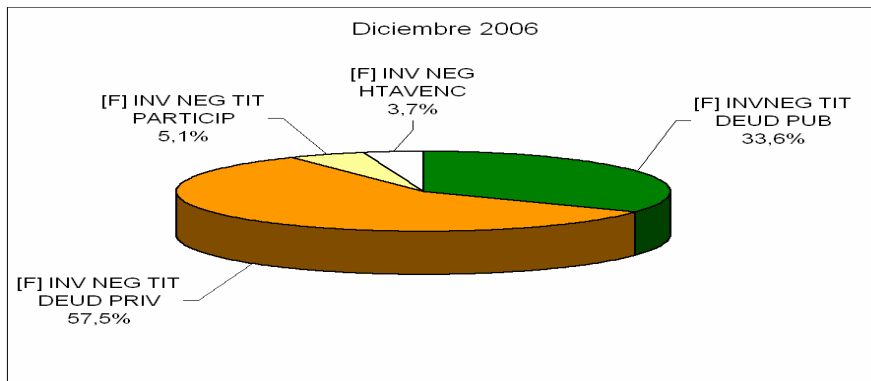


2. Closed Mutual Funds

Closed mutual funds were CIS in which the participants were not able to enter or leave the fund at any time but only whenever the corresponding prospect provided the opportunities to do so. Consequently, their investment regime allowed their portfolios to be more heterogeneous than open funds.

The portfolio of closed mutual funds as of December 31, 2006 is depicted in the following pie:

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3. Collective Investment Schemes Governed by Decree 2175 of 2007

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

a. Money market CIS

Their portfolio may only be composed of short term debt instruments

b. Real Estate CIS

60% of their portfolio should only be composed of i) real estate located in Colombia or abroad, ii) Securities issued in real estate securitization processes, iii) foreign collective investment schemes with similar characteristics.

c. Margin Account CIS

These CIS are constituted to manage margin accounts.

d. Speculative CIS

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

e. Market Index CIS

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

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

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

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

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

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

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

According to the answers given by all the trust companies that were interviewed, the most important corporate governance risks are related with Transparency and Disclosure, and Control Environment.

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

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

- High concentration of property
- There are no incentives for them to be more active
- Insufficient offer of securities
- Current regulation is insufficient

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

6. Corporate Governance of Mutual Funds

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

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

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

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

VII. ISSUES TO BE TAKEN INTO ACCOUNT FOR THE WHITE PAPER ON THE ROLE OF II'S IN THE PROMOTION OF GOOD CORPORATE GOVERNANCE

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

1. Differential treatment for mandatory and voluntary pension funds

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

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

Colombia is making the transit towards a system in which institutional investors will be required to disclose the importance that they give to the situation of the corporate governance environment of the issuer in the context of the process that leads towards the investment decision. We believe that special importance must be placed on the obligations that institutional investors must observe in reviewing the corporate governance environment of the issuers they invest in, on the aspects that should be taken into account in such assessments, and the need to disclose to the market the importance that such analysis has within the investment decision process.

3. Disclosure obligations on behalf of the issuers

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