*The Sixth Meeting of the*
*Latin American Corporate Governance Roundtable*

***20 - 21 September, 2005***
***Lima, Peru***

# White Paper Progress Report – Chile

This paper was prepared by Mr. Dieter Linneberg, advisor at the Chilean Securities Commission, and Mr. Fernando Lefort, executive director of the Chilean Centre for Corporate Governance. It will be circulated for comment to a range of other institutions and experts concerned with corporate governance before being finalised. It is published under the responsibility of the OECD Secretariat.

Based on the reform priorities of the Latin American White Paper on Corporate Governance, this report provides comments regarding progress over the past three years, key developments, obstacles to progress, and priorities for further improvement.

**Issue 1. Taking Voting Rights Seriously.**

***White Paper Recommendation:*** Steps should be taken to facilitate shareholder participation in General Meetings and voting of shares. 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. If the legal framework allows shares with different voting rights, this needs to be fully justified and accompanied by commensurately stronger and more effective protection of minority shareholders.

**Progress over the past three years**

In May 2003, the World Bank published the Corporate Governance Country Assessment of Chile as part of the Reports on The Observance of Standards and Codes (ROSC). The report indicated that, in Chile, shareholders rights to participate in fundamental corporate decisions and to exercise their voting powers in Extraordinary and Annual General Meetings were mostly observed.

Title VI of Chile's Corporations Law establishes the procedures for calling a shareholders meeting, the subjects that need to be reviewed and the quorums required for approval. The Law was amended in 2000 in order to enhance minority shareholders rights.

**Key developments**

Although there have been no key developments in the legal/regulatory framework in this area over the last three years, general awareness of the importance of and issues relevant to corporate governance and shareholders rights has clearly increased during this period. Institutional investors such as pension fund managers have, in general, prudently exercised their right to vote in order to defend shareholders rights. For instance, on July 15, 2004 an extraordinary shareholder meeting of Telefónica CTC Chile took place in order to approve the sale of CTC subsidiary Telefónica Movil de Chile. According to the Law, CTC requires a 2/3 majority vote to approve the transaction. In that meeting, the transaction was approved with the votes of pension funds that required a US$50 million increase in the price paid by Telefónica Spain.

**Obstacles to progress**

A key obstacle to increasing the effective exercise of voting rights of minority shareholders is the ownership structure of Chilean companies. In many cases, controlling shareholders of Chilean companies hold more than 2/3 of voting rights either directly or using pyramid structures and shares with superior voting rights. Although these structures reduce minority shareholders powers to oppose to controlling shareholders decisions, such preferences and structures are required to be disclosed to the market and investors are generally aware of them.

**Priorities for improvement**

Voting rights are considered to function reasonably well and thus voting rights in general are not considered a high priority subject for improvement in the legal/regulatory framework at the present time. However, one aspect that should be tackled is voting procedures and practices. In Chile, voting is performed by show of hands or secret ballot. Cumulative voting is the common practice and proxy voting is permitted. Voting by mail is not allowed. Currently, an amendment to the Securities Market and Corporations Laws, known as MK2, is being considered by Congress. The proposed amendment would, if enacted: introduce voting by mail; require that the external auditors be present at shareholders meetings; and expand the scope of

transactions requiring 2/3 of votes for approval. In particular, shareholders would be able to determine what constitutes an essential asset of the company in order to require the 2/3 quorum for its sale.

Another area for improvement is the voting rights of foreign shareholders, normally American Depository Receipt (ADR) holders. The ROSC for Chile recommended increasing the current 20-day notice period for convening a shareholders meeting to 30 days to allow sufficient time for international investors to attend. An amendment under the MK2 project is tackling this problem by requiring an additional general meeting announcement issued 20 to 30 days before the ones already required by law. This notice must also briefly provide information on the agenda of the meeting and the means available to shareholders to comment on the agenda.

**2.- Treating Shareholders Fairly during Changes in Corporate Control and De-listings**

***White Paper Recommendation:*** The legal and regulatory framework must provide for clear and *ex ante* rules regarding how minority shareholders are to be treated when there is a change in corporate control. Improvements should also be made to ensure a fair, practical and predictable system for valuing the shares of minority investors in cases of de-listings or exercise of withdrawal rights.

**Progress over the past three years**

As background, it is illustrative that in December 2000, the Corporations and Securities Market Laws were amended under the so-called OPA Law. The main goal of the amendment was to protect minority shareholder rights in Chilean companies, especially during changes in corporate control. The Law requires a public tender offer every time a person or group intends to acquire control of a company paying a significant control premium. The conditions of the offer must be made public and offered to all shareholders on the same conditions, therefore allocating the potential control premium on an equal basis.

More specifically, a tender offer must be made whenever the acquisition allows one person or a group of persons acting in concert to control the corporation. The price per share must be the same and the offer prorated across all shareholders. Additionally, that controller is required to carry out a tender offer for all the remaining shares whenever its interest reaches two thirds of the voting shares. Also, when the intention is to secure control of a subsidiary, a tender offer must be first made for the shares of the holding company.

Since the OPA Law was enacted, 34 firms have changed control, in transaction totalling more than US$ 4 billion. Also, even though the Law included a transitionary opt-out rule that allowed controlling shareholders to sell their stakes without carrying out a tender offer for a period of up to three years, few takeovers were carried out for firms that exercised such opt-out. Therefore the majority of transactions were made under a tender offer mechanism, despite the fact that listed companies, representing over 70 percent of market assets, could opt out under the transitionary rule. In January 2004, the transitionary rule expired, and since that date, all changes of corporate control in Chilean companies must be carried through tender offers.

Recently, the country witnessed the first hostile takeover carried out through a competitive tender offer over the retail company Almacenes Paris. Minority shareholders benefited from the competitive bid.

**Key developments**

During the years 2001 and 2002, Chile has been highly rated by international entities concerning the degree of shareholders protection. For instance, the Santander Central Hispano bank rated Chile first among the major Latin-American markets in shareholder protection; McKinsey & Company highlighted the low shareholder protection premium required for Chilean stocks, implying reduced ground for improvement, and the World Bank's ROSC report observed that Chile broadly observed the principles on corporate governance set by the OECD. In these assessments the regulation of tender offers played an essential role.

**Obstacles to progress**

The high level of ownership concentration and the presence of pyramid structures and in some cases dual class shares remain obstacles to the well-functioning of the market for corporate control in Chile. A competitive bid such as the one on Almacenes Paris is still very rare in the Chilean economy.

In general terms, shareholders in Chile have well established withdrawal rights, extending to cases in which the controlling shareholders wish to de-list the company. Although the Law establishes simple procedures to value shares in such cases, problems may arise when the liquidity of shares has severely decreased and accounting values have to be considered.

**Priorities for improvement**

In terms of takeover regulations, there have been discussions about whether to eliminate the requirement of a tender offer for the remaining outstanding shares whenever the controlling shareholder accumulates 2/3 of company stock. This proposal is aimed at allowing for withdrawal rights under this circumstance. Additionally, there is a proposal for establishing "squeeze out" rights under which the controlling party is allowed to buy back all the remaining shares and the minority shareholders are obligated to sell whenever the controller's holdings reach a considerable threshold (i.e. 95%). These proposals may ultimately be enacted under the above-mentioned amendment to the law being discussed in congress (MK2).

In relation to the high level of ownership concentration and the presence of pyramid structures and its effect on the absence of competitive bids, it is expected that shareholder dispersion will occur gradually in Chile, considering the high demand for corporate stock by institutional investors. In relation to dual class share structure, the OPA Law restricted the issuance of shares other than common shares, but the remaining dual class shares were not required to be eliminated as political consensus could not be reached.

**Issue 3. Ensuring the Integrity of Financial Reporting and Improving the Disclosure of Related Party Transactions**.

***White Paper Recommendation:*** National accounting standards should be brought into compliance with International Financial Reporting Standards and the quality of the financial reporting process should be assessed with a view to eliminate conflicts of interest. The disclosure of related party transactions and potential conflicts of interest in such transactions should also be improved and supported by better information about corporate ownership and control structures.

**Progress over the past three years**

**Over the past decade, Chile sought convergence of its economic and business standards with those of other industrialized nations, including in the field of corporate financial reporting and accounting. This trend is expected to continue.**

**At present, private sector financial reporting and auditing standards are established by four different entities: the Chilean College of Accountants (CCC), the Superintendency of Securities and Insurance (SVS), the Superintendency of Banks and Financial Institutions (SBIF), and the Superintendency of Pension Fund Administrators (SAFP), with some degree of co-ordination among these four entities. However, the existence of multiple sources of accounting principles contributes to a lack of clarity for the users.**

**The Chilean Corporations Law requires that all corporations prepare annual financial accounts in accordance with the Chilean generally accepted accounting principles (GAAP) and that registered corporations be audited each year by an independent auditor.**[1]

[1] In Chile, companies must register at the SVS Registry in order to be authorised to issue public offer securities. There are almost 600 companies registered and over 300 of them are also listed in the stock exchange.

**Prior to 1997, Chilean GAAP tended to be based up U.S. standards. Since 1997, Chilean standard-setting authorities have been converging national standards with international accounting and auditing standards, while at the same time retaining some local rules or interpretations of said standards in those instances needing specific reference to the Chilean context.**

During 2004 a World Bank ROSC on Accounting & Auditing was carried out in the Chilean market. The ROSC states that Chilean GAAP has been converging to IFRS during the last decade, which has led to improvements in the financial reporting by corporate entities. However significant differences remain. For instance, Chilean GAAP fails to require disclosure in certain critical areas such as segment information. As a result, financial statement users are not fully informed.

In terms of accounting standards, certain aspects were highlighted as being treated inadequately, namely: a) foreign investments in hyperinflationary or unstable economies b) accounting for financial instruments c) subsidiaries excluded from consolidation d) provisions, e) earnings per share, f) special purpose entities, g) events after the balance sheet date, h) financial reporting of interests in joint ventures and, i) discontinuing operations.

**The ROSC recommends that Chile adopt IFRS, allowing for a reasonable transition period that would enable Chilean stakeholders to assess the implications of such changes and to prepare adequately to meet the new requirements. Also, the ROSC recommends that IFRS should be adopted as the mandatory financial reporting standards for all public-interest entities in Chile. Early adoption of IFRS should be encouraged and the Corporations Law should be amended to provide legal backing to the use of IFRS for statutory financial reporting.**

Currently, Chile is in the process of adopting International Financial Reporting Standards for listed companies. This project is a direct-follow up to the Accounting & Auditing ROSC carried out between January and April 2004

In relation to the disclosure of related party transactions and potential conflicts of interest in such transactions, current regulations establish the following regime:[2]

- If transactions involve substantial amounts, the company's board of directors must decide whether or not the terms are consistent with market conditions.[3]
- If the board is unable to reach a decision, it may, with the abstention of any board member with an interest in the transaction, approve or reject the proposal, or otherwise designate the matter to two independent evaluators.
- The evaluators' reports shall be made available to shareholders and the board of directors during a period of 20 working days.
- Shareholders who represent 5% or more of the shares may request an extraordinary meeting to resolve the matter with consent from two-thirds of the shareholders.

Nevertheless, some improvements remain to be made in terms of related party transactions and are being considered in future regulation as described in the "main priorities" section, below.

**Key Developments**

The key development in this area is the reaching of consensus among market participants to move toward the application IFRS standards. In relation to related party transactions and conflict of interest, some general

[2] A related party transaction is defined as a transaction in which a controlling shareholder, a board member, an executive and any person or company related by business or family ties to them have an interest.
[3] A transaction is considered substantial if it amounts to more than 1 percent of the book value of equity or more than 650,000 US dollars.

consensus has also been reached in identifying the main changes that must be made to the law and such changes are reflected in the amendments being discussed in Congress.

Obstacles to progress

**One obstacle to progress is the abundantly-detailed regulation of Chilean GAAP, that has been internalized by market participants and which makes it harder to switch to a set of different (and more principles-based) accounting rules. Nevertheless, participants are aware that changes can be expected in the future and appear prepared to cooperate closely with regulators. Also, IFRS must be applied to financial institutions such as insurance companies and securities firms. Regulators should reform their prudential capital rules to accommodate financial statements based on fair values, rather than on statutory rules.**

The proposed amendment MK2 also contemplates a reform to the Corporations Law that will more clearly define the concept of conflict of interest and will establish a procedure for approving transactions subject to potential conflicts of interest. A first version of the reform proposes that related party transactions in which a majority of directors can be considered related parties must be approved by two thirds of votes at an extraordinary shareholders meeting. This would also apply to transactions among companies affiliated to the same economic group. The reforms are facing some opposition because they are seen as too much of an obstacle for developing business, but will probably pass with some modifications.

**Priorities for improvement**

The main priorities for improvement are being tackled in two ways. In relation to accounting standards, as mentioned above, a project is in place to apply IFRS to all Chilean firms. In relation to auditing and related party transactions, the most important measures, submitted to the Chilean Senate as part of the previously mentioned MK2 legislation, are:

- Modernization of the external auditors industry: In order to guarantee technical suitability, open stock companies must be audited by firms (today, these audits may be performed by individuals). Requirements guaranteeing these firms' professionalisation, as well as their economic and technical independence, would be established. To this effect: a) the External Auditor cannot, with respect to the audited company, carry out activities compromising its independence (e.g., provide advice to the Finance Manager, and, at the same time, audit the financial statements); b) The external auditors' total income from a single group of companies may not exceed 10% of such auditors' total income from all clients.

- Related party transactions: The amendments to the law being discussed in Congress would strengthen the current legal mechanisms, adding additional provisions which are seen as priorities, including:

    - Protection for shareholders in the case of disposition of essential assets: A mechanism to identify these assets (as proposed by the Board of Directors) is defined. Current rules prescribe that the sale of these assets must be approved by 2/3 of the shareholders' meeting.

    - Certain related individuals, regarded as company "insiders" will be required to inform in advance of their intent to either buy or sell securities in their company, and, otherwise the major provisions that regulate transactions between related parties are as follows: they must return the generated gain or avoided loss by the purchase and subsequent sale of securities, or sale and subsequent purchase, within a 180-day period (regulation known as "short-swing profits rule"). This would not only discourage certain related parties from using proprietary

information, but because this is information of interest to the market, it would mitigate information asymmetry.

- Conflicts of Interest: The current Corporations Law contemplates a procedure to prevent only conflicts of interest that arise with respect to individuals: directors, managers, and main executives (that is, when the company is going to directly contract with these individuals, their relatives or companies where they are shareholders or directors). That procedure was described in the "progress over the last three years" section, above. Nevertheless, in terms of transaction with related firms, even though the Law establishes an arm's length transaction requirement, there are no specific procedures mandated in such circumstances. Therefore the procedure applied to transactions in relation to conflict of interest with individuals would be extended as well to transactions among related firms.
- The appropriation of business opportunities of the company by some shareholders is limited and regulated: No shareholders may use, for their own benefit, the company's business opportunities, except when the company's board of directors has previously rejected or dismissed it in a vote without the participation of the interested director.

- Information in the securities market: a proposal has been made to reform regulations regarding insider information clarifying the presumptions (which no longer refer to those who "have access to" but to those who "have" such information). Mechanisms for the prompt disclosure of said information are created: a company that has it must immediately transmit it to the general manager, and the latter will decide on its disclosure (until now, this decision fell to the board of directors, but this body does not meet permanently).

**Issue 4. Developing Effective Boards of Directors.**

***White Paper Recommendation:*** Laws and practices reflect that all directors, individually and collectively, should act independently in the interest of the company and all of its shareholders. There should be greater specificity concerning the procedural steps for fulfilment of the director's duties of care and loyalty and an explicit ambition by boards to clearly define their work procedures as well as those of special board committees. Boards should also improve their ability to manage conflicts of interest and ensure compliance with laws and ethical standards.

**Progress over the past three years**

The functioning of boards of directors in Chile was one of the areas where the World Bank's ROSC report detected deficiencies. In particular, several studies carried out in Chile had shown that boards of directors in Chile have, as expected, little presence of independent directors, tend to have few committees, and to act merely as an advisory board for the controlling shareholder. Three main recommendations emerged from the World Bank report: (i) create an institute of directors; (ii) define more precisely the concept of independent director; and (iii) impose penalties of varying severity for violations of the duties of care and loyalty.

Fortunately, progress in this key area of corporate governance has started to occur in Chile. First, in 2005 the Centro para el Gobierno de la Empresa (CGE) was founded with the support of the Pontificia Universidad Catolica de Chile, the Sociedad de Fomento Fabril (SOFOFA), the Pension Fund Managers Association, the Santiago Stock Exchange, the Santiago Chamber of Commerce and the AMCHAM (American Chamber of Commerce). The mission of the CGE is to promote the adoption of corporate governance best practices in Chile and serve as a point of encounter for directors, businessmen, academics and any body interested in understanding and promoting good corporate governance in Chile. The CGE board of directors is composed of nine members with wide experience as corporate directors representing controlling shareholders, minority shareholders both from pension funds and investment funds, the stock exchange, and the academic community. The CGE has launched a series of seminars and conferences designed to discuss the most relevant areas of corporate governance in Chile, and it has actively interacted

with governmental authorities in order to improve legislation and set a common agenda of topics for further advances.

**Key Developments**

CGE seminars and conferences have reached a broad audience of corporate directors and will be key to improving directors' awareness of their duties of care and loyalty. However, the creation of the Centre after many years of failed efforts indicates that the general level of awareness of corporate governance issues among the Chilean business community has reached a level of maturity that invites optimism about the potential for further progress of Chilean boards.

Another indication of this higher level of maturity is the recent pronouncement of the Chilean Supreme Court condemning the former executives and board members of ENERSIS for failing to carry out their duties of care and loyalty. This judgement, confirming a US$ 70 million fine imposed by SVS, also showed that regulations aimed at the fulfilment of the director's duties of care and loyalty, existing before the OPA Law, were robust although some amendments have been and are being made in this area.

**Obstacles to progress**

Chilean legislation narrowly defines an independent director as one that was elected without needing the votes of the controlling shareholders. Therefore shareholder concentration results always in a majority of non-independent directors, according to the legal definition, on the board. Also, controlling shareholders in Chile have no legal incentives to elect board members that are independent *de facto* even if they have been elected with the controlling shareholder votes.

In addition, controlling shareholders in the main Chilean companies see with certain apprehension the proposals to improve the functioning of the board of directors, reducing the scope for consensus in this area.

Moreover, effective measures to improve the functioning of the board of directors are not simply a matter of regulation but also self-regulation, therefore the space for government initiatives in this area is narrow.

**Priorities for improvement**

Greater importance should be given to clarifying the definition of and promoting the role of independent directors. Both the OPA Law and the MK2 reform have introduced the idea that there are key monitoring roles to be played by independent directors, given that directors elected by controlling shareholders may face a conflict of interest. In particular, MK2 proposes to increase the minimum number of directors to 11 in order to increase the chances that minority shareholders can elect a director. It is not clear what effect this measure would have on firms. Although there would be a majority of independent directors in the auditing committee, it would also involve more costs to the operations of the board of directors and the auditing committee as well, with a potential deterrence for those companies seeking to go public. In addition, there is no indication that the legal definition of independent director will be changed in the reform (MK2).

**Issue 5. Improving the Quality, Effectiveness and Predictability of the Legal and Regulatory Framework.**

***White Paper Recommendation:*** Parallel to strengthening the capacity of rule-making and enforcement bodies, steps should also be taken to ensure that the framework supports effective use of private actions. Depending on the legal context, this may include the introduction of class action suits and mechanisms for alternative dispute resolution, such as private arbitration in the areas of company law and corporate governance.

**Progress over the past three years**

The Securities Market Law and the Corporations Law comprise the legal framework governing capital markets and listed companies in Chile. The main body of both laws was written in 1981 and amended in 1989 and expanded upon in 1994. Both laws were amended again by Law Nº 19,705 of 2000 known as the Corporate Governance Law or OPA Law. The Securities Market Law and the Corporations Law have been written and reformed with the objective to achieve some of the strengths of their homologues in the US. However, the Chilean legal system as a whole generally follows the tradition of French Civil Law and, therefore, a clear written law leaves less room for interpretation than is the case in the Anglo-American legal tradition. Consequently, since the Chilean Judiciary system does not have the flexibility of a judiciary under Common Law, some tensions arise between the spirit of the Law and its application. In addition, disputes on corporate matters taken to courts of law tend to be long and the final outcome uncertain.

Three main supervisory entities overlook different aspects of financial markets and institutions in Chile: the Superintendency of Securities and Insurance Companies (SVS), the Superintendency of Banks and Financial Institutions (SBIF) and the Superintendency of Pension Fund Managers (SAFP). The Central Bank also participates actively in the financial system regulatory and supervisory process, especially in issues regarding international transactions and foreign market participants. The main supervisory entity, the SVS, was created in 1980 as an autonomous public organization that relates to the Chilean Finance Ministry with a Superintendent selected by the President. The SVS regulates all issuers of securities, the stock exchanges, the insurance industry and all capital market participants with the exception of pension fund managers and banks. More than 200 people work at the SVS. Its budget was recently increased in order to improve its enforcement capacities.

By far the most important development regarding the legal and regulatory framework in Chile in the last few years has been the corporate governance amendments of the Corporations and Securities Market Laws under the so called OPA Law. The new regulatory framework started in the year 2001, and had full applicability by 2004. Together with this reform, the SVS has increased its supervisory powers and its capacity to fine offenders.

Although the Santiago Chamber of Commerce has established an Arbitration Centre, the use of private arbitration in the areas of company law and corporate governance is nil and there have been no clear efforts to increase their relative importance.

**Key Developments**

A recent amendment to the Consumer Protection Law approved the class action mechanism in the context of violations to consumer rights, and introduced a mechanism through which suits initiated by the SERNAC (Supervisory Authority on Consumer Affairs) can give origin to a class action suit against the offender. Although there is still an ongoing debate regarding the constitutionality of such procedures, the SVS understands that the same sort of legal action could be used regarding infractions to Corporations and Securities Market Laws. However, as of today the constitutionality of such a legal action is not clear.

**Obstacles to progress**

Self-regulation has not been important in Chilean capital markets. Regulations are usually imposed by the appropriate authorities following the Civil Law tradition. According to the Securities Market Law, public corporations must be registered at the Securities Registrar kept by the SVS. At the moment of the initial public offering, a public corporation must sell at least 10 percent of its shares. As a continuing obligation, listed companies must provide all relevant information to the SVS in a timely fashion and prepare quarterly financial statements, which must be externally audited in December. However, the stock exchanges impose no additional requirements to listed companies.

**Priorities for improvement**

The key priorities in this respect are related to increasing awareness of investors' rights as shareholders. Measures should be taken in order to generate mechanisms aimed at simplifying shareholders' attendance and voting in shareholders' meetings. Also the Superintendency of Securities and Insurance is carrying out a redesign of its supervisory framework. In this context a project of risk based supervision is being implemented, aimed at identifying key weakness of regulated entities and corporations in terms of compliance, solvency and market conduct. This same project also is establishing requirements for the implementation of internal controls on the same entities.

A more active role from the private sector in creating effective dispute resolution mechanisms is also needed.