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White Paper on Strengthening the Role of Institutional Investors in Latin American Corporate Governance

This revised White Paper has been provided for consideration by participants to the Latin American Roundtable on Corporate Governance meeting in Santiago, Chile. It was prepared on the basis of information gathered for the 2007 and 2008 Roundtable meetings in Medellín, Colombia and Mexico City, Mexico and more recent developments. It is provided to Roundtable participants under the responsibility of the OECD and IFC Secretariat. Written comments or questions may be addressed to Daniel.Blume@oecd.org or Davit.Karapetyan@ifc.org by no later than 16 December 2009 prior to the issuance of a final version.

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CHAPTER I - ABOUT THIS WHITE PAPER

1. This *White Paper on Strengthening the Role of Institutional Investors in Latin American Corporate Governance* reflects the priority of the Latin American Roundtable on Corporate Governance to encourage the emergence of active and informed owners as an important lever for influencing better governance in the region. The Roundtable's 2003 *White Paper on Corporate Governance in Latin America* already identified a number of consensus recommendations in this regard, which this more focused *White Paper on Institutional Investors* builds and expands upon. It has done so by drawing upon both internationally recognized policy guidelines and best practices, starting with the *OECD Principles of Corporate Governance*, and country-specific research and consultations at previous Roundtable meetings and in a range of Latin American countries, including Argentina, Brazil, Chile, Colombia, Mexico and Peru. Different countries in Latin America have different market characteristics and legal frameworks, with some such as Chile and Peru featuring pension funds as the dominant institutional investor investing in their local stock markets, whereas some others have a more mixed institutional investor environment. This *White Paper* thus attempts to note differences in policies and practices among countries, and to differentiate recommendations when appropriate to fit the country-specific context.

2. Reports initially prepared for the 2007 Roundtable in Medellín and updated to reflect developments for consideration at the December 2-3, 2008 Roundtable meeting in Mexico involved the following lead institutions and consultants in preparing them: **Argentina** - the Center for Financial Stability (Pablo Souto); **Brazil** - Brazilian Institute of Corporate Governance (IBGC), (Adriane de Almeida), and the Capital Markets Investors Association (AMEC) and National Association of Investment Banks (ANBID); **Chile** – the Superintendency of Securities and Insurance, the Superintendency of Pension Funds, and University of Chile Center for Corporate Governance, (Alvaro Clarke and Dieter Linneberg); **Colombia** – The Financial Superintendency (Sandra Perreira); **Mexico** - the Center for Excellence in Corporate Governance (Jorge Fabr e); and **Peru** - the Association of Private Pension Funds (Carlos Eyzaguirre). This White Paper has subsequently been updated to take into account comments at the 2008 Roundtable as well as more recent developments, including those related to the financial crisis.

3. The country co-ordinators¹ circulated an initial draft of this *White Paper* for comment among "country task forces" and/or selected representatives of investors, regulators, stock exchanges, corporate governance institutes and other interested stakeholders prior to the issuance of a revised draft to all Roundtable participants for consideration at the 2008 Roundtable meeting. This *White Paper* also draws upon the synthesis report prepared for the 2007 meeting, "Institutional Investors and Corporate Governance in Latin America: Challenges, Promising Practices and Recommendations."

4. This *White Paper* is intended to serve as a reference for policy-makers, regulators, investors, companies and other market participants and stakeholders interested to support the increased involvement and responsibilities of IIs in promoting good corporate governance practices in Latin America. It identifies some of the measures that these stakeholders can take to support and enable such investors to further contribute to corporate governance improvements in the region. For these purposes, it is structured into five chapters: 1) About This White Paper; 2) the Importance of Institutional Investors in Promoting Good Governance; 3) The Latin American Context: Market and Institutional Characteristics; 4) Recommendations to Strengthen Policy and Good Practices; and 5) Additional Steps: Strengthening Market Forces.

¹ The country co-ordinators were the same individuals as the consultants mentioned above, with the exception of Argentina, where Emilio Ferr e of the Argentina Securities Commission co-ordinated input during 2008.

CHAPTER II - THE IMPORTANCE OF INSTITUTIONAL INVESTORS IN PROMOTING GOOD GOVERNANCE

5. The Roundtable has strongly affirmed the importance that institutional investors (IIs) can have in influencing improvements in corporate governance at policy and company levels, particularly within an environment of concentrated ownership, because of the positive impact that governance improvements have in protecting minority shareholder interests and in contributing to better company performance and share value. IIs can provide an informed counterbalance to controlling shareholders 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 Latin American context, policy-makers and regulators have given particular priority to encouraging such behavior by pension funds, because in many cases they manage compulsory savings and therefore are seen to have a duty to serve the public interest and to exercise vigilance in protecting the future benefits of retirees. With low liquidity in most Latin American markets, pension funds also have a long-term stake in the market, giving them a correspondingly stronger 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.

6. IIs other than pension funds have also found benefits in integrating governance oversight and engagement into their investment strategies, but the policy and regulatory framework has tended to provide greater leeway to such funds to evaluate their own costs and benefits of adopting an active ownership strategy. For example, an investment fund investing in thousands of equities throughout the world may face greater difficulty in attending shareholder meetings and actively reviewing the governance of its investee companies than a domestic fund specializing in local markets and investing in few companies. On the other hand, companies with much larger portfolios may emphasize participation through the use of proxy voting and advisory services as a cost-effective way to ensure that corporate governance concerns are addressed in their investee companies.

7. Despite a number of "active ownership" success stories, the Roundtable has noted that actual practices have often fallen short of the potential, with IIs too often taking a passive role and failing to exercise their ownership rights in an active and informed manner. The importance of this issue was also underlined during the 2004 revision of the *OECD Principles of Corporate Governance*, which concluded that, "The effectiveness and credibility of the entire corporate governance system and company oversight will, therefore, to a large extent depend on institutional investors that can make informed use of their shareholder rights and effectively exercise their ownership functions in companies in which they invest."

8. On a global level, the recent financial turmoil has reinforced the focus on the issue of whether institutional investors should have done and should do more to monitor companies. The OECD's Steering Group on Corporate Governance has spent the past year reviewing corporate governance lessons from the financial crisis, developing key findings and considering the issuance of new recommendations to address the corporate governance gaps that were made apparent by the crisis. One of the OECD's key findings was that "Shareholders have tended to be reactive rather than proactive and seldom challenge boards in sufficient number to make a difference. An ineffective monitoring by shareholders has been experienced both in widely held companies and in the companies with more concentrated ownership. In some

instances, shareholders have been equally concerned with short termism as have managers and traders, neglecting the effect of excessive risk-taking policies.”²

9. While the OECD’s final recommendations of relevance to institutional investors were due to be finalized in December, 2009, too late to incorporate directly into this version of the White Paper, this report does make reference where relevant to its interim “Key Findings and Main Messages” that were issued in June 2009.

10. At the crux of IIs’ decisions on whether to play an informed and active role in exercising their ownership rights is an economic calculation on whether the benefits of such an approach outweigh the costs. Monitoring the market and individual companies, reviewing their governance arrangements, making use of proxy advisory services, participating and voting in shareholder meetings, and challenging the decisions of corporate management and boards, whether through litigation, arbitration or more informal mechanisms, all carry costs. To the extent that certain IIs are active in pursuing better corporate governance in their investee companies while other minority shareholders remain passive, there is also a “free rider” problem, in which passive investors can obtain the benefits of active investors’ engagement while not incurring the costs. Nevertheless, there are a sufficient number of examples not only in Latin America but globally of IIs obtaining positive rewards by playing an active role, and facing negative consequences when they did not play such a role, that a strong case can be made for both policy-makers and the private sector to encourage the active engagement of investors in ensuring good governance practices.

² See “Corporate Governance and the Financial Crisis: Key Findings and Main Messages,” page 53, OECD, June, 2009, available at www.oecd.org/daf/corporateaffairs

2.1 The Current Consensus: Recommendations of the Latin American White Paper on Corporate Governance, OECD Principles of Corporate Governance and other Global Experience

11. 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 1:

Box 1: 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.

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.

12. It is worth noting that, following up on the recommendation contained in para. 36 above, Development Finance Institutions have been meeting periodically, with active involvement of many institutions including the International Finance Corporation (IFC), African Development Bank (AfDB), Andean Development Corporation (CAF), European Bank for Reconstruction and Development (EBRD), Inter-American Investment Corporation (IIC), Islamic Development Bank (IsDB) and the Netherlands' Development Finance Company (FMO), to promote progress in corporate governance globally. These institutions developed a common approach in 2007 to promote better corporate governance (See Box 2), and have subsequently met annually to monitor progress and exchange experience on how to effectively implement this approach. The Brazilian National Development Bank (BNDES) also has established corporate governance policies to take into account good corporate governance in their investments.

Box 2: Excerpts from the “Corporate Governance Approach Statement by Development Finance Institutions”³

IV. Why an Approach Statement on Corporate Governance by DFIs

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.

13. 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, following broad global consultation including input from the Latin American Roundtable, provided 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).

14. 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).

³ For more information please see < http://www.ifc.org/ifcext/corporategovernance.nsf/Content/DFI_Statement>.

15. However, the *OECD Principles* also go a step further with three 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 it notes 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.”
3. **“The corporate governance framework should be complemented by an effective approach that addresses and promotes the provision of analysis or advice by analysts, brokers, rating agencies and others, that is relevant to decisions by investors, free from material conflicts of interest that might compromise the integrity of their analysis or advice” (Principle V.F).** The Principle’s annotations note that while these intermediaries can play an important role in providing incentives for company boards to follow good governance practices, concerns have arisen in response to evidence that conflicts of interest often arise and may affect judgement. “This could be the case when the provider of advice is also seeking to provide other services to the company in question, or where the provider has a direct material interest in the company or its competitors.” The annotations suggest that experience in other areas has shown that the preferred solution is to demand full disclosure of conflicts of interest and how the entity is choosing to manage them, including disclosure about how the entity is structuring the incentives of its employees in order to eliminate the potential conflict of interest.

16. The Recommendations contained in Chapters 4 and 5 of this *White Paper on Institutional Investors and Corporate Governance* integrate the above recommendations from the Roundtable’s 2003 *White Paper* and *OECD Principles* as policies and practices that already have obtained broad international consensus. However, this *White Paper* also aims to go further, by taking into account both Latin American

and global best practice experience, and recommendations from a range of institutional investors that have a reputation for promoting active and informed ownership.

17. On a global level, this includes the examples of the California Public Employees' Retirement System (CalPERS) and the Teachers Insurance and Annuity Association - College Retirement Equities Fund (TIAA-CREF), which 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. TIAA-CREF issued its "*Policy Statement on Corporate Governance*" along with a set of "*Proxy Voting Guidelines*."

18. CalPERS and TIAA-CREF recognize that there is 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.

19. Likewise, the International Corporate Governance Network (ICGN) approved a "*Statement of Principles on Institutional Shareholder Responsibilities*" in 2007. 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."

20. 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.

21. A number of other countries and organizations have issued statements to promote an active role for IIs to adopt and promote good corporate governance practices in their investee companies, including the Australian Council of Superannuation Investors' guidelines on good practice, German Corporate Governance Code for Asset Management Companies, Pension Fund Association Corporate Governance Principles (Japan), Eumedion Corporate Governance Handbook (the Netherlands), Council of Institutional Investors' Corporate Governance Policies (US), etc. An attempt has been made to incorporate aspects of this experience into the recommendations of this *White Paper*. More specific experience from Latin American institutional investors is addressed in the next chapter.

CHAPTER III - THE LATIN AMERICAN CONTEXT: MARKET AND INSTITUTIONAL INVESTOR CHARACTERISTICS

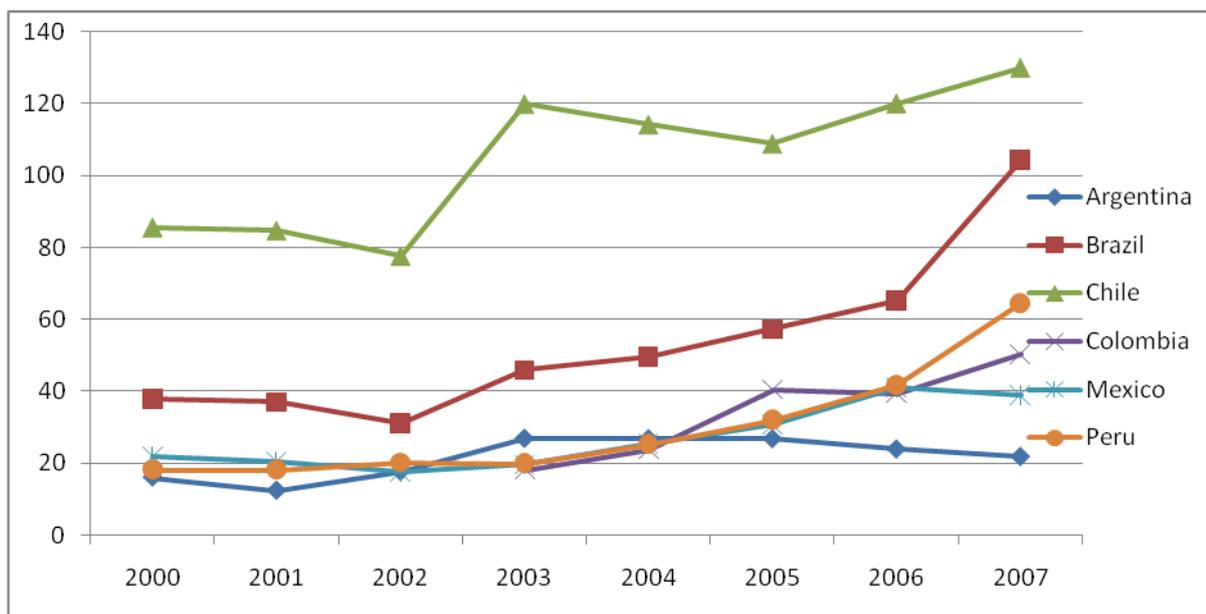
3.1 Economic and Capital Market Developments in Latin America

22. This *White Paper* was developed during a period of financial and equity market turmoil in which markets were extremely volatile. Stock market indexes dropped sharply all over the world beginning in the second half of 2008, including in Latin America. While there has been a strong recovery in share values during 2009, the IPO market in Latin America has remained weak relative to the middle part of the decade. Pension fund and other investment fund holdings experienced a corresponding drop in value during the downturn, generating some pressure to move assets from equity funds to more conservative investment strategies such as investment in bonds and other government debt instruments. There may also be increased pressure to impose regulatory restrictions aimed at minimizing the risk of such losses in the future.

23. Earlier data collected for this review through 2007 provided a picture of steady and stable growth in Latin America over a five-year period. Different countries' markets have grown at different speeds, with some like Argentina relatively stagnant, and others, particularly Brazil, but also Chile, Colombia, Mexico and Peru, showing sizeable recent increases. Although these data do not fully reflect most recent and substantial losses in the market and the subsequent rebound, it nevertheless provides good insight into the overall market structure and characteristics of key Latin American countries, and the role of different types of institutional investors in Latin American equity markets.

24. Most stock markets had been expanding faster than their overall economies' Gross Domestic Product (GDP) during this decade through 2007 (Table 1 below). Brazil has been the most dynamic Latin American equities market, though it too has slowed sharply, as the Brazilian report indicates: as of September 1, 2008, Bovespa (the Brazilian stock exchange) reported the listing of just 4 new companies, against 64 in 2007, 26 in 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, reaching US\$29 billion by the end of 2007. This figure dropped back to US\$4.7 billion through the first 9 months of 2008.

Table 1: Market capitalization as % of GDP for selected Latin American countries (2000-2007)



Source: Stock Market's Significance in the National Economy, World Federation of Exchanges

25. 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 -- 124% as of 2007. The Chilean market size to GDP is well above Latin American standards, and comparable to those of the most developed markets in the world.

26. Although the overall growth in these countries' stock markets was positive in the period leading up to the financial crisis, there remains an important concern, exacerbated to some extent by the crisis, that, apart from Brazil, the markets have not developed sufficient levels of liquidity to sustain a healthy market for investors, including institutional investors. Table 2 provides a wider set of indicators against which to assess recent activity in the market, in which the dramatic drop in share values during 2008 both in Latin America and elsewhere clearly appears, while there has been limited IPO activity in most markets.

Table2: Domestic market cap, value of local shares traded, number of local listed companies and IPOs

	Market Cap USD bn (2008)	Market Cap USD bn (2007)	Value Traded USD bn (2008)	Value Traded as % of Market Cap 2008	Listed comp. 2008	Newly listed compared to 2007.
Argentina	39.8	57.1	6.6	16.58%	112	1
Brazil	592.	1 369.7	724.2	122.33%	392	- 12
Chile	131.8	212.9	36.2	27.47%	238	- 3
Colombia	87.7	101.9	20.3	23.15%	89	- 1
Mexico	234.	397.7	110.5	47.22%	373	6
Peru	37.9	69.4	6.3	16.62%	244	18
Australia	683.9	1 298.3	1 213.2	177.39%	2 009	11
India	647.2	1 819.1	301.6	46.60%	4 921	34
Spain	948.3	1 781.1	2 410.7	254.21%	3 576	39
Thailand	103.1	197.1	116.	112.51%	525	2
Turkey	118.3	286.6	247.9	209.55%	317	- 2
UK	1 868.1	3 851.7	6 271.5	335.72%	3 096	- 211
US^a	11 605.3	19 664.5	70 085.5	603.91%	5 963	597

a) Aggregated data from Nasdaq and NYSE.

Source: World Federation of Exchanges

27. Market liquidity in Latin America is relatively low in comparison to more developed OECD as well as many emerging markets. For example, in 2007, value traded as a percentage of GDP was far higher in Thailand (60%), and Turkey (103%) than the 43% rate of even the leading Latin American country, Brazil. Latin America also fared far less well in comparison to OECD countries such as Spain (164%), the UK (157%), and the US (201%). These percentages rose substantially among all countries in 2008 following the financial crisis, when trading volume increased dramatically, but again, as evident in Table 2 above, value traded in all Latin American countries except Brazil was substantially lower than in most other countries shown in the table. High ownership concentration and 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, often leading to portfolio replication among pension funds, 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.

28. Additional weaknesses or vulnerabilities in the functioning of Latin American markets have been identified in relation to the overall market infrastructure. With relatively few listed companies and low liquidity, there is less of a market willingness to pay for corporate governance services, such as proxy voting services and rating agency services that take corporate governance into account as part of their criteria for rating companies. At the same time, in more developed markets, rating agencies have become a target of criticism in some cases for having conflicts of interest related to providing separate consulting services to companies at the same time as they are rating them. This has resulted in stronger calls for measures to be taken to ensure or require that such services disclose their ownership interests, any potential conflicts of interest they may have, and how they are addressing them. In Latin America, because there is relatively little market demand for these services, most regulators have not yet focused on and set up requirements aimed at minimizing such conflicts of interest in their practices.

3.2 Characteristics of institutional investors in Latin American Markets

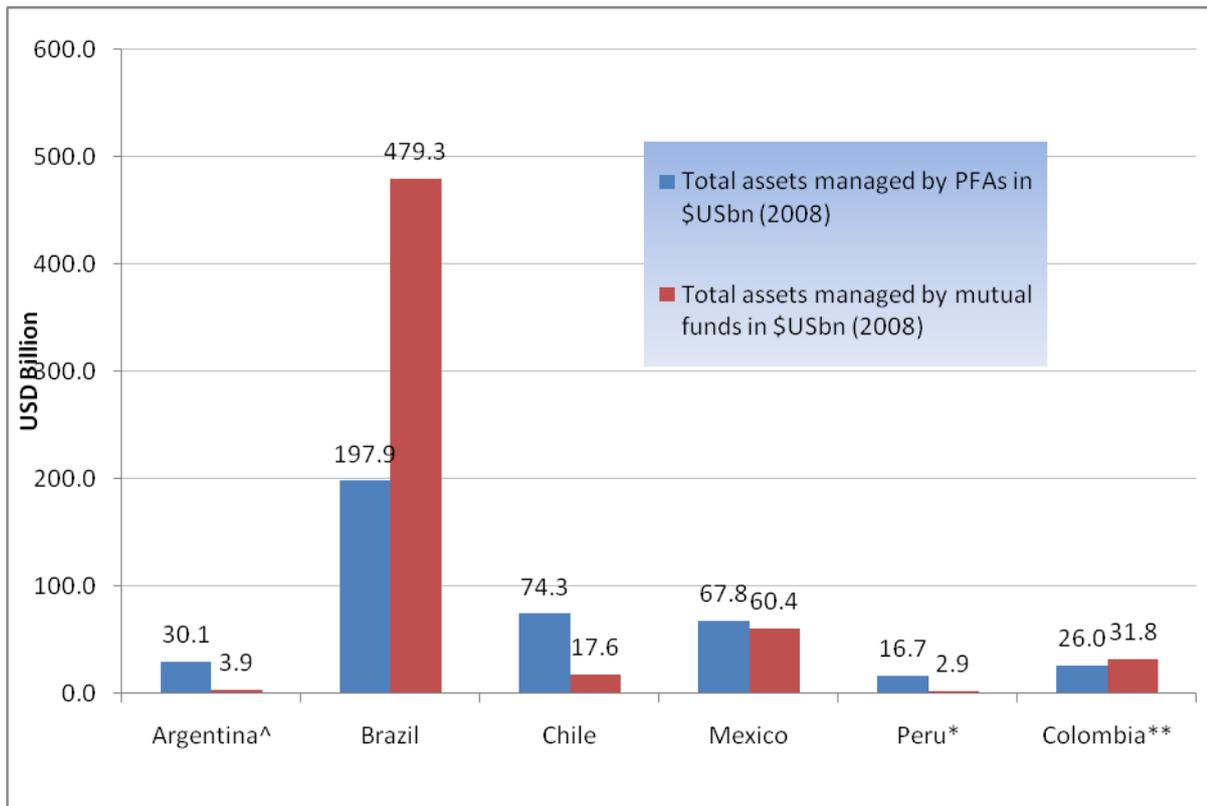
29. Despite these limits on investment opportunities and other weaknesses in the development of capital markets in Latin America, institutional investors have no doubt been playing a role in stock market growth, as the largest and most influential minority shareholders in many listed companies. The *White 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.”

30. 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 system, have provided an important contribution to growing pools of domestic investment. Pension fund assets under management in the region have grown by an average of 16 percent annually since 1999, reaching US\$390 billion by the end of 2006.⁴ These funds are the most dominant institutional investors in the market in many Latin American countries (Table 3 below). Brazil is the strongest exception, where mutual funds make up a much bigger share, and to a lesser extent in Colombia.

⁴ See the Latin American Economic Outlook, Chapter 2, “Pension Reform, Capital Markets and Corporate Governance,” published by the OECD Development Centre.

Table 3: Assets managed by PFAs and mutual funds



PFAs data source: International Association of Pension Fund Supervision Organs, AIOS- and Secretaria de Previdência Complementar -SPC- for Brazil (PFA figures for Dec 2008, at exchange rate of 31/12/2008).

Mutual funds data source: 2008 Investment Company Factbook, ICI (www.ici.org)

[^]Argentina: Total assets managed by PFA figure for 2007 (2008 unavailable).

^{*}Peru: Mutual funds figures are based on CONASEV statistics for December 2008 (at exchange rate 31/12/2008)

^{**}Colombia: Mutual funds figures based on 2007 figures provided by the Superfinanciera (only includes trust funds).

31. 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 4 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.

Table 4: PFAs portfolio ceilings by main asset classes in Latin American and OECD countries

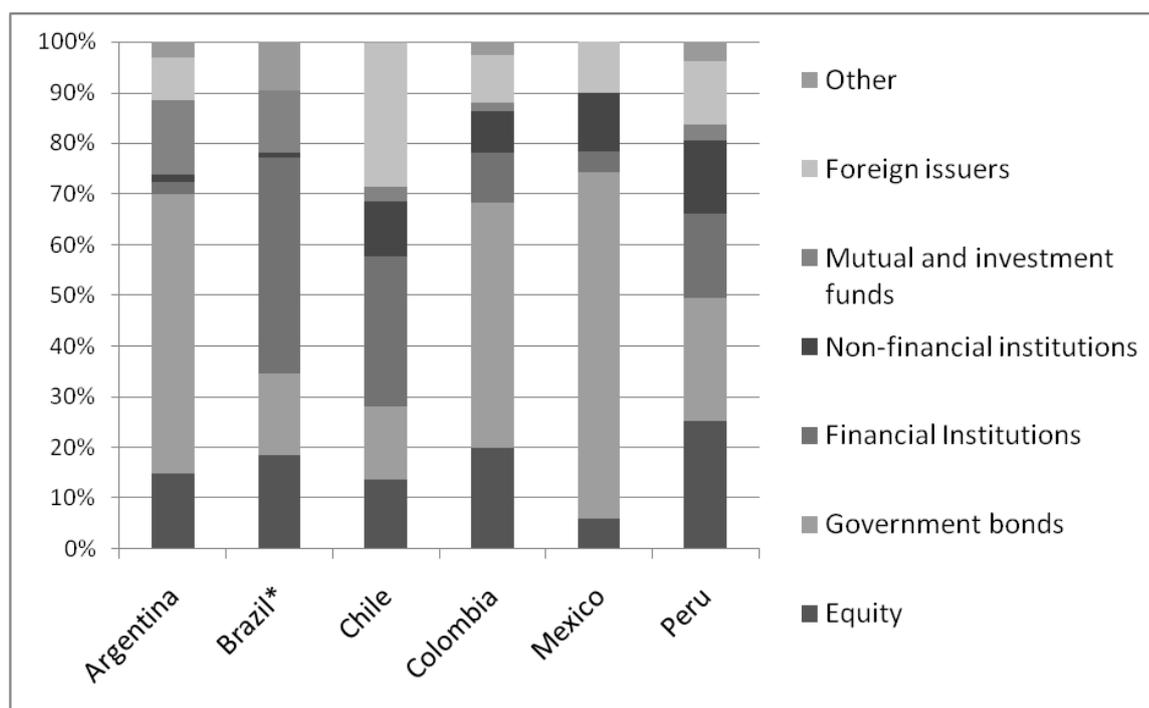
	Government securities	Financial institutions	Stocks	Corporate bonds	Investment funds	Foreign securities
Argentina	80 %	40 %	50 %	40 %	20 %	10 %
Brazil	No limit	20 %- 80 %	35% - 50%	20 %- 80 %	20 %- 80 %	10 %
Chile	40 %-80 %	40 %- 80 %	0 %-80 %	30 %- 60 %	0 %-40 %	40 %
Colombia	50 %	30 %	40 %	30 %	5 %	40 %
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, 2008 and country reports

32. Limits on investments in foreign securities and low liquidity in Latin American markets has contributed to what the Chileans and Brazilians call the “*manada*” effect, which means that pension fund managers end up structuring almost identical portfolios due to limited supply of stocks in the national market as well as investment limits set by the regulator. Pension fund managers tend to replicate the “average” portfolio, which is often based on following the practices of one or more of the largest pension fund managers. In Chile, this effect is also caused by a requirement of minimum return that has induced pension funds to choose similar portfolios. Similarly, in Peru and Argentina, the “minimum return policy” for pension funds, as well as the very short list of companies in which pension funds are allowed to buy stock, has contributed to portfolio replication.

33. Within this framework of limits, a significant share of pension fund portfolios is being invested in the equity market, with Peru leading all Latin American countries at 41%, and Mexico on the opposite end of the scale with about 4% 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.

Table 5: Portfolio Composition of PFAs (2008)*



Source: AIOS and *Secretaria de Previdência Complementar -SPC-* for Brazil.

*Note: All figures based on end of 2008 figures except Brazil data based on June, 2008. Equity for Brazil includes local and foreign.

34. Data on **mutual fund investment portfolios** and percentages invested in equities was not available in all countries, but Mexico reported US\$10.5 billion (14 percent) of its US\$75 billion was invested in equities, while about 19 percent of Brazil's US\$615 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 45%. However, over 90% of these investments are in foreign equity, particularly in securities from Brazil (while Brazilian mutual funds invest far lower percentages of their portfolios in their own countries' equity).

35. This *White Paper* does not provide comparable data on the size of other institutional investors, such as insurance funds, financial institutions, and private equity, because for the most part their influence on corporate governance of listed companies is much less important, as their investment in equity markets tends to be much smaller than those of mutual funds and especially pension funds.

36. A notable exception mentioned in the country reports concerns the **growing role of private equity** in Mexico and Brazil, of particular relevance in helping to prepare privately held companies to adopt measures, including corporate governance improvements. In Brazil, private equity investments, in some cases concentrated on bringing privately held companies to the market through improvements in corporate governance, had grown from US\$5.6 billion at the end of 2004 to US\$16.7 billion as of July 2007. In Mexico, private equity investments rose from USD\$1 billion in the year 2000 to USD\$8 billion as of 2007. Overall, however, these amounts remain quite small in comparison to the size of mutual and pension fund investments in Latin American companies.

37. In addition, Roundtable participants from Argentina and other smaller, less liquid markets such as in Central America suggested a potential for **banks to play a larger and complementary role** to other institutional investors in influencing corporate governance through their review of corporate governance practices as part of their lending processes. The role of financial institutions in Latin America and their impact on corporate governance is attracting growing attention in the region, including as an issue for

discussion at the 2009 meeting of the Roundtable and possible future follow-up. However, given the predominant role of pension and mutual funds among institutional investors in Latin America, this *White Paper* has chosen to concentrate mainly on these two types of investors in its analysis and recommendations.

38. *An additional issue of growing prominence in Latin America relates to the role of the state – for example as owners of sovereign wealth funds, pension funds and state-owned enterprises, and the state’s influence on corporate governance through these different potential channels for investment. The OECD’s Guidelines on Corporate Governance of State-Owned Enterprises provide relevant guidance in this regard, but the subject is a complex one that merits further attention. The Roundtable may wish to consider giving additional follow-up attention to both the role of financial institutions and the role of the state in corporate governance, since these issues could not be addressed within the scope of this White Paper.*

3.3 Overcoming Barriers to Positive II influence on Corporate Governance in Latin America

39. Latin American countries have taken differing legal and regulatory approaches to the question of how best to encourage and enable IIs to responsibly exercise their ownership rights and promote good corporate governance in the companies in which they invest. But there remain many market, regulatory and cultural barriers for IIs to play that role. A quick overview of some of the highlights of these legal approaches is provided below along with cross-references to the relevant recommendations contained in the following chapter of this White Paper.

3.3.1 Relaxing regulatory limits on investment in equity

40. Countries of the region have different regulatory limits set on the amounts that pension funds may invest in equities, as shown in Table 4 above. These limits generally reflect the regulator’s views on prudential regulation of the industry and their interest to limit unnecessary risk-taking for the benefit of the funds’ beneficiaries, the desire to protect and encourage the development of local capital markets and to take account of the level of sophistication of the funds to make investment decisions outside such parameters.

41. On average, pension funds are allowed to invest up to 50% of their funds in stock of companies (Chile and Peru provide for a threshold of up to 80%, whereas the limits to invest in foreign stocks are generally much lower – on average 10% (Chile and Colombia provide for a threshold of up to 40%). In short, the regulator directs the pension funds to invest in more conservative instruments, which in some cases may limit the extent to which funds can distinguish companies with better corporate governance and invest in them at higher levels to reward them for their better practices.

42. Within the framework of such limits, the approach taken in Brazil has sought to establish incentives for pension funds to reward good governance by establishing ***variable limits on investments in equity***. Brazilian regulators allow PFAs to invest up to 50% of their portfolio in equities from the three corporate governance listing segments of the stock market, the Novo Mercado, on which companies are required to commit to higher than legally-required standards of corporate governance. These PFAs may only invest up to 35% of their portfolios in the regular market segment. However, the overall share of pension fund investment in equities was only about 20% on average (including foreign equities) in 2007, well short of either the 35% or 50% limits, making it unclear whether such incentives are having an impact in practice. This suggests that as a general rule, regulatory limits on equity investment need to be regularly reviewed with a consideration of practical market realities and whether such limits are achieving their intended purposes. 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 had outperformed those listed in other market segments by 25% in terms of share value as of 2007.⁵

43. Lacking a Novo Mercado-style corporate governance benchmark which enables companies to make binding commitments to higher than legal standards, other countries have not followed suit with such incentives for PFAs to invest in better governed companies.

44. The most restrictive approach to prudential regulation among the six countries reviewed was found in Mexico, where pension funds are not permitted to invest in individual listed companies. Until recently, the only option for pension funds to invest in equity was through instruments which replicate selected share indexes. However, a new regulation issued in July 2009 by CNBV, the Mexican securities regulator, allows for the establishment of new investment trust funds, called Development Capital Certificates (DCCs), regulated by the CNBV, which can invest in individual companies which may be either private or publicly-traded. Pension funds are allowed to invest up to 10 percent of their portfolios in DCCs, providing them with a means for differentiating between well-governed and less well-governed companies. Although the DCCs were established primarily as a way to raise capital for infrastructure projects, this new initiative does provide an instrument for institutional investors that potentially could be used to target some of their resources directly towards better-governed companies.

3.3.2 Requirements for investor activism

45. On the other hand, a number of countries, including Chile, Colombia and Peru, have taken a more direct regulatory approach to imposing requirements on pension funds to take actions aimed at promoting their role as active and informed owners.

46. **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* (see also para. 89). 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 AFP⁶... 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."

47. **Chile** has also taken a step to mandate active ownership by *requiring its pension funds to vote* on all matters in the shareholders' meetings (see also para. 90). 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.

Guerra, Sandra, "Brazil, the Virtuous Circle"; Governance, September 2007 - Issue 167.

⁶ Article 94, Regulation of The Unified Text of the Private Pension Fund Law, enacted by Supreme Decree N° 004-98-EF, modified by, Article 2, Supreme Decree N° 182-2003-EF, 12-12-2003.

48. **Colombia** adopted a new approach in 2007, requiring that pension funds specifically take into account corporate governance in their investment analysis and decisions, and to disclose the importance that they place on corporate governance in their investment decision process (see also para. 72). This approach was facilitated by Colombia's recent adoption of a national corporate governance code and a requirement that all companies issue detailed annual corporate governance reports disclosing whether they are complying with the code's measures and explaining how they do it, while an explanation is voluntary in cases of non-compliance with code provisions. Similar to pension funds, the regulatory framework in Colombia through Circular 54 requires that managers of mutual funds consider within their investment policies the relevant corporate governance regulations, in particular the adoption of the national code by the corresponding issuers.

49. **Argentina's** approach to pension fund influence on company governance is currently uncertain, due to its move to nationalize its pension system beginning in January 2009 (see also para. 130). Privately managed pension funds, which invested approximately 15 percent of their funds in Argentina's equity market, were taken over by state ownership. Argentina's publicly-owned pension fund system, the so-called Sistema Integrado de Pensiones Argentino (SIPA), established a Council of the Fondo de Garantía de Sustentabilidad to monitor its financial resources. This Council was to be composed of representatives from the Social Security Administration (ANSES), one from the Ministries Chief Cabinet, two from the retirees, three from the workers, two from business associations, two from banking associations, and two from the National Congress.

3.3.3 Enabling IIs to participate and vote in shareholder meetings

50. Another barrier to IIs responsibly exercising their ownership rights is the lack of laws and regulations enabling IIs to exercise the voting rights in practice. In particular, in country task force discussions held in **Brazil** and **Chile**, one of the key concerns raised by investors was the need to facilitate participation of shareholders in general meetings, either through streamlined proxy voting procedures or direct participation. **Brazil's** regulator, CVM, recently reviewed requirements to try to facilitate the use of proxy voting and other forms of shareholder participation by clarifying that a shareholder who wishes to delegate his voting powers to other authorized representatives is not required by law to have the authorization document with his signature notarized (see also para. 92). Companies can require this as a condition for voting but are free to waive it if they so decide. In practice, a consulting firm will offer its services to companies that prefer to receive their powers of attorney by means of a website called "On-line Shareholders' Meetings." The web site will register shareholders and their digital signatures in conformity with security matters stipulated by the company. Votes will be accepted up to one hour prior to the meeting. Foreign shareholders, investment funds and shareholders are expected to benefit, since it will be easier and quicker to establish powers of attorney in favor of local representatives, making it easier for themselves to be represented at distant locations.

51. In addition, CVM's proposals, to be implemented at the beginning of 2010, also provided for the use of blogs, web sites and on-line broadcasts of shareholders' meetings. While these are new measures and it is too early to know how widely Brazilian companies will adopt these practices, they represent important steps to facilitate shareholder participation, and several companies have already shown interest in adopting some of these measures.

3.3.4 Co-ordination of Minority Shareholder Support for Better Governance

52. Low liquidity and scarcity of investible shares have caused long-term investors, especially pension funds, to have similar portfolios and therefore to own shares in the same companies. While this similarity of portfolios has the drawback of failing to provide 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 co-ordinating and pooling their votes to pursue common goals.

53. The *OECD Principles*' annotations state that shareholders should be allowed, and even encouraged, to consult with each other, subject to exceptions to prevent abuse. The aim of this recommendation is to facilitate the exercise of shareholder rights by reducing the costs and increasing the effectiveness of shareholder intervention, partly resolving the "free rider" problem. However, many OECD countries have tended to focus on several issues where the potential for abuse could be a concern, imposing disclosure requirements in relation to co-operation when the co-operation relates to acquiring, holding, voting or disposing of a company's securities. This may relate particularly to takeover bids, tender offers, disclosure requirements triggered by crossing of thresholds related to significant holdings, insider dealing and insider reporting.

54. In the Latin American context, such concerns remain important to address, particularly for institutional investors who may be acting in concert to assume control. In the majority of cases, however, control is well established by a dominant shareholder or controlling group, and institutional investor co-operation is considered desirable from the perspective of influencing corporate governance improvements, including in particular the election of board members by minority shareholders as a counterbalancing interest to controlling shareholders. Particularly 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. The active and coordinated actions taken by **Peru's** and **Chile's** pension funds in electing board members is a positive example of these types of actions.

55. Another approach to coordination, more focused on ensuring that minority shareholder rights are respected more generally, occurs in **Brazil**, led 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 (see para.155). AMEC was established 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 numerous listed companies.

3.3.5 Developing clear governance benchmarks

56. A common concern identified by many of the country task forces was the lack of an objective benchmark, 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 rewarded by the market. The special corporate governance listing segments of Bovespa 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 accounted for approximately 64% of the total market capitalization in BM&FBovespa as of October, 2009. Likewise, virtually all IPOs in Brazil are listings in one of the three corporate governance segments.

57. 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. Colombia's new disclosure requirements concerning compliance with its voluntary corporate governance code is notable to watch because of its corresponding requirement that pension funds take company corporate governance into account in their investment decisions. Currently, these types of codes exist in several other Latin American countries as well (Argentina, Panama, Peru and Mexico) with varying degrees of disclosure required. Chile has no disclosure requirements in relation to its voluntary corporate governance code. Enforceability has been a main issue, since the codes are voluntary and the degree of disclosure that occurs can be quite uneven, making it difficult for investors to have a good basis for comparison and to actually pay a premium on those companies implementing the code's recommendations.

3.3.6 Promoting successful practices to overcome cultural resistance

58. 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, reinforcing a culture of passive ownership. 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, within a competitive market for pension fund plans, this practice could be countered to some extent by clear disclosure to pension fund beneficiaries about the real performance and risks associated with their retirement savings. In this respect, investor education on the benefits of good corporate governance as a contribution to higher share value and reduced risk could also be helpful in overcoming passive investor behaviour.

CHAPTER IV - RECOMMENDATIONS TO STRENGTHEN POLICY AND GOOD PRACTICES

4.1 Policies and good practices to encourage more active involvement of institutional investors (IIs) in promoting better governance

59. **Institutional investors may more effectively and efficiently contribute to improvements in corporate governance in Latin America through actions on multiple levels: (i) on the policy level led by governments, legislators and regulatory agencies (and in some cases, through stock exchange listing requirements); (ii) the level of self-regulation facilitated by associations and other collective organizations of IIs; (iii) the level of actual practices of individual IIs; and (iv) the level of companies encouraging and enabling their investors, including IIs, to act as responsible owners.**

60. The recommendations below deal specifically with how IIs can better and more actively promote governance practices in their investee companies to create long-term shareholder value. However, some of the required or recommended actions are possible and cost-efficient to implement only if the proper legal, regulatory and policy framework is in place. This requires attention from policy-makers to introduce measures aimed at creating the right conditions and incentives for IIs.

61. Correspondingly, the recommendations below distinguish between policy measures as the **text in bold** indicates, and practical recommendations of what IIs should/could do as the *text in italics* indicates.

62. Most recommendations are general to all markets in the Latin American region. However, considering peculiarities of each country such as the size and relevant importance of different categories of IIs, the state of the legal and regulatory framework and the history of IIs' involvement in promoting better corporate governance, this White Paper also provides some country-specific recommendations. The country-specific framework will also influence different reform priorities in each market.

63. **Each country must determine what type of policy-level intervention makes the most sense from its own perspective, whether using laws, , securities market regulations or acts of regulatory agencies for different categories of IIs, or self-regulatory initiatives. The legal and regulatory involvement should not merely impose additional requirements on IIs to responsibly exercise their ownership rights, but also enable and incentivize the IIs to efficiently do so. In doing so, the regulators should weigh the costs and benefits involved in establishing higher standards, seek to minimize costs of implementation and ensure that the benefits to be achieved through adoption of such standards outweigh the costs.** There is an active debate in emerging markets on this issue, with some of the more successful market experiences suggesting that higher standards can attract greater investment, increasing the incentives for companies to list. However, If the new requirements and standards become too costly to implement, without perception of corresponding benefits, IIs and the investee companies may be discouraged from improving their corporate governance .

64. Every country in the region needs to define for itself what role the policy framework should play to contribute to corporate governance improvements in their companies and markets in general. The policy framework should take into account such factors as how advanced the legal and regulatory framework is in the country, how stringent the enforcement practices are, the existence and the market share of the IIs in the economy, and the level of corporate governance and capital market development. A legal and regulatory framework characterized by better enforcement practices, the existence of a relatively large and established IIs' industry and active market in general in the given country will likely lead policy-makers to focus at a minimum on eliminating any existing barriers to enable IIs to play their proper role. Countries

with a less developed framework for IIs' activities may prompt policy-makers to concentrate their efforts on not only eliminating the barriers but also considering relevant incentives to stimulate the IIs to take initial steps toward activism in corporate governance, or even possibly mandating certain actions by IIs to responsibly exercise their rights. Incentives may be in the form of tax incentives for longer-term investments by IIs that take an active ownership approach; permitting that IIs invest larger portions of their assets in companies with better governance; developing enabling legislation/regulation to allow IIs to access the necessary information from potential investee companies; or supporting initiatives to promote debate and educate all relevant stakeholders on the role of IIs.

65. The sections below follow the typical path of investment decision-making by IIs with the relevant policy, practical and country-specific recommendations included. Country-specific policies and practices are cited as relevant to contribute to a fuller understanding of the context for these recommendations.

4.2 Distinguishing better-governed companies for investment purposes

66. **Consistent with recommendations of the White Paper on Corporate Governance in Latin America (paras. 36-37, 39), legislators and regulatory agencies in the region should take measures to create reasonable conditions for IIs to efficiently include governance analysis in their investment appraisal processes.**

67. **This White Paper incorporates the recommendations of the White Paper on Corporate Governance in Latin America (para. 40) regarding the specific solutions that country regulators may devise to encourage IIs whose portfolios are subject to regulatory limitations to distinguish better-governed companies for investment, for example, by restricting investment in companies that don't meet minimum standards of corporate governance, or by permitting proportionally greater investment in companies that meet certain higher corporate governance and disclosure requirements.**

68. In Brazil, the regulatory framework facilitates the recognition by IIs of better governance in particular through BOVESPA's special corporate governance segments of Levels 1 and 2 and the Novo Mercado, which provide a means for companies to commit to higher than legally-required standards of corporate governance.

69. In Peru, Resolution 680 of the Peruvian SBS requires pension fund managers to invest in those companies and funds that follow good corporate governance principles and mandates that pension funds promote good corporate governance and investment practices in their investee companies. Moreover, companies eligible to receive pension fund investment are approved by the regulator based on the size and liquidity of the company. Peru's regulator may take measures to introduce additional objective governance parameters for eligibility which may potentially broaden the pool of investible companies.

70. *Other things being equal, IIs should identify and allocate larger portions of their portfolios to companies with better corporate governance to safeguard their investment and encourage improved corporate governance in target companies, since better governance creates value for all shareholders in the long term. To do this, evaluation of governance risks and opportunities should be integrated into the IIs' overall due diligence process and analysis of potential clients.*

71. Such analysis, while helpful to sort out better investment choices and to make less risky and arguably more profitable investments, is not always economically justified for each II and in each investment. For some IIs, this approach is a key part of their investment strategy and philosophy. For others, this analysis may play a smaller role. In all cases, investors must look at the full range of factors impacting on the potential success of their investments. However, as a general rule, attention given to governance before the investment is made improves the chances that the investment will be successful and that the IIs are ready to address any governance shortcomings and opportunities that may appear during the life of the investment.

72. In Colombia, pension funds are required to evaluate the corporate governance system of each issuer according to governance standards and to explain how it has taken this evaluation into account in its investment process. Each fund manager has adopted its own criteria for evaluating the investee company's corporate governance and has incorporated it into its models of investment analysis. The rating produced by the new model of analysis is required to be taken into account in the evaluation of the risks of the issuer and is assigned a specific weight at the time of allocating the quota of investment. All fund managers have access to issuers' corporate governance answers from the Survey of Country Code (Regulation 028/07). However, this system could be further strengthened by establishing earlier deadlines for submission and disclosure of reports to ensure that IIs have timely access to them for shareholder meetings and investor decisions. Additionally, some of them further analyze the potential client's governance based on internally developed criteria which most commonly include identifying whether the issuer has codes of good governance, internal control manuals and codes of conduct, and weighting of the results of the Survey of Country Code in the following areas: General Meeting of Shareholders, Board of Directors, information disclosure and dispute resolution.

73. The ability of IIs to analyze the risks and opportunities associated with corporate governance as part of their investment criteria in many cases is limited due to a restrictive legal and regulatory framework, low liquidity of securities of potential investee companies, and the capacity of IIs to efficiently carry out such analysis. Voluntary, "comply or explain" corporate governance codes and questionnaires in some countries represent an attempt to increase corporate governance information available to the market, but these efforts do not necessarily provide a sufficient basis for IIs to assess corporate governance practices of reporting companies. Nevertheless, legal and regulatory frameworks in Latin America should be conducive to providing IIs with flexibility in their investment choices. Restrictive legislation may impede the possibility for investors to make a distinction based on differences in corporate governance quality levels in their investee companies. Regulators should seek to eliminate unnecessary limits on investment choices or make them more flexible to allow IIs to reward better governed companies within the boundaries of prudential regulation for IIs.

74. In countries where pension funds are relatively small, fragmented and occupy a relatively small market share among other types of IIs, the loosening of legal restrictions should be combined with measures aimed at strengthening the prudential regulation of investment choices and education to improve the pension funds' capacity to analyze governance risks and opportunities. If the regulator prefers to limit the pension funds' ability to directly invest in shares of companies, it should consider permitting investment in specialized corporate governance indexes that stock exchanges may develop to recognize higher than legally required corporate governance and transparency standards.

75. In Mexico, prudential regulations restrict the pension funds' ability to invest in shares of individual companies due to the potential risks associated with equity investments. However, recent regulation allowing pension funds to invest up to 10 percent of their portfolios in investment trust funds that can invest in individual companies does allow pension funds the potential to indirectly target and reward individual companies with good corporate governance practices. While this provides welcome new flexibility, it will be important to establish corresponding measures to ensure that the rights and interests of the pension fund beneficiaries will be protected, for example, if in the case of smaller pension funds there is a lack of capacity to fully evaluate the risks associated with investment decisions at the individual company level. Thus, the regulator may consider taking steps to increase the funds' capacity to analyze such investment choices.

76. Private equity funds in Mexico tend to play a more active role in promoting better governance in their investee companies. When analyzing investment opportunities, these funds evaluate the management and Board of potential investee companies. They normally acquire majority stakes and nominate directors

to the Boards, actively exercise ownership rights and include them in their investment contracts and shareholder agreements. The situation is similar in Brazil.

4.3 Formalizing and disclosing the policies of institutional investors related to corporate governance of investee companies

77. *Consistent with the OECD Principles of Corporate Governance and recommendations of the White Paper on Corporate Governance in Latin America (para. 42), IIs should clearly formulate their policies regarding corporate governance, including the policies and procedures they have in place to take into consideration corporate governance of the companies in which they invest. Such policies and the II's compliance with them should be communicated to the market and potential clients to ensure transparency of the investors' activities.*

78. *Transparency of an II's consideration of governance issues could be supported by developing and approving a corporate governance code or guidelines that define the specific investor's views and expectations in terms of governance of their potential clients. Meeting these standards/guidelines could also be the necessary pre-condition for the company to qualify for an investment from the institutional investor. Moreover, such codes are a useful general benchmark for companies wishing to improve their governance practices. Co-ordination among institutional investors to endorse a common code/guidelines may be useful in sending a stronger signal regarding desirable corporate governance practices that the market will reward.*

79. **The policy framework should seek to protect institutional investors from undue political influence regarding their investment decisions, especially when IIs have formal policies dealing with corporate governance of their potential clients. Such measures could include, for example, restrictions against government officials serving on pension fund boards. This will allow the IIs to consistently apply and not compromise their own policies in their regular operations.**

80. Some countries of the region have legally recognized national corporate governance codes as a benchmark for disclosure, and mandated that IIs in their investment processes consider the extent to which companies follow these practices. This is the case for pension funds in Colombia and Peru. However, Peru does not require IIs to disclose their governance policies for investee companies. **The regulator should ensure that investors disclose how they apply their governance criteria in the investment process to properly monitor compliance.**

81. A number of Latin American pension funds in Brazil, Chile and Peru have issued corporate governance codes/guidelines separate from national voluntary codes that include a set of benchmarks and principles which pension funds may refer to in determining their investment decisions and their share voting policies.

82. In Chile, one of the largest pension fund managers, Cuprum, issued in 2006 a corporate governance statement aimed at guiding its investment and voting decisions. 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. This governance statement was particularly important in the Chilean context because in Chile a voluntary governance code was not issued until late 2007, by Chile's business-sponsored Corporate Governance Centre. In Brazil, three of the largest pension funds, Previ, Petros and Funcef, have issued corporate governance statements providing guidance to their investee companies. Peru's pension funds association, meanwhile, has developed a corporate governance handbook for the reference of its members and as guidance to board directors.

83. *Institutional investors should ensure that their investment, voting and other policies on responsibly exercising their ownership rights are properly and regularly evaluated and improved where*

needed. The results of such evaluation and possible modifications in their relevant policies should be disclosed to their existing and potential clients, as well as the IIs' beneficiaries.

4.4 Exercising ownership rights in portfolio companies

84. Consistent with the OECD Principles of Corporate Governance and recommendations of the White Paper on Corporate Governance in Latin America (para. 38), the legal and regulatory framework in Latin America should ensure that the effective exercise of ownership rights by institutional investors is facilitated.

85. IIs should responsibly exercise their ownership rights when investing with a long-term perspective. Such ownership rights could be on multiple levels – acting as a responsible shareholder, contributing to the improvement of the functioning of Boards of Directors, strengthening the accountability of the senior management, promoting information disclosure and transparency, and encouraging the market in general to reward better-governed and sanction poorly-governed companies.

4.5 Voting at General Meetings of Shareholders

86. The ability of IIs to attend the General Meetings of Shareholders (GMS) and vote depends on the legal framework providing the investors with the opportunity to receive the necessary notice, agenda and other relevant information about the Meeting sufficiently in advance to be able to make informed decisions on how to vote. Consistent with recommendations of the White Paper on Corporate Governance in Latin America (para. 23), unnecessary restrictions discouraging or preventing shareholders from voting should be eliminated. Specifically, legislation should stipulate rules for domestic and foreign IIs to be able to attend the GMS and vote through proxy or by means of electronic communication (Internet). Eliminating such barriers is especially important in the context of increased cross-border voting.

87. Requirements for notarization of proxies, while an important aspect of ensuring that the delegation of voting powers is valid, nevertheless creates obstacles for foreign investors to meaningfully participate in and vote at GMS. The situation is further complicated by the fact that the actual voting is often carried out by local custodians or other intermediaries that do not always confirm with the relevant II that the delegated voting has actually taken place. Therefore, IIs should strengthen their oversight of how voting on their behalf is being exercised in each portfolio company.

88. With necessary conditions present, IIs should actively participate in Annual and Extraordinary GMS and vote their shares when doing so is economically justified. The degree to which some IIs will exercise their voting and other rights will often depend on their investment strategy which may focus on an activist or engaged approach to portfolio companies. The investors of IIs, the principals, therefore, may expect and be willing to pay IIs for their more active approach and hold them accountable.

89. In practice, IIs in some countries of the region already follow this recommendation either as part of their own policy or as legally mandated. In Peru, representatives of the pension funds (AFPs) must voice their points of view on the topics that are discussed at GMS, cast their votes and verify that their voting is reflected in the minutes. They must report to the respective AFPs on the results of their endeavors.

90. Chile has also taken a step to mandate responsible exercise of voting rights by requiring its pension funds holding more than 1 percent of the investee company's equity to vote on all matters in the GMS. Regulators in other countries of the region may look to replicate this experience.

91. Seeking to remove unnecessary obstacles for effective voting at GMS, Peru amended its General Business Organizations Act in June 2008 to introduce electronic voting. This modification aims to facilitate the participation of minority shareholders in publicly-held corporations but also applies to all other business forms. This mechanism, however, requires further regulation, since there are no provisions

regarding the form of the agenda proposals, the content of notice calls, the issuance of new agenda proposals, etc.

92. Brazil's regulator has also taken steps to streamline and facilitate procedures for obtaining proxy voting authorization and for monitoring shareholder meetings by Internet (see para. 50). There are also initiatives aimed at making available and facilitating the use of electronic voting and allowing for viewing of the GMS through on-line webcasts. **Other jurisdictions should review their procedures to see if they also can make similar progress in reducing obstacles to voting and shareholder participation.**

93. *Consistent with the OECD Principles of Corporate Governance and recommendations of the White Paper on Corporate Governance in Latin America (paras. 41-42), IIs should develop and publicly disclose their policy and procedures on the use of their voting rights.⁷ This is intended to ensure transparency of their voting practices and to strengthen the IIs' accountability to their beneficiaries. Useful guidance is provided by ICGN's recommendation that IIs disclose an annual summary of their voting records together with their full voting record in important cases. Voting records should include reference to the number or proportion of votes cast for or against the recommendations of the company management. In cases when IIs have not voted or were unable to exercise their votes, they should disclose the reasons for that.*

94. *Irrespective of the IIs' investment thesis, there is a growing level of expectation for IIs, who are often the most sophisticated and organized minority shareholders in the companies, to responsibly exercise their right for the benefit of all shareholders and lead by example. At the same time, this will lead to better results for the beneficiaries of the IIs as better corporate governance arguably may lead to better long-term success. This expectation is particularly true with respect to such types of investors that have also a social role, e.g., pension funds.*

95. Providing relevant incentives for IIs to adhere to this recommendation can be supported by legal/regulatory intervention, or through self-regulatory measures. Each country should consider pros and cons of these two approaches and make a policy choice.

96. While Peru requires pension funds to disclose their voting policies, and Chile requires its pension funds to vote, most other Latin American countries do not legally require such measures. A third group of countries has adopted self-regulation. Specifically, guidelines based on "comply or explain" principle, or standards/guidelines developed by associations of IIs encourage their members or the industry in general to voluntarily disclose their voting policies and practices.

97. In Brazil, the regulator requires that IIs report to it on their voting practices. The securities market regulator has issued Instruction 409 according to which if a mutual investment fund has an active voting policy, it is obliged to inform the regulator how it exercises the voting rights related to stakes in its investee companies. This information includes the summary of the votes cast during the fiscal year by the fund manager or by his/her representatives at GMS of their investee companies and a brief justification of the votes cast, or the explanation of the reasons for abstention or non-presence in the Meeting.

98. Additional self-regulation has been adopted in Brazil, where ANBID, the National Association of Investment Banks representing not only banks but other investment funds and consulting companies focused on investment advice, has issued "ANBID's Self-Regulation Code for Investment Funds". The Code requires that ANBID's members abide by rules to allow proxy voting and that they develop a "Policy for Representation of Fund Investments in Meetings", covering the principles and procedures to be adopted by this representation, aligned with "Guidelines for a representation policy of funds in meetings", issued by

⁷ This recommendation is also supported as a key finding of the OECD's June 2009 report, *Corporate Governance and the Financial Crisis*, which states that, "It should be regarded as good practice for institutional investors acting in a fiduciary capacity to disclose their voting records in order to make more transparent any conflicts of interest and how they are being managed."

ANBID's Funds Self-Regulation Committee. While ANBID membership is voluntary, ANBID has set up a monitoring and enforcement system to promote all members' compliance with the Code, leading to the issuance of 58 letters and 206 fines from June 2007 through June 2008.

99. *Where legal frameworks allow, IIs should responsibly exercise also their other shareholder rights related to voting, such as to elect board members, where legally allowed propose items to be included in the agenda of the GMS and demand or convoke an Extraordinary GMS to discuss urgent issues such as those related to company restructurings, changes of control and rights associated with different classes of shares. Another important issue that IIs should pay attention to is executive compensation practices in which IIs should seeks to ensure that such compensation is linked to the managers' performance and that their incentives are aligned with those of shareholders.*⁸

4.6 Encouraging communication between IIs and investee companies

100. *Communication between the IIs and the companies in their portfolios should be encouraged. This complementary approach should be facilitated by the investee companies, too, since it is in the interests of both the IIs and their investee companies to have clarity of their positions regarding important matters. Additionally, the quality of information communicated is just as important as having a regular dialogue between the companies and investors.*

101. *IIs should take steps to effectively engage with their investee companies on issues of concern to investors related to the company's corporate governance practices. This engaging relationship could over time be formalized so that there is a mutual expectation that certain items are at the center of attention of all relevant parties and will create a certain degree of discipline for investors and companies as well.*

102. The regulators should ensure that there are proper rules in place to safeguard the principle of equal access to information, and that IIs who as a result of their size and more active intervention may have greater opportunities to access company information are not improperly receiving material non-public information ahead of other shareholders. In practice, the interaction between the IIs and their investee companies may take the form of investors communicating to the companies their corporate governance-related concerns rather than the discussion of company operational results or other material information.

103. *IIs can also effectively influence corporate governance through an active dialogue with the Boards of their investee companies. Such dialogue should be established at a minimum with the Chairman of the Board or the lead non-executive/independent director when the Board Chairman position is taken by the CEO or the controlling shareholder. The dialogue should aim to ensure that the Board overall acts in the best interests of the company and all its shareholders and that proper good governance policies and procedures are in place for the Board's operations.*

104. *Where such communication is not possible or not effective, IIs could resort to the means of public communication to voice their position on issues subject to decision-making by shareholders. This is especially helpful when the IIs seek to exert pressure on management and/or controlling shareholders of their investee companies to act in the best interests of the company and all its shareholders.*

⁸ This recommendation is also supported by several key findings of the OECD's June 2009 report, *Corporate Governance and the Financial Crisis*, which concludes that "In many cases it is striking how the link between performance and remuneration is very weak or difficult to establish . . . Remuneration schemes are often overly complicated or obscure in ways that camouflage the situation. . . Corporations should be able to explain the main characteristics of their performance-related remuneration programs in concise and non-technical terms. . . It should be considered good practice that remuneration policies are submitted to the annual meeting and as appropriate subject to shareholder approval."

4.7 Encouraging communication between various IIs

105. Consistent with the OECD Principles of Corporate Governance, the legal and regulatory framework should allow and even encourage communication among IIs investing in the same company, because collectively they may better influence corporate governance in ways that ensure protection of all minority shareholder rights. This communication may cover such aspects as co-operation and co-ordination of actions when nominating and electing board members, proposing agenda items and holding discussions with the investee company to improve its corporate governance.

106. While shareholders should be allowed to communicate with each other in relation to those issues mentioned above, restrictions are nevertheless necessary to avoid market manipulation, particularly acting in concert to achieve changes in corporate control. Clear rules for proxy solicitation are necessary for such cases, but should not be so restrictive as to prevent shareholders from consulting with each other in other circumstances over the exercise of their basic rights.

107. Brazil's regulator seems to be moving in the right direction by recently addressing the issue of allowing Internet forums or blogs, where shareholders can post their comments regarding the agenda of the GMS. These blogs may even remain open during the Meetings, with the supervision of company management. The purpose of these blogs is to enable shareholders to discuss among themselves the issues on the agenda, organize to vote on any issues such as the selection of the minority shareholders' representatives to the Board of Directors and the Fiscal Council.

108. IIs should seek to coordinate their activities to ensure protection of basic shareholder rights not only within the context of a specific investee company but also on a more general market level. Being on the same page and collectively setting good practices and expressing concern over certain actions or inaction of their clients or in the market in general will be beneficial for both the IIs and the companies.

109. The coordinated actions taken by Peru's and Chile's pension funds in electing board members are one example of such actions. In Brazil, coordination is also focused on ensuring that minority shareholder rights are respected more generally. The IIs monitor material transactions involving existing or potential investee companies and request information from the boards and investor relations departments of such companies involved in corporate restructuring when believed to pose a risk to minority shareholders rights.

110. IIs should not only take measures so that well-governed companies receive recognition translated into more or longer-term investment, but also consider sanctioning poorly-governed companies through the development of focus groups where such negative practices are disclosed to the market. This can be done by raising awareness about those companies where the controlling owners and/or the management do not act in the best interests of the company and its shareholders. IIs may cooperate to share information about such companies or set up internal procedures enabling all staff responsible for investment decisions to be aware of poorly-governed companies.

4.8 Improving the functioning of Boards of Directors

111. Consistent with the recommendations of the White Paper on Corporate Governance in Latin America (paras. 32-33), the legal and regulatory framework should provide for mechanisms to allow institutional investors to effectively influence the composition of the Boards of their investee companies.

112. Institutional investors should contribute to the improvement of the functioning of the Board of Directors of investee companies where possible and cost-effective for IIs. The most effective way of doing this is by influencing the composition of the Boards. This is particularly important in Latin America due to the high concentration of ownership, allowing the controlling shareholder to appoint all or the majority of directors. IIs should seek that the Boards of their investee companies have a sufficient number of non-

executive and independent directors. Specifically, IIs should vote for the election of such non-executive and independent directors, and in cases where legally allowed propose their own candidates which meet the criteria for non-executive and independent directors.

113. Investee companies should do their best to help the IIs identify the needs on the Board level to enable the investors to nominate/vote for candidates that meet not only independence requirements but that they also possess needed professional background and skills.

114. The regulator may require that certain types of IIs, e.g., the public pension funds, actively nominate independent directors as might be defined by the local jurisdiction. In the case, effective mechanisms for ensuring that IIs do nominate and vote for such directors and for overseeing the activities of these directors are important to achieve the desired impact.

115. Brazil's and Chile's pension funds play an active role in electing board members, and Peru's pension funds often play a more informal role in consultation with the controlling shareholders and companies in which they invest to identify suitable independent candidates for board election. Moreover, Previ, one of Brazil's largest pension funds, also organizes annual meetings with all of the board members that it has nominated to educate them on playing an active and informed role with respect to corporate governance issues.

116. Chilean IIs, especially pension fund managers, have enough ownership stakes collectively to be able to elect directors in most of the Chilean listed companies in which they invest. Once elected, these directors should represent the company independently, in other words act in the best interests of all shareholders and the company, rather than representing the pension fund manager or other shareholders that elected them. The law further requires that independent directors be part of the Directors Committee, which is in charge of overseeing related party transactions, selection of auditors and rating agencies, and executive compensation schemes, among other things. Recent Chilean legislation further strengthens this framework by providing new criteria related to economic and family relationships to determine eligible independent directors that shareholders may vote for.

117. In Peru, the representatives of pension funds are forbidden to vote for candidates that are shareholders, directors, managers or workers of an AFP. This has been translated into promoting good governance in their investee companies through the nomination of non-executive and 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 pension fund managers have invested had gone from having board meetings three times a year to having board meetings every month. Peru's pension fund association's handbook for directors also provides guidance on their corporate governance expectations. The quality of information provided to the directors has also improved.

118. Other countries of the region may benefit from emulating Peru's approach. Furthermore, Brazil's IBGC has launched a certification program to ensure, among other things, that directors nominated by IIs will have the necessary skills, education and experience to serve on Boards of investee companies.

119. Even when there is no legal or regulatory requirement, IIs should actively seek to promote the involvement of independent directors by identifying such director candidates and sensitizing them to good corporate governance concerns. IIs may find it useful in some cases to involve professional head-hunting firms to assist them in candidate searches.

120. The involvement of IIs at the Board level may also be expressed by actively supporting the establishment and functioning of relevant Board committees and by encouraging the staffing of these committees with non-executive and independent directors who have the required specialist skills. Such a Board committee as an Audit Committee or a Nominations and Corporate Governance Committee may play a significant role in improving the Board's decision-making and contributing to value-creation for all shareholders.

121. In Chile, important initiatives regarding the Boards of Directors have been supported by some of the largest pension fund managers. Such initiatives include the rotation of directors after six years of being appointed in order to preserve their independence, and the search for director candidates by a professional “head-hunter” entity and evaluation of directors’ performance.

4.9 Strengthening the accountability of management

122. Institutional investors should seek to strengthen the accountability of senior management of their investee companies to perform in line with the company’s business strategy and to preserve and increase shareholder value. Commonly this will be done by persuading and equipping the Board to improve its management oversight. More specifically, investors should encourage the Board to set performance indicators for management, and monitor progress towards these indicators. It is also important to ensure that the management’s interests are aligned with the interests of the company and its shareholders in the long term through incentive-based compensation among other things. IIs could further request that the Board keep the investors periodically informed of how managerial performance is being overseen and what corrective actions the Board has taken.

123. The monitoring of management’s performance will allow IIs to identify any potential problems early on and to take measures to address them. IIs concerned with particular corporate governance issues should request that the company’s senior managers provide additional information on such topics. Further, the IIs may hold separate meetings with the management of investee companies to discuss any issues related to the performance of the company.

124. The close involvement of some IIs on the Board and senior management levels should be balanced with the view to safeguard against the improper use of inside information. The regulator should ensure that rules are in place requiring the reporting of material information to the market as a whole on a timely basis, and ensuring that proper insider trading rules are in place and enforced. The IIs should take steps not to act on the basis of such information before it is reported to the market, while the company should also take steps to provide that same information to the market as soon as possible.

4.10 Addressing internal corporate governance issues of institutional investors

125. Consistent with the recommendations of the White Paper on Corporate Governance in Latin America (para. 35), the legal and regulatory framework should establish a regime that provides for advanced corporate governance standards for institutional investors. Such rules should at a minimum address accountability of fund managers to the beneficiaries of the II, establishment of proper oversight by the Board/Trustees over management, putting in place relevant mechanisms for dealing with conflicts of interest, discouraging fee structures that set inappropriate benchmarks by focusing on the quantity rather than the quality of investment decisions, as well as other aspects of the regulatory framework that cause managers to act in ways that do not maximize returns for investors.⁹

126. In some countries, the regulator may choose to require the IIs voluntarily adhere to the national Corporate Governance Code’s recommendations or explain why and where they deviate from such recommendations. This already happens in Peru, where all pension funds are listed on the stock exchange

⁹ This White Paper is not intended to provide specific recommendation on corporate governance of specific types of institutional investors. Rather, it recognizes the importance of paying attention to such issues as ensuring that conflicts of interest are properly managed and disclosed, and that in general corporate governance and transparency standards of IIs are as robust as those for listed corporations; and how the supervisory bodies of IIs ensure that their management acts to promote good corporate governance practices of their investee companies to achieve positive long-term results, and that the managers’ compensation terms are properly aligned to address this goal,

and are required to disclose their own governance policies and practices in terms of compliance with the Principles of Good Corporate Governance for Peruvian Corporations.

127. *Institutional investors should pay attention to their own internal corporate governance issues as well to ensure that they follow governance practices that are fundamentally as robust as best practices for publicly listed corporations and similar to what they require of their clients where it is relevant. This is particularly true with respect to the proper oversight of their management, acting in the interests of their beneficiaries and managing conflicts of interests.*

128. **The OECD Guidelines for Pension Fund Governance <http://www.oecd.org/dataoecd/18/52/34799965.pdf> provide a good reference for Latin American regulators to benchmark against their country's regulations in this area. Specifically, a good policy framework should be supported by an appropriate division of operational and oversight responsibilities and appropriate control, communication, and incentive mechanisms that encourage good decision-making, proper and timely execution, transparency, and regular review and assessment.**

129. **While there is no equally recognized framework for mutual fund governance, similar attention is needed to the same aspects of Board oversight and independence, accountability to investors, management compensation incentive structures and dealing with conflicts of interests as critical aspect of a well-functioning legal regime and structure for mutual fund governance.**

130. While new legislation in Argentina (see par. 49 in Chapter 3) effectively nationalized its pension fund industry starting in 2009, it has not specified the minimum governance standards to be followed by the new system, apart from providing for the creation of a Council composed of different constituencies to monitor the use of its financial resources. **Consistent with recommendations in other parts of the report, good governance practices should also be applied to state-run pension funds, drawing upon not only the OECD Guidelines for Pension Fund Governance, referred to above, but also the OECD Guidelines for Corporate Governance of State-Owned Enterprises: www.oecd.org/daf/corporate-affairs/soe. The recommendation set out in para. 36 of the White Paper on Corporate Governance in Latin America, developed for state-owned development banks and multilateral finance institutions, is also valid in this case, calling for state-owned resources to ensure that in financing companies they promote the highest standards of governance and transparency demanded in the capital market.**

131. With regards to mutual funds in Argentina, the fund management firms are required to disclose their by-laws, quarterly and annual financial statements, ownership structure, board and management composition, minutes of the meetings of shareholders and the board, and the mutual fund prospectus (including the fund's objectives, investment policies, management fees, etc.). Finally, insurance companies are required to establish an Internal Control Committee to be comprised of at least three non-executive directors for pension funds and at least one non-executive director for insurance companies. However, legislation does not include any requirements regarding independence of directors and dealing with conflict of interests and could further be improved in these areas.

132. Legislation in Brazil provides for some governance rules for public sector company-closed pension funds which require them to have an Advisory Committee, a Fiscal Council and an Executive Board. The Fiscal Council should evaluate the conformity of the fund's asset management to legal requirements and the fund's own investment policy. Further, each different type of pension plans should be managed according to its own specific investment policy, which should be reviewed annually. Finally, pension funds' accounts are to be audited by independent auditors.

133. Brazil's legal and regulatory framework also provides for certain rules on governance of mutual funds. Under the Brazilian regulation, mutual funds are a gathering of resources constituted under a condominium structure and registered with the national securities regulator. The regulator sets requirements to authorize management of such funds, and disclosure requirements related to the daily

value of the quota (assets) and the net equity of the fund. A trial balance sheet and a statement of the portfolio composition and diversification must be disclosed on a monthly basis. Annually the fund managers shall disclose the financial statements accompanied by the independent audit report.

134. In Mexico, the legal and regulatory framework includes several rules regarding corporate governance of pension and mutual funds. Specifically, their Boards must be composed of between 5 and 15 members, of which 33% have to be independent. Funds must also have an Audit Committee led by an independent director.

135. In Chile, pension funds are required by law to create a directors' committee for investments and settlement of conflicts of interest. The committee is required to control and assess the fulfillment of the investment and conflicts of interest-related policies and issue an annual report to the Board of Directors of the pension fund. A copy of this report must also be submitted to the pension funds' regulator. The composition of this committee is also legally mandated – the committee shall comprise three directors, at least one of whom must be an independent director. Legislation also addresses the issue of director independence by prohibiting members of the legislature, government ministers and deputy chiefs of public services within their term in office and during the 12 months following departure from their post to serve as directors of pension funds.

136. Consistent with the OECD Principles of Corporate Governance, the legal and regulatory framework should ensure that IIs disclose how they manage material conflicts of interest that may affect the exercise of key ownership rights regarding their investments. Latin American regulators should require that institutional investors disclose information on their ownership and their policies for dealing with conflicts of interest, and to disclose to their clients the nature of their actions taken to implement the policies.

137. Mutual funds and pension fund managers in the region are often owned by or affiliated with other financial institutions, and in such cases, usually banks. Likewise, listed companies in which these IIs invest – which in the case of pension fund managers tend to be among the largest companies in each country – can also be among the bank's main clients. Consequently, II managers may resist – or be pressured against – adopting an active ownership strategy that could eventually challenge the Board and/or management of the investee company, as the company may then complain to the bank/pension fund manager's 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.

138. In Chile, this issue is addressed on a legislative level by requiring pension fund managers to establish proper mechanisms to deal with conflicts of interest as approved by the Board of the pension fund manager. These mechanisms must be disclosed to the regulators, as well as to the general public on the fund manager's website.

139. While sound regulation and supervision on conflicts of interest limit abuses arising from these relationships, IIs should take additional steps to manage existing and potential conflicts of interest and disclose their policies and procedures for dealing with such conflicts. More specifically, II fund managers may introduce “Chinese” walls between their investment decision-makers and other companies in the same group, as well as between different decision-makers dealing with debt and equity investments in the same investee company. 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 on key issues to the benefit of the fund and in accordance with such policies, rather than merely in accordance with the wider commercial interests of certain owners/fund sponsors.

4.11 Exiting from the investment as last resort

140. Exiting from investment in company stocks at any time and for any reason is a fundamental right of IIs. However, the right to divest should be carefully balanced in generally illiquid capital markets against the long-term interests of the IIs, their portfolio companies and the economy in general.

141. One of the reasons for such divestment could be deteriorating corporate governance policies and practices of the investee company. In this case, IIs should try to encourage the investee companies to address corporate governance concerns. When such efforts are not economically justified or once exercised do not lead to improvement, the divestment of IIs could be seen by the market as a signal that the investee company does not pay sufficient attention to protecting investor rights which might lead to less investment in that company.

142. However, the option to exit in practice may be constrained, including due to low liquidity of stocks and restrictions on certain investment choices. Some countries of the region have restrictions or even a prohibition to invest in foreign companies, which limits the range of equity choices available to II fund managers. Brazilian closed pension funds are not allowed to invest abroad. There is a 3% limit for investment in BDR (Brazilian Depositary Receipts) and companies from Mercosul (Argentina, Uruguay and Paraguay). This limits their ability to vote with their feet by moving from local to foreign securities, when local issuers are unresponsive to governance concerns. However, the securities regulator's rule 409 allows "multimercado" funds to invest abroad up to 20% of their assets under management, and other funds can invest up to 10%. More conservative fixed income investments remain another alternative. Similar to other countries in Latin America, Chilean, Colombian and Peruvian pension funds face limited liquidity in the domestic market, constraining the choice of actively traded stocks in which they can invest. Thus, if they are seeking higher returns from stocks, they have an interest in exercising voice rather than exit, and tend to hold stocks. Recent Chilean pension law reforms have started to increase pension fund flexibility by relaxing limits on how much these pension funds can invest in equities overseas.

CHAPTER V - ADDITIONAL STEPS: STRENGTHENING MARKET FORCES

143. In addition to steps described in chapter 4 above taken by policy-makers and institutional investors to promote better governance in investee companies, the overall efficiency of and incentives provided by the market are critical to ensure value creation through good corporate governance. A range of actions should be pursued to create conditions under which the IIs' exercise of their shareholder rights is cost-efficient and valued both by the market and client companies.

144. **The regulatory agencies together with other relevant institutions, institutional investors and potential investee companies should promote a debate to identify the best ways to reach the goals of achieving good corporate governance be it through direct regulation or self-regulation by individual IIs, their industry or the market in general. The answer to these questions will be specific to each country in the region, depending on the landscape of institutional investors and the private sector, history and current state of regulation, private sector culture and other factors influencing the investment strategies of IIs.**

145. **At the same time, different actors in the market should take steps to encourage the development of institutional mechanisms to support the activities of IIs promoting good governance. Specifically, (i) an active and informed media should not only communicate IIs' reactions to successes and failures of investee companies to the market but also have capacity to independently investigate and report on stories of good or bad corporate governance behavior; (ii) international and local credit and corporate governance rating agencies could become a significant repository of information on corporate governance policies and practices of companies and provide benchmark comparisons of the companies' governance; and (iii) proxy voting and other corporate governance advisory service-providers can reinforce IIs' capacity to put their investment and governance policies into practice.**

146. **Institutional investors who do not have an internal capacity to evaluate governance behavior of their existing and potential clients may resort to external advice as input towards their decisions. The regulators in Latin America should ensure that appropriate mechanisms are in place to address potential conflicts of interest, while also ensuring that there are no impediments to the establishment and functioning of such advisory service-providers to support IIs in their governance-related decisions. Credit and corporate governance rating agencies, proxy voting firms and other service-providers are important and complementary to institutional investors' capacity to successfully promote good governance for the benefit of their clients and their own beneficiaries.**

147. Governance rating agencies can play an important role in collecting information on and analyzing corporate governance policies and practices of companies that are often the targets for investment by IIs. This analysis, along with other information, is then used by IIs to make decisions on how to exercise their voting rights in investee companies. Furthermore, governance rating agencies have recently ventured into the area of rating the companies' corporate governance and benchmarking against each other. Although these agencies do not claim that the level of governance rating is necessarily linked to the performance of these companies, concerns have nevertheless been raised over the accuracy of such ratings, particularly noting the potential for conflicts of interest in relation to rating agencies providing more favorable ratings than justified in the interest of attracting more business, including separate consulting services contracts. Recent market failures of many highly-rated companies are a sign that governance ratings should not be exclusively relied upon for investment decisions.

148. **With an increasing number of credit rating agencies and corporate governance rating agencies and advisory services providers offering ratings and analysis, the regulators in Latin America should ensure that the operations of these institutions are properly overseen. Such regulatory oversight may be necessary to ensure that requirements are in place for them to report on ownership interests and how they deal with conflicts of interest.**¹⁰

149. *Such agencies should take steps to ensure separation of ratings analysis from other consulting services. Being paid by the clients whom these agencies rate may create incentives to give more positive ratings than are merited in order to attract more business.*

150. Corporate governance analysis is also being carried out by some credit rating agencies in several countries around the world and in the region. While in a wider context, some rating agencies have developed corporate governance analytical criteria to be applied as a component of their credit analysis and rating, in most Latin American countries such rating agencies do not or have only just started to take into consideration corporate governance issues in their analysis. *In Latin America, traditional rating agencies could play a stronger role by considering corporate governance issues in their ratings, especially in a region in which low liquidity and tight groups of control represent a higher financial risk for minority shareholders.*

151. *However, the effort cannot come from credit or governance rating agencies alone, since the demand for these services from the investors' side is also crucial. The IIs should use the governance ratings and other analysis from rating agencies and other service providers only as input for their own decision-making and not outsource it to these external players entirely.*

152. *To have a stronger and a more organized voice as an industry and be in a better position to protect the interests of individual institutional investors, IIs should seek to establish associations consisting either of all IIs operating in the relevant market or at least IIs of a specific category such as pension funds or mutual funds. Such associations will not only better protect the rights and interests of their members but also communicate and influence policy-making in the market and set common benchmarks of behavior, including a recognized and consistent view on the role of corporate governance in the operations of the IIs.*

153. **Organized structures of institutional investors can be used not only to solicit feedback and support the implementation of the legal and regulatory framework, but also may eventually negotiate the right of the industry to self-regulate. The choice of regulation vs. self-regulation should be country-specific, subject to policy decisions. The need to set and enforce the rules to regulate the activities of IIs and supporting structures will lead to greater focus on legal and regulatory intervention. On the other hand, the maturity of the industry and its ability to come up with clear guidelines that individual IIs will agree to follow, coupled with credible monitoring and self-enforcement mechanisms, may gradually convince the regulators to rely more on self-regulation.**

154. In Peru, pension fund managers are united in the Association of AFPs. This Association organizes training programs for representatives of AFPs sitting on the Boards of investee companies. It also represents the voice of the industry with the regulator. In particular, the Association supported the committee that issued the Peruvian national corporate governance code. The Mexican Association of Securities Intermediaries (AMIB) believes that mutual funds can influence good governance on the level of supporting the development of public policy and regulation on corporate governance and take the relevant steps in this direction.

¹⁰ The OECD's *Corporate Governance and the Financial Crisis: Key Findings and Main Messages*, June, 2009, calls for reinforced attention to these institutions following the crisis: "As the importance of institutional shareholders increases, greater attention needs to be given to proxy advisors and to the potential for conflicts of interest. It is also claimed that there is a danger of "one size fits all" voting advice so that a competitive market for voting advice needs to be encouraged." (page 11).

155. In Brazil, there are several organizations involving institutional investors: AMEC (Capital Markets' Investors Association) is a body made up of representatives of several independent portfolio management companies as well as those linked to financial institutions. AMEC was established in 2006 to represent the interests of fund investors as minority shareholders; and ANBID - National Association of Investment Banks – represents not only banks but other investment funds and capital markets consultants incorporated as non-financial companies. Its objective is to seek the market's consolidation as an instrument for fostering the country's development. ANBID specifically is leading the self-regulation charge for the funds industry by issuing several guidelines and setting up structures to deal with emerging issues. This Association has also approved its Self-Regulation Code for Investment Funds.

156. *When organized, the relevant associations of IIs should develop and implement programs to monitor agreed-upon benchmarks of better practices of IIs to promote their implementation. This monitoring will not only increase the transparency of operations and accountability of IIs' managers to the industry and their own beneficiaries, but will also allow them to collect and analyze the feedback from their investee companies and other stakeholders on their views regarding the industry practices and where such can be modified/improved.*

157. In Brazil, the activist approach of Brazil's principal pension funds has played an important role in influencing the relevant legal and regulatory framework and has contributed to a perception in the market of pension funds as important players in the effort to improve corporate governance practices.

158. Associations of IIs should seek to educate their members concerning how good governance could help them with the value of their investments and support the initiatives aimed at increasing the IIs' capacity to analyze governance risks and opportunities during the investment process as well as to act as long-term active owners. The same could also be done by developing and supporting regular fora where hot topics related to the role of IIs could be discussed.

159. **Regulators should encourage associations or other structures of organized representation of the IIs industry's interests to take steps to establish, maintain and encourage the use of effective conflict resolution mechanisms. Together with the regulators, IIs should try to improve judicial and alternative dispute resolution mechanisms to enable fast and efficient resolution of any disputes.**

160. When disputes cannot be resolved more cost-effectively, individual IIs may need to consider taking legal action against their clients to protect their rights and those of their beneficiaries, or resorting to arbitration when this cheaper and more expedient way of dealing with conflicts is available. Some countries of the region expressly provide this right for shareholders with investments above a certain threshold. In Mexico, the 2006 Securities Market Law has expanded the right of shareholders to initiate civil lawsuits against members of the board and executives, lowering the ownership threshold required for such suits to 5%, while with 20% they can challenge the resolutions of the shareholder meetings in court. In Brazil, the corporate law of 1976 permits a 5% shareholder to bring a suit. If successful, there is a 20% premium above the case value. Additionally, under the Novo Mercado rules, companies listed on this special segment contractually agree to resolve shareholder disputes through arbitration. This latter approach could be replicated in other countries of the region.