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CHANGES IN BOARD PRACTICES IN CHILE

(Session 2)

BY

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I. Introduction

During 2001 a number of amendments to the Chilean Corporations Law, the Pension Funds Law and to the Securities Law, became applicable. The most important changes were described and commented in my paper presented to the Buenos Aires Roundtable last year. I would like to share now my views on how those rules have been implemented and what can be anticipated as their practical consequences in the Chilean corporate environment for the years to come.

I will focus the analysis in two main issues[1] (quite related), namely: the duties and powers of the Board, and the so-called Directors Committee.

II. Duties and Powers of the Board

1. Management.

Management of the corporation is vested on the Board. The Corporations Law provides the general principle: "administration of the corporation is exercised by the Board elected by the shareholders meeting"[2]. The Law then materializes that principle in various concrete powers and obligations of the Board, for example: the Board appoints and removes the general manager and other executive officers of the company, determines their powers, controls and supervises their actions; the Board proposes to the shareholders meetings all important corporate decisions; it must approve the most relevant businesses of the corporation; it represents the corporation for all legal purposes, etc.

That broad power is based on two assumptions: First, the owners of the company, the shareholders, are actually deciding the corporation's management by appointing and removing the Board members from time to time. Second, once appointed, each director acts on the sole interest of the corporation and not for the benefit of the particular shareholders whose votes elected him[3].

In many cases both of these assumptions are (or have been) in practice far from being true, as shall be commented below. This is the cause of most of the recent amendments introduced to the Corporations Law, the Securities Law, and to the Pensions Funds Law.

2. Control of Chilean corporations.

Unlike the securities market in some developed countries, in Chile most publicly traded corporations are controlled by a few shareholders, which own large

[1] All comments in this paper refer to the rules applicable to publicly traded corporations (sociedades anónimas abiertas).
[2] Article 31.
[3] I am using the masculine third person, although, naturally, the sense of the sentences does refer to men and women indistinctly.

stakes of the issued shares. Minority shareholders frequently is a literal expression in the Chilean context.

Thus, usually the right to appoint the majority of the members to the Board is concentrated in the voting power of shares owned by one or very few hands. In many cases, minority shareholders neither own enough shares, nor have the chance to acquire proxy power to vote enough shares, to elect even one director.

As a result of that, the effective power of the common minority shareholders to change the management of a company, if they betray the common interest of the shareholders, may be very limited.

It has been only through the operation of Pension Funds (AFPs), and to some degree Investment Funds also, that minority shareholders have come to play a more relevant role in the appointment of directors and thereby in the management of Chilean corporations. The Pension Funds Law has been a critical element to this effect, since it prohibits AFPs to vote for the appointment of any candidate to be a director who receives votes from the controlling shareholders. Therefore, AFP´s have been forced to coordinate and carefully chose names to vote.

The number of directors in the Board is another relative limitation for minority shareholders to have an influence on the management. The mandatory minimum number of directors is five and in some cases seven. The by-laws of many corporations used to provide for the minimum required number of directors. In such cases, a relatively high number of votes is required to elect a member to the Board.

Again, the interest of controlling shareholders to have AFPs as shareholders (which increases the value of the shares), and consequently the need to allow room for the AFPs to appoint directors, has probably been the main driver behind Boards with larger numbers of directors. [4]

3. Independence of directors.

The Corporations Law assumes that directors in managing the company must act only in consideration of the interest of the company. Article 42.1) clearly establish the rule by saying:

"*Directors shall not: 1) Propose amendments to the by-laws or issuance of securities, or adopt policies or make decisions which are not in the corporate interest, but in their own interest or* that of related third parties."

Furthermore, article 39 provides:

"*The directors elected by a group or class of shareholders have the same duties for the corporation and the remaining shareholders, and they cannot fail to them on the excuse of defending the interest of those who had elected them*."

[4] In the Appendix there is a summary of the most relevant rules of the Pension Funds Law which have helped to temper the effect of excessively concentrated control of Chilean corporations.

Given the rather concentrated ownership of many publicly traded corporations in Chile, the principle mentioned above is in practice difficult to enforce. It is frequent that members to the Board sit in the Boards or in executive positions of other companies of the controlling shareholder. It is not uncommon that members to the Board are close relatives to the controlling shareholder.

In cases where a decision for the interest of the corporation may hurt the interest of the controlling shareholder, can they freely act as demanded by law? It may be certainly difficult.

Triggered by the so called "Chispas" case[5] in the late 90s, the movement in terms of legal and regulatory adjustments, as well as, of capital markets business environment, has been to strengthen the independent behavior principle. Progress is being made, although perhaps at a slower pace than one may have wanted.

On the legal and regulatory side, perhaps the strongest pressure to incentive Directors to behave on the sole interest of the corporation is the year 2000 amendment to the rules allowing legal actions against directors and other corporate officers who betray the corporations interest. I am not yet aware of lawsuits under the new rules, which have made much easier to seek directors responsibilities. However, the mere enactment of these rules has already produced a sense of awareness among directors everywhere. I will come back on this aspect later in this paper.

III. Directors Committee

1. A new institution.

The Directors Committee is the name used in the Corporations Law[6] since December 2000 to designate the Chilean version of an audit committee.

Since 2001 corporations which "stock exchange equity" (patrimonio bursátil)[7] is equal or larger than approximately US $ 38 million, must have a committee formed by three directors (at least two must be "independent" from the controlling shareholder), to supervise management compliance. As of last year also, these companies are required to have at least a seven members Board of Directors.

The duties of the Directors Committee include, for example:

a) To supervise the auditors reports, the financial statements presented by the executive officers to the shareholders, and to previously express an opinion about them.

b) To propose the auditors of the company to the Board.

[5] Commented in my previous presentations to the Sao Paulo and Buenos Aires Roundtable meetings. This is the case involving management and controlling shareholders of Enersis S.A., in the takeover of this corporation by ENDESA (Spain).

[6] Article 50 bis.

[7] Corporation value calculated as average Stock Exchange price per share times the total number of issued shares.

c) To review all aspects of any material transaction with related parties and report on such operations. This report must be read and presented by the Chairman at the next Board meeting, prior to deciding whether to approve the transaction or not.

d) To review the remuneration and compensation systems of the executive officers.

According to estimates of the Superintendencia de Valores y Seguros (SVS) there are between 30 to 40 corporations obliged to have a Directors Committee. After April 2002, once all ordinary annual shareholders meetings are concluded and reported, the SVS should have more precise information about the number of Directors Committees that have operated during 2001, their activity, and, also, how many there will be this year 2002.

2. Comparative analysis.

During the last years, there has been a worldwide tendency towards the introduction of a new corporate governance organ, normally called "audit committee". This new institution is commonly understood as a collective corporate comptroller and its powers change from one country to another, depending on the role imposed by the respective laws.

Normally, these committees are conceived as a great help to the Board. Actually, they may be useful links between the Board and financial reporting, auditing and risk management related to the company. They may also deeply analyze the top executives' performance, and be well informed about company's affairs.

The Chilean Committee has followed this universal tendency, but it has some specific characteristics that show the special aim of the legislator at this respect.

First, the Chilean law has sought the strengthening of the control and supervision function inside the company. As everywhere, the Committee is regarded as a valuable help to the Board. However, the Chilean law introduces an important new issue: the Committee also has controlling functions regarding the Board itself, specifically in connection with related transactions, as referred above. This particular emphasis must be analyzed in the context of the year 2000 amendments to the Corporations Law, which have strongly supported the rights of the minority shareholders against abuses from the majority shareholders or the directors of the company.

Second, the composition of the Committee shows clearly how important minority shareholders have become. They have de right to appoint the majority in the Committee, regardless the number of directors of the controlling shareholder. Therefore, its is obvious that the new regulation is determined to give to the minority shareholders supervision powers over the majority's administration of the company.

Third, the history of the recent amendments to the Corporations Law indicates that one of the major goals of the new Committee was to provide faithful and quick information to the markets. Again, the aim is to protect minority shareholders.

But not only the minority shareholders are protected by the Committee; it is also a guarantee to a special kind of shareholders. These are the "institutional" investors, mainly the AFP's. As mentioned throughout this paper, these investors are crucial in the current Chilean capital market due to the enormous amount of their investments and the serious impact on the market value of the shares they invest. However, they are not allowed to interfere with the management of the stock corporations. Therefore, the new Committee is a way to give them a window to supervise management conducts.

Finally, it may be said that the Chilean law has not, as some others have, demanded any special requirements to be appointed as member of the Committee. They should have some knowledge of financing management, auditing and internal control, but that is not mentioned in the Law nor in its complementary regulations.

3. Independent Directors.

As it may be deducted from what has been commented above, one important issue to be solved in most Chilean corporations is whether the are at least two "independent" Directors in the Board to be appointed for the Directors Committee.

Independent Directors are those who have been elected without the votes of a controlling shareholder, or who would have been elected even when his votes from the controlling shareholder are not taken into account.

Some corporations did have the minimum number of independent Directors by April 2001, when the Directors Committees were to be appointed by the Board, for the first time, according to the new rules. Many did not, and in such a case directors related to the controlling shareholder had to be included in the Committee, even if they are majority.

4. Operational restrains.

According to the Corporations Law, the annual ordinary shareholders meeting must approve: i) the annual budget for the operation of the Directors Committee, and ii) the remuneration to be paid to the members of the Committee.

Here it lays what may become a very practical limitation to the theoretical powers of a Directors Committee. A controlling shareholder may dramatically reduce the Committee's effectiveness by approving a modest budget and a poor remuneration. Without budget to hire proper advisors, or without adequate compensation for the additional responsibilities, directors at the Committee may be quite ineffective.

5. Appearance and reality.

There has been no public report of any wrongdoing detected by Directors Committees last year. This could lead to think that these committees have been ineffective so far. After talking to some directors of publicly traded corporations, members and non-members of Directors Committees, I have come to conclude that this is not necessarily the case. There are several reasons to this conclusion.

First, the mere fact of the enactment of the rules regarding Directors Committees, its duties and powers, as well as, the rules (again) which make easier to demand compensations from negligent directors, have already created a much more careful attitude among directors and executive officers. This is particularly true with respect to members of the Directors Committee, who as such have a double responsibility in front of the shareholders.

Second, since AFPs are normally appointing at least one director in many corporations, this has become a "natural" member to the Directors Committee. In fact, because of his election by the AFPs, he is normally the director with the highest authority in the Committee, a sort of "*de facto* management comptroller". Few directors would dare now to vote approving an action being spotted as wrong by the "Director of the AFPs".

Third, the Committees meets at least once a month to hear the reports from the executive officers of the company, auditors and management in general. Minutes must be made of these meetings and they are open to be accessed by the AFPs and other shareholders within the 15 days prior to the annual shareholders meetings. This creates a formal need to be careful both sides, management and Directors Committee. A director now cannot risk not asking an obvious and smart question on a sensitive issue, and executive officers cannot risk not to report such issues or to provide evasive answers to the Committee.

Thus, lack of negative findings may be is goods news. It may well be that the existence of the Directors Committees is already making a very positive effect in Chilean corporate management.

IV. What can be expected

1. Professional independent directors.

The rules imposed on AFPs regarding limitations on voting to appoint directors are creating the need for more professional-independent-qualified directors.

AFPs are now fully aware of the risks associated to excessive trust in controlling shareholders management, as well as, on their own political power as comptrollers and defenders of the minority shareholders interest. AFPs need qualified independent persons to act as "their" directors to achieve maximum use of their legal and political power. As commented in the Appendix, AFPs can neither vote for persons related to the controlling shareholders, nor related to the AFPs groups. Hence, the need for independent directors has arisen.

It should not surprise that in the coming years a larger number of professional, highly qualified, and thoroughly screened independent directors appears in the Chilean corporate arena.

2. Fewer cases involving abuses in related party transactions.

The action of Directors Committees and the legal changes to more easily prosecute legal responsibilities of wrongly oriented management should reduce the chances for abusive behavior. Accordingly, I believe every year there should be less cases of judicial complain against persons involved in related party transactions and trading of insider information.

Also, new cases are likely to be more effective in terms of obtaining compensations for damages inflicted upon the corporation and minority shareholders.

3. The "Enron" effect.

After Enron's bankruptcy, all issues related to fair and transparent management have become very sensitive at all levels in Chile. Regulators, shareholders, AFPs, management, are all paying much more attention to proper audit practices and standards, internal early warning and reporting procedures, Board meeting formalities, etc.

I imagine that beginning this year, procedures to select auditors, clearances and procedures to appoint directors to the Board and to the Directors Committee, shall all be thoroughly performed.

Likewise, budgets for the operation of Directors Committees and remuneration of its members will very likely increase.

Nobody wants to be caught *à la Enron*.

4. Still some negative signs.

Despite what I have described above may be seen as positive conclusions, there are still some negative elements in the corporate governance field.

Some of them are "structural problems" of the Chilean economy and they are difficult to help. The capital market is small. Many more companies should be listed and a less concentrated controlling shareholders presence is badly required.

The Chilean Government is considering introducing more flexibility to the capital market to induce both more companies to become publicly traded, and new actors to join the investors side. By next year there should be new legal changes to report in this regard.

Another negative sign is the fate of the so-called Code of Sound Corporate Practices. During the last two years the SVS together with a group of prestigious members of the Chilean business community, have been working in writing a corporate good conduct code, similar to those used in developed capital markets. After a promising and publicized presentation of the first draft for consideration of the principal economic groups, the project is currently frozen. The silent message from these groups has been that they are not yet ready to gladly submit to international standards of corporate governance. Without the support of these groups the code is nothing but a theoretical exercise.

Next year we all shall see whether positive signs have finally prevailed over bad ones in the Chilean corporate sky.

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APPENDIX

Summary of Relevant Rules of the Pension Funds Law

1. Qualified Corporations.

AFPs can only invest in shares of corporations which fulfill certain conditions, most of them aimed to ensure that some minimum number of minority shareholders exist, so that control is not totally in the hands of one or few shareholders. For example, the by-laws of these corporations must provide that:

a) Nobody can, directly or indirectly, concentrate more than 65% of the voting shares.

b) Minority shareholders must own at least 10% of the voting shares.

c) At least 15% of the voting shares must be owned by 100 unrelated shareholders, each one of them with a minimum investment of approximately US $ 2.500.

2. AFPs voting restrictions.

In the election of members to the Board of Directors AFPs a bound by several rules aimed to ensure that AFPs act separately from the controlling shareholders. For example AFPs cannot vote in favor of persons:

a) Who are controlling shareholders or related to the controlling shareholders.

b) Who are shareholders or related to a shareholder owning 10% or more of the voting shares.

c) Who are Directors of the AFP or other entities related to the Group.