
OECD


**Organisation for Economic Co-operation and Development**

*In co-operation with the World Bank Group*

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

8 - 9 October, 2004

# ISSUES PAPER ON ENFORCEMENT

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Moderator, Session 1:
Legal, Regulatory and Institutional Framework for Enforcement:
the State of Play

This paper serves as a background note and as a tool for supporting discussions and development of future recommendations on a very important topic: Enforcement - specifically on how to analyse the key elements of enforcement, including the legal and regulatory frameworks and practical considerations, and articulate useful suggestions on how to facilitate effective enforcement. These suggestions will include specific recommendations on the role the private sector and in particular that institutional investors can take to improve enforcement.

By strengthening corporate governance and enforcement, the investment climate in the region will be enhanced – to the benefit of investors and entrepreneurs in the continent.

## Background

A number of important initiatives have been taking place in the region over the past four years - such as corporate law reforms in Chile, Brazil, Mexico and Argentina, the elaboration of several codes of best practice, and last but not least the Sarbanes-Oxley Law, which has important implications for Latin issuers in the US market.

Among the most important of these initiatives is the White Paper on Corporate Governance, built on the discussions of the Latin American Corporate Governance Roundtable. This paper was introduced over the course of several meetings in late 2003 and earlier this year. At each such meeting, the single most frequent request for follow-up was on how to promote better enforcement, including greater involvement of the private sector in these efforts.

Aside from macroeconomic considerations, it is the consensus that the perception of poor enforcement is the most important factor contributing to a bad climate for the development of local capital markets. We can all agree with Ira Millstein [(1)] that "attracting investment requires protecting investors. Investor protection requires both sound laws and their effective enforcement."

Indeed, it could even be the case that the second of these requirements is at least as important as the first – the practice of enforcement is at least as important as the framework of legislation. As a matter of fact, scholars such as La Porta, Lopes-de- Silanes, Shleifer [(2)] and others have found that "jurisdictions that better enforce legal rights tend to have more developed financial markets regardless of their laws."

## The White Paper and Enforcement

**Better corporate governance should facilitate better enforcement.**

At least four distinct sections of the White Paper deal with issues that are important to better enforcement:

i. Encouraging the Emergence of Active and Informed Owners (White Paper, pars. 34-42);

ii. Effectiveness of Regulatory and Supervisory Enforcement (White Paper, pars. 134-147)

iii. Private Rights of Action (White Paper, pars. 148-149);

iv. Improving the Variety and Capacity of Mechanisms for Adjudicating Disputes (White Paper, pars 150-153).

The White Paper (WP) gives a broad overview of enforcement issues. In this paper I would like to briefly summarise what in my view are the key issues that if effectively addressed should lead to better enforcement. Most of these issues are covered in the WP. Where appropriate I will add some extra comments of my own. I have intentionally tried to avoid recommendations that would require a change in the country law, although for some recommendations the local regulator may be involved in issuing a new ruling. The objective in highlighting these issues is to help support the discussions to take place in the different sessions of the forthcoming Latin American Roundtable meeting to be held in October in Rio. I am certain that these and other issues that will come out of this meeting will help to improve enforcement.

## Session 1: the Legal, Regulatory and Institutional Framework for Enforcement

### Issue # 1: Independence of the Regulator

It usually needs law reform but it is essential. The regulator is the first line of defense on corporate enforcement. The greatest possible degree of political (fixed mandate) and financial independence are necessary for good enforcement.

### Issue # 2: Listing Requirements

Prevention is always better than prosecution. If investors own shares that are listed on stock exchanges with more rigorous (in terms of governance) listing requirements, enforcement in these exchanges should be better and faster. In Brazil, Bovespa´s Novo Mercado and Level Two are good examples of a non-governmental initiative that helps good companies communicate the better-than-average quality of their governance to the market.

## Session 2: Encouraging the emergence of active and informed owners

In order to discuss ways to foster effective shareholder activism, the issues have been grouped into five broad categories dealing with 1) information, 2) time, 3) data, and 4) effective policies to induce activism.

**Issue # 3: Information**

**Disclosure of resolutions presented at shareholders meetings**

There is one clear way to illuminate conflicts of interest in advance, in such a way that all shareholders can vote on an informed basis - a requirement that any resolution that involves an important business decision, such as mergers and acquisitions or transactions with related parties, has to be presented with arguments, perhaps with a legal or investment opinion, that show the potential benefits to the company.

Sunshine through better disclosure is probably the best remedy for this ailment. Resolutions presented have to be for the benefit of the company and not any particular group of shareholders. Only through better disclosure can we improve the discussion of those issues that can lead to abuse and consequently create the need for enforcement. Examples are: the company proposes a resolution, management acts in self interest, controlling shareholders vote on an important matter in a way that shows a clear conflict of interest, e.g. management fees based on sales, inter-company loans to controlling groups and other related transactions, such as acquisition or sale of assets to or from shareholders. Only with the requirement of a document explaining the benefits to the company can "stupid votes" be prevented.

**Issue # 4: Time**

**Capacity of the regulator to suspend a shareholder meeting for a certain period**

Time is probably investors' best friend and prevention is always preferable to prosecution where enforcement is concerned, even in the most efficient markets. Very often time is needed for investors to analyse matters and to discuss their implications for the company with managers and controllers to allow these latter to explain their objectives and reasoning. Recent regulation in Brazil allows the CVM board to suspend a shareholders meeting for up to 15 days, in response to a shareholder request indicating that there is insufficient information or time to consider a particular resolution or transaction. This is designed to give all concerned enough time to analyse and clarify possible conflicts of interest and sometimes to CVM to issue an opinion. Early results seem to show that this is a very powerful and efficient tool for the regulator.

**Issue # 5: Data**

**Auditor and Accounting Standards**

Rotation of the auditing firm and the adoption by regulators and stock markets of international accounting standards are the best examples of good initiatives. Information is the first material for enforcement. If the data is reliable and presented in a manner that is easily understood everywhere, enforcement will be made easier. Long relationships between audit firm and companies can lead to cozy ties and lax audits. Rotation creates an automatic review and this is good especially in a region that is known to have few resources for an effective review by the regulator.

**Issue # 6: Inducement I**

Institutional investors have to wake up to their responsibilities as fiduciaries of those on whose behalf they are investing funds (pensioners; mutual fund investors). This group traditionally represents the largest single group of investors in equities in Latin America, though some such as Mexico are more restricted in how public funds can be invested in equities.

I see great value in initiatives that require institutional investors to disclose on a regular basis their policies on voting, as well as how they actually voted and participated in shareholders meetings. Brazilian CVM (for mutual funds) and SPC (for pension funds) have both required such disclosure. It is too early (they are less than 2 years old) to assess their impact on the market, and I am not sure if this is the only way to encourage investor activism, but it is certainly a beginning. Perhaps the press can help in this area by developing rankings, publicizing votes and so on.

In countries where foreign investors play an important role, their activism should also be encouraged.

**Issue #7: Inducement II**

**Development Banks in the region can make a fundamental contribution**

They play a vital role in providing long-term funding and subscribing shares often at times when no other investor is performing this function. Great progress could be made if the Development Banks would insist that corporate governance issues, such as the ones in the White Paper or the IFC corporate governance methodology presently in effect, be analysed and addressed in their investment decisions and reflected in pricing.

**Issue #8: Inducement III**

**Voting versus non voting shares, tag along and other rights**

Several countries and many companies in the region have their liquidity concentrated in non-voting shares (though Chile does not have non-voting shares). Several issues can be raised around this topic. For example, during changes of control, shareholders that own non-voting shares have increasingly protested that they have not been fairly compensated as owners of voting shares.

Curiously this process in Brazil was accelerated during the privatization period as the new owners, having paid perhaps too much for control, tried to compensate by paying low prices for non-voting shares during delistings. Brazil, Chile and México have issued new "OPA" laws and regulations to mitigate the delisting problem. However if the market does not price this and other potential risks associated with non-voting shares, one cannot ask for the regulator to enforce what is not in the law.

The same rationale goes for companies that deserve a premium for good corporate governance, as several have extended tag-along rights for non-voting shares and other rights non-existent in the law, e.g. minority shareholder board representation. In short, the markets also have to play their part. All things being equal, they must be willing to pay more for companies which maintain good corporate governance practices, and penalize the valuation of shares of companies which do not.

## Session 3 -- Civil Enforcement: Private Rights of Action

### Issue # 9: Active and Independent Boards and Derivative Suits

The legal frameworks in the region are increasingly clear, certainly in the case of Brazil, that a director owes a duty of loyalty and a duty of care to the *company,* and not to the shareholders that voted for his or her appointment.

It should be common practice for board members, especially those not related to controlling shareholders, to seek outside assistance on complex cases AND to express their opinion in writing on certain issues of special concern to shareholders. These opinions should in turn serve as inputs to decisions to be made or ratified at shareholders meetings.

Derivative suits, so little understood and rarely used, should be considered more often. When boards are lax and shareholders in general are not active, a derivative suit by one shareholder can help enforcement. Brazil's petrochemical privatization gave origin to one case that is at the present time at the Supreme Court. The decision may encourage this course of action.

### Issue # 10: Training and Knowledge

The market will function better if regulators, judges, and investors have better understanding of the laws, rulings and their implications. Training is key. With overworked judges, slow processes and almost non-existent specialized courts, their training is paramount if anyone is serious about improving enforcement. The same goes for regulators and investors. Universities and professional associations should get more involved in this objective, offering courses at all levels, including continuing education.

## Session 4: -- Improving the Variety and Capacity of Mechanisms for Adjudicating Disputes

### Issue #11 -- Arbitration and Mechanisms for Adjudicating Disputes

When Bovespa announced its Novo Mercado rules, one of the most lauded initiatives was the use of arbitration as an effective way to compensate for judicial system inefficiency. Apparently arbitration is one of the biggest obstacles for companies to join Level Two of Novo Mercado. If corporate disputes can be settled faster, why are market participants so reluctant? This is an area where perhaps this panel can come up with suggestions.

Mediation panels and the encouragement for the regulator to use consent decrees more often should be considered. Indeed, consent decrees have proven to be an effective tool to get things done. In the past four years, several administrative cases have been settled through this mechanism in Brazil. This frees up valuable time for the regulator to concentrate on bigger and more complex cases.

Finally I would like to highlight some key words: prevention, culture, regulator independence, institutional investor transparency and activism inducement, and development bank lending rules, to name a few discussed in my paper. I know that the priorities as well as the issues vary from country to country, but progress on some of these issues will lead to more investor confidence and better markets. Better markets translate into better valuations and better access to capital for Latin entrepreneurs.

References:

(1)Remarks by Ira M. Millstein, "Non-Traditional Modes of Enforcement For The Developing World," Lex Mundi, San Francisco, California, September 16, 2003.

(2)La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert W. Vishny. "Investor Protection and Corporate Governance," *Journal of Finance* (2000)