Background notes for Session 2

29 November 17:00 to 18:30

Break-out Group Discussions on Corporate Governance Perspectives on Annual General Meetings, Company Groups and Anti-Corruption

The three enclosed background notes are intended to provide a brief introduction to the issues and questions that will be discussed during the three break-out group discussions scheduled during session 2 of the Roundtable (17:00-18:30 on November 29th), addressing the corporate governance challenges associated with 1) annual general meetings 2) company groups, and 3) anti-corruption efforts. It is provided to assist participants in preparing for and choosing which sessions to attend.

Break-out Discussion Group on Annual General Meetings

The Companies Circle Working Group on Annual General Meetings ("AGMs") was created as a result of the Companies Circle members' interest in further improving the effectiveness and quality of the decisions in their Annual General Meetings. In the spirit of the *Practical Guide to Corporate Governance – Experiences from the Latin American Companies Circle* published in 2009, the study also intends to contribute to improvements in the effectiveness and quality of deliberations of AGMs in the region by further sharing the member companies´ experiences and practices with other Latin American companies.

The study derives from the analysis of the legal and regulatory frameworks and corporate governance codes in Argentina, Brazil, Colombia, Mexico and Peru, as well as from experiences and practices of the Circle member companies. As the subject is very broad, this study focuses on three topics:

1) Presentation of business results;
2) Information on the election of board members; and
3) Information on board and management compensation.

The Circle is scheduled to discuss a preliminary set of practices that companies should consider in carrying out AGMs at its annual meeting of November 28th, and the AGM Working Group Chair, Marcello De Simone of Ultrapar (Brazil), will lead-off the break-out session with a presentation of issues where the group has reached some degree of consensus, and those where further discussion may be useful.

It is important to note that Latin American countries differ significantly in terms of the legal and regulatory requirements established for the timing, information and level of detail required for disclosure at Annual General Meetings, and in the mix between legal requirements and voluntary recommendations of national corporate governance codes, so what are considered good practices may differ depending on individual country contexts. Nevertheless, the Circle Working Group has attempted to identify a series of practices relevant for companies to consider within these sub-topics.

The break-out group discussion is seen as an opportunity for the Circle Working Group on AGMs to obtain broader stakeholder input and feedback on some of the issues that the Working Group is considering before deciding on a final report for wider dissemination.

Among the issues the AGM Working Group may seek feedback on (and not intended as a comprehensive list of all issues under consideration by the Working Group) are the following:

1) For the presentation of business results:

- The timing for companies to disclose business results before AGM and the level of detail on the business reports that companies should disclose;
- The key elements to address in explaining the risk management systems that are in place, to allow investors to evaluate the reliability of the information;
- The disclosure of the link between the operational results and the organization's strategy, governance and financial performance, as well as the social, environmental and economic context within which it operates;
- The necessity to release results in English simultaneously with native language when the company has international investors.

2) For the election of boards of directors:

- Information and procedures that need to be in place to support informed decisions on the election, re-election or dismissal of board directors;
- The timing in advance of the AGM that shareholders who wish to propose candidates or slates of candidates are expected to submit their nominations and provide information to the company to be disclosed to all shareholders;
- The steps that should be taken to encourage and facilitate electronic voting for board members.

3) Regarding information on board and management compensation:

- The composition and level of detail on remuneration of boards and management necessary for shareholders to make informed decisions about the company's interests.

Corporate Governance Challenges for Company Groups

Discussion [1]

The corporate governance debate has been largely shaped by the agency problems arising within individual firms and between different stakeholders. It has been the successes and failures of the governance system in individual firms that have drawn the attention of policy-makers and practitioners in recent decades. Additionally, global standard-setting institutions for the most part have take this same approach, and consequently developed general principles that address the problems that arise at the firm-level. However, governance issues arising in firms that are part of economic groups or conglomerates have to date drawn relatively minor attention. [2] Since successfully managing governance issues in economic groups also indirectly facilitates financial and economic integration (acting as a convergence mechanism), addressing these particular issues should also be part of a broader discussion.

These issues are particularly striking when looking at the corporate governance debate in Latin America, since economic groups or conglomerates are the predominant form of commercial structure in this region. Although accurate information about ownership structure is hard to compile, Lefort (2000) found that 80% of LAC-6 [3] issuers of ADRs are affiliated with a conglomerate. More recent data show that in Chile the ten largest listed firms -that account for almost 50% of market capitalization- are members of an economic group, while there are 156 economic groups being supervised and regulated by the Chilean Superintendencia de Valores y Seguros. In Argentina, 8 out of the ten largest listed domestic firms are part of an economic group. In Colombia, anecdotal evidence suggests that over 140 separate groups exist. In the case of Mexico, there are 4 economic groups within listed firms; the largest group accounts for 53% of overall market capitalization.

A number of studies have approached this issue trying first to identify the economic structure in the region and then to understand the rationale for such a wide presence of this phenomena. Notably, this is also true for most countries in the world, with a few exceptions in some of the most developed markets.

Underdevelopment of capital markets, taxation structure, high agency and transactions costs, are among the most important reasons why large economic groups in emerging economies have developed so widely. This market response to market failures or regulations comes at a cost of creating conflict of interest within companies and inside the group that may jeopardize the efficiency of firms and their competitiveness. Also, if economic groups largely dominate the commercial scene, countries may as a result face larger macroeconomic instability and a higher likelihood of rigid political systems influenced by the interests of concentrated wealth that may impede economic reforms. Although empirical evidence regarding the net effect of the costs and

[1] Silvina Vatnick and Pablo Souto from the Center for Financial Stability (CEF) prepared this Note. The authors are grateful to Andrés Bernal, Alvaro Clarke and Marta Vaca for their helpful comments and suggestions that have enriched the document. As usual, all remaining errors are our own.

[2] An important exception was the debate around the impact that economic groups in Asia had in the dynamics of the so-called Asian crisis of 1997.

[3] LAC-6: Argentina, Brazil, Chile, Colombia, Mexico and Peru.

benefits of economic groups is still inconclusive, there are some studies that conclude that the costs outweighs the benefits.

The way in which these groups are structured depends on certain idiosyncratic factors within each country; pyramidal structures and cross shareholdings blocks are the most common. The presence of a financial intermediary within the group -in many cases as the holding company- can add to the potential conflicts of interest and increases macro instability by including a financial channel that can increase the vulnerability of the group.

Most importantly, what these conglomerate structures allow is to drive a wedge between voting rights (equity holdings) and cash-flow rights (assets disposal). Controlling shareholders are then able to reap benefits from companies that exceed (in some cases, by far) what they would get in a fair environment, thereby causing damage to other stakeholders, mostly minority shareholders and creditors. Related-parties transactions, self-damaging corporate strategies (including entrenchment of directors and senior managers), tunneling, preferences on new shares issuances, and dividends policies are the common mechanisms used to benefit the group at the expense of individual stakeholders.

As already mentioned, economic groups are very important in the Latin American region. This is even more so when looking at listed firms. In these cases, where -by definition- a minority shareholder exists, the conflicts of interest facing directors and managers are readily apparent. In this region, although significant advances have been made in the last two decades, property rights and enforcement of contracts are still weak, so this issue needs special attention. Furthermore, the presence of the state -either as a minority or controlling shareholder of a firm belonging to a group- poses different challenges in terms of the impact it may have on corporate performance, as well as on the legal and regulatory response.

Lack of transparency regarding the ownership structure and the conditions under which transactions with related-parties are conducted, the costs of monitoring such transactions (and the associated free-rider problem), and the cross appointment of directors among firms belonging to a group, all make it difficult for affected parties to identify and measure the damage, and to request compensation.

And all of the elements mentioned above are present to one degree or another in the region, thereby limiting access to and increasing the cost of capital for domestic firms. Some evidence in this regard can be found in the World Bank's 2012 Doing Business Report. The Report includes an index that measures the strength of investors' protection; Latin America and the Caribbean ranks fourth (out of seven regions) in terms of these protections. The LAC region records better figures in the "Ease of Shareholders Suits Index" (ranking second), while its worst performance is found in the "Extent of Disclosure Index" (ranking seven out of seven). In summary, the Latin American region appears to be well positioned in terms of investors´rights to sue directors and/or managers for misbehavior once the damage has been done (ex-post mechanism), while the region offers relatively few protections to prevent such damage to investors/shareholders from occuring (ex-ante). In an environment where enforcement of rules in this area is weak, lengthy and costly, this fact deserves greater attention of policy-makers and market participants.

In the context as described, public policy clearly has a role to play in addressing these problems and in strengthening investors' rights, particularly minority shareholders and creditors. Actual legislation and regulation have taken into account these facts, but seem so far to fall short in preventing abusive behavior. In the surveyed countries (Argentina, Chile, Colombia and Mexico), we found legal provisions that: 1) characterize what an economic or company group is[4]; 2) define controlling shareholders and entities; 3) establish reasonable procedures in cases of related-parties transactions; 4) mandate preparation of consolidated financial statements; and 5) request information about the ownership structure, among others. However, actual enforcement of these regulations seems to be affected by the factors noted in the paragraph above.

In this context, more analysis - including benchmarking - and discussion is needed in order to properly identify the structure of economic groups in the region and assess their relative performance in order to determine whether the net benefits of economic groups are positive or not. Also, a thorough analysis of the legal and regulatory environment is needed based on the above-mentioned considerations, while a comparative analysis with other relevant experiences (Korean chaebols, Japanese keiretsus, Nordic-type corporations, etc.) could also contribute to an effective and tailor-made policy response.

Depending upon the specific conditions within each country, legislation, regulation and/or voluntary actions (of the "comply or explain" type) could be called for. In the end, such policy responses can provide answers to some of the following questions/issues:

- Given that economic groups are increasingly of a regional scope rather than national, should policy responses be developed from a coordinated, regional perspective?

- How could international standards (OECD, BIS, IOSCO, etc.) be adapted to explicitly include the specific factors arising when economic groups are dominant?

- Is there a role for institutional investors (particularly pension funds) to serve as gatekeepers in this regard? What about facilitating the establishment of institutional investors' advisory services?

- Since the state does not necessarily pursue behavior to maximize benefits as it is understood for private economic agents, how can an incentives-based scheme be developed that would motivate the state to add value to corporations?

- How can the duties of care and loyalty of directors be improved and defined in such a way that they become operational for monitoring purposes and sanctions? How can the responsibilities of directors to preserve company value and to maintain loyalty to the company be improved and defined in such a way that they become more operational for purposes of monitoring and sanctions?

[4] It is important to note that for the purposes of corporate governance enforcement issues, there may need to be a distinction made between "economic groups" which may have control or influence over a wide number of unrelated activities, and company groups which may refer to a smaller and more formally related set of companies with more explicit legal requirements applying to the associated companies within a group under company law and IFRS accounting standards.

- How can a company group effectively promote good corporate governance practices in the companies that it controls, while still allowing the board members to act independently in exercising their duty of loyalty to the company on whose board they serve?

- Can independent directors play a relevant and effective role in decision-making on sensitive matters where minority shareholders are at risk? Would it be desirable to limit the cross-sitting of directors (or change their liabilities or limit their powers in certain cases) in companies that are part of a group?

- Should stronger disclosure practices over the ownership structure and related-parties transactions be put in place (ex-ante)? If so, do the costs outweigh potential benefits in this case?

- How can other internal control mechanisms (audit function) be better conducted to minimize abusive actions (ex-ante)?

- What mechanisms could be more efficient in allowing affected parties to obtain redress (ex-post)? Can out-of-court dispute resolution mechanisms have a role in this regard? If so, how to enhance their powers and visibility?

- Since abusive actions by controlling parties to obtain private benefits through exercise of their control is a consequence of a cost-benefit analysis, is there a role for the media to play in deterring misbehavior by in effect increasing reputational costs?

The Role of Corporate Governance in Preventing Corruption

Provocateurs:

Leah Ambler, OECD Legal Analyst – "The OECD Anti-Bribery Convention and Good Practice Guidance on Internal Controls, Ethics, and Compliance"

John Zemko, CIPE – "Corporate Governance as the Foundation for Transparency in Public and Private Transactions"

Marcos Bertin, PSAG GCGF – "The Role of Quality at the Board to Prevent Corruption"

Chair:

Santiago Chaher, GCGF Consultant

Rapporteur:

Maria Magdalena Rego, GCGF Consultant

What is this session about?

Corruption takes place in every economy, political system or part of the world. Bribe solicitation by public officials is not the only cause, as someone has to pay the money, or offer the advantage in the first place. It is as important to fight corruption from the side of the private business community as it is from the public sector, with both serving as equal potential participants in these illegal practices. In this sense, can corporate governance mechanisms play a role in eliminating – or at least minimising - the risk of corruption in commercial activities?

In this break-out session, the "provocateurs" will present three different aspects of corporate governance as a tool to prevent corrupt acts. First, we will explore at the macro level the OECD work on fighting bribery of foreign public officials in international business-one of the most prevalent forms of corruption- and the frameworks that Latin American governments have put in place to prevent, detect and punish transnational bribery. Second, we will focus on the connections between improving corporate governance and building stronger institutions in democratic society by describing the components of corporate governance that relate specifically to the broader societal goal of reducing corruption. Third, we will hear about the tools and practices that boards could apply – with special focus on improving the quality of processes- to fight corruption within their companies' structures.

Questions to the audience:

1. The OECD Good Practice Guidance sets out general guidelines, agreed by governments, on how a company can eliminate bribery from its business activities. How can it be effectively applied in practice?
2. What joint efforts can the private sector make with the public sector (national, regional and local) to reduce corruption through stronger governance and the institution of the values of transparency, accountability and responsibility?

3. How can company boards and executives ensure that employees at all levels, including in subsidiaries and related companies, are aware of the anti-bribery policy of that company, and put it into practice?

Steps:

- The chair will introduce the session in 4 minutes;

- Each provocateur will have approximately 12 minutes on their agreed topic in order to provoke the audience into thinking about the issues;

- The audience will be seated in smaller groups and will be given approximately 30 minutes to discuss the set of questions (presented above);

- One person at each table will then be given approximately 5 minutes to summarize their table's views on the questions;

- The rapporteur will note the views and will present these at the plenary session.