

# **REPORT ON THE OBSERVANCE OF STANDARDS AND CODES (ROSC)**

## **Corporate Governance Country Assessment CHILE**

**May 2003**

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This Corporate Governance Assessment was completed as part of the joint World Bank-IMF program of Reports on the Observance of Standards and Codes (ROSC). It benchmarks the country's observance of corporate governance against the OECD Principles of Corporate Governance and is based on a template developed by the World Bank. This assessment was undertaken on the basis of the template prepared by Fernando Lefort for the World Bank. Acknowledgments are due to the Ministry of Finance, Superintendence of Securities and Insurance, the Santiago Stock Exchange, and leading experts on legal, accounting and auditing issues, academics, state-owned companies, capital market issuers, and institutional investors. Olivier Frémond and Mierta Capaul of the Corporate Governance Unit, Private Sector Advisory Services of the World Bank drafted the final report. The ROSC assessment was cleared for publication by the Ministry of Finance on May 22, 2003.

## I. EXECUTIVE SUMMARY

This ROSC provides an assessment of the corporate governance policy framework and practices in Chile. The country's legislative and regulatory framework dealing with corporate governance has been upgraded in recent years, and Chile has become a standard setter in this field for the entire Latin American region.

Chile's equity market is fairly large and successful. The market capitalization of the 249 listed firms represented 89 percent of GDP at year-end, 2001. Corporate ownership is concentrated and pyramid structures are common. Business groups/conglomerates are the predominant corporate form. Institutional investors, especially pension funds, are active equity investors. The Securities Market Law and the Corporation Law form the legal framework governing the capital markets. The securities market is regulated by the Superintendence of Securities and Insurance (SVS).

Overall, Chile scores well on the assessment on compliance with the OECD Principles, scoring "Observed" or "Largely Observed" for 14 of 23 Principles; no Principle is deemed "Not Observed."

The policy recommendations may be grouped under three broad categories: legislative reform, institutional strengthening and voluntary/private initiatives. The report recommends further amendments to the Corporation Law and Securities Market Law to increase transparency for investors; more transparency in and accountability of SVS; additional resources for SVS to strengthen its ability to conduct market surveillance; and the preparation of a road map to improve the general enforcement of investor property rights. Finally, the report proposes the creation of an Institute of Directors to provide training for supervisory board members, disseminate best practice, and promote dialogue between the public and private sectors.

## II. CAPITAL MARKETS AND INSTITUTIONAL FRAMEWORK

As of December 2001, 249 stocks were traded on the Santiago Stock Exchange, with a total market value of USD 56.3 billion, or 89 percent of 2001 GDP.<sup>1</sup> The ten largest companies represented 40 percent of the equity market. The turnover ratio has been decreasing since 1997, to 7.5 percent of market capitalization in 2001. Average daily trading is approximately USD 20 million, with the same ten largest firms accounting for 70 percent of trading.<sup>2</sup> Capital issues have also decreased since 1997, averaging USD 1.2 billion per year over the last five years, with only USD 270 million in 2001, or three percent of fixed capital formation. There has been no new listing on the Chilean stock market since 1997, while approximately 20 companies have delisted, mainly due to mergers and acquisitions or to avoid the new law, *Ley de OPA*. Of the 60 most traded stocks, 68 percent of their shares are owned by controllers. The concentration level is higher with less traded stocks. The real free float was between seven and 16 percent of issued stocks, depending on firm size.<sup>3</sup> A large portion of trading in Chilean shares occurs abroad; 25 Chilean firms have ADR programs, representing about 50 percent of total 2001 turnover.

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<sup>1</sup> 2001 GDP was USD 63.5 billion (*Source*: World Bank, World Development Indicators Database, August 2002). See Annex C for additional Chile and regional market statistics.

<sup>2</sup> *Source*: Santiago Stock Exchange.

<sup>3</sup> To be listed, companies must have at least 500 shareholders, and ten percent of their shares must be owned by 100 shareholders.

Business groups/conglomerates are the predominant corporate structure in Chile. Around 70 percent of non-financial listed companies belong to one of about 50 conglomerates, that together control 91 percent of the assets of listed non-financial companies.<sup>4</sup> These figures remain stable. Pyramid structures are widespread. The holding company at the pyramid's top is seldom listed; when it is, it usually trades at a discount to net asset value. The 1986 Banking Law restricted related lending and prohibited banks from owning corporate shares. These regulations have decreased the importance of banks for conglomerates. Conglomerates are seen as value-enhancing in Chile.

Institutional investors consist of seven pension fund management companies with over USD 35 billion in assets and insurance companies managing USD 12 billion in assets (55 and 19 percent of GDP respectively). Chile has a mandatory defined contribution pension system. Pension funds have been allowed to invest in equities since 1985. By year-end 2001, their equity holdings comprised over 30 percent of total assets; domestic equities amounted to USD 3.5 billion, or ten percent of total asset portfolio and seven percent of national market capitalization. These figures decreased over the last five years, as domestic stock prices fell and pension funds diversified into foreign investments. Pension funds favor less concentrated companies, because of limits the regulator imposes on ownership concentration of portfolio companies.

The Securities Market Law (SML) and the Corporation Law (CL) form the legal framework governing listed companies. Although the Chilean legal system follows the tradition of French civil law, these two laws were strongly influenced by U.S. law and practice. Their main body was passed in 1981 and amended in 1989 and 1994. In 2000, both laws were overhauled by Law N° 19,705, known as the Corporate Governance Law or *Ley de OPA*.<sup>5</sup> Five areas of the laws were affected: (1) the market for corporate control was regulated, requiring that transactions involving changes of control are performed through a tender offer under a version of the equal opportunity rule; (2), the regulator increased the reporting and disclosures requirements for related party transactions and regulated operations between connected parties; (3) large listed corporations were required to form a board committee with a majority of board members unrelated to the controller. This committee's functions were specified by law; (4) share repurchases were allowed in order to implement stock option packages as an incentive to executives; (5) equal treatment of foreign (mainly ADR) shareholders was guaranteed by law, especially regarding voting procedures. The SML was amended again in 2001 to deal with the administration of voluntary savings. The government has prepared a proposal for an amendment to the SML regarding more flexibility for private companies, to be submitted to Congress in March 2003. SVS is also working on a proposal for the creation of the figure of private arbitrageurs under the *Cámara de Sociedades Anónimas* and through special courts.

Three supervisory entities oversee financial markets: the Superintendence of Securities and Insurance (SVS), the Superintendence of Banks and Financial Institutions (SBIF) and the Superintendence of Pension Fund Managers (SAFP). SVS was set up in 1980 as an "autonomous public organization" under the Ministry of Finance's oversight. Chile's President nominates the SVS's Superintendent, and the Minister of Finance appoints the candidate for an indefinite term.

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<sup>4</sup> Eduardo Walker, "Ownership and Capital Structure of Chilean Conglomerates: Facts and Hypotheses for Governance," *Abante*, Vol. 3, N°1, 2000.

<sup>5</sup> *Ofertas Públicas de Adquisición*.

The Superintendent appoints two intendents – one each for the securities market and insurance sector. SVS does not submit a formal annual report to parliament. It regulates public companies, the stock exchanges, brokerages,<sup>6</sup> mutual and investment funds, and auditors of listed firms. SVS can subpoena market participants, access private records, and impose sanctions.<sup>7</sup> The Ministry of Finance submits legislative changes to Parliament. SVS has introduced a process of consultation through its website before issuing new rules and regulations, though the process is not embedded in law. Unlike the Central Bank, which manages its own budget, SVS's budget is allocated by the government. In 2002, SVS had a budget of USD 5 million and about 200 employees.

### III. REVIEW OF CORPORATE GOVERNANCE PRINCIPLES

The following review assesses Chile's compliance with each OECD Principle of Corporate Governance. Policy recommendations may be offered if a Principle is less than fully observed.<sup>8</sup>

#### Section I: The Rights of Shareholders

**Principle IA:** The corporate governance framework should protect shareholders' rights. Basic shareholder rights include the right to: (1) secure methods of ownership registration; (2) convey or transfer shares; (3) obtain relevant information on the corporation on a timely and regular basis; (4) participate and vote in general shareholder meetings; (5) elect members of the board; and (6) share in the profits of the corporation.

*Assessment: Largely observed*

*Description of practice:* Only registered shares exist in Chile. Shares are registered with the *Depósito Central de Valores* (DCV),<sup>9</sup> with other share registrars, or with the company.<sup>10</sup> Registration in the share register constitutes legal proof of ownership. Shareholder identity is public. After each trading day, DCV sends company registrars a list of their issuers' shareholders.

**Convey or transfer shares.** For shares deposited with DCV, clearance and settlement occurs in DVP at T+2 for securities and T+3 for cash. Clearance and settlement takes place on a bilateral level, with intra-day netting. There is no novation.<sup>11</sup> As of December 2002, the Central Bank did not provide real time gross settlement (RTGS), but a project to introduce electronic payment using RTGS is expected to begin in 2003. DVP does not occur simultaneously if one of the securities is not deposited with DCV. In this case, the buyer and seller sign a sales and purchase agreement; the buyer pays by cashier's check against the contract and requests the transfer from the share registrar. Thus, along with bank risk, there is principal risk in such transactions.<sup>12</sup>

**Obtain relevant information on the corporation on a timely and regular basis.** Listed companies must disclose material information to SVS, which publishes it in the press and on its website. The Santiago Stock Exchange may suspend trading in a stock for up to five days if it

<sup>6</sup> Though not individual brokers.

<sup>7</sup> Article 4 of Law 3538. Administrative sanctions include suspension, delistings and fines. Fines and levies go directly to the government. The *Ley de OPA* requires a down-payment of 25 percent of the penalty before an appeal.

<sup>8</sup> **Observed** means that all essential criteria are met without significant deficiencies. **Largely observed** means only minor shortcomings are observed, which do not raise questions about the authorities' ability and intent to achieve full observance in the short term. **Partially observed** means that while the legal and regulatory framework complies with the Principle, practices, and enforcement diverge. **Materially not observed** means that, despite progress, shortcomings are sufficient to raise doubts about the authorities' ability to achieve observance. **Not observed** means no substantive progress toward observance has been achieved.

<sup>9</sup> 15-20 percent of market cap in custody. Source: DCV.

<sup>10</sup> If they have a *departamento de accionistas*.

<sup>11</sup> Buyers must secure a cashier's check against collateral from a private bank.

<sup>12</sup> In this case, there is a transfer of registration to the broker.

suspects that material information has been kept from the market. Listed firms must submit quarterly reports and annual financial statements to SVS and the exchange. The Second Reform to the Capital Market will propose an amendment to the SML and the CL in order to allow issuers to disseminate information via the Internet and e-mail.

**Participate and vote in general shareholder meetings.** Shareholders have the right to attend and vote at shareholders meetings. See Principle IC.

**Elect members of the board.** The appointment and remuneration of board members is determined by shareholder vote. Cumulative voting is permitted and common.

**Share in the profits of the corporation.** Companies must distribute at least 30 percent of annual after tax profits as shareholder dividends in cash within 30 days.

*Policy recommendations:* Set a time frame for full compliance with G30 recommendations; complete the Central Bank's electronic payment project on time; remove principal risk in all shares transactions. Amend the SML and the CL to allow issuers to disseminate information via the Internet and e-mail. Issuers should consider creating investor relations websites.

**Principle IB:** Shareholders have the right to participate in, and to be sufficiently informed on, decisions concerning fundamental corporate changes, such as: (1) amendments to the governing documents of the company; (2) the authorization of additional shares; and (3) extraordinary transactions that in effect result in the sale of the company.

*Assessment: Observed*

*Description of practice:* Shareholders vote to amend articles of association. They also vote on the authorization and issuance of new shares and have preemptive rights. The transaction must occur within three years of authorization and may be staggered. Shareholders may also vote on decisions to dispose of or mortgage 50 percent or more of the company's assets.<sup>13</sup> Major issues like company dissolution, major transformations, mergers or status reform, capital reductions, and changes in board attributes must be discussed at Extraordinary (General) Shareholders Meetings (EGM). Major decisions and changes require the approval of two thirds of voting shares. In practice, many controllers maintain control at 67 percent in order to make fundamental corporate decision without the need for support from outside shareholders.

**Principle IC:** Shareholders should have the opportunity to participate effectively and vote in general shareholder meetings and should be informed of the rules, including voting procedures, that govern general them. (1) Shareholders should be furnished with sufficient and timely information concerning the date, location and agenda of general meetings, as well as full and timely information regarding the issues to be decided at the meeting. (2) Opportunity should be provided for shareholders to ask questions of the board and to place items on the agenda at general meetings, subject to reasonable limitations. (3) Shareholders should be able to vote in person or in absentia, and equal effect should be given to votes whether cast in person or in absentia.

*Assessment: Largely observed*

*Description of practice:* Annual general meetings (AGM)<sup>14</sup> take place within four months after annual financial statements are prepared. The agenda includes board member and auditor elections, approval of financial statements and dividends, and other items put forth by the board. Local institutional investors note that agendas are often insufficiently detailed. The board, SVS

<sup>13</sup> A sale of 50 percent or more of assets or their use as collateral gives rise to withdrawal rights for dissenting shareholders.

<sup>14</sup> AGM (Annual General Meeting) is used as an internationally-accepted convention. Terms like ordinary shareholder meetings (OSM) are common in some countries, like Chile.

and shareholders (with ten percent of voting shares) may request EGMs. If the board fails to convene the EGM within 30 days, shareholders may petition the courts. Meetings and agendas must be announced in a major newspaper at least three times in the 20 days before the meeting,<sup>15</sup> and invitations and agendas must be mailed to registered shareholders. A first AGM requires a 50 percent quorum. The second meeting may be held with no quorum, provided shareholders receive proper notice.<sup>16</sup> Voting is performed by show of hands or secret ballot. Proxy votes are allowed, but voting by mail is not. At the end of the AGM, shareholders are given the chance to discuss issues not on the original agenda. At EGMs, only items on the agenda may be discussed.

*Policy recommendations:* Consideration should be given to extending the 20-day notice period for convening an AGM to 30 days to allow sufficient time for international investors to attend.

**Principle ID:** Capital structures and arrangements that enable certain shareholders to obtain a degree of control disproportionate to their equity ownership should be disclosed.

*Assessment: Partially observed*

*Description of practice:* Shareholders must disclose ownership exceeding, directly or indirectly, the ten, 33, 50 and 66 percent levels. The CL prohibits cross-holdings,<sup>17</sup> but dual class shares with restrictive/preferential rights to appoint directors are allowed. Pyramid structures are not complex, and firms must disclose electronically, on a quarterly basis, the identities of their 12 largest shareholders and the voting powers of different share classes. However, conglomerates may be controlled through private holding companies and therefore, in reality, it can be difficult to ascertain a firm's controller. To do so, investors must search *Diario Oficial*<sup>18</sup> archives to identify the owners behind each investment company.

*Policy recommendations:* SVS should continue its work on disclosure forms designed to help investors identify the real beneficial owner.

**Principle IE:** Markets for corporate control should be allowed to function in an efficient and transparent manner. Anti-takeover device should not be used to shield management from accountability.

*Assessment: Largely observed*

*Description of practice:* During the 1990s, a wave of changes of control occurred through private transactions at an average control premium of 70 percent.<sup>19</sup> Minority shareholders did not participate in this upside. Shareholder dissatisfaction about the Enersis/Chispas takeover<sup>20</sup> prompted the introduction of the *Ley de OPA*. The law established that share transactions that result in a person's or group's acquisition of control of a corporation must be conducted through a tender offer.<sup>21</sup> Thus, the control premium is allocated to all shareholders on an equal basis. The acquirer must disclose his/her takeover intentions and the conditions offered to all shareholders; the acquiree must give his/her opinion on the terms of the offer. A prorated offer for all stock is not required if the control premium is not substantially different from the average market price

<sup>15</sup> A quorum of a hundred percent of voting shares allows to constitute the meeting without the proper notice.

<sup>16</sup> The meeting must be advertised and take place within 45 days of the first meeting.

<sup>17</sup> Article 88 of the Corporation Law.

<sup>18</sup> All presidential decrees and laws are published in *Diario Oficial*, Chile's official daily legislative journal.

<sup>19</sup> Eduardo Walker, "Gobierno Corporativo, Protección a los Accionistas Minoritarios y Tomas de Control," *Elementos Conceptuales de la Ley de OPAS*, Serie Documentos de Discusión N°1, SVS, 2001.

<sup>20</sup> See Annex D.

<sup>21</sup> Except in the event of equity issuance, mergers or acquisitions as a result of death or forced transfer.

over the last 60 days,<sup>22</sup> the payment is made in cash, and the stock has low liquidity. If the acquiror acquires two thirds or more of the company, s/he must tender for all outstanding shares. A *Ley de OPA* provision allowed firms to postpone the law's enforcement for three years, subject to approval by 60 percent of shareholders. About half of all listed companies (representing 80 percent of assets) filed for the transitory rule, which subjects them to the *Ley de OPA* in 2004. Policymakers should monitor the law's effects on the market for corporate control. If the mandatory tender offer rule reduces the rate of return of the sellers of control, transactions may not occur and ultimately, minority investors may suffer. Some companies<sup>23</sup> have issued dual class shares with varying rights to elect board members, sometimes with a cap on individual ownership. Such capital structures prevent the efficient function of the market for corporate control, and like ownership caps, may shield management from accountability.

**Principle IF:** Shareholders, including institutional investors, should consider the costs and benefits of exercising their voting rights

*Assessment: Largely observed*

*Description of practice:* Pension funds have decisively influenced corporate governance in Chile, pressing for more disclosure requirements, and for the protection of minority shareholder rights. Pension funds usually elect one board member in large companies. They may not invest in non-voting stock. A pension fund that owns more than one percent of a company's equity is legally obliged<sup>24</sup> to attend the AGM and to exercise its voting rights. It must inform SAFP how it voted, but the voting policy is not disclosed to fund members. However, pension funds must announce their votes publicly at the AGM, giving the press an opportunity to report. Market analysts say that pension funds increasingly ask their portfolio companies about their strategy,<sup>25</sup> and interest by institutional investors in exercising voting rights is growing.

*Policy recommendations:* Lessons learned in the U.S. and the U.K. show that shareholder activism, an important engine of change in corporate governance, grows when pension funds must disclose their voting policies to members. Policymakers should consider whether such a requirement should be introduced in Chile.

## Section II: The Equitable Treatment of Shareholders

**Principle IIA:** The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights. All shareholders of the same class should be treated equally. (1) Within any class, all shareholders should have the same voting rights. All investors should be able to obtain information about the voting rights attached to all classes of shares before they purchase. Any changes in voting rights should be subject to shareholder vote. (2) Votes should be cast by custodians or nominees in a manner agreed upon with the share's beneficial owner.

*Assessment: Largely observed*

<sup>22</sup> The premium is defined annually by SVS. It is currently ten percent.

<sup>23</sup> For example, SQM has A & B shares. Both share classes have the same economic and voting rights at AGMs, except that the Series A can elect seven out of eight board members, the Series B can elect one board member, and nobody can own more than 37.5 percent of Series A. Thus no one can elect more than three board members, and no one can control the board. Similarly, Andina has two classes of shares. The series B can only elect one director and cannot vote on any other issue.

<sup>24</sup> From the pension fund law, Decree Law No. 3,500 of 1980.

<sup>25</sup> An important milestone in this respect was the sale of Telefonica's Internet company to Telefonica España in 1999. The pension fund industry disagreed with the negotiated sale price for the subsidiary. Pension funds jointly sued Telefonica's board for breach of fiduciary duty. The case went to arbitration, and the pension funds lost.

*Description of practice:* Chilean law allows the issuance of voting and preferred shares with limited or no voting rights. Classes of shares with restricted voting rights must receive some type of preference in exchange. The restriction must be limited to five years.<sup>26</sup> The issue and alterations of voting rights and other forms of privileges must be approved by two thirds of voting shares. Dual class shares are found in holding companies controlling the utility companies, though they are not common overall. By 2000, less than seven percent of listed companies had preferred shares.<sup>27</sup> Since 2001, all shareholders of a class must be treated equally during changes of control. A shareholder's opposition to the transformation of the company or its statutes, a merger, the disposal of 50 percent or more of assets, the creation of or changes in the preferences assigned to a particular class of shares, gives him/her the right to sell his/her shares to the company at market price.<sup>28</sup> Shareholders who deem that their rights have been violated in a change of control can file suit against the directors and/or the company. The *Ley de OPA* introduced an arbitration mechanism to settle such disputes. The arbitrator is nominated by the judiciary and his verdict is binding. The arbitrator settles disputes with funds (ten percent of the transaction) deposited as collateral by the new controller before the tender.

The *Ley de OPA* grants beneficial owners of depositary receipts the same rights to information and vote as any other shareholder. Their rights are exercised through a custodian, who must vote according to beneficial owner instructions. Foreign market disclosure requirements must be disclosed in Chile as well. Domestic information requirements must be translated into English.

Shareholders representing at least five percent of capital may sue a party for compensation on behalf of the company. Although the concept of personal action is clearly stated in the SML, and the *Ley de OPA*'s provisions represent a marked improvement in this regard, board members and managers tend to represent the controller's interest. Since the information provided to shareholders does not include all the connections between the companies of a conglomerate, in practice, it is difficult for minority shareholders to discover whether their rights have been violated. SVS should focus its scarce resources on monitoring potential fraud to minority interest. The judiciary system is slow and cumbersome for effective enforcement.

*Policy recommendations:* The supervision of conglomerates should be a priority for SVS, given their importance in Chile. With respect to improving overall enforcement, SVS requested a seminar to discuss international best practice and lessons learned; the results should contribute to a roadmap for enhanced enforcement and redress in Chile and the entire Latin American region.

<b>Principle IIB:</b> Insider trading and abusive self-dealing should be prohibited.
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*Assessment: Partially observed*

*Description of practice:* Insider dealing is a criminal offense in Chile.<sup>29</sup> The SML considers company executives, board members, controllers, large shareholders and their families to be insiders of the company and any firm the company controls. They must refrain from trading based on inside information. If an investor is hurt by insider trading, s/he can sue the insider. If

<sup>26</sup> Article 20 of the Corporation Law.

<sup>27</sup> Fernando Lefort; also Eduardo Walker, "Ownership and Capital Structure of Chilean Conglomerates: Facts and Hypotheses for Governance," *Abante*, Vol. 3, N°1, 2000.

<sup>28</sup> Article 69 of the *Ley de OPA*.

<sup>29</sup> Article 60 of the Securities Market Law. Prison terms can range from 180 days to five years.

no investor is hurt, the insider must return the ill-gotten profits or avoid the loss to the State.<sup>30</sup> SVS monitors legal compliance on insider trading and can impose sanctions.<sup>31</sup> Over the last five years, it has pursued about 20 cases, five of which resulted in prosecution of 12 people. However, there have been no convictions, and most cases are still on trial. SVS's administrative sanctions have been suspended pending resolution in the courts. SVS has insufficient tools to detect insider dealings; it lacks an electronic surveillance system and cannot access investor phone records.<sup>32</sup> The Stock Exchange fulfills a monitoring role and may suspend transactions for up to five days if it suspects that relevant information is unknown to the market.<sup>33</sup> Anecdotal evidence indicates that insider trading is more common than indicated by the above caseload. Insiders share information, making it difficult to relate trading to specific inside information.

*Policy recommendations:* The SVS should develop an electronic surveillance system to monitor insider trading. The seminar proposed under IIA would raise awareness among judges.

<p><b>Principle IIC:</b> Members of the board and managers should be required to disclose any material interests in transactions or matters affecting the corporation.</p>
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*Assessment: Largely observed*

*Description of practice:* Board members and senior managers must disclose their dealings in company shares to SVS.<sup>34</sup> A transaction between the company and a director, manager or controller, directly or indirectly, is deemed a related party transaction. This definition includes loans to directors and consulting contracts, but not leases. The related party must disclose his/her interest to the board and SVS. The *Ley de OPA* mandates that companies with a market capitalization of above USD 37 million must form a *comité ejecutivo o de directores*. One of its functions is to pre-vet related party transactions and, if the transaction involves substantial amounts, indicate whether it meets market conditions. The board must either approve or reject the transaction with the abstention of the interested director or, if the board is unable to reach a decision, hire two independent evaluators. Their reports are available to the board and shareholders for 20 working days and transmitted to the regulator. Related party transactions must be disclosed at AGMs. When expert opinions differ substantially, or if shareholders with five percent of outstanding shares consider the transaction detrimental to them, the transaction must be approved at an EGM by 2/3 of voting shares. Practice suggests that despite all efforts, misuse of corporate assets and abuse in connected party transactions remain a recurrent problem in Chile. It is not easy to identify “related parties” given the complicated ownership and control structure of most conglomerates, nor to assess the fairness of a transfer price.

*Policy recommendations:* While the authorization provisions help avoid expropriation of minority shareholders, the definition of related party transactions could be fine-tuned through full compliance with IAS 24.

<sup>30</sup> Chapter 25 Articles 164 to 172 of the Securities Market Law.

<sup>31</sup> SVS Decree 3538, Article 27-29. SVS can impose fines up to 15,000 UF (USD 300,000) or 30 percent of the transaction.

<sup>32</sup> The Second Reform to the Capital Market will propose an amendment to allow SVS to access telephone records.

<sup>33</sup> Article 44, SML, or when daily price variation reaches 10 percent for most traded stocks or 20 percent for least traded stocks. This is a procedure established by the Stock Exchange, rather than law. The Stock Exchange requires SVS authorization to suspend transactions for more than five days (Article 48, SML). The suspension of transactions, the reasons for suspension and the issuer's response are immediately relayed to the market and the SVS.

<sup>34</sup> An amendment to the Securities Law is being prepared whereby directors will be barred from trading in their company's shares during a 20-day period around shareholders meetings.

### Section III: Role of Stakeholders in Corporate Governance

**Principle IIIA:** The corporate governance framework should recognize the rights of stakeholders as established by law and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises. The corporate governance framework should assure that the rights of stakeholders that are protected by law are respected.

*Assessment: Largely observed*

*Description of practice:* Employees, the environment and consumers are protected by the Constitution and several laws. Employee rights are set forth in the Labor Code and enforced by the Labor Inspection, which represents worker interests in Labor Courts.<sup>35</sup> The environment is protected by law and a series of norms established by the regulator CONAMA,<sup>36</sup> modeled on the U.S. system. The Environmental Law mandates the preparation of a report on environmental impact, approved by CONAMA before implementation of any major business project. Other norms regulate pollution and trigger restrictions on corporate activity. Customers are protected from corporate abuse by the Consumer Protection Service and the Anti-Monopoly Commission.

Although the legal framework protecting stakeholders is fairly well developed, Chilean corporations still too often relate to their stakeholders in a confrontational manner, perpetrating the idea that entrepreneurs and stakeholders are rent-seeking rivals. Anecdotal evidence indicates that this approach often leads to corporate short sightedness, which may jeopardize important opportunities for future economic development in Chile.

*Policy recommendations:* Organize a seminar on Corporate Social Responsibility to disseminate best practice and lessons learned. As this assessment did not review creditor rights, a Creditor Rights ROSC to assess creditor rights and the insolvency framework in detail is recommended.

**Principle IIIB:** Where stakeholder interests are protected by law, stakeholders should have the opportunity to obtain effective redress for violation of their rights.

*Assessment: Partially observed*

*Description of practice:* Employees, consumers and any person or organization whose rights have been violated can seek redress through the courts. However, going to court in Chile may result in a long, cumbersome and uncertain process. In addition, employees may seek redress through the Labor Inspection, and consumers through the Consumer Protection Service. CONAMA acts as a regulator and supervisory institution for violation to the Environmental Law.

**Principle IIIC:** The corporate governance framework should permit performance-enhancement mechanisms for stakeholder participation.

*Assessment: Largely observed*

*Description of practice:* Current labor legislation requires corporations to compensate workers with a ‘gratification’ that, similar to the statutory dividend requirement, should be 30 percent of after-tax earnings distributed in proportion to wages. There is a proviso that individual gratifications are capped at four times the monthly minimum salary. In practice, the bonus component of the wage bill seldom adds up to 30 percent of net earnings.

<sup>35</sup> Workers rights include protection against unfair dismissal, an adequate working environment, and, during collective bargaining, the right to information about the financial health of the company.

<sup>36</sup> *Comisión Nacional del Medio Ambiente*, or National Commission on the Environment.

The CL has allowed companies to repurchase their own shares since 2001.<sup>37</sup> This provision introduced the possibility of stock option packages, which the CL also addresses.<sup>38</sup> However, stock options seem limited at this time. By the end of 2001, a survey of over 300 large Chilean firms showed that managers' variable income represented about 20 percent of annual wages.<sup>39</sup>

*Policy recommendations:* Stock options are meant to align manager and shareholder interests and enhance company performance. Chilean corporations, and ultimately their shareholders, might benefit by wider use of such schemes. However, policymakers should pay careful attention to the international debate on the use/abuse of stock options and their accounting treatment. Ultimately, the CL may need to be amended to reflect international consensus on the issue. In addition, adequate corporate governance procedures within firms, such as the establishment of compensation committees, are essential to oversee the allocation process.

**Principle III D:** Where stakeholders participate in the corporate governance process, they should have access to relevant information.

*Assessment: Observed*

*Description of practice:* Disclosure requirements imposed on issuers at the time of the initial public offer and on a continuous basis are comprehensive and are made available to investors and stakeholders by SVS in electronic and printed form. During collective bargaining, workers may receive additional information about company financial statements and restructuring plans.

#### Section IV: Disclosure and Transparency

**Principle IVA:** The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and the governance of the company. Disclosure should include, but not be limited to, material information on: (1) The financial and operating results of the company. (2) Company objectives. (3) Major share ownership and voting rights. (4) Members of the board and key executives, and their remuneration. (5) Material foreseeable risk factors. (6) Material issues regarding employees and other stakeholders. (7) Governance structures and policies.

*Assessment: Partially observed*

*Description of practice:* CL requires public companies to prepare annual financial statements with a balance sheet, income and cash flow statements, and directors' and auditors' reports. Summary financial statements are published in the press. The company must break down board member compensation, including travel, representation and other expenses, but no information is provided on board member and key executive identity and qualifications.<sup>40</sup> SVS also requires listed firms to publish quarterly financial statements in a format known as "FECU." Companies must inform SVS and the Stock Exchange of material information. Unless considered strategic, this information is made public by SVS. Directors must disclose their purchase and sale of company securities and any related party transactions. Corporations must periodically reveal the identities of their 12 major shareholders (although such disclosure seldom discloses the ultimate owners) and send the Securities Registrar a list of all shareholders. Issuers must disclose voting rights and other privileges of all share classes in the annual and interim financial statements. The onus is on issuers to disclose shareholder agreements between their members. Companies are not

<sup>37</sup> Subject to shareholder approval, firms can buy back up to ten percent of their shares if the purchase is for employees only. A firm may also buy back up to five percent of its shares and hold them for 24 months; after that it must either cancel or sell them.

<sup>38</sup> According to Article 27 (a-d) of the CL, shareholders must approve the strike price, which must be determined by taking into account the book value per share and the market value.

<sup>39</sup> Fernando Lefort, "Compensación a Ejecutivos en Chile," MV-AMROP, 2002.

<sup>40</sup> However, this information is available on the SVS website.

required to disclose information regarding other important matters, such as changes in equity, company objectives, material foreseeable risk factors, internal control, material issues regarding stakeholders and governance structures and policies.

*Policy recommendations:* Comprehensive disclosure of changes in equity, material foreseeable risk factors, material issues regarding stakeholders and governance structures and policies should be part of the disclosure requirements of issuers. A Management Discussion and Analysis should also be mandatory. SVS should establish a zero-tolerance policy toward late filings.

**Principle IVB:** Information should be prepared, audited, and disclosed in accordance with high quality standards of accounting, financial and non-financial disclosure, and audit.

*Assessment: Partially observed*

*Description of practice:* Listed companies prepare financial statements according to Chilean GAAP, which differs somewhat from IAS.<sup>41</sup> In particular, disclosure standards for related party transactions do not fully comply with IAS 24. The definition of a related party does not include the idea of controlling groups; this is expected to be rectified in 2003. Financial statements must be audited by an accredited independent auditor.<sup>42</sup> The auditing profession is regulated by Accounting Professional Board norms and SVS rules. Chilean audit standards do not fully comply with International Standards on Auditing (ISA). An external auditor is proposed by the *comité ejecutivo* and nominated by shareholders at the AGM.<sup>43</sup> S/he must certify the financial statements and report findings at the AGM. Eighty percent of listed company audits are performed by a “Big Four” firm. Most large companies also have internal auditors, who report to the CEO and *comité ejecutivo*. There are no specific financial qualification requirements for membership in the *comité ejecutivo*.

*Policy recommendations:* Conduct an Auditing and Accounting ROSC. Develop a road map for IAS adoption by listed firms and ISA by auditors. Prepare guidelines for the *comité ejecutivo*.

**Principle IVC:** An annual audit should be conducted by an independent auditor in order to provide an external and objective assurance on the way in which financial statements have been prepared and presented.

*Assessment: Partially observed*

*Description of practice:* External auditors must be independent from audited firms. Independence is defined in the Code of Ethics and Auditing Standards of the voluntary Association of Auditors. The CL stipulates that auditors may not directly or indirectly own over three percent of the audited firm’s equity and that revenues from one client cannot exceed 15 percent of total revenue. The law notes no restrictions on consulting, but SVS requires issuers to separately disclose audit and consulting fees. Auditors are liable for any damage their reports, opinions and omissions cause shareholders. They must report to the board and SVS if they discover directors or managers conducting illegal activities, fraud or insider abuse. SVS is the main supervisory body overseeing compliance with proper auditing processes. As of December 2002, SVS’s audit

<sup>41</sup> An attempt to reconcile Chilean GAAP with IAS took place in 1985, but as of December 2002, the former was not materially in conformity with the latter. If Chilean GAAP does not address a specific matter, issuers must follow IAS.

<sup>42</sup> SVS has a list of authorized auditors for listed companies. Eligibility to the list requires a degree in accounting and a minimum of three to five years of professional experience.

<sup>43</sup> This (only) applies to large firms (market capitalization over USD 37 million.)

department had a staff of 40. Fierce competition among the large auditing firms appears to have decreased audit quality and depth. Most audit firms are insured against lawsuits.<sup>44</sup>

*Policy recommendations:* In light of recent international corporate scandals, consideration should be given to barring auditors from performing specific consulting tasks. SVS should improve its supervisory capacity regarding the auditing process. The Accounting and Auditing ROSC should address the system of auditor practice review, including quality assurance arrangements.

**Principle IVD:** Channels for disseminating information should provide for fair, timely, and cost-effective access to relevant information by users.

*Assessment: Largely observed*

*Description of practice:* Financial statements and audit reports are public. They must be mailed prior to the AGM to large shareholders and shareholders that request them, and submitted to SVS, which posts them online. Summaries are published in the press within ten to 20 days before the AGM.<sup>45</sup> In addition, listed companies must disclose quarterly interim results. Material information must be disclosed to the market as soon as it is known.

*Policy recommendation:* To ensure that investors can access complete information from multiple sources, SVS could require the posting of annual and interim results on issuers' websites. SVS must ensure that material information is disclosed to the market immediately, in order to minimize the danger of insider trading and self dealing.

## Section V: The Responsibility of the Board

**Principle VA:** The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders. Board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the company and the shareholders.

*Assessment: Partially observed*

*Description of practice:* CL establishes the board as the company's governing body. Company statutes specify the number of board seats.<sup>46</sup> Directors may serve for a maximum of three years and are accountable and liable to shareholders. The board must sign the audited financial statements and report to shareholders on the firm's condition. Directors must act on a fully informed basis, with due diligence, in the firm's and all shareholders' best interests. There is market concern that directors in small to mid-sized firms do not always fully grasp their duties and obligations. A survey of listed firm directors found that 12 percent have no college degree.<sup>47</sup>

*Policy recommendations:* Create an Institute of Directors (IOD) to educate and guide inexperienced directors, disseminate best practice, and advise on a range of issues such as director independence and committee structures, in particular audit, risk management, and management nomination and compensation committees.

**Principle VB:** Where board decisions may affect different shareholder groups differently, the board should treat all shareholders fairly.

<sup>44</sup> These policies are general instead of specific to a particular auditing job or to a particular audited company. Anecdotal evidence suggests that most corporations do not know that the auditors are taking such insurance policies.

<sup>45</sup> Article 76, Corporation Law.

<sup>46</sup> Usually between seven and 11.

<sup>47</sup> Spencer Stuart and Business School, Pontificia Universidad Católica de Chile, "Chile 2000: Indice de Directorios," 2000.

***Assessment: Partially observed***

***Description of practice:*** Board members have a fiduciary duty to the firm and all shareholders. Decisions affecting shareholders differently must be disclosed to SVS. Related party transactions must be disclosed to shareholders and performed at market prices. As directors often represent the interests of those electing them, however, they do not always represent shareholders equally.

***Policy recommendations:*** Define more precisely the concept of independent board member. Modify the CL to impose penalties of varying severities for breaches of duties of care and loyalty (with greater severity for breaches of the duty of loyalty).

**Principle VC:** The board should ensure compliance with applicable law and take into account the interests of stakeholders.

***Assessment: Largely observed***

***Description of practice:*** Boards generally comply with applicable laws and uphold stakeholder rights in corporate decisions. Compliance with this Principle applies across the corporate sector, because the legal framework makes board members liable individually and collectively for their decisions, and because stakeholders have access to more effective judiciary channels to seek redress than the ordinary civil courts.<sup>48</sup> However, as noted above, improvement in civil court efficiency is needed. Where a court system does not function well, the legal framework's deterrence is limited. At the very least, directors have an incentive to avoid full compliance with the letter of the law, and stakeholders are deterred from seeking redress through the courts.

**Principle VD:** The board should fulfill certain key functions, including (1) Reviewing and guiding corporate strategy, major plans of action, risk policy, annual budgets and business plans; setting performance objectives; monitoring implementation and corporate performance and overseeing major capital expenditures, acquisitions and divestitures. (2) Selecting, compensating, monitoring and, when necessary, replacing key executives and overseeing succession planning. (3) Reviewing key executive and board remunerations, and ensuring a formal and transparent board nomination process. (4) Monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions. (5) Ensuring the integrity of the corporation's accounting and financial reporting systems, including the independent audit, and that appropriate systems of control are in place, in particular, systems for monitoring risk, financial control, and compliance with the law. (6) Monitoring the effectiveness of the governance practices under which it operates and making changes as needed. (7) Overseeing the process of disclosure and communications.

***Assessment: Partially observed***

***Description of practice:*** CL specifies that board duties include the selection, compensation and oversight of management and executives, but other specific administrative functions are not listed. However, in practice, boards of large listed companies tend to perform the key functions set out in this Principle. The *comité ejecutivo* has at least three members. The committee (i) reviews the financial statements; (ii) proposes external auditors and risk rating agencies; (iii) examines related party transactions; (iv) reviews board member and senior management remuneration;<sup>49</sup> and (v) performs other functions mandated by bylaws, the board or the AGM.

***Policy recommendations:*** Define precisely the board's key functions; create an IOD to educate and guide directors, and disseminate best practice and lessons learned, as discussed in VA.

**Principle VE:** The board should be able to exercise objective judgment on corporate affairs independent, in particular, from management: (1) boards should consider assigning a sufficient number of non-executive board members capable of exercising independent judgment to tasks where there is a potential for conflict of interest. Examples of such key responsibilities are financial reporting, nomination, and executive and board remuneration. (2) board members should devote sufficient time to their responsibilities.

<sup>48</sup> Specific labor courts, for example, have the reputation of being tougher than ordinary civil courts.

<sup>49</sup> Board compensation is usually not significant in Chile except in the largest companies, but being a director is prestigious.

***Assessment: Partially observed***

***Description of practice:*** The CEO seldom chairs the board, nor is he related to the controlling family. Managers and executives are usually professionals, with no family ties to the majority shareholders. Shareholders elect directors, renewing the board in totality, at the AGM. Board members need not own shares. The introduction of the *comité ejecutivo* is a significant step toward the assignment of independent directors to tasks of potential conflict of interest. The majority of its members must be “independent,” i.e. elected without the votes of the controller. However, if there are an insufficient number of independent members on the board, a majority of the *comité* may be related to the controller.

A special provision in the pension fund legislation allows pension funds to act in concert and elect one director through cumulative voting. This member cannot be related to the controlling shareholder. Once elected, this appointee cannot have any relationship with the pension fund that differs from its relationship with other shareholders; s/he, therefore, tends to act independently.

A recent survey of board practices in large listed Chilean companies found that 55 percent of board members are not directly related by family to the controllers, or are not executives of the firm or of another firm owned by the same controller.<sup>50</sup> Only 24 percent have executive directors; when they do, they have two to three. Overall, executive directors accounted for nine percent of board seats. Another study of board composition at listed firms in conglomerates found that directors sat on an average of two boards, with one percent sitting on two or more boards of firms controlled by different groups. This suggests that even those who might be considered “independent directors” are often the controller’s employees or otherwise connected.

***Policy recommendations:*** A more precise definition of independence is needed in Chile. Best practice on the use of nomination and compensation committees should be disseminated. Publication of board attendance could be considered.

<b>Principle VF:</b> In order to fulfill their responsibilities, board members should have access to accurate, relevant and timely information.
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***Assessment: Largely observed***

***Description of practice:*** Boards have proper and timely access to relevant information. They may delegate actions to executives. CL permits directors to hire expert advisors at company cost, although this is rare. Anecdotal evidence suggests that board members do not exercise their rights fully, especially in small to mid-size companies.

***Policy recommendation:*** See VD above.

#### **IV. SUMMARY OF POLICY RECOMMENDATIONS**

This section summarizes, expands and prioritizes the above recommendations to improve Chile’s compliance with the OECD Principles. The next step should be to develop a detailed action plan, prepared in cooperation with Chilean authorities and in consultation with the private sector and other stakeholders. In addition to the recommendations below, an Auditing and Accounting

<sup>50</sup> Spencer Stuart and Business School, Pontificia Universidad Católica de Chile, “Chile 2000: Indice de Directorios,” 2000.

ROSC and an Insolvency and Creditor Rights ROSC are advised. The former would aid in the development of a road map for IAS adoption by all listed firms and ISA by auditors.

Legislative reform: Amendments to the CL and/or the SML are needed to (i) extend the notice period for convening an AGM to 30 days to allow foreign investors time to vote; (ii) require disclosure by issuers of changes in equity, material foreseeable risks, material issues regarding stakeholders and governance structures and policies, and management discussion and analysis; (iii) impose penalties of varying severities for breaches of the duties of care and loyalty (with greater severity for breaches of the duty of loyalty); and (iv) allow issuers to disseminate information via the Internet and e-mail. The definition of related party transactions could be fine-tuned by complying fully with IAS 24. *Priority: medium*

Institutional strengthening: Clearance and settlement procedures should be reviewed to eliminate principal risk in all share transactions. A time frame for full compliance with G30 recommendations should be set. The Central Bank should expedite initiation of electronic payment.

SVS must become more transparent and more accountable to the body politic. At the same time, reforms are needed to strengthen SVS's enforcement powers. Measures to improve SVS's transparency and accountability would increase the perception of fairness by market participants; this would, in turn, improve SVS's ability to fulfill its mission. To improve transparency and accountability, SVS could be required to prepare and submit to Parliament an annual report; internal procedures/responsibilities to avoid conflicts of interests in SVS investigations and sanctions could be clarified; and the process of consultation through SVS's website before issuing new regulations could be set by law. Regarding enforcement, SVS needs an electronic system to fulfill its surveillance mission. In addition, one major exogenous obstacle SVS faces in fulfilling its mission is the inefficiency of the civil and criminal courts and the lack of magistrate expertise on securities issues. As in most jurisdictions, SVS's sanctions are almost systematically appealed through the courts. Since procedures are lengthy and magistrates unfamiliar with securities markets, rulings are either unreasonably delayed or sanctions overturned. Two steps are recommended to address this. First, a seminar should be organized on international best practice and lessons learned regarding the enforcement of investor property rights. Second, the seminar's contributions should serve as the basis for a roadmap for enhancing property rights enforcement in Chile and the entire Latin American and Caribbean region.

In addition, SVS should establish a zero-tolerance policy toward late filings. To secure the recruitment and retention of talented professionals inside SVS, consideration should be given to aligning SVS's salaries with those of the Central Bank. *Priority: high*

Voluntary/private initiatives: An IOD should be set up to educate and guide directors, disseminate best practice and lessons learned, and advise on issues such as the key functions of the board, risk management, and committee structures and procedures, in particular with regards to audit, nomination and compensation committees. The IOD should issue guidelines regarding director independence. Issuers should consider creating investor relations websites. *Priority: high*

## Annex A: Summary of Observance of OECD Principles of Corporate Governance

PRINCIPLE		O	LO	PO	MO	NO	Comment
<b>I. THE RIGHTS OF SHAREHOLDERS</b>							
IA	Basic shareholder rights		X				<ul style="list-style-type: none"> <li>Central Bank project to introduce electronic payment using RTGS expected to begin in 2003.</li> <li>Along with bank risk, principal risk exists in some transactions.</li> <li>Material information disclosed to SVS as soon as it is known and published on SVS website and in press; issuers need not mail financials to shareholders.</li> </ul>
IB	Rights to participate in fundamental decisions.	X					<ul style="list-style-type: none"> <li>Major issues discussed at an Extraordinary General meeting (EGM) and require presence of 2/3 of voting shares.</li> <li>In practice, many controllers maintain control at 67%.</li> </ul>
IC	Shareholders AGM rights		X				<ul style="list-style-type: none"> <li>Agendas often insufficiently detailed.</li> <li>SVS, board, and shhs controlling 10% of voting shares may call EGM. If board fails to convene in 30 days, shareholders may petition courts.</li> <li>Meetings/agendas must be appear in press thrice in 20 days before meeting; invitations/agendas must be mailed to shareholders.</li> <li>First AGM requires 50% quorum; no quorum for second notice.</li> </ul>
ID	Disproportionate control disclosure			X			<ul style="list-style-type: none"> <li>Cross-holdings prohibited; dual class shares with restrictive/preferential rights to appoint directors allowed.</li> <li>Difficult to ascertain firms' controllers.</li> </ul>
IE	Control arrangements should be allowed to function.		X				<ul style="list-style-type: none"> <li><i>Ley de OPA</i> establishes that share transactions resulting in company control must be made through tender offer. Anyone acquiring 2/3 of firm must tender for all outstanding shares.</li> </ul>
IF	Cost/benefit to voting		X				<ul style="list-style-type: none"> <li>Pension funds may not invest in non- voting stock.</li> <li>Pension fund with &gt;1% of firm's equity must attend AGM/vote.</li> <li>Pension fund must inform SAFP how it voted, but voting policy is not disclosed to fund members. However, funds must cast votes orally, giving press chance to report.</li> </ul>
<b>II. EQUITABLE TREATMENT OF SHAREHOLDERS</b>							
IIA	All shareholders should be treated equally		X				<ul style="list-style-type: none"> <li>Law permits shares with limited or no voting rights.</li> <li>Shareholders with 5% of capital can sue on firm's behalf.</li> <li>Classes of shares with restricted voting rights must get some type of preference. Restriction must be of limited duration.</li> <li>Issue and alterations of voting rights/other privileges must be approved by 2/3 voting shares, disclosed in company statutes.</li> <li>Dual class shares uncommon.</li> <li>Few listed firms have preferred shares.</li> <li>Shareholders (same class) must be treated equally in control changes.</li> </ul>
IIB	Prohibit insider trading			X			<ul style="list-style-type: none"> <li>Insider trading is a criminal offense.</li> <li>SVS monitors compliance and may impose sanctions</li> <li>SVS lacks enough tools to detect insider dealings (e.g. lacks electronic surveillance system). Insider trading purportedly widespread; difficult to relate trading to specific information.</li> </ul>
IIC	Board/Mgrs. disclose interests		X				<ul style="list-style-type: none"> <li>Definition of related party transaction does not include leases.</li> <li>Misuse of corporate assets and abuse in connected party transactions remain a problem. Difficult to identify "related parties" given conglomerate ownership and control structures, nor to assess fairness of transfer pricing.</li> </ul>
<b>III. ROLE OF STAKEHOLDERS IN CORPORATE GOVERNANCE</b>							
IIIA	Stakeholder rights respected		X				<ul style="list-style-type: none"> <li>Legal framework protecting stakeholders is well developed, but firms often confrontational with stakeholders.</li> </ul>
IIIB	Redress for violation of rights			X			<ul style="list-style-type: none"> <li>Employees, consumers and others can seek redress through courts and other relevant protection agencies, but court process may be long, cumbersome and uncertain.</li> </ul>
IIIC	Performance enhancement		X				<ul style="list-style-type: none"> <li>CL allows companies to repurchase own shares.</li> <li>CL allows stock option packages.</li> </ul>

IIID	Access to information	X				<ul style="list-style-type: none"> <li>• Disclosure requirements for issuers at IPO and on a continuous basis comprehensive; available from SVS.</li> <li>• During collective bargaining, workers may receive additional information about financial statements and restructuring plans.</li> </ul>
<b>IV. DISCLOSURE AND TRANSPARENCY</b>						
IVA	Disclosure standards		X			<ul style="list-style-type: none"> <li>• Onus on issuers to disclose shareholder agreements.</li> <li>• Companies not required to disclose information on changes in equity, company objectives, risk factors, internal control, material issues and governance structures and policies.</li> </ul>
IVB	Standards of accounting & audit		X			<ul style="list-style-type: none"> <li>• Chilean GAAP disclosure standards for related party transactions do not fully comply with IAS 24.</li> <li>• Current related party definition does not cover controlling groups.</li> <li>• Chilean audit standards do not fully comply with ISA.</li> <li>• No financial qualifications for membership of <i>comité ejecutivo</i>.</li> </ul>
IVC	Independent audit annually		X			<ul style="list-style-type: none"> <li>• External auditors must be independent.</li> <li>• SVS requires separate disclosure of audit/consulting fees.</li> <li>• Auditors liable for damage they cause shareholders.</li> <li>• Audit quality/depth have sunk amid large audit firm competition.</li> <li>• Large companies must form <i>comité ejecutivo</i> with majority of directors being independent of the controller.</li> </ul>
IVD	Fair & timely dissemination		X			<ul style="list-style-type: none"> <li>• Financial statements and audit reports must be mailed to large and requesting shareholders; SVS posts online.</li> <li>• Material information disclosed on SVS site as soon as it is known</li> </ul>
<b>V. RESPONSIBILITIES OF THE BOARD</b>						
VA	Acts with due diligence, care		X			<ul style="list-style-type: none"> <li>• Small/mid-size firm directors do not grasp duties/ obligations.</li> </ul>
VB	Treat all shareholders fairly		X			<ul style="list-style-type: none"> <li>• Directors have fiduciary duty to the firm and all shareholders.</li> <li>• Decisions affecting shareholders differently disclosed to SVS.</li> <li>• Related party transactions must be disclosed to shareholders and performed at market prices.</li> <li>• Board members often represent interests of those who elected them and do not always represent shareholders equally.</li> </ul>
VC	Ensure compliance w/ law		X			<ul style="list-style-type: none"> <li>• Board members legally liable individually and collectively.</li> <li>• Stakeholders have access to more effective judiciary channels to seek redress than ordinary civil courts.</li> </ul>
VD	The board should fulfill certain key functions		X			<ul style="list-style-type: none"> <li>• CL does not specify board functions other than selection, compensation and oversight of management</li> <li>• <i>Ley de OPA</i> mandates large firms to convene a <i>comité ejecutivo</i> to fulfill certain key functions.</li> </ul>
VE	The board should be able to exercise objective judgment		X			<ul style="list-style-type: none"> <li>• CEO seldom chairs board; generally unrelated to controller.</li> <li>• In small to mid-size firms, CEO often selects directors, giving him disproportionate influence at board meetings.</li> <li>• Even those who might be considered “independent directors” are often the controller’s employees or otherwise connected.</li> <li>• Boards generally lack committees, except the <i>comité ejecutivo</i>.</li> </ul>
VF	Access to information		X			<ul style="list-style-type: none"> <li>• Boards may delegate some actions to executives. Some members in small/mid-size firms do not exercise rights fully.</li> </ul>

## Annex B: Summary of Policy Recommendations

<b>I. THE RIGHTS OF SHAREHOLDERS</b>		
IA	Basic shareholder rights	Set a time frame for full compliance with G30 recommendations. Complete the Central Bank's electronic payment project on time. Remove principal risk in all share transactions. Change the Securities Market Law and the Corporation Law to allow issuers to disseminate their information by Internet and e-mail. Issuers should consider creating investor relations websites.
IB	Rights to participate in fundamental decisions.	None.
IC	Shareholders AGM rights	Consideration should be given to extending the 20 day notice for convening a general shareholders meeting (AGM) to 30 days, in order to allow international investors sufficient time.
ID	Disproportionate control disclosure	Superintendence of Securities and Insurance (SVS) should continue to work on disclosure forms to help investors identify beneficial owners.
IE	Control arrangements should be allowed to function.	None.
IF	Cost/benefit to voting	None.
<b>II. EQUITABLE TREATMENT OF SHAREHOLDERS</b>		
IIA	All shareholders should be treated equally	At SVS request, organize a seminar to discuss international best practice and lessons learned about the enforcement and redress of property rights of securities investors. The seminar's outcome should provide input to the construction of a roadmap for enhancing the enforcement of property rights in Chile and the entire Latin American region.
IIB	Prohibit insider trading	The SVS lacks an electronic surveillance system to effectively monitor and enforce insider trading laws. The seminar proposed under IIA should raise awareness among judges.
IIC	Board/Mgrs. disclose interests	While provisions help avoid expropriation of minority shareholder rights, the definition of related party transactions could be fine tuned to comply fully with IAS 24.
<b>III. ROLE OF STAKEHOLDERS IN CORPORATE GOVERNANCE</b>		
IIIA	Stakeholder rights respected	Organize a seminar on Corporate Social Responsibility to disseminate best practice and lessons learned. As this assessment did not review creditor rights, a Creditor Rights & Insolvency ROSC to assess creditor rights and the insolvency framework in detail is recommended.
IIIB	Redress for violation of rights	None.
IIIC	Performance enhancement	Chilean companies and their shareholders might benefit if stock options were more widely used, thereby aligning management and shareholder interests. Policymakers should pay close attention to the international debate on the use/abuse of stock options and their accounting treatment. Ultimately, the Corporation Law may need to be amended to reflect international consensus on the issue. Adequate corporate governance procedures within firms, like a compensation committee, are essential to oversee the allocation process.
IIID	Access to information	None.
<b>IV. DISCLOSURE AND TRANSPARENCY</b>		
IVA	Disclosure standards	Comprehensive disclosure of changes in equity, material foreseeable risk factors, material issues regarding stakeholders and governance structures and policies should be part of issuer disclosure requirements. Management Discussion & Analysis should be mandatory. SVS should set zero-tolerance policy on late filings.
IVB	Standards of accounting & audit	Conduct an Auditing and Accounting ROSC. Develop a road map for IAS adoption by all listed companies and ISA by auditors. Prepare guidelines for <i>comité ejecutivo</i> .
IVC	Independent audit annually	In light of recent international corporate scandals, consideration should be given to barring auditors from performing specific consulting tasks. SVS should improve its supervisory capacity regarding the auditing process. The Accounting and Auditing ROSC should address the system of auditor practice review, including quality assurance arrangements.
IVD	Fair & timely dissemination	To ensure that investors can access complete information from multiple sources, SVS could require the posting of annual and interim results on issuers' websites. Material information should be disclosed to the market immediately to minimize chance of insider trading and self-dealing.
<b>V. RESPONSIBILITIES OF THE BOARD</b>		
VA	Acts with due diligence, care	Create an Institute of Directors (IOD) to educate and guide inexperienced directors, disseminate best practice, and advise on a range of issues such as director independence, committee structures, in particular audit, risk management, and nomination and compensation committees.
VB	Treat all shareholders fairly	Define more precisely the concept of independent board member. Modify the Corporation Law to impose penalties of varying severities for breaches of duties of care and loyalty (with greater severity for breaches of the duty of loyalty).
VC	Ensure compliance w/ law	None.
VD	The board should fulfill certain key functions	Define precisely the board's key functions. Create an IOD to educate and guide directors, and disseminate best practice and lessons learned, as discussed in VA.
VE	The board should be able to exercise objective judgment	A more precise definition of independence is needed. Best practice on the use of nomination and compensation committees should be disseminated. Publication of board attendance could be considered.
VF	Access to information	See VD.

## Annex C: Markets and Market Participants

Chile's capital markets are relatively large and successful. Although dwarfed by Argentina's, Brazil's and Mexico's in terms of total market capitalization, Chile's market capitalization as a percent of GDP is the highest in the region, suggesting its capital markets are a significant engine of growth for the economy. Value traded, and turnover relative to market capitalization are generally equal to or higher than those of comparison countries, based on standard market indicators.

### Chile and Selected Latin American Countries: 2001 Equity Market Statistics

	Market Capitalization		Value	Turnover	# of Listed Companies	S&P/IFC
	USD	% of GDP	Traded % of GDP			Ratio
<b>Chile</b>	<b>56,310</b>	<b>88.6</b>	<b>9.5</b>	<b>0.5</b>	<b>249</b>	<b>-8.3</b>
Argentina	192,499	71.7	2.2	0.2	111	-31.7
Brazil	186,238	37.1	20.1	3.1	428	-22.5
Mexico	121,403	19.7	7.3	1.7	168	12.8
Colombia	13,217	15.9	0.5	0.3	123	25.2
Peru	11,134	20.6	2.8	0.5	207	14.2
Venezuela	6,216	5.0	0.6	0.5	63	-20.1
Bolivia	116	1.5	0	1.0	18	..

*Source: World Bank World Development Indicators. All figures for year-end 2001. Value traded and turnover are for calendar year 2001. S&P/IFC Investable Index price change is the USD price change in the stock markets covered by the S&P/IFCI country index, supplemented by the S&P/IFCG country index.*

## Annex D: Case Study of Corporate Governance Abuse in Chile

### Abuse in the Market for Corporate Control: The Enersis -“Chispas” Case

In 1997, Endesa España, an electric generation and distribution company and Spain’s largest utility, saw an opportunity for expansion in Latin America through the takeover of what today is Chile’s largest private energy sector holding company, Enersis S.A. The deal became a landmark case in minority shareholder rights and equitable treatment and has influenced Chilean corporate governance reform.

Enersis, formerly the public utility Chilectra Metropolitana, was privatized in the late 1980s. Following privatization, the company was restructured as Enersis, a holding company for numerous subsidiaries and investments. It gained control of Chile’s largest electric utility, Endesa Chile, and soon became one of Latin America’s most significant conglomerates with business interests throughout the region. Enersis was itself controlled by a group of five investment companies, known as the Chispas, which collectively controlled a 32 percent stake in Enersis, the majority of whose owners were Chilectra Metropolitana’s former employees, who had acquired stock through the privatization. Several “Pension Fund Administration” companies (AFPs) also owned interests in one of the Chispas (“Sociedad de Inversión Luz”). The Chispas stock had been issued as dual class A and B shares, but only B shares had voting rights. B class shareholders owned 0.06 percent of Enersis through the Chispas – the former manager of the Chilectra Metropolitana public utility held one of the largest blocks of B shares – but their voting rights gave them significant control. Conversely, the AFPs held only A shares, which yielded higher dividends than the B shares but did not allow the AFPs to exert control that was proportional to their substantial investment.

Endesa España created a strategic alliance with Enersis’ management and made a tender offer for A and B shares. However, it offered USD 253.34 for the B shares and only USD 0.30 for the A shares.<sup>1</sup> The Spanish company also offered Class B shareholders the option of purchasing up to five per cent of its own shares at discounted prices, and guaranteed the Enersis managers among them their positions for at least five years. Enersis executives applied pressure and influence to encourage employees to sell their shares. This led to cries of corruption by some observers, who cited the fact that some Enersis executives were former Pinochet government officials and were now in a position to reap large benefits at the expense of institutional and individual investors. Most small investors had no real objection to the deal, given that their initial investment had appreciated a great deal due to Enersis’ growth and expansion over the years. The AFPs argued that the benefits of the tender were too unevenly distributed and that pressure was being placed on those who chose not to accept the tender for A shares. The AFPs eventually succeeded in having the tender voided.

However, despite unfavorable publicity about the case, in 1999, Endesa Espana succeeded in buying a controlling share of Enersis (26.2 percent), although by that time, Enersis’ former controllers had been legally ejected. The deal also allowed Endesa España to gain control of a very attractive Enersis energy generating subsidiary, Endesa Chile (25.3 percent). (At that time, both Enersis and Endesa Chile had restrictions in place that limited the ownership of an individual or group to 26 percent.). Today, Endesa España controls over 60 percent of Enersis.

<sup>1</sup>Currency rate 1 CLP = USD 0.00136939, as of January 22, 2003.

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