

Chapter 4

Additional steps: strengthening market forces

Chapter 4 sets out policy and good practice recommendations and annotations for policy-makers and regulators (**in bold**) and for the private sector (*in italics*) on steps to strengthen market forces that would encourage or enable an effective institutional investor role in corporate governance. Recommendations address the role of direct regulation versus self-regulation, the media, credit rating agencies, corporate governance and proxy advisory services, the benefits of establishing II associations, and of supporting effective dispute resolution mechanisms.

A note on the recommendations in Chapters 3 and 4:

The recommendations below distinguish between policy measures as the **text in bold** indicates, and practical recommendations of what IIs (or companies, when relevant) should/could do, indicated *in italics*.

4.1. Supporting better market conditions for an effective institutional investor role

In addition to steps described in chapter 3 above taken by policy-makers and institutional investors to promote better governance in investee companies, the overall efficiency of and incentives provided by the market are critical to ensure value creation through good corporate governance. A range of actions should be pursued to create conditions under which the IIs' exercise of their shareholder rights is cost-efficient and valued both by the market and client companies.

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

4.2. The role of media, credit rating agencies, and advisory services

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

Institutional investors who do not have an internal capacity to evaluate governance behaviour of their existing and potential clients may resort to external advice as input towards their decisions. The

regulators in Latin America should ensure that appropriate mechanisms are in place to address potential conflicts of interest, while also ensuring that there are no impediments to the establishment and functioning of such advisory service-providers to support IIs in their governance-related decisions. Credit and corporate governance rating agencies, proxy voting firms and other service-providers are important and complementary to institutional investors' capacity to successfully promote good governance for the benefit of their clients and their own beneficiaries.

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

With an increasing number of credit rating agencies and corporate governance rating agencies and advisory services providers offering ratings and analysis, the regulators in Latin America should ensure that the operations of these institutions are properly overseen. Such regulatory oversight may be necessary to ensure that requirements are in place for them to report on ownership interests and how they deal with conflicts of interest.¹

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

Corporate governance analysis is also being carried out by some credit rating agencies in several countries around the world and in the region. While in a wider context, some rating agencies have developed corporate governance analytical criteria to be applied as a component of their credit analysis and rating, in most Latin American countries such rating agencies do not or have only just started to take into consideration corporate

governance issues in their analysis. *In Latin America, traditional rating agencies could play a stronger role by considering corporate governance issues in their ratings, especially in a region in which low liquidity and tight groups of control represent a higher financial risk for minority shareholders.*

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

4.3. Enhancing II effectiveness through associations

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

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

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

development of public policy and regulation on corporate governance and take the relevant steps in this direction.

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

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

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

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

4.4. Supporting effective conflict resolution

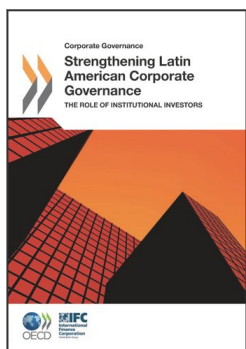
Regulators should encourage associations or other structures of organized representation of the IIs industry's interests to take steps to establish, maintain and encourage the use of effective conflict resolution

mechanisms. Together with the regulators, IIs should try to improve judicial and alternative dispute resolution mechanisms to enable fast and efficient resolution of any disputes.

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

Notes

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



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