

## Executive Summary

### **Active and informed ownership to support better corporate governance in Latin America**

*Strengthening Latin American Corporate Governance: the Role of Institutional Investors* reflects the priority of the Latin American Roundtable on Corporate Governance to encourage the emergence of active and informed owners as an important lever for influencing better governance in the region. It draws upon both internationally recognized policy guidelines and best practices, starting with the *OECD Principles of Corporate Governance*, and region and country-specific work, including the Roundtable's 2003 *White Paper on Corporate Governance in Latin America* and 2007 report, *Institutional Investors and Corporate Governance in Latin America: Challenges, Promising Practices and Recommendations*. It has been developed through a three-year process of Roundtable consultations and research in a range of Latin American countries, including Argentina, Brazil, Chile, Colombia, Mexico and Peru.

Different countries in Latin America have different market characteristics and legal frameworks, with some such as Chile and Peru featuring pension funds as the dominant institutional investors (IIs) investing in their local stock markets, whereas some others have a more mixed institutional investor environment. This publication thus notes differences in policies and practices among countries, and differentiates recommendations when appropriate to fit the country-specific context.

This publication is intended to serve as a reference for policy-makers, regulators, investors, companies and other market participants and stakeholders interested to support the increased involvement and responsibilities of IIs in promoting good corporate governance practices in Latin America. It identifies some of the measures that these stakeholders can take to support and enable such investors to further contribute to corporate governance improvements in the region. For these purposes, it is structured into four chapters: 1) the Importance of Institutional Investors in Promoting

Good Governance; 2) The Latin American Context: Market and Institutional Characteristics; 3) Recommendations to Strengthen Policy and Good Practices; and 4) Additional Steps: Strengthening Market Forces.

## **The importance of IIs in promoting good governance in the Latin American context**

Institutional investors (IIs) can play an important and influential role in improving corporate governance at policy and company levels, particularly within the type of concentrated ownership environment that is predominant in Latin America, because of the positive impact that governance improvements have in protecting minority shareholder interests and in contributing to better company performance and share value. IIs can provide an informed counterbalance to controlling shareholders to safeguard against the company's board and management working for interests other than those of the company and its shareholders as a whole. In Latin America, policy-makers and regulators have given particular priority to encouraging such behaviour by pension funds, because in many cases they manage compulsory savings, and therefore are seen to have a duty to serve the public interest and to exercise vigilance in protecting the future benefits of retirees. In addition, as they generally concentrate on domestic markets, these pension funds also tend to have relatively small portfolios of listed companies that may more easily lend themselves to more focused engagement. With low liquidity in most Latin American markets, pension funds have a long-term stake in the market, giving them a correspondingly stronger reason to consider corporate governance practices as a way to improve company value over the longer term, supporting longer-term strategies for their funds' growth.

IIs other than pension funds have also found benefits in integrating governance oversight and engagement into their investment strategies, but the policy and regulatory framework has tended to provide greater leeway to such funds to evaluate their own costs and benefits of adopting an active ownership strategy. However, the Roundtable has noted that actual practices have often fallen short of the potential for both pension funds and other IIs, with IIs too often taking a passive role and failing to exercise their ownership rights in an active and informed manner. Nevertheless, there are enough active ownership "success stories," not only in Latin America but globally, of IIs obtaining positive rewards by playing an active role, and facing negative consequences when they did not play such a role, to make a strong case for both policy-makers and the private sector to encourage the active engagement of investors in ensuring good governance practices.

## Recommendations to strengthen policy and good practices

Latin American countries have an extensive and widely varying set of laws, regulations, good practice recommendations and voluntary codes relevant to encouraging institutional investors to play an active and informed role in promoting good corporate governance. The Roundtable’s review of Latin American and OECD countries’ experience in this regard led to agreement on a number of recommendations set out in detail in Chapters 3 and 4, with recommendations for policy-makers and regulators as well as practical recommendations more directly aimed at institutional investors. These include recommendations on the following issues:

- **Finding the overall balance between legal requirements, self-regulation and voluntary practices.** Legal and regulatory action should not merely impose additional requirements on IIs to responsibly exercise their ownership rights, but also enable and incentivize the IIs to efficiently do so. In doing so, the regulators should weigh the costs and benefits involved in establishing higher standards, seek to minimize costs of implementation and ensure that the benefits to be achieved through adoption of such standards outweigh the costs. Calculations of the appropriate mix of legal versus voluntary requirements will vary by country depending on such factors as the effectiveness of the existing legal and institutional framework for enforcement of regulatory requirements, the maturity and depth of the capital market, and the number, size and relative importance of IIs in the market.
- **Distinguishing better-governed companies for investment purposes.** Legislators and regulators should enact measures that enable or encourage IIs to efficiently include governance analysis in their investment appraisal processes. For example, IIs subject to regulatory limitations may be encouraged to distinguish better-governed companies by restricting their investments in companies that don’t meet minimum standards of corporate governance, or by allowing proportionally greater investment in companies that meet certain higher corporate governance and disclosure requirements. However, regulators should also seek to eliminate unnecessary limits on investment choices or make them more flexible to allow IIs to reward better governed companies within the boundaries of prudential regulation for IIs.
- In countries where pension funds are relatively small, fragmented and occupy a small share of the market among other types of IIs, loosening of legal restrictions should be combined with measures to

strengthen the prudential regulation of investment choices and education to improve the pension funds' capacity to analyze governance risks and opportunities.

- **Formalizing and disclosing the policies of institutional investors related to corporate governance of investee companies.** IIs should clearly formulate their policies regarding corporate governance, including policies and procedures in place to take corporate governance into consideration in the companies in which they invest. Such policies and the IIs' compliance with them should be communicated to the market and potential clients, and may take the form of a corporate governance code or guidelines, including codes endorsed by a wider group of IIs. Such codes or guidelines should be monitored to ensure implementation, and updated and improved when appropriate.
- **Exercising ownership rights in portfolio companies.** The legal and regulatory framework should ensure that the effective exercise of ownership rights by IIs is facilitated. When investing with a long-term perspective, such ownership rights may be exercised at multiple levels – contributing to the improvement of the functioning of Boards of Directors, strengthening the accountability of senior management, promoting information disclosure and transparency, and encouraging the market in general to reward better-governed and sanction poorly-governed companies.
- **Voting at General Meetings of Shareholders.** The ability of IIs to attend the General Meetings of Shareholders (GMS) and to make informed votes depends on the legal framework providing the investors the necessary notice, agenda and other relevant information sufficiently in advance. Thus, unnecessary restrictions discouraging or preventing shareholders from voting should be eliminated, and rules should ensure that domestic and foreign shareholders are able to attend the GMS and vote through proxy or by means of electronic communications. In line with this trend, there is a growing expectation that IIs, who are often the most sophisticated and organized minority shareholders in companies, should lead by example and responsibly exercise their right for the benefit of all shareholders. IIs should also develop and publicly disclose their policy and procedures on the use of their voting rights, which may take the form of an annual summary of their voting records together with their full voting record in important cases, including votes cast for or against the recommendations of company

management. In cases where IIs have not voted or were unable to exercise their votes, they should disclose the reasons for that.

- **Encouraging communication between IIs and investee companies.** IIs should take steps to effectively engage with their investee companies on issues of concern to investors related to the company's corporate governance practices. At the same time, regulators should ensure that there are proper rules in place to safeguard the principles of equal access to information, to ensure that IIs with more active intervention are not receiving material, non-public information ahead of other shareholders.
- **Encouraging communication among various IIs.** The legal and regulatory framework should allow and even encourage communication among IIs investing in the same company seeking to collectively support corporate governance improvements in ways that ensure protection of all minority shareholder rights, subject to restrictions to ensure against market manipulation and collusion during changes in corporate control. Communication may cover such aspects as co-operation and co-ordination of actions when nominating and electing board members, proposing agenda items and holding discussions with the investee company to improve its corporate governance. Such co-operation may extend to encouraging good practices within the market more widely.
- **Improving the functioning of boards of directors.** The legal and regulatory framework should provide mechanisms to allow IIs to effectively influence the composition of boards of their investee companies. IIs may contribute to improving the functioning of boards of directors, including through identification of well-qualified candidates for the board, nomination and election of independent and non-executive directors, and through support for evaluation of the boards and directors' performance.
- **Strengthening the accountability of management.** IIs should seek to strengthen the accountability of senior management in their investee companies, for example, by persuading and equipping the Board to improve its management oversight, including by encouraging the Board to set performance indicators for management and to monitor progress towards these indicators.
- **Addressing IIs' own corporate governance.** The legal and regulatory framework should provide for advanced corporate governance standards for IIs, addressing at a minimum the accountability of fund managers to the beneficiaries of the II,

establishing proper oversight by the Board/Trustees over management, putting in place relevant mechanisms for dealing with conflicts of interest, aligning fee structures in favor of investment decisions based on their quality rather than distorting incentives in favor of high-quantity “churning” of investment portfolios, as well as other requirements or incentives that cause managers to act in ways that do not maximize returns for investors. The *OECD Guidelines for Pension Fund Governance* provide more detailed recommendations in this regard. For state-owned pension funds, the *OECD Guidelines on Corporate Governance of State-Owned Enterprises* also make relevant recommendations.

- **Exiting from the investment as a last resort.** While exiting from investing in companies is a fundamental right, IIs with active and long-term investment policies, motivated in part by the limited alternatives available in illiquid markets, may consider exiting from an investment only as a last resort. In situations where IIs’ efforts to encourage investee companies to address corporate governance concerns have not led to improvement, a decision to exit may be seen by the market as a signal that the investee company does not pay sufficient attention to protecting investor rights, which may send a wider signal reinforcing negative market reactions to companies that adopt poor corporate governance practices.

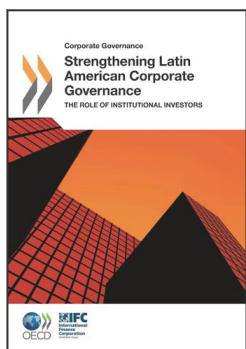
## Strengthening Market Forces

This report also identifies recommendations aimed at other market players and incentives within the market that may impact on the effectiveness of institutional investors in exercising their shareholder rights.

- **Ensuring the integrity of external advice.** IIs in the region sometimes lack sufficient capacity and expertise to effectively take into account corporate governance issues in their investment decisions and voting practices. International and local credit rating agencies, proxy voting and corporate governance advisory services can reinforce IIs’ capacity to put their investment and governance policies into practice. However, regulators 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 services providers to support IIs in their governance-related decisions. Regulatory oversight may be necessary to ensure that requirements are in place for such agencies and advisory service providers to report on their

ownership interests and how they deal with conflicts of interest, including steps to ensure separation of ratings analysis from other consulting services.

- **Influencing the perception of corporate governance in the market.** The media have a role to play in reporting on corporate governance issues, including IIs' perspectives on the successes and failures of investee companies in this regard. IIs that have organized themselves into associations have in many cases found greater effectiveness in increasing awareness of corporate governance concerns and supporting higher corporate governance standards. As traditional legal/judicial mechanisms for insitutional investors to address abuse of minority shareholder rights are often found to be slow and unreliable, this may also extend to IIs playing a role in establishing or encouraging the use of effective alternative dispute resolution mechanisms such as arbitration.



**From:**  
**Strengthening Latin American Corporate Governance**  
The Role of Institutional Investors

**Access the complete publication at:**  
<https://doi.org/10.1787/9789264116054-en>

**Please cite this chapter as:**

OECD/International Finance Corporation (2011), "Executive Summary", in *Strengthening Latin American Corporate Governance: The Role of Institutional Investors*, OECD Publishing, Paris.

DOI: <https://doi.org/10.1787/9789264116054-2-en>

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