Chapter 1

The importance of institutional investors in promoting good governance

Chapter 1 describes the importance of the role of institutional investors in promoting good corporate governance in the companies they invest in, particularly in the Latin American context of concentrated ownership and often illiquid markets. The chapter refers to leading international initiatives, conclusions and consensus recommendations that provide a starting point for Latin American consideration of this subject, such as those set out in the *White Paper on Corporate Governance in Latin America* (2003), *OECD Principles of Corporate Governance* (2004), the *Corporate Governance Approach Statement by Development Finance Institutions* (2007), the International Corporate Governance Network's *Statement of Principles on Institutional Shareholder Responsibilities* (2007), and the OECD's *Corporate Governance and the Financial Crisis: Conclusions and Emerging Good Practices to Enhance Implementation of the Principles* (2010).

The Roundtable has strongly affirmed the importance that institutional investors (IIs) can have in influencing improvements in corporate governance at policy and company levels, particularly within an environment of concentrated ownership, 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 the Latin American context, policy-makers and regulators have given particular priority to encouraging such behaviour by pension funds, because in many cases they manage compulsory savings of a large number of individual contributors in each country, and therefore are seen to have a duty to serve the public interest and to exercise vigilance in protecting the future benefits of retirees (the public and social policy perspective). 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 also 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 (the perspective of fiduciary responsibility towards the fund beneficiaries).

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. For example, an investment fund investing in thousands of equities throughout the world may face greater difficulty in attending shareholder meetings and actively reviewing the governance of its investee companies than a domestic fund specializing in local markets and investing in few companies. On the other hand, companies with much larger portfolios may emphasize participation through the use of proxy voting and advisory services as a cost-effective way to ensure that corporate governance concerns are addressed in their investee companies.

Despite a number of "active ownership" success stories, the Roundtable has noted that actual practices have often fallen short of the potential, with IIs too often taking a passive role and failing to exercise their ownership rights in an active and informed manner. The importance of this issue was also underlined during the 2004 revision of the *OECD Principles of Corporate Governance*, which concluded that, "The effectiveness and credibility of the entire corporate governance system and company oversight

will, therefore, to a large extent depend on institutional investors that can make informed use of their shareholder rights and effectively exercise their ownership functions in companies in which they invest."

On a global level, the recent financial turmoil has reinforced the focus on the issue of whether institutional investors should have done and should do more to monitor companies. The OECD's Corporate Governance Committee completed a review of corporate governance lessons from the financial crisis in 2010, developing key findings and conclusions to address the corporate governance gaps that were made apparent by the crisis. One of the OECD's key findings was that "Shareholders have tended to be reactive rather than proactive and seldom challenge boards in sufficient number to make a difference. Ineffective monitoring by shareholders has been experienced both in widely held companies and with more concentrated ownership. In some instances, shareholders have been equally concerned with short-termism as have managers and traders, neglecting the effect of excessive risk-taking policies."[1]

To follow up on these findings, the Corporate Governance Committee decided to undertake a survey and peer review of OECD member country practices during 2011, which may lead to further recommendations in this area. This report has served as one of the references in the development of the OECD's further work in this field.

At the crux of IIs' decisions on whether to play an informed and active role in exercising their ownership rights is an economic calculation on whether the benefits of such an approach outweigh the costs. Monitoring the market and individual companies, reviewing their governance arrangements, making use of proxy advisory services, participating and voting in shareholder meetings, and challenging the decisions of corporate management and boards, whether through litigation, arbitration or more informal mechanisms, all carry costs. To the extent that certain IIs are active in pursuing better corporate governance in their investee companies while other minority shareholders remain passive, there is also a "free rider" problem, in which passive investors can obtain the benefits of active investors' engagement while not incurring the costs. Nevertheless, there are a sufficient number of examples 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, that a strong case can be made for both policy-makers and the private sector to encourage the active engagement of investors in ensuring good governance practices.

1.1. The current consensus: recommendations of the Latin American White Paper on Corporate Governance, OECD Principles of Corporate Governance and other global experience

Although individual country contexts differ, it should be noted that the Roundtable has already achieved consensus around a number of key recommendations set out in its *White Paper*. Relevant recommendations are excerpted for reference in Box 1.1:

Box 1.1 **White Paper recommendations to encourage the emergence of active and informed owners [paragraphs 32 – 42 extracted from previous document]**

32. Legal provisions intended to provide minority shareholders with the opportunity to elect directors should be workable in practice.

33. Where legislation provides for proportional director nomination, cumulative voting or other mechanisms to promote minority shareholder participation, voting systems should function in practice in a way that provides non-controlling shareholders with a realistic opportunity to collectively achieve a voice by influencing the composition of the board of directors. When the legal framework does not include provisions that provide minority shareholders with the opportunity to influence the board composition, other means, such as listing requirements and voluntary commitments among shareholders to achieve a proper diversity among board members could be considered.

34. Governments, regulators and beneficiaries should insist that pension funds and other institutional owners have the incentives and governance structures that encourage them to exercise their ownership functions in an informed and effective way.

35. The right regulatory environment and good governance practices encourage institutional investors to: (1) make investment decisions that are intended to maximise returns for shareholders; and (2) effectively exercise their fiduciary duties as shareholders in the companies in which they have invested the funds entrusted to them. The pension system regulatory regime and its supervisory system should provide pension managers with the appropriate incentives to maximise returns on fund investments. The priorities in this area may vary from country to country, but in each case policy makers, regulators and supervisory authorities should be vigilant to protect against the potential for conflicts of interest on the part of fund managers, or fee structures that set inappropriate benchmarks, or other aspects of the regulatory framework that cause managers to act in ways that do not maximise returns for investors.

36. Likewise, special attention needs to be paid to the management of investments of state-owned development banks (and their multilateral counterparts, such as International Finance Corporation, Inter-American Investment Corporation, Andean Development Corporation, etc.) and the effects of government-controlled finance allocation on governance. While direct state ownership of industry has declined, in several countries state-channelled resources and multilateral development bank financing remain important sources of long-term financing. Governments and multilateral development banks need to ensure that such sources of financing

and guarantees insist on the highest standards of governance and transparency demanded in the capital market. Co-investment strategies, where public and private sector entities invest on the same terms, can provide a mechanism for ensuring a level playing field while encouraging the broader adoption of common governance standards by institutional investors of all types.

37. Objective evaluations of governance and transparency practices should be factored into the investment decisions of state-owned and multilateral development banks and affect pricing. State-owned and multilateral development banks should therefore consider policies that recognise the risk mitigation accorded by good governance practices by progressively improving the financing terms for clients as they meet objective benchmarks outlined in national codes or articulated in bank-specific or collectively-developed programmes.

38. With a view to encouraging active and informed shareholder participation by pension funds and other institutional investors, outdated and unnecessary restrictions on the ability of such investors to exercise their shareholder rights should be removed.

39. Pension funds, both private voluntary and privately managed mandatory schemes, are potentially the most powerful group of domestic investors with an interest in good corporate governance. Given the mandatory nature of some schemes, and the critical social function they perform, regulators need to be particularly diligent that companies that issue securities eligible for investment by pension funds are sufficiently transparent and well-governed.

40. At the same time, legislators, regulators and beneficiaries should recognise that existing shortcomings in pension fund governance and regulations that discourage competition in portfolio management (such as requirements that explicitly or implicitly require fund portfolios to mimic an index) limit the incentives for fund managers to put a high enough premium on transparency and governance. An appropriate policy response in such circumstances (and one with which there are a number of recent experiences in the region) may be to modify the legal investment regime – i.e., by permitting proportionally greater investment in companies that meet certain objective corporate governance and disclosure requirements.

41. Institutional investors who act as fiduciaries should articulate their approach to the corporate governance of investees and their policies on voting shares held in such companies and disclose these on a regular basis to the public and their beneficiaries.

42. Institutional investors should provide as much detail as possible in the disclosure to their beneficiaries and the public regarding their standards for corporate governance of portfolio companies and their general policy concerning the execution of key rights, such as pre-emptive and tag-along rights. The disclosure on voting practices should set out the institutional investor's assessment of the costs and benefits of actively participating in corporate governance as a shareholder, and, for example, identify on what specific types of General Meeting agenda items it would ordinarily exercise its vote. Institutional investors should also disclose the process and procedures that they have in place to make decisions on how to exercise their voting rights, including their reliance on proxy advisory services and co-operation with other institutional investors to nominate board members. The purpose of this information should be to provide beneficiaries with an adequate basis upon which to make an informed judgment about whether the institutional investor is taking into account the risks of poor corporate governance in portfolio companies, and whether the institutional investor takes the opportunity to reduce risk and maximise return for beneficiaries by actively participating in governance as a shareholder.

It is worth noting that, following up on the recommendation contained in the White Paper's para. 36 in Box 1 above, Development Finance Institutions have been meeting periodically, with active involvement of many institutions including the International Finance Corporation (IFC), African Development Bank (AfDB), Andean Development Corporation (CAF), European Bank for Reconstruction and Development (EBRD), Inter-American Investment Corporation (IIC), Islamic Development Bank (IsDB) and the Netherlands' Development Finance Company (FMO), to promote progress in corporate governance globally. These institutions developed a common approach in 2007 to promote better corporate governance (See Box 1.2), and have subsequently met annually to monitor progress and exchange experience on how to effectively implement this approach. The Brazilian National Development Bank (BNDES) also has established corporate governance policies to take into account good corporate governance in their investments.

Since the Roundtable's adoption of the *White Paper* in 2003, the OECD has also issued a revised version of the *OECD Principles of Corporate Governance (2004),* which, following broad global consultation including input from the Latin American Roundtable, provided reinforcing recommendations supporting corporate governance frameworks that protect and facilitate the exercise of shareholder rights (Chapter II). While the *OECD Principles* "do not seek to prescribe the optimal degree of investor activism," they nevertheless suggest that many investors are likely to conclude in considering the costs and benefits of exercising their ownership rights that positive financial returns and growth can be obtained by undertaking a reasonable amount of analysis and by using their rights (Principle II.F).

As in the *White Pape*r, the *OECD Principles* recommend that "Institutional investors acting in a fiduciary capacity should disclose their overall corporate governance and voting policies with respect to their investments" (Principle II.F.1).

Box 1.2. **Excerpts from the "Corporate Governance Approach Statement by Development Finance Institutions"***

IV. Why an Approach Statement on Corporate Governance by DFIs

DFIs can be leaders in the promotion of good corporate governance practices because of their emphasis on sustainability in their role as providers of financing and advisory services to emerging market companies. Good corporate governance is a public good and can be considered a pillar of sustainable economic development on par with good environmental and social practices.

Considering the linkages between good corporate governance and access to capital, company performance, and sustainable economic development, improving corporate governance practices has become an important element of the development mission of DFIs.

V. Approach Statement

Each DFI that adopts this Approach Statement will endeavour to:

1. Develop or adopt guidelines, policies or procedures on the role of corporate governance considerations in its due diligence and investment supervision operations; these could cover aspects such as: commitment to good corporate governance, the rights and equitable treatment of shareholders, the role of stakeholders, disclosure and transparency, and the composition and responsibilities of the Board of Directors.

2. Provide or procure training on corporate governance issues to its investment and supervision staff.

3. Encourage companies where it invests in (whether directly or indirectly) to observe local codes of corporate governance in the spirit of best international practice. Engage company management and board members in a dialogue to foster improvement in those cases where corporate governance practices are weak.

4. Promote the use of internationally-recognized financial reporting standards and encourage investee companies to adopt or align their accounting principles and practices to such standards.

5. Collaborate with other DFIs on an ongoing basis, and when appropriate with its partners, to further advance the cause of good corporate governance.

* For more information please see *http://www.ifc.org/ifcext/corporategovernance.nsf/Content/DFI_Statement*.

However, the *OECD Principles* also go a step further with three recommendations that the *White Paper* did not address:

1. **"Institutional investors acting in a fiduciary capacity should disclose how they manage material conflicts of interest that may affect the exercise of key ownership rights regarding their**

investments" (Principle II.F.2). This recommendation seems particularly relevant in the Latin American context, as it notes that conflicts of interest "are particularly acute when the fiduciary institution is a subsidiary or an affiliate of another financial institution, and especially an integrated financial group," which is a common occurrence in the region.

2. **"Shareholders, including institutional shareholders, should be allowed to consult with each other on issues concerning their basic shareholder rights as defined in the Principles, subject to exceptions to prevent abuse" (Principle II.G).** The *OECD Principles'* annotations state that shareholders by themselves may have too small a stake in the company to warrant the cost of taking action or monitoring performance. Even if they do invest resources in such activities, others would also gain without having contributed (i.e., the "free riders" gain the benefits). Institutional investors may have policies of investment diversification in order to spread risk, increasing the likelihood that at an individual level, costs of playing an active role will be too high. The *OECD Principles* suggest that "To overcome this asymmetry, institutional investors should be allowed, and even encouraged, to co-operate and co-ordinate their actions in nominating and electing board members, placing proposals on the agenda and holding discussions directly with a company in order to improve its corporate governance. More generally, shareholders should be allowed to communicate with each other without having to comply with the formalities of proxy solicitation." The *OECD Principles* also warn, however, that co-operation among investors could be used to manipulate markets and to obtain control over a company while circumventing takeover regulations or competition law. In this respect it notes that some countries limit or prohibit institutional investor co-operation, or closely monitor shareholder agreements. Yet, it is suggested that "if co-operation does not involve issues of corporate control or conflict with concerns about market efficiency and fairness, the benefits of more effective ownership may still be obtained. Necessary disclosure of co-operation among investors, institutional or otherwise, may have to be accompanied by provisions which prevent trading for a period so as to avoid the possibility of market manipulation."

3. **"The corporate governance framework should be complemented by an effective approach that addresses and promotes the provision of analysis or advice by analysts, brokers, rating agencies and others, that is relevant to decisions**

by investors, free from material conflicts of interest that might compromise the integrity of their analysis or advice" (Principle V.F). The Principle's annotations note that while these intermediaries can play an important role in providing incentives for company boards to follow good governance practices, concerns have arisen in response to evidence that conflicts of interest often arise and may affect judgement. "This could be the case when the provider of advice is also seeking to provide other services to the company in question, or where the provider has a direct material interest in the company or its competitors." The annotations suggest that experience in other areas has shown that the preferred solution is to demand full disclosure of conflicts of interest and how the entity is choosing to manage them, including disclosure about how the entity is structuring the incentives of its employees in order to eliminate the potential conflict of interest.

The Recommendations contained in Chapters 3 and 4 of *Strengthening Latin American Corporate Governance: the Role of Institutional Investors* integrate the above recommendations from the Roundtable's 2003 *White Paper* and *OECD Principles* as policies and practices that already have obtained broad international consensus. However, this publication also aims to go further, by taking into account both Latin American and global best practice experience, and recommendations from a range of institutional investors that have a reputation for promoting active and informed ownership.

On a global level, this includes the examples of the California Public Employees' Retirement System (CalPERS) and the Teachers Insurance and Annuity Association - College Retirement Equities Fund (TIAA-CREF), which have recognized their role as long-term investors and active owners in their portfolio companies, and assumed a responsibility for monitoring the activities and promoting best practices therein. CalPERS has issued its *"Core Principles of Accountable Corporate Governance,"* covering several subjects from board independence and processes to audit integrity. These principles call for a one-share one-vote policy and for the adoption of a corporate governance code in each of the markets in which they invest. TIIA-CREF issued its *"Policy Statement on Corporate Governance"* along with a set of *"Proxy Voting Guidelines."*

CalPERS and TIIA-CREF recognize that there is not a one-size-fits-all approach to the exercise of ownership rights and that each voting decision has to be considered separately within its context. However, these documents provide a set of benchmarks and principles that guide both funds' investment and ownership decisions and can give a detailed description of how they will most likely vote on a several range of issues.

Drawing upon its Principles, CalPERS has publicly issued a *"black list"* of companies considered to be underperforming in the market, aiming to exert pressure to promote corporate change and increase their share value.

Likewise, the International Corporate Governance Network (ICGN) approved a "*Statement of Principles on Institutional Shareholder Responsibilities"* in 2007. ICGN brings together some of the largest institutional shareholders – its members are estimated to hold assets exceeding $10 trillion. The Statement sets out the ICGN's view of the responsibilities of institutional shareholders both in relation to their external role as owners of company equity, and also in relation to their internal governance. The Statement also claims that "Institutions that comply with the enlarged principles will have both a stronger claim to the trust of their end beneficiaries and to the exercising of the rights of equity ownership on their behalf."

The United Nations *Principles for Responsible Investment* (UNPRI)[2] is an initiative supported by more than 800 investment institutions from 45 countries with aggregate assets under management of US$22 trillion. It features voluntary guidelines for investment firms to address environmental, social and governance (ESG) issues based on six principles:

- Incorporate ESG considerations into their investment considerations;
- Adopt an active ownership policy;
- Encourage investee companies to disclose more on ESG;
- Get together as a group and promote UNPRI;
- Recognise the power of investor collaboration;
- Report on activities.

Another example of institutional investor self-regulation is in the UK, where the Institutional Shareholders' Committee published its Code on the Responsibilities of Institutional Investors in 2009, which with some adjustments served as the basis for the UK Stewardship Code, issued by the UK Financial Reporting Council in July 2010.

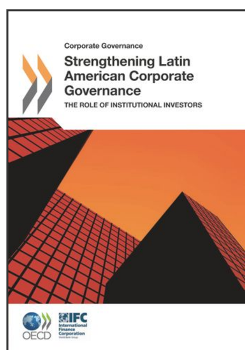
The UK Stewardship Code aims to "enhance the quality of engagement between institutional investors and companies to help improve long-term returns to shareholders and the efficient exercise of governance responsibilities by setting out good practice on engagement with investee companies to which the FRC believes institutional investors should aspire."[3] It encourages investment firms to voluntarily disclose on their Web sites how they are addressing recommendations in the code, including to: set out

their policy on how they will discharge their responsibilities; monitor the performance of, and establish, where necessary, a regular dialogue with investee companies; intervene where necessary; evaluate the impact of their engagement; and report back to clients/beneficial owners. The Financial Reporting Council report on the Code noted that the financial crisis has launched a wider debate in Europe on whether institutional investors should be required to disclose their policies through comply-or-explain reporting mechanisms.

A number of other countries and organizations have issued statements to promote an active role for IIs to adopt and promote good corporate governance practices in their investee companies, including the Australian Council of Superannuation Investors' guidelines on good practice, German Corporate Governance Code for Asset Management Companies, Pension Fund Association Corporate Governance Principles (Japan), Eumedion Corporate Governance Handbook (the Netherlands), Council of Institutional Investors' Corporate Governance Policies (US), etc. An attempt has been made to incorporate aspects of this experience into the recommendations of this report. More specific experience from Latin American institutional investors is addressed in the next chapter.

Notes

1. See "Corporate Governance and the Financial Crisis: Conclusions and Emerging Good Practices to Enhance Implementation of the Principles" page 28, OECD, 2010, available at *www.oecd.org/daf/corporateaffairs*.
2. For more information, see *http://www.unpri.org/*.
3. For more information, see *http://www.frc.org.uk/corporate/investorgovernance.cfm*.



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