



Pension Trends

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Corporate Governance and Pension Funds Administrators (AFP). The case of Chile.

- **Good corporate governance practices maximize company value and therefore promote economic growth.**
- **Pension funds in Chile have contributed to improving standards of corporate governance mostly in two ways: i) promoting the development and deepening of capital markets, which have enabled the development of a more complete financial industry, improving information and limiting monitoring costs; and ii) directly by defending the interests of minority shareholders.**
- **The pension reform of 2008 has gone even further in addressing the problems of conflict of interest which could arise between pension fund administrators and fund members, and at the same time makes the regulation of pension fund investments more flexible.**

1. A definition of corporate governance and why it is relevant

Literature contains several definitions of corporate governance. In general, it is appropriate to conceptualize corporate governance as the system of standards, practices and procedures that determine and regulate the internal actions of a company, and thereby establish rights, roles and obligations on all parties involved, such as managers, executives and shareholders. A company's corporate governance establishes the structure and standards which govern or determine decision making and control mechanisms.

In particular, it considers the structure of incentives for directors and executives in order to protect the interests of the company and its shareholders. It also includes monitoring and checks on decision making and results. The objective of corporate governance is therefore to maximize the Company's long-term value.

Good corporate governance provides many wide-ranging benefits. For companies these include benefits from greater efficiency and better quality management and also limiting risks. At the same time the market's perception of the company improves, which increases confidence. This impacts competitiveness by lowering the cost of capital, which in turn, increases the value of the company. A survey by McKinsey in 2002 found that three out of four investors are prepared to pay a premium for good corporate governance. This premium is the difference in price that an investor is disposed to pay for a company with good corporate governance over a company with similar results but without good corporate governance.

In theory, an economy where good corporate governance practices are common will generate more value and therefore greater growth. The aforementioned survey found that the premium investors are prepared to pay is higher in countries where corporate governance is less developed. This ends in a loss of value in the market as a result.

In addition, Agosin and Pastén (2003) found that good corporate governance is essential for the operation of capital markets. This is going to determine the possibilities to get external finance by companies. In developed economies, with deep and complex capital markets, companies have a range of options for obtaining finance; however, these options are normally more limited in less developed markets.

2. Market models: the US/UK model vs. the continental European model

In order to study issues related to corporate governance, two major ways in which markets may be organized have been defined. This depends on the structure of the "agency" problem (see below) observed in the companies. This turns in differing corporate governance models and requirements for the companies involved. The agency problem in economic literature arises when a relationship is established between two individuals –or groups of individuals- where one of these (the principal) delegates to the other (the agent) functions which are in the benefit of the principal. The level of effort or care taken by the agent in its activities will have a direct impact on the returns which will be made by the principal. This relationship is characterized by being carried out with asymmetry of information, where it is not possible – or is extremely expensive- for the principal to verify the level of effort being applied by the agent in its tasks.

The US/UK model is characterized by markets where company's ownership is diluted among a large number of shareholders. Meaning that owner's participation in the company's decision is very limited. In this case, the agents are the directors of the company, while the principals are the shareholders. It's possible to find situations in which conflicts of interest may arise, whether as a result of opportunistic behavior by the executives, or due to problems generated by shareholders taking collective action. By definition, in this model there is a very large number of shareholders who has varying interests.

The administration and control of the company is in the hands of the directors, so if conflict of interest situations arise, the risk is that the interests of the shareholders will be prejudiced, which is equivalent to a reduction of the potential value of the company in the longer term.

The corporate governance system which derives from this model aims to avoid that the interests of shareholders be harmed in the event of such conflicts of interest.

The second model, known as the Continental European model, is characterized by an economy with highly concentrated company ownership. In this case, the controllers have enormous influence on decision making. In this type of markets, it is quite common to see controlling groups which have stakes in a large number of companies and sectors of the economy. In this model, the agent is the controller, while the principal is the minority shareholder. Under this system, situations of conflict of interest may arise when actions are taken in the interests of the controlling group, in spite of maximizing the value of the company.

As a result of this highly concentrated company ownership, these markets usually have very limited distribution of information, low participation by independent directors and financial markets which poorly develop and with limited liquidity.

3. Corporate governance in Chile

The Chilean market structure is like the continental European model. It is common for companies are owned by large conglomerates with interests in various sectors of the economy, also control the majority of the directors. In addition, there are a large number of family companies.

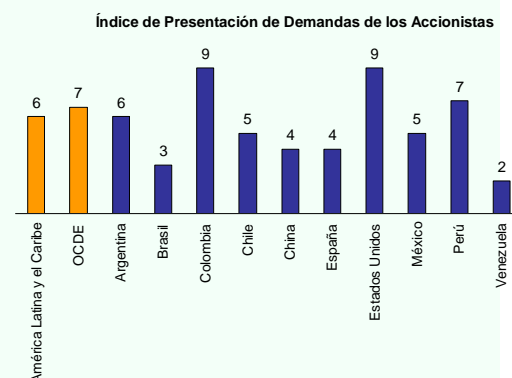
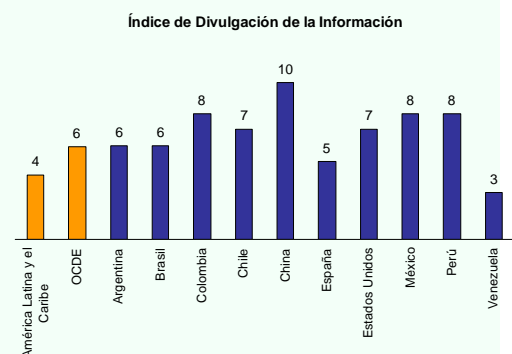
Whilst various studies have produced different results, they all conclude that company ownership is highly concentrated in Chile. Lefort and Walker (2000) studied company ownership structure in the 1990s, and found that around 70% of non-financial companies traded on the stock market belonged to a conglomerate. In 1998 the five largest economic groups controlled 54% of total assets, and this percentage had increased during the period under analysis.

Agosin and Pastén (2003) studied the largest 177 companies out of a total of 282 companies traded on the Chilean stock market in 1999. They found that at the beginning of the 1990s, the five largest economic groups owned 30% of stock market capitalization, and in total, had interests in 301 companies. Considering the ten largest economic groups, it was found that they owned 90% of the shares. These highly concentrated levels of company ownership were common across differing sectors of the economy.

According to McKinsey (2007), the largest shareholder in 75% of companies traded on the stock market owns more than 30% of the company. Among the companies included in Chile's IPSA stock market index, the largest economic grouping owned 41.2% of capitalization, whilst the three largest shareholders owned 61%. It also found that around 40% of company decisions were taken outside the board of directors.

However, despite the high level of concentration of company ownership in Chile, the level of corporate governance is not too dispiriting. The McKinsey (2004) study identified Chile as one of the developing countries which best complied with the corporate governance principles developed by the OECD; furthermore, institutional investors consider that Chile had the best level of corporate governance of any emerging market. However, a more recent analysis by McKinsey in 2007 shows some slight improvements, it also shows that Chile has fallen in comparison to other countries.

The "Doing Business 2008" survey carried out by the World Bank in 2007 measured the degree of investor's protection -particularly minority shareholders- from potential abuse by company directors and administrators. This survey evaluated the transparency of transactions, the responsibility of



Fuente: Banco Mundial (2008).

directors in setting their own contracts, and the possibility of shareholders to take legal actions against directors and administrators. As can be seen from the charts, Chile's overall rating was six of a maximum of ten, placing it above average for Latin American and Caribbean countries. Also Chile exceeded the average for OECD countries in terms of distribution of information and the responsibility of directors. However, it scored relatively lowly in the possibility of shareholders to take legal action.

There are two institutional features particular to the Chilean market which significantly reduces the occurrence of conflicts of interest. Firstly, the 1982 economic crisis made clear the enormous costs of an inadequate financial markets regulation,, particularly in the context of a highly concentrated economy, where the major groupings also had interests in banks. One of the consequences of the crisis in Chile was the establishment of a rigorous regulatory system for banking and financial institutions, which were subject to monitoring and public audit carried out by highly qualified bodies - the Superintendencia de Bancos e Instituciones Financieras (SBIF – the Bank and Financial Institution Regulator) and the Superintendencia de Valores y Seguros (SVS – Financial Instrument and Insurance Regulator). Despite Chile being a developing economy, with relatively shallow capital and financial markets, it have a sophisticated regulatory requirements for banks and financial institutions. For example, banks are not permitted to make loans to related companies; assets and liabilities in foreign currencies must be balanced; adequate provisions must be made for low quality loans; and the regulator periodically evaluates the quality of portfolios and is able to force banks to increase their reserves if this is considered necessary (Agosin and Pastén, 2003).

Secondly, Chile has major and well developed institutional investors: AFPs – wich is not common in developing countries markets.

4. The role of AFPs in corporate governance in Chile

4.1. AFPs, capital markets and protection for minority shareholders

The effect of the system of individual capitalization on corporate governance in Chile has been positive, and has been achieved through two routes: the substantial development and deepening of capital markets, and direct protection for minority shareholders through AFPs.

Pension funds have made a very significant contribution to the development of Chile's capital markets (Corbo and Schmidt-Hebbel, 2003), contributing an enormous volume of resources, which in 2007 amounted to 63.8% of GDP, of which around two thirds are invested in the domestic market. This recognized and significant contribution to Chile's economy in general, and to capital markets in particular, has had a positive effect on corporate governance in the domestic market. The increase in the volume of transactions has enabled economies of scale to develop, which has resulted in the financial services sector becoming ever more comprehensive, and this in turn has enabled increased information flows and reduced monitoring costs.

AFPs have had a direct effect on behalf of the funds that they administer in contributing to promoting improvements in corporate governance in Chileans companies in defense of the interests of minority shareholders.

Whilst AFPs manage large sums, the regulations stipulate that they play the role of minority shareholders of the companies in which they have invested. The regulations limit the role AFPs can play in companies, stopping them from participating directly in the management of the companies in which they have invested. Their ability to express their opinions and represent their interests is limited to taking part in General Meetings of Shareholders and the nomination of some independent directors. As a result, in Chile's capital market, the AFPs are the main minority shareholder. It should be considered that they are highly informed and powerful, and their actions are highly visible.

It has been observed that the AFPs contributed to appointing an important number of the independent directors of Chilean companies, and this percentage increases as the funds invested in the company growth.

According to Iglesias-Palau (2000), in 1998, 10% of company directors had been appointed through the votes of AFPs; figures for 2007 show that this percentage had increased to 16%¹.

We should highlight here that the obligation of paying pension contributions for Chilean workers has resulted in the public paying attention to capital markets, whereas before this system was introduced, individual participation in capital markets was limited to very small fraction of the population. However, it is now possible to argue that practically the entire population of working age has, or should have, an interest in the performance of the capital markets through their participation in pension funds. AFPs system has increased transparency and the availability of market information, and has given to the AFPs a powerful weapon: they have a powerful voice which can raise objections if an abuse occur; whilst this does not happen very often, it perhaps could pass unnoticed without the existence of an informed agent which the public listens to (see table I).

Table I¹

The “Chispas” case

One interesting example of AFPs defending the interests of minority shareholders is the so-called “Chispas case”.

In 1997, the largest Chilean holding operating in the electrical utility sector, Enersis Chile, was sold under unusual circumstances to Endesa España, a Spanish company which operates in the same sector.

Originally Enersis was a public company, Chilectra Metropolitana, which was privatized at the end of the 1980s. Workers and managers were allowed to obtain shares in the company, this was a way of privatization system known as “popular capitalism”. The general manager of the state company became the largest shareholder in the private company. The company was subsequently restructured and involved in investments which transformed it into a holding. The conglomerate continued to grow and took control of the main electricity generator in the country, Endesa Chile. Through these investments, Enersis increased its value 50 times, becoming one of the largest conglomerates in Latin America, with interests in Chile, Argentina, Peru, Brazil and Colombia.

When Endesa España made an offer to buy the company, several AFPs had major interests in Enersis. However, the AFPs had very low power in the company. Each “Chispa” (spark) –small companies forming part of Enersis- had two classes of shares: A and B. “A” shares had a right to higher dividends, but had no voting rights. As a result, Enersis was really controlled by the owners of the “B” shares, despite these only representing 0.06% of the company.

Endesa España negotiated directly with the controllers and made a PTO for A and B shares, offering 840 times more for B shares than A shares (\$220 per share for A shares, and \$185,000 per B share). In addition, Endesa España granted owners of B shares the possibility to buy their own shares at a preferential price, and guaranteed that they would stay on as directors of Enersis for at least five years.

The small individual shareholders –the majority being ex-employees of Chilectra Metropolitana- were very enthusiastic about the deal offered by Endesa España, as they considered that the share price had multiplied many times in just ten years. However, the AFPs had more knowledge and information and attempted to abort the deal, because they considered that the benefits for the owners were being very unevenly distributed. Furthermore, the AFPs argued that there were incentives for prejudicial actions against minority shareholders that didn’t accept the tender for A shares.

The AFPs were successful in blocking the deal, and it was eventually revoked by the Chilean courts. In 1999 Endesa España finally succeeded in acquire Enersis, but the former controllers were legally excluded.

¹ Based on Agosin and Pastén (2003).

¹ AFPs are obliged to vote for independent directors

4.2. Corporate governance in the AFP system, investments and conflicts of interest

There is another aspect which involves AFPs where conflicts of interest may arise, which make it desirable to have a solid corporate governance structure. This potential conflict of interest take place between the AFPs and their executives, who play the role of “agents”, and the members of the funds -who are the ultimate owners of the pension funds, meaning that their are interest in maximizing the expected profitability of the fund- who play the role of “principals”. It is possible to imagine situations in which there would be conflicts of interest between the AFPs and their administrators and the fund members. Such conflicts could arise as a result of the asymmetry of information between the two sides, given that the AFPs have vastly superior knowledge of finance, markets, financial instruments, and so on. The investment regulations are justified because of this potential conflict of interest. The regulator, among other occasional objectives, specifically has the objective of stopping AFPs from extracting income from the companies in which they invest pension fund resources; stopping financing of subsidiaries or related companies on favorable terms; and stopping AFPs from exposing fund members to undesirably high levels of risk.

As a result, Chilean legislation establishes a number of regulations on the investment activities of AFPs in order to protect fund members. The 2008 reform to the pension system introduced a number of changes to the public institutions involved, to the control regulations and to the pension fund investments regulation, also the reform reinforce several aspects related to corporate governance of the system ².

In terms of the public bodies, the reforms continued the role of oversight and audit of the system, and the power to establish standards and impose penalties by the Pensions Regulator (the legal successor to the AFP Regulator). The law prohibits public employees to reveal or use information to which they have access in the performance of their duties.

The law expressly states that investments “*made using pension fund resources shall have the sole objective of generating adequate returns and safety. Any other objective for such investments will be considered contrary to the interests of the pension fund, constituting a serious infringement to the duties of the administrators*”³. So the law clearly establishes the concept of conflict of interest and the penalties for such occurring.

The law specifically prohibits pension funds being invested –whether directly or indirectly- in AFP shares, insurance companies, mutual fund administrators, and investment funds, stock market funds, stock broker funds, and financial advisor companies, companies which manage contributions portfolios, and sports, educational and charity companies which are excluded from obligations to provide information.

In order to align the AFPs and fund members incentives, it is stipulated that the cash reserves of each type of fund should replicate the Administrator’s portfolio. The cash reserve represents the majority of the capital of the AFPs, therefore have a direct impact on the Administrators returns. As a result of this measure, the AFPs share with their members the interest in obtaining the highest returns possible with an acceptable level of risk.

The role of director of a AFP is not compatible with being an executive or director of a bank or other financial institution, stock exchange, collateralization agency, investment or mutual fund manager, insurance company or other AFP.

² For details of the Provisional Reform of 2008, see Law 20,255.

³ Decree Law N°3,500

The use or spreading privileged information is expressly prohibited; anyone who breaches this stipulation will get imprisoned, and will have civil liability for any economic damage or loss which might occur as a result.

At the same time, the AFP is responsible for compensating the fund for any direct loss or damage caused by any of its directors or employees, or persons who provide services to it, as a result of their performance or failure to comply with any legal stipulations.

The 2008 reform conserved the regulations on conflicts of interest that we have described and added additional provisions. For example, investment of pension fund resources -whether directly or indirectly- in financial instruments issued or guaranteed by the AFP itself, or which are issued or guaranteed by any company related to the AFP, is now totally prohibited. In addition, the reform introduced a separation of commercial functions between the AFP and those that can be performed by entities in its Business Group.

Significant changes were also introduced in terms of regulation and control of pension fund investments, together with a number of specifications aimed explicitly at conflicts of interest.

Before this reform, AFPs could only invest in the financial instruments expressly authorized by legislation, which in many cases also had to be approved in advance by the Comisión Calificadora de Riesgos (Risk Evaluation Commission). Furthermore, for each type of fund the law stipulated maximum investment limits for every financial instrument in which AFPs were permitted to invest. There were more than 60 specified limits established which must be respected at all times.

In addition, a minimum floor for the real annual return was defined for each type of fund. To ensure this requirement, were established a “profitability fluctuation reserve” (reserva de fluctuación de de rentabilidad) and a “cash reserve” (encaje) which the administrators have to keep and use to compensate the fund if returns fall below the floor s.,.

The reform introduced by Law 20,255 indicated that only an essential, simplified structure of eligible instruments and investment limits would be maintained in the law, whilst more precise details would be delegated to the Executive through the Investment Regime (IR).

The IR will regulate direct and indirect investments, establishing a range of specifications; for example, it will include calculation methodologies, maximum values, types of operations permitted, the degree of liquidity of financial instruments, mechanisms and periods for eliminating excess investments which might occur, and other factors.

It states that the investment limits may be differentiated based on the risk classification of the financial instrument; the concentration of share ownership; diversification in the investment portfolio; the time the issuer has been operating; whether investment requirements are being complied with; the value of the pension fund and the derivative instrument.

The reform stipulates the possibility of carrying out supervision based on risk; in other words, the IR may authorize the regulation of pension fund investments through the measurement of risk in investment portfolios.

The IR includes the creation of a permanent Consejo Técnico de Inversiones (CTI – Technical Investment Council), which will advise the Executive on issues relating to pension fund investments in order to achieve adequate levels of risk and returns. In particular, the CTI's functions include commenting on the content of the IR; the modifications which the pensions regulator proposes to the IR; issuing technical opinions on all issues relating to pension fund investments, in particular the structure of investment limits, and recommending any modifications which are considered appropriate; and preparing proposals on reports on the IR as considered necessary.

The members of the CTI may not be managers, administrators or directors of a AFP or of any entity in a AFP's business group during the time that they are performing this role. The law prohibits members of the CTI from directly or indirectly using in their own benefit or for third parties information to which they have access in the performance of their duties which is not publicly available. Infringement of this stipulation may result in a prison sentence and being barred from holding public office or positions during the period of the sentence.

CTI members must not take part in any session which considers or takes decisions relating to issues in which they are involved or have an interest.

The reforms also include removing certain regulations or making them more flexible, for example:

- They establish lower minimum requirements for minimum profitability.
- They eliminate the profitability fluctuation reserve.
- A gradual increase in the limit on abroad investment, potentially rising to 80%, for "A-type" funds.
- Operations involving derivatives are authorized.
- Conditions have been eased for holding investments in foreign currency without exchange hedging.
- Limits on risk hedging operations have been eliminated.

The greater flexibility in terms of investments derives from the existence of a trade-off between strict regulation –which gives greater security- and returns. It recognizes that the financial market is highly complex and constantly evolving, so being able to respond rapidly is essential in order to maximize performance, both in terms of risk and rewards. For this reason, the reforms establish a lighter and more flexible regulatory structure, which can respond quickly, whilst at the same time protecting the operation of the system and guaranteeing risks are kept below adequate levels for fund members.

The reforms stipulate that the Board of a AFP must formally establish investment policies for each type of fund that it manages, and that these must be reported to the regulatory body and to the public.

In addition, the AFP must have a procedure for resolving conflicts of interest, which must be approved by its board. The procedure for resolving conflicts of interest must be made public, and must, as a minimum, cover the following:

- Internal control standards and procedures to ensure adequate management and resolution of conflicts of interest which might affect directors, managers, administrators and senior executives in the AFP.
- Confidentiality and handling of privileged information.
- Requirements and procedures for choosing candidates for positions as directors in the public limited companies in which the Pension Funds invest.

Failure by the AFP to comply with the investment policy or the conflict of interest resolution policy defined by its board will be reported by the pension regulator and punished.

AFPs must also form an Investment and Conflict of Interest Resolution Committee with the following functions and attributes:

- To supervise compliance with the investment policies prepared and approved by the board, which must be compatible with the procedure for resolving conflicts of interest; and to supervise compliance with the limits on investments for pension funds established by law and in the IR.
- To review the objectives, policies and procedures for administering the risk of pension fund investments.
- To examine the records relating to the operation of pension fund in derivatives and foreign instruments.
- To prepare a policy for resolving conflicts of interest, and to propose this to the board of the AFP for approval; this policy may only be rejected by a vote the majority of the board members.
- To supervise appropriate compliance with the conflict of interest resolution process.
- To send an annual report to the board on the above issues; this report must include an evaluation of how the investment and conflict of interest policies were applied and complied with. A copy of this report must be sent to the pension regulator.

The Investment and Conflict of Interest Resolution Committee must have three AFP directors, two of whom must be external and appointed by the board, which will also determine who will chair the committee.

During discussion of the reforms, the possibility of allowing banks to become involved in the AFP industry in order to increase competition was examined. In the end, it was decided to keep the role limited to pension fund administrators. One of the arguments that held most weight in not allowing banks to enter the AFP industry was the potential conflict of interest in administration of the fund.

The main concerns in terms of potential conflicts of interest which might arise for banks which have a AFP as a subsidiary are:

- Banks offer a wide range of products for current consumption; the preference for present as opposed to future consumption could lead to the bank making sales which sacrifice the profitability of savings and therefore future pension benefits.
- If a bank had a AFP as a subsidiary, it would effectively be both demanding and supplying financial instruments.
- The banks act in the financial market on their own behalf, whilst AFPs act on behalf of third parties. If the bank and the AFP are part of the same company, investment decisions could be taken in the best interests of the bank, to the detriment of the pension fund.

5. Conclusions

Good corporate governance practices have enormous benefits for companies and the economy as a whole. Companies which adopt these policies increase their efficiency, reduce costs, limit risks and raise their profile in the country and with the markets; all of these effects have a positive impact in terms of increasing competitiveness and reducing costs of capital, which eventually leads to increase the companies's value, leading in turn to higher economic growth.

In addition, it has been shown that the advantages of good corporate governance practices are even higher in developing economies. Less developed countries usually don't have deep financial markets, this limits credit or made it more expensive. Good corporate governance practices determine the possibility and extent of external finance which companies can obtain.

The individual capitalization system established in Chile over 25 years ago has contributed to increasing the standard of corporate governance in the national market, mainly through two ways:

- The development of capital markets. Pension funds have contributed enormous volumes of resources to Chilean capital markets; in 2007, they had invested the equivalent of 40% of the year's GDP in the domestic market. The increase in the volume of transactions has made the market more sophisticated and has enabled economies of scale to develop; this has resulted in financial services sector becoming even more comprehensive, and this in turn has increased information flows and reduced monitoring costs.
- Directly defending the interests of minority shareholders. Due to the regulations AFPs play the role of minority shareholders in the companies in which the pension funds have been invested. As a result, AFPs appointing a significant number of independent directors. AFPs have made more difficult for controllers to extract rents, due to the high information and visible presence that AFPs have. Even when the rent extraction is not frequently in the Chilean market, it might well have passed unnoticed without the presence of AFPs.

The pension reform of 2008 increases control and prevention of conflicts of interest which might arise between members and the AFPs; at the same time, the provisional reform also made the regulation of pension funds more flexible.

The greater flexibility in terms of managing pension fund investments results from the existence of a trade-off between strict regulation –which gives greater security- and higher returns, which enables more flexible fund management. However, as the funds under management represent the savings for the future of Chilean workers, risk must be kept at prudent levels. In order to achieve this, the reforms aim to create light and flexible control on investments; to stipulate incompatible activities; and to establish obligatory internal control mechanisms which are audited and regulated by the Regulator of the particular area of activity.

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