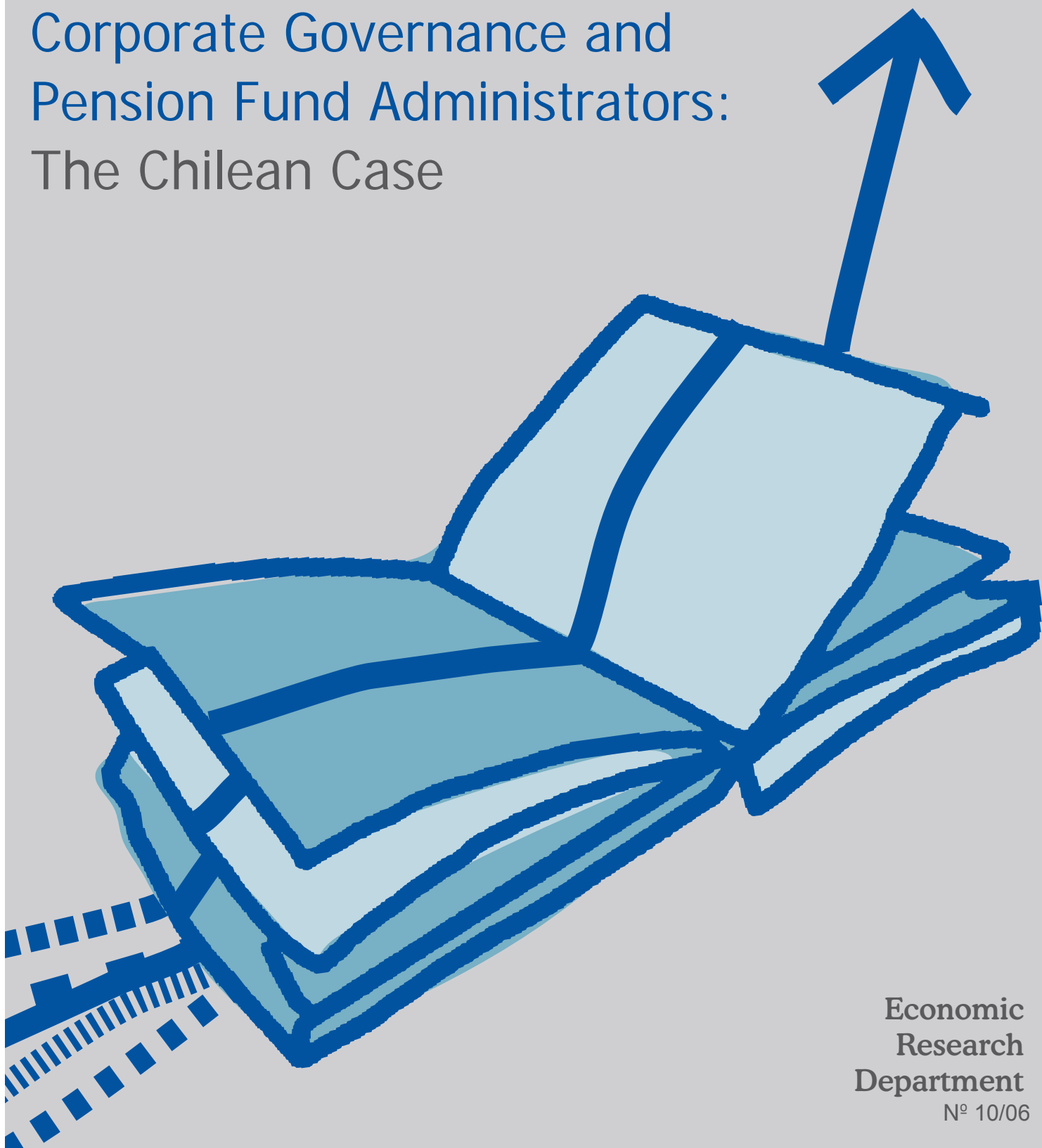


WORKING Papers

Corporate Governance and
Pension Fund Administrators:
The Chilean Case



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Research
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Corporate Governance and Pension Fund Administrators: The Chilean Case

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1 Introduction

The corporate governance of a company refers to the system of standards, practices and procedures that determine and regulate the actions that are performed within it. Corporate governance determines the establishment of rights and responsibilities for those involved in the operation of the company, like the Board of Directors, the Administrative Staff and the shareholders. In this way, the structure and standards that regulate or determine the decision making and the corporate control mechanisms are established.

A company with good corporate governance will obtain multiple benefits, among which is an increase in market confidence and therefore the value derived from that, which will increase the possibilities of access to capital. Additionally, good corporate governance can drive gains in management efficiency and quality management.

If good practices in corporate governance are the standard in an economy, rather than the exception, then it can be presumed that more value will be generated and competitiveness and access to financing will increase, all of which will lead to positive growth.

The capital market in Chile can be characterized by being made up of companies that belong to large conglomerates, which in turn tend to have interests in different sectors of the economy, including the financial sector. These large economic groups control the majority of the directors from listed companies.

In this framework of distinct concentrations of ownership, an element that has had a significant affect on the current Chilean market structure is the individual contribution pension system. Since its creation in 1981 and up to the present day, pension funds have accumulated a total sum equivalent to more than 60% of GDP as of December 2009, 56% of which were resources invested in the national market. While regulation prevents Pension Fund Administrators (PFA) from individually possessing more than 7% of the stock of the companies they invest in, USD \$16,363 million has been invested directly into domestic stocks (13.9% from pension funds by the end of 2009), thus making PFAs the primary minority shareholders and a significant institutional investor.

As minority shareholders, the PFAs have the advantage of not having to face the problems individually, because the law allows different administrators to act collectively to elect managers (although they are expressly prohibited from participating in the management of the corporations). Another important

factor is that the actions taken by the PFAs have high visibility, which increases their power despite their minority shareholder status.

The PFAs have been transformed into the primary minority investors, and as such they are both highly informed and their actions are highly visible. These characteristics have allowed them to positively influence the corporate governance of national companies in direct and indirect manners.

PFAs have indirectly improved the corporate governance of Chilean companies by expanding the capital market; this has contributed in a big way toward increasing the volumes and frequency of transactions, which has simultaneously increased interest in raising capital by issuing stock. In addition to these factors permitting advantages in terms of economies of scale and reducing information and monitoring costs, it also elevates the quality of financial services. The increase of information and professionalization of industries related to the capital market has created a push toward progressive improvement in the standards for the corporate governance of companies.

The direct influence of the PFAs on the improvement of the corporate governance of Chilean companies has materialized through actively exercising their shareholder rights. Specifically, the PFAs have contributed by incorporating independent directors, overseeing operations and raising objections when they believe that the rights of independent shareholders are being trampled.

Apart from exercising shareholder rights, the effect that PFAs have on the regulation of the stock market is notable. In fact, the PFAs have raised awareness of situations where there is no regulation or where it is very lax; for example, this paper briefly reviews the case of Chispas and the subsequent enactment of the Public Offers of Acquisition (POA) law, as well as the Fasa Case and the subsequent creation of the Corporate Governance and Independent Directors law.

2 Conceptual Framework

2.1 Definition and relevance of Corporate Governance

There exist varied definitions for corporate governance in literature. In general, it is practical to conceptualize corporate governance as the system of standards, practices and procedures that determine and regulate the actions within a company, establishing rights, roles and obligations for the different actors involved, like the board of directors, the administrative staff and

shareholders. In short, the corporate governance of a company establishes the structure and the standards that govern or determine decision making and control mechanisms.

In a word, it considers the structuring of incentives that will be established for directors and administrators, for the purpose of protecting the interest of the company and that of its shareholders. It also addresses the oversight and control of the decisions and results. In this way, the ultimate objective of corporate governance is to maximize the value of the company in the long term.

The benefits of good corporate governance are broad. For companies, it addresses gains in greater efficiency and quality of management, as well as limiting risks, and potentially, obtaining a better perception on the part of the market. As a result, market confidence in the company is raised, allowing for an adequate channeling of resources toward the company. All of which results in increases in competitiveness and lower capital costs, which in turn increases the value of the company.

A survey performed by McKinsey & Co. in 2002 shows that three out of four investors are willing to pay a premium -or price premium- for good corporate governance. The premium corresponds to the difference in price that the investor would pay for a company with good corporate governance over another that has similar financial results, but that does not have good corporate governance.

At the aggregate level, theoretically, an economy in which good corporate governance is common will generate more value and therefore greater growth. In fact, the survey mentioned in the previous paragraph reflects that the premium is increased in countries that show more deficient corporate governance practices, which would be evidence of a loss in value in the market from said deficiency.

Additionally, good corporate governance practices become fundamental to the operation of capital markets, and will ultimately determine the conditions, possibilities and the degree to which companies will be able to finance their investments with external resources. Therefore, as Agosin and Pastén (2003) point out, good corporate governance is the primary goal for developing economies in particular, as it allows them to increase financing sources for their companies. Developed economies possess deep and complex capital markets, which gives companies diverse alternatives for obtaining financing and makes the need to establish good corporate governance practices less necessary.

2.2 Agency Problem

In order to study subjects relating to corporate governance, two major characteristics of market organization have been defined in great detail according to the structure of the agency problem that presents itself in companies; that in turn results in distinct models and requirements for the corporate governance of companies that it comprises.

In economic literature, the agency problem occurs when a relationship is established between two individuals –or two groups of individuals- where one of these, called the *principal*, delegates to the other, known as the *agent*, the performance of functions that are of their own interest or benefit, in a manner which the level of effort or diligence that the agent puts into their activities will impact the benefit that the principal will experience. This relationship is characterized by the performance in a context of asymmetry of information, where it is not possible–or it is very costly- for the principal to verify the level of effort put forth by the agent in their commission.

2.2.1 Market Models: Anglo-Saxon vs. Continental European

The Anglo-Saxon model is composed of markets made up of companies whose ownership is diluted among a great number of shareholders, resulting in a decreased participation in decision making in companies. In this model, the agent is the company administrators and the principal is the shareholders. Situations may arise in which the interests of both are in contradiction, whether due to opportunistic behavior on the part of executives or a collective action problem that the shareholders face, which by its definition in this model are both frequent and heterogeneous.

Undoubtedly, the determination of salaries and bonuses for the managers and directors of companies is a situation in which the interests of shareholders and administrators are in conflict. Beyond this situation, the conceptual difference in incentives between these two groups could even put the long term viability of the company at risk, as the shareholders' interest lies in maximizing the after tax profits and the long term value of the company, which is directly related to their share of the company's future discounted cash flow. The goal of the company's management is to maximize their salaries, which depends directly on the short term profits of the company, given that their incomes are not tied to the long term performance of the company and they have the option to change jobs in the face of difficulties that the company could eventually face, they have the incentive to incur excessive risks in order to demonstrate bloated profits in the short term.

The corporate governance system that arises from the Anglo-Saxon market model is constructed to avoid undermining shareholders in conflict of interest situations.

The second market model is the model from Continental Europe and it is characterized by presenting an elevated concentration of company ownership, in which those in control have a huge influence in decision making. In the Continental European type of markets it is frequently seen that groups of controllers participate in a great number of companies and sectors of the economy. The agency problem in this model is established between the company controller and the minority shareholders, and in this scenario the agent is the controller and the principal is the minority shareholder. Situations could arise in which the agent/controller has incentives other than to increase the value of the company, or else have the ability to extract a profit from minority shareholders. In short, the controller can be tempted to act on behalf of the interests of the controlling group even though that would put the company in question at risk instead of maximizing the value of the company; this can occur in many ways, for example by negotiating with companies the controllers are associated with.

In Continental European type markets, because of the highly concentrated corporate holdings, a small amount of information is typically shared, particularly when it comes to opportunistic information, and in addition, there is generally low participation from independent directors. Finally, it is common in these economies to see capital and financial markets that are not very deep and that are relatively illiquid.

2.3 Market Model and Corporate Governance in Chile

2.3.1 Market model in Latin America

In the majority of Latin American economies, we can see a market structure of the Continental European type, where it is common for companies to belong to large conglomerates that have interests in different sectors of the economy. The elevated concentration of ownership means a high proportion of companies are controlled directly or indirectly by one of the large conglomerates, which in general are tied to native families, or less frequently, by foreign conglomerates, investor groups or associations.

TABLE 1: OWNERSHIP CONCENTRATION IN LATINAMERICAN COMPANIES, 2002				
COUNTRY	SAMPLE	% of LARGEST SHAREHOLDER	% of 3 LARGEST SHAREHOLDERS	% of 5 LARGEST SHAREHOLDERS
ARGENTINA*	15	61%	82%	90%
BRAZIL	459	51%	65%	67%
CHILE	260	55%	74%	80%
COLOMBIA	74	44%	65%	73%
MEXICO*	27	52%	73%	81%
PERU	175	57%	78%	82%
AVERAGE	168.3	53%	73%	79%

* Data from 20-F ADR filings.

SOURCE: OECD, 2004

The evidence presented in Table 1 indicates the percentage of shares owned by the principal actors in the market, confirming the high concentration of holdings in Latin America. Indeed, considering the majority of listed companies in Brazil, Chile, Colombia and Peru, the principal shareholders maintain between 44% (Colombia) and 57% (Peru) of the shares from the set of companies. Expanding the analysis of the three major actors in said markets, we see that they are holdings between 65% (Brazil and Colombia) and 78% (Peru) of shares. In Chile as well as in Peru, the percentage of total shares held by five major shareholders reaches 80% or more. In Argentina and Mexico the concentration of shares can be seen in companies that have issued ADR filings, that is to say those that have been listed in the United States. The principal shareholder in Argentina maintains 61% of the shares and the five major actors reach a level of 90%, which confirms the existence of markets where holdings are highly concentrated; in Mexico the largest shareholder has 52% of the shares and the five largest hold 81% of shares.

In addition to the concentration of share holdings, there are practices that affect the type of relationships that are established between shareholders, controllers and management. In Latin America, it is common to see complex corporate structures that tends to prejudice minority shareholders. The ownership structure of one company corresponds to the way in which it distributes the representative titles of capital from said company among the different owners, whether they be persons or legal entities. The control structure of a company, for its part, corresponds to the manner in which the use of control or authority within the company is distributed, but this does not necessarily coincide with ownership. To the extent that a company grows and becomes more complex, a break between ownership and control can be seen, which can be explained by the contracting of professional management.

While process of separating roles, control and ownership in companies is normal and desirable as they grow, there are times when said break occurs in part because of different goals for the best economic specialization, for example the optimization of tax payments. In Latin America, there are often control and ownership models that are highly complex, that generate better conditions in the event of corporate governance problems, such as:

- **Pyramid or chain structure of cascade corporations:** This consists in the formation of various corporations whose principal holdings are shares from other investment companies, with one of these companies owning shares from the various corporations in question. This cascade structure eventually allows the concentration and leveraging of control over blocks of growing stock. In this way, elevated levels of control can be reached over a company with a comparatively small investment.
- **Dual class shares:** A listed company may issue shares from different classes, some with voting rights and others without them, or with a restricted rights. This practice allows a clear distinction between control and ownership, as the shares with voting rights (independent of the percentage of ownership that they represent) are the only ones that grant control.
- **Cross Properties:** Takes place when two or more companies are holders of each other's shares. This is commonly observed in conjunction with the pyramids of control.

TABLE 2: SEPARATION OF OWNERSHIP AND CONTROL IN LARGE LATINAMERICAN COMPANIES, 2002				
COUNTRY	% of FIRMS WITH NON VOTING SHARES	NON VOTING / VOTING SHARES	% of FIRMS IN PYRAMIDS	% CASH FLOW RIGHTS OF CONTROLLER
ARGENTINA	4%	0.14	93%	68%
BRAZIL	87%	1.29	89%	60%
CHILE	7%	0.07	68%	57%
MEXICO	38%	-	72%	59%
AVERAGE	34%	0.5	81%	61%

* Data from 20-F ADR filings.

SOURCE: OECD, 2004

As the evidence in Table 2 demonstrates, it is common to see complex ownership and control structures. It points out the elevated incidence of pyramid structures, particularly in Brazil and Argentina, as well as the very high proportion of companies that have issued shares without voting rights in

Brazil and the high proportion that they represent (120% of total shares with voting rights).

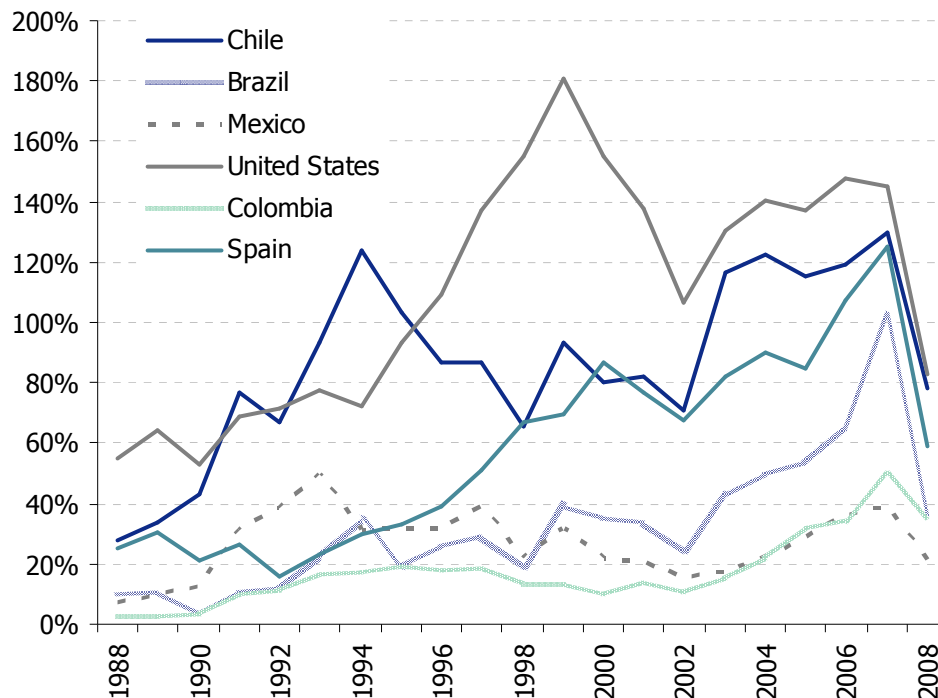
2.3.2 Market model in Chile

As mentioned, the Chilean market presents a Continental European type structure; the listed companies are generally tied to one of the large conglomerates that operate in the country that have interests in different sectors of the economy, including the banking and financial sector. The concentration of ownership leads to the majority of the directors being named by controllers of the companies. A large number of the conglomerates are linked to families and there are also a high number of large family companies

While the concentration rates differ among studies carried out for the Chilean economy, all conclude that the ownership is highly concentrated. Lefort and Walker (2000), who study the ownership structure in Chile during the 90s, have found that close to 70% of non-financial corporations that are traded on the stock market belong to a conglomerate. They also observed that these large groups controlled between 76% and 95% of the directors of companies in which they participated, a proportion that is greater than their stock participation. In 1998 the five largest economic groups controlled 54% of the total stock, and in 1994 said percentage was only 51%, thus highlighting the increased concentration during the decade. The 90s was a positive decade for the Chilean economy, with an average annual GDP growth rate of 6.4%, and in addition, during this period the capital market was deepened. Chart 1 shows that the market capitalization as a percentage of GDP increased sharply reaching levels markedly higher than other Latin American economies. Therefore neither the economic growth nor the deepening of the capital market¹ would have impeded the increase of concentration during the 90s.

¹ While there have been improvements in some aspects in the Chilean capital market, it is still barely development. For example, the stock turnover in 2008 reached only 21%, while the U.S. was 232%, 178% in Spain and 74% in Brazil.

CHART 1: MARKET CAPITALIZATION AS % OF GDP



SOURCE: World Economic Indicators, WB

Agosin and Pastén (2003) investigate the top 177 companies of the total 282 that were traded on the stock exchange in 1999, and found that at the beginning of the 90s, the five largest economic groups were owners of 30% of the market capitalization of the Stock Exchange in Santiago and jointly held interests in 301 companies. They found that the three largest economic groups hold, on average, close to three fourths of shares of the companies investigated. Then, considering the ten largest economic groups, we can see that they hold 90% of total stock. They also indicate that these high levels of concentration are common for companies from different economic sectors.

According to McKinsey (2007), the largest shareholder have more than 30% ownership of 75% of the companies traded on the exchange. Among companies listed on the IPSA stock index, the largest economic group holds 41.2% of the shares, and 61% of stocks are concentrated among the three largest stockholders. They also found that close to 40% of decisions made by companies are made outside of the Board of Directors, demonstrating low standards of corporate governance.

Despite the marked concentration of ownership in the Chilean economy, a characteristic that encourages neither the sharing of opportune information, nor good corporate governance, the results are not so discouraging. The study

by McKinsey (2004) placed Chile as one of the developing countries with the highest compliance to corporate governance principles developed by the Organization for Economic Cooperation and Development (OECD). In addition, according to the opinion of institutional investors, it was the emerging country with the highest level of corporate governance. The new measurement carried out by McKinsey in 2007 shows slight improvements, however there was a setback in its position relative to other economies.

The survey carried out by the World Bank in the year 2009 (“Doing Business 2010” measured the degree of investor protection, particularly of minority investors, in the face of potential abuses on the part of company directors and administrators. They evaluated the transparency of transactions, the extent of directors liability and the capacity that shareholders have for bringing directors and administrators to justice. As seen in the Table 3, Chile receives a general grade of six out of a maximum of ten, placing itself above the average for countries in Latin America and the Caribbean and over the average of the OECD countries. Nevertheless, it receives a low grade in relation to the ability of shareholders to initiate claims.

TABLE 3: PROTECTING INVESTORS, DOING BUSINESS 2010				
COUNTRY / REGION	STRENGTH OF INVESTOR PROTECTION, SYNTHETIC INDEX	EXTENT FO DIRECTOR LIABILITY INDEX	EXTENT OF DISCLOSURE INDEX	EASE OF SHAREHOLDERS SUITS INDEX
LATAM AND CARIBBEAN	5.1	5.3	4.0	6.0
OECD	5.8	5.0	5.9	6.6
ARGENTINA	4.7	2	6	6
BRAZIL	5.3	7	6	3
CHILE	8.3	8	8	9
COLOMBIA	6.0	6	7	5
CHINA	5.0	1	10	4
SPAIN	5.0	6	5	4
UNITED STATES	8.3	9	7	9
MEXICO	6.0	5	8	5
PERU	6.7	5	8	7
VENEZUELA	2.3	2	3	2

There are two specific provisions from the institutional court that limit the occurrence of conflicts of interest in the Chilean market in an important way. First, the 1982 crisis made clear the enormous costs that insufficient regulation causes in the financial market, particularly in the context of a highly concentrated economy, where large economic groups could also participate in the banking and financial sector. One of the consequences of the crisis in Chile was the establishment of a rigorous regulatory system for banking and financial institutions, whose oversight and supervision are charged to highly technical organizations, the Superintendent of Banks and Financial Institutions (Superintendencia de Bancos e Instituciones Financieras - SBIF) and the Superintendent of Securities and Insurance (Superintendencia de Valores y

Seguros - SVS). Indeed, despite the fact that Chile has a developing economy, with capital and financial markets that are relatively shallow, it has sophisticated banking and financial rules and regulations that are applied in a rigorous manner. For example, banks are kept from giving loans to related companies, assets and liabilities in foreign currencies are not allowed, they must have adequate provisions for higher risk loans, the regulator must periodically evaluate the quality of portfolios, and in addition, it has the authority to obligate banks to increase their reserves if they consider it necessary (Agosin and Pastén, 2003).

The second distinctive characteristic of the Chilean market is the presence of large and well developed institutional investors: PFAs are active in the capital markets, which is not a common characteristic of developing countries. Pension funds make up an important actor within the Chilean market, as their value exceeds 60% of GDP and close to 60% of those funds are invested in the domestic market.

3 PFAs, capital markets and protection of minority shareholders

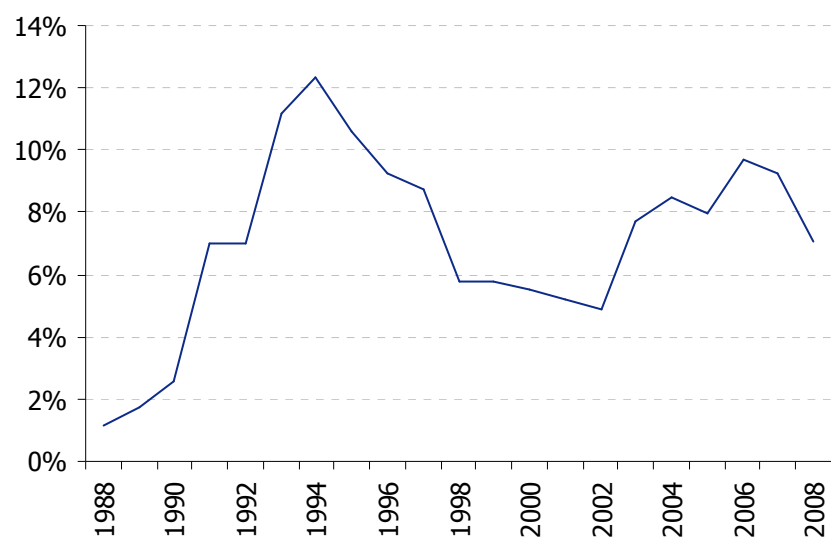
Thirty years ago, Chile reformed its pension system, replacing the former distribution system with an individual contribution system. The effect of this pension system on corporate governance in the Chilean market has been positive and it has materialized through two channels, an indirect one through the development and intensification of the capital market and a direct channel through the direct protection of minority shareholders that have made up the PFAs. This in turn caused an increase in and perfecting of market regulation in regard to conflicts of interest, releasing of information and other aspects that directly relate to the functioning of corporate governance within companies.

3.1.1 Indirect positive influences of PFAs on the corporate governance of companies

The PFAs began investing in stock in 1985 and since that time they have held an important role in the market characterized by being active investors, and contributing to the expansion of the Chilean capital market. Pension funds have provided a huge volume of resources, reaching high levels of participation in the local market setting, as shown in Chart 2. This great financial saving has lead to a known and important provision of pension funds to the Chilean economy in general (Corbo and Schmidt-Hebbel, 2003), and particularly to the capital market, which through different channels has had a positive effect on

the corporate governance of national companies. Indeed, the increase in volume and frequency of transactions has made issuing stock more attractive as a financing alternative to the increasing number of companies that are listed on the exchange. This major and frequent movement of capital has developed advantages in terms of economies of scale, resulting in a financial industry that is increasingly complete and of higher quality, which in turn has facilitated the increase of information and the opportunity to share it, in this way monitoring costs have been reduced. This more dynamic, transparent and professional environment towards which companies are progressing has, in turn, forced them to increase the quality of their corporate governance.

**CHART 2: PENSION FUND INVESTMENT
IN CHILEAN STOCKS AS % OF MARKET
CAPITALIZATION**



SOURCE: World Development Indicators, WB

3.1.2 Direct positive influences of PFAs on the corporate governance of companies

Another channel by which the PFAs, through the funds they administer, have contributed to fostering improvements in the corporate governance of Chilean companies is by directly defending the interests of minority shareholders.

The PFAs manage large amounts of resources, however, due to regulations that prohibit them from individually holding more than 7% of ownership in companies they invest in, they play the role of minority shareholders activists

before the controlling groups of the companies in which they are invested . As seen in Table 4, Pension Fund Administrators collectively hold large percentages, although they are limited in their individual ownership in the majority of companies with an equity presence in the Chilean market.

TABLE 4: SHARES OF HIGH MARKET CAPITALIZATION COMPANIES OWNED BY PENSION FUNDS, SEPTEMBER 2009	
CORPORATE SHARES	% OF SHARES HELD BY THE PENSION FUNDS
ANTARCHILE	2.2%
CAP	9.8%
CENCOSUD	11.0%
CMPC	13.0%
COPEC	6.8%
ENDESA	19.5%
ENERGIS	17.1%
FALABELLA	3.9%
LAN	5.7%
SQM-A	0.0%
SQM-B	4.6%

SOURCE: Santiago Stock Trading and Pension Superintendence

Regulations limit the participation of PFAs in companies, which impedes participating directly in the management of the companies in which they have invested. This is an adequate limitation, given that administrators must only provide services related to pensions; they constitute a unique turnkey corporation, which implies that in investment matters their fundamental job is to manage portfolios, and not to co-manage companies. Adding the job of co-managing companies in which they invest to the functions of the PFAs, would make them lose their focus on, managing pensions, and it would also obligate them to surmount enormous management structures that would impact the cost of the pensions system.

Under the regulatory system that opportunely limits their participation in companies in which they invest, the possibility and responsibility for exercising their shareholder rights (as representatives of the funds they administer) is reduced to participating on Boards of Shareholders and through the election of independent directors, when appropriate. In this way, PFAs in the Chilean capital market have stood tall as the principal minority shareholder, with the distinctive characteristic of being informed, powerful actors whose actions have high public visibility.

The law imposes the obligation on the PFAs to attend all meetings for equity shareholders, bond shareholders and asset managers for contributors of investment funds in which pension funds have been used for the acquisition of stocks, bonds or securities. The board of directors is responsible for designating their representative, who will only be able to act in accordance with the faculties conferred upon them. In addition, it is stipulated that in meetings and assemblies they shall always make a declaration regarding any agreement that is adopted and will record their votes in the corresponding minutes.

The law requires the PFAs to vote for independent directors, in accordance with the definition established by the Corporate Law, and it indicates a series of additional requirements.² Additionally, the law empowers PFAs to act harmoniously amongst themselves and with other minority shareholders in order to elect directors, which facilitates the election of one or more directors. Although it is expressly stipulated that, *“they may not perform any management that implies participation or has influence on the management of the corporation in which they have elected one or more directors”*. While the law establishes standards for the election of directors³, PFAs have gone beyond that, setting up a transparent and professional process for the election of their candidates a few years ago, which requires hiring a consultant for their selection. More recently, in 2009, the Superintendent of Pensions added to the initiative by publishing a registry of directors which establishes the condition that in order to be a candidate for inclusion in the registry (which any professional living in the country can subscribe to), the director must be voted in by representatives of the PFAs.

In this way, we have seen that PFAs contribute to the election of a large fraction of independent directors in Chilean companies, a percentage that has been increasing following the increase in resources invested. According to Iglesias-Palau (2000) in 1998, 10% of all company directors were elected by PFA votes, and data from 2007 indicates that said percentage would reach 16% in the medium term. In any case, it is important to specify that directors appointed with PFAs' votes perform the same fiduciary responsibilities as the rest of the board. Each member of the board has the legal obligation and responsibility to act in the interest of all the shareholders, with the sole objective of benefiting the company as a whole; which is to say that it would be absolutely contrary to their obligations to take action favoring a subgroup.

² See D.L. 3,500 article 155.

³ The AFP board of directors will determine the name of the candidate for whom the board representatives will vote, which together with the substance of this agreement shall be written in the minutes of the board of directors of the administrator. In addition, it is stipulated that the AFP representatives are obligated to declare their vote in viva voce and shall make a record of it in the minutes of the respective shareholders meeting.

Therefore, a director who is appointed by a vote of the PFAs should work to ensure that neither the interests of management, nor those of the pension funds supercede the long-term interests of the company, which will in turn benefit all the shareholders.

An additional aspect to consider is the public awareness of PFA investment in the market. The pension system in Chile is obligated to make contributions to workers' pensions and thus the functioning of the capital market is not of insignificant interest to the society. Prior to this system, participation was reserved for a very small proportion of the population, whereas it can be argued that the current system covers practically the entire working-aged population through their remittance of pension fund fees, and so they should have an interest in the functioning of the capital market.

As a result of this greater public interest and as the transparency and provisions for market information rises, the pressure on companies to provide information in an opportune manner is increasing due to public demand..

The visibility of actions carried out by PFAs and the associated interest that accompanies them, makes for a powerful instrument for confronting and pressuring the controllers of companies in the face of behavior that is contrary to good corporate governance practices, despite their minority positions. In boxes I and II, two cases are exposed in which the PFAs participated where there were complex situations having to do with conflicts of interest and the functioning of corporate governance. The first is a case of disloyalty due in part to a group of shareholders and the second has to do with the failure of a board of directors.

The cases reviewed later reinforce the idea that the PFAs can influence the functioning of the corporate governance of companies. While we don't often see controllers partaking in behavior such as charging fees or inadequately managing roles within companies, the cases we are reviewing show that when it does occur the PFAs are more informed in order to detect them, they have more resources for initiating legal actions and their opinion is heard by the public, which constitutes an additional pressure on the company in question.

Lastly, another important factor of the influence of the PFAs over the functioning of corporate governance, is the effect they have over the regulation of the banking and financial markets. As previously demonstrated, with the individual contribution system, the stock market affects a highly sensitive aspect of the public's interest: their pensions. PFAs have not only managed to get corporations to pay greater attention to them, but have also drawn the attention of the authorities. With pensions depending, in part, on the functioning of the stock market, the regulator has the incentive to improve

their oversight and regulation, given that the poor financial risk managed could have enormous political and monetary costs.

In fact, in 1985 and partly due to the needs that the new pension system imposed, an obligatory risk qualification system was created. As the system has matured, new needs or those aspects that are insufficiently regulated have been seen in these markets.

3.2 The role of PFAs in fostering good corporate governance: A case analysis

The two cases that are reviewed later in this document in which the PFAs have actively exercised the rights they have in the name of managed funds, have each culminated with the enactment of laws that regulates the aspects in question.

- The Chispas Case catalyzed the suggestion for the Initial Public Offer (IPOs) Law that regulates the purchase of shares for taking control of a company. The Act stipulates that those deals led to a series of actions that must be done under the same conditions for all the shareholders of that series. Specific aspects of the law include that: Shareholders may withdraw their shares until the closing day of the offer, the validity of the offer can not be less than 20 days and nor more than 30 days, it is possible to extent by between 5 and 15 days. It is also defined that if there is any dispute, an arbiter shall be appointed.

The Law states that if the number of shares offered by the issuing company is less than the number of shares desired by bidders, the bidders will have to buy them in proportion to each shareholder's bid. If the issuer or any of its related persons acquire shares of the company at a beneficial price between 90 days before and 120 days after the bid, they must pay the highest price paid to the participants of the IPO. The IPOs Act allows PFAs to participate in the offer with the same rights as any other shareholder.

In order to increase transparency and available information, the supplier is required to disclose its intention to the market to take control of the company through its bids. It is also obligated to disclose the details of the bid price, the duration and mechanism of financing the purchase. Furthermore, it must also submit a report containing the financial, legal and business details of the supplier or its controller

- The Fasa case led to the promulgation of the corporate governance law. This Act specifies the concept of privileged information, establishes new

demands on boards of directors and forces listed corporations that have more than 12.5% of their shares in the hands of minority shareholders to have an independent director, who is also assigned a series of functions.

The standard for independent directors generated a big controversy, due to the fact that it threatened the balance granted by “one share, one vote”. Nevertheless, the intent of the standard is to solve the collective action problem that can present itself during the election of directors if minority shareholders are not able to come to an agreement. It establishes that if none of the individual candidates obtain a sufficient majority, the one with the highest number of votes will be elected.

It is still necessary in Chile to become more aware of the relevance of corporate governance in business and economic success. It is practical to think of additional measures that can be taken with the objective of improving the standard. For example, there could be an incentive for the certification of the corporate governance of companies (similar to risk qualification) in order to make their functioning more easily observable by the market, and eventually, to increase the demand for it in this respect. Another interesting alternative is to promote the introduction of a *controller* who would carry out a new role in companies, which could consist of one person or a group of people reporting directly to the board of directors who is autonomous to the management of the company. They would be charged with reporting all risks that the company could face, and to that end they would be absolutely independent and have powers granted by the board of directors to seek information at all levels of the company.

Beyond the particular corporate governance situation in Chile, the recent financial crisis has made clear the high costs that deficiency in the markets can have in this matter. It is practical to envision a greater preoccupation by the market with aspects relating to risk management within the companies, the establishment of rights and responsibilities for all parties who have an interest in the company, control and decision making mechanisms, among many other factors that reflect the quality of corporate governance in companies.

3.2.1 The Chispas case ⁴

A hallmark example of when the defense initiated by PFAs in the interests of minority shareholders is in the context of what has become popularly known as the Chispas case.

⁴ Based on Agosin and Pastén (2003). Self Translated

In 1997, Enersis, the largest electricity holding company in Chile was sold under irregular circumstances to Endesa España, from Spanish holdings that operated in the same sector. Enersis was originally a public company: Chilectra Metropolitana was privatized in the late 80s, by the mechanism known as "popular capitalism", according to which workers and administrators could acquire shares of their own company. Through this mechanism the general manager of the government utility company became the principal holder of shares of the privatized company. Later, restructuring and investments were realized, which turned Enersis into a holding company. The Enersis controllers were a series of investment holding corporations by former workers, which jointly held 32% of stock. The conglomerate grew and acquired control of the principal electric generation company: Endesa Chile. The different investments in Enersis signified an increase of 50 times its value, making it one of the largest conglomerates in Latin America, with interests in Chile, Argentina, Peru, Brazil and Colombia.

When Endesa España made the purchase offer, various PFAs held a large portion of shares in Enersis. Nevertheless, the power of the PFAs in the company was minimal. Each of the small "Chispas" that made up part of Enersis had class A and B shares. The class A shares had rights to greater dividends, but did not have voting rights. Therefore, Enersis was really controlled by the holders of class B shares, even though they only represented 0.06% of the company. The former general manager of Chilectra Metropolitana was the principal holder of the class B shares.

Endesa España negotiated directly with the controllers and made a public offer to acquire class A and B shares, proposing a price 840 times greater for class B shares (\$220 was offered for class A shares and \$185,000 for class B shares). In addition, Endesa España gave holders of class B shares the option of purchasing their own shares at a preferential price and assured them that they would be kept on as Enersis administrators for at least five years.

The small individual shareholders –mainly former Chilectra Metropolitana employees- were very happy with the sale, taking into consideration that the price of shares had multiplied many times in just ten years. Nevertheless, the PFAs that had greater knowledge protested about the operation because they thought the benefits of holders were being unequally distributed. Furthermore, the PFAs argued that there were prejudicial effects for minority shareholders that did not accept the offer for class A shares.

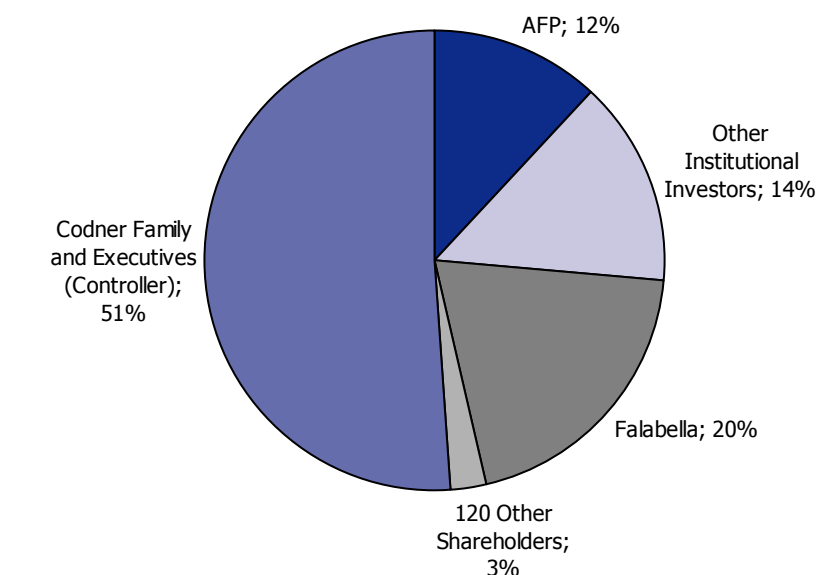
The PFAs were successful in their suit and eventually the operation was revoked by the Chilean courts. Endesa España was finally able to acquire Enersis in 1999, but the former controllers were legally excluded.

3.2.2 The Fasa case

Fasa (Farmacias Ahumada S.A.) is a chain of pharmacies that had 1,255 branches in Chile, Mexico and Peru in December 2008..Its sales in that same year reached USD 1,769 million. Fasa's history begins in 1969 with the opening of its first branch in Santiago, Chile, after a period of growth in the Chilean market. In 1996 it begins the internationalization of the company through the opening of Boticas Fasa in Peru, and that same year the affiliated company Laboratorios Fasa S.A. was created, which developed products under its own brand.

In 1997 the company went public on the commodities exchange in Santiago, raising close to USD 21 million. The next year, the Chilean holding company Falabella S.A.C.I whose principal activity is minority trading, acquired 20% of Fasa and the North American investment fund Latin Health Care Fund acquired 7.7% of the holdings. These operations implied an increase in Fasa's capital equal to USD 47 million. Despite the incorporation of these new shareholders, the Codner family, the founders of the company, always maintained control over it. As shown in Chart 3, in September 2009 they held 51% of Fasa shares.

GRAPH 3: OWNERSHIP STRUCTURE OF FASA, SEPTEMBER 2009



Source: Fasa

FASA is managed by a board of directors made up by nine incumbent members and nine alternate members, who hold terms of three years in their

jobs and can be reelected. The board of directors that was working at the beginning of 2008 had been set in April 2007. At the head of it was the founder and CEO of the company, José Codner, and with his votes four other directors had been elected: Eduardo Bellinghausen, Gabriel Berczely, Alex Fernández and Jaime Sinay. Two directors were elected by the PFAs votes: Pablo Lamarca and Ernesto Labatut. The remaining two directors were elected by Falabella's votes: Juan Cuneo and Juan Benavides, whose positions were vice president and general manager of the holding company, respectively.

In Chile, the pharmaceutical market is consolidated and made up by three large chains –Fasa, Cruz Verde and Salcobrand- that jointly monopolize more than 90% of the market (Fasa with close to 30%). An intense pricing war began in 2005 that lasted almost three years, which squeezed the profit margins. In December 2008, the National Economic Attorney (Fiscalía Nacional Económica - FNE) filed an injunction against the three pharmaceutical chains that had come to a collusive agreement, in order to put an end to the pricing war and so began an upward trend in the price of medications. The injunction specifies, "the defendants executed and participated in acts and conventions for the purpose and for the result of creating a full-fledged upswing in the retail price of pharmaceutical products, impeding, restricting or deterring free competition". On March 13, 2009 a settlement was agreed upon between the FNE and Fasa, in which the latter accepted the charges and provided evidence, however it stipulated that *"neither the Executive Vice President nor the board of directors ever had knowledge of said acts [collusive agreement], much less did they agree on or order them"*. The settlement also established a fine equivalent to a little over one million dollars. In exchange for their confession and cooperation, the FNE dropped the charges against Fasa and its executives.

The settlement between Fasa and the FNE was made public on March 24, however the board of directors was only informed the previous day at 17:20. On March 28, in a meeting of the Association of Pension Fund Administrators (Asociación de Administradores de Fondos de Pensiones - PFA), the PFAs, in their capacity as minority shareholders, declared their concern and eventually called for a special meeting for Fasa shareholders. Given that more than 10% of Fasa stock were held by five PFAs, regulations allowed them to demand a special shareholders meeting that would have to be called within a maximum period of 30 days. On March 30, the company directors appointed by the PFAs and Falabella sent a letter to the controller and president of the board, José Codner, in which they requested the removal of the executive vice president, Alejandro Rosemblatt (Codner's son-in-law) and the company's attorney, Sergio Mesías, because they had not informed the board of directors regarding the evidence of collusion that had been discovered in the company, nor the negotiations taking place with the attorney general. Sources close to the board

of directors indicated that during the board meetings held since December 2008, the controller assured them that the FNE's injunction would have had no effect. The renowned collusion was also reputed in a letter, and management was criticized for not knowing about it. In the second letter, sent by Juan Benavides (general manager of Falabella and Fasa director), there was a request for a special shareholders meeting, following the letter that had already been written by the PFAs, so that the management could explain the scope and consequences of the collusion agreement. On March 31, the controller and the four directors appointed by him made a public statement in which they bewailed the public criticism made by the other directors -those that were from Falabella and the PFAs- and announced their whole hearted support for the actions of the executive vice president and the corporate attorney; following them, Fasa management had the duty to enter into a settlement with the attorney general, which they also believed to be a good arrangement for the shareholders.

The shareholders meeting and the special shareholders meeting were held on April 28. The meeting was extremely tense, with strong accusations between both parties. The aforementioned occurring despite Fasa management having previously approached the PFAs in order to explain the settlement reached with the FNE. Nevertheless, the PFAs, as well as Falabella, insisted on the removal of the executive staff from the pharmaceutical company; this request had already been presented in the board meeting a few weeks before, although it had been rejected five votes to three.

In the tense meeting, Juan Cuneo (director appointed by Falabella and vice president of that holding company) maintained that "the decision that has brought about one of the most complex crisis in the history of Fasa should have been discussed, analyzed and defined by the board of directors." Then he added that he did not understand "why the responsible parties are not being sanctioned and why the management that should have been capable of detecting these acts is still in the company." Controller José Codner justified management's actions by saying, "Believe me, there were mandates. Morally, we should have gone to the board of directors, but *we did not have a board that I considered to be fit* to risk the settlement that we had with the attorney general (of the economy)"; then he added, "Why was the board of directors not informed at its base? The first one who should know is Juan Cuneo and he should stand up to the consequences." At this point the controller alludes to the existing trade relationships between Falabella and one of the competitor's pharmaceutical chains, and also to their relationship with some laboratories, a situation that would also affect the directors appointed by the PFAs.

Finally, a fact that curiously was not objected to by the Superintendent of Securities and Insurance (Superintendencia de Valores y Seguros - SVS), a

vote was submitted to approve the 2008 certificate and payment of dividends report, however the voting was line by line, and so those opposing the minority shareholders were not included.

After the meeting, which was attended by a representative of the regulator, which is not common, the minorities continued to insist on the necessity of restructuring the board of directors. José Codner's attorney met with each of the PFAs looking to come to an agreement, however Codner's proposal did not leave the PFAs convinced, given that it did not include making adjustments to the board of directors. After the failure of these attempts, the PFA of Habitat publicly requested the removal of Codner from the board of directors and of Rosemblatt and Mesías from the management. Capital's PFA went even further and announced that it would submit a claim against José Codner based on infractions of corporate statutes and corporate law, for which the PFA requested the collaboration of an arbitrary court in accordance with Fasa statutes. The claim was finally presented on August 20, in which Codner was also accused of causing "damages, injuries and even deprivation of rights emanated from the actions of Fasa". In response, the President of the pharmaceutical company filed a countersuit against the PFA for its liability in the abusive exercise of its shareholder rights and for damaging the image and honor of José Codner. In addition, he filed a claim against Capital PFA's mother company, ING, in the Netherlands in response to a meeting held by the management and the directors appointed by the PFAs, which supposedly implicated an undue manipulation of directors in order to breach their confidentiality duties.

On July 2, the SVS filed charges against the entire Fasa board of directors and their executive vice president. Charges were filed against Codner and Rosemblatt for exceeding arrogantly exceeding the powers (Codner) of their roles as directors and not informing the board regarding the settlement agreement. The eight remaining directors were accused of lacking the diligence to obtain information. The PFA Association expressed its public backing of SVS' action, although it stated it trusted the actions of the directors elected by its members' votes.

The filing of charges by the SVS generated a new break in the board of directors, this time between the controller and the four directors appointed by their own votes, given that they had begun to work toward protecting their prestige, as reported to the press by sources close to Codner. The situation became unbearable and finally on November 3, a special meeting of shareholders was called to renovate the board of directors and to announcing that it would work on formulating a code of corporate governance and upgrading the company's code of ethics. Nevertheless, this new corporate governance plan also caused friction when Codner proposed Fernando Lefort

to be appointed consultant (Subject Matter Expert), which was questioned by various directors (including those elected by the controller's vote), and in turn six of the nine directors requested a special meeting. The reason for opposing Lefort's appointment was that he wrote a report for Codner to be presented in the arbitration hearing held with Capital's PFA. The two other issues that were argued when presenting the claim were the lease of an office paid by the pharmaceutical company for Codner and his salary as CEO of FASA, which surpassed 9% of the 2008 annual company earnings.

On November 4, just one day after the special shareholder meeting was called, José Codner resigned as Board President and CEO of Fasa, though he announced he would stay on as director. He communicated his decision to the rest of the Fasa directors through a letter in which his indignation was apparent: "Now you have practically no weapons against our Krumiros⁵ of the board of directors elected by us: Jaime Sinay, Gabriel Berczely, Alex Fernández and Eduardo Bellinghausen. Yesterday I lost a vote with seven opposed and one abstention". In another part of the letter he adds, "I hope to never see any of you again for the rest of my life." A week later Gabriel Berczely sent a harsh response letter to Codner in which he reproached Codner that their only liability (directors elected by their votes) was not to commune with his deliria, and added "you have created the board of director's problems, not only with your decision to omit information, but mainly with your subsequent actions: incendiary statements, aggressiveness in board meetings, reiteration of decisions without consulting the board, etc."

Finally, on November 26, a Fasa shareholders meeting was held in which José Codner was removed from the board of the directors and the four directors elected by his votes were also called for removal. The directors elected by Falabella maintained their positions, and those elected by the PFAs may have resigned, however the administrators did not achieve the realization of the selection process for new candidates, and so they were asked to stay on as directors until April.

Enrique Cibié, President of Fasa Peru, became president of the board. He was close to the controller and also had the approval of Falabella and the PFAs. Additionally, by the vote of the controller, the following people were appointed: Álvaro Fisher, businessman; Emilio Rodríguez, president of LAN Peru; Nicolás Tagle, attorney of José Codner's consultancy office; and Fernando Lefort, expert scholar in corporate governance. The general manager and Codner's son-in-law, Alejandro Rosemblatt, was also replaced by Marcelo Weisselberger, who acted as corporate finance director for that same company.

⁵ Krumiros: Strike Breakers

On January 4, 2010, the SVS sanctioned the president, top executive and directors of Fasa for noncompliance with the obligations imposed by Corporate Laws. The SVS states that *“these sanctions have to do with the responsibilities of corporate governance of these directors for the inadequate procedures followed in the face of the process taking place against FASA by the FNE.”* The only executive against whom charges had been filed, but that was not fined was the attorney, Sergio Mesías, because it was believed that he was only following orders.

Specifically, the executive vice president, Alejandro Rosemblatt was issued a 2,000 UF⁶ fine for *“not duly informing the board of directors and in a opportune manner”*. The board president, José Codner, was fined 1,500 UF because *“he assumed the functions of the decision making body [the board of directors] that was created to manage the company, through his decision to omit all information regarding this matter from the members of such body”*.

In addition, the SVS fined the rest of the company directors 300 UF each for *“not having duly and opportunely exercised their legal right to inform one another, as they should have in light of the facts that they had.”* The regulator questions how, with the FNE investigation against FASA being of public knowledge, a matter that was mentioned in June 2008 according to the board minutes, plus the board of directors being informed in December 2008 regarding the hiring of an expert attorney to have at arm’s length (even when the hiring was done six months earlier), the directors did not consult, analyze or question the supposed act of collusion or the process that FNE was following while in the meetings.

All of the sanctioned parties appealed their fines imposed by the SVS, except José Codner, who decided to pay the fine, even when he appeared to be against the resolution made by the authorities. He made his decision known through a letter sent to the SVS, in which he harshly criticized the settlement *“I inform the superintendent of my total and absolute rejection to the content and the decision adopted”* he then adds *“the fundamental error in the resolution... consists in that it attempts to –not only in a pretentious manner but also an illegal one- create illegal conduct out of thoughts and actions that really are not that but just a manifestation of prude judgment (and definitely of individual freedom) on the part of a fiduciary administrator... an extraordinarily grave precedent is being set, which implies that the SVS could co-manage companies”*.

Although the failure of the board of directors is evident, which affects the participants jointly, it does not seem as appropriate to impose sanctions on the

⁶ At December 2009 an UF amounted USD 41, so that the fine of UF 2,000 is equivalent to USD 82,708.

directors for “*not exercising their right to inform one another*,” as we should not lose sight of the fact that their role is a directive, and not an executive one. Although it may be desirable in some cases for directors to be more inquisitive, the threat of a fine may affect their strategic role by muddying it up with topics of an operative nature.

It is worth pointing out that the failure of this board of directors was brought about due to poor management carried out by the controller and the top administrative staff of the company. In this case, the problem did not occur because of a contingent extraction of fees from minority shareholders, but because of a lack of diligence and understanding of the board of directors' rights and responsibilities.

The settlement with the FNE made clear the erroneous practices and procedures carried out in FASA. In fact, the board of directors would have probably approved of the settlement if it had been presented to its members, just as some members of the board reported later on. Effectively, the deal was beneficial to the interests of the company, given that it reduced the potential fine from USD 15 million to a little more than USD 1 million, and FNE declined to file complaints against FASA, its directors, executives and workers.

A decision was made to not follow the appropriate procedure, which disobeys the Corporate Law article 39 that establishes the right of directors to be informed; according to the controller, this is due to his lack of confidence in the board and his fear that the settlement would get out, which would have implied his failure. Again, the Law in force stood out, which article 43 requires directors to keep information confidential. In addition, if suspicions exist as to whether a director has conflicts of interest, the law grants authority and mechanisms, such as attending the shareholders meeting, to resolve the issues. The unfortunate statements made by the controller in the shareholders meeting on April 28, brought about a definitive rift in the board of directors and the controversy continued with a series of accusations back and forth.

Another important milestone of this case was the entrance of the SVS into the conflict before the authorities announced it. The problems within the board of directors pitted those elected by the controller against those elected by the minority shareholders. Then, the controller lost the backing of the directors he elected, and the public accusations continued with Codner's salary coming being questioned, along with the hiring of a few attorneys and the leasing of offices which were charged to the company.

The failure of this board of directors negatively impacted the images and reputations of FASA as well as that the executives involved.

Finally, the SVS imposed fines on the entire board, the controller and the executive vice president. The board of directors, for its part, was partially revamped, but kept the directors that had been elected by the minority shareholder. The top administrative staff was also replaced and work was done to fully reform the corporate governance system and rewrite the corresponding code. The code of ethics was also updated, as well as the policies for the delegation of authority and the formation of ethics channels.

According to a survey carried out by Ernst & Young together with the El Mercurio newspaper that consulted 119 top executives from the largest companies in the country regarding the Fasa case, more than 60% of those surveyed reported they had taken measures within their respective companies at the management or board levels to introduce a new code of conduct or internal regulation. Furthermore, 53% of those surveyed affirm that the board of directors of their company has increased their requests for information from management.

4 Conclusions

The effect of the individual contribution pension system on corporate governance in the Chilean market has been a positive one. We can clearly see two channels through which the system has impacted the corporate governance of companies.

In 1981, the pension system in Chile was reformed, replacing the former distribution system with an individual contribution system. This system greatly increased domestic financial savings, streamlining and expanding related industries. Indeed, the increase in the volume of transactions and in their frequency has allowed them to take advantage of economies of scale, which facilitated the surge of more and more professional and competitive industries, in addition to an increase in the information available and an improvement in the spread of opportunity. This environment has progressively imposed greater demands on the administrative requirements on securities companies.

Another channel through which PFAs, through the funds they manage, have contributed directly to improving the corporate governance of Chilean companies is through actively exercising their rights as minority shareholders. While the PFAs manage large amounts of resources, regulations ban them from possessing more than 7% of stock in companies they invest in individually, thus as the principal minority shareholders in the Chilean market they have stood up to the economic groups that control companies where they have invested their resources. Under these regulations, the PFAs have to

exercise their right as shareholders through their participation in Shareholder Meetings and through the election of directors proportional to the shares they own. The regulation expressly demands that the Administrators (or a representative thereof) participate in all meetings, for which a voting record should be kept in the minutes. Additionally, the PFAs are authorized to make arrangements amongst themselves or with other minority shareholders for the election of one or more directors, as appropriate, which must be independent parties according to the definition of the law. In this way, it has been observed that PFAs have contributed to electing a significant portion of independent directors in Chilean companies; a figure, which in 2007, represented 16% of directors.

PFAs have the capability to influence the functioning of corporate governance in companies despite possessing a small proportion of stock. They have the capability of confronting controllers if necessary because they have a strong weapon: the visibility of their investments and the interest surrounding them. While it is infrequent in Chile to see controllers abuse their power by attempting to extract fees from minority investors for example, when that does occur the PFAs are increasingly informed on how to detect it, they have more resources for initiating legal action and their opinion is heard by the public, which constitutes a significant deterrent to economic groups considering abusing their power.

One fundamental aspect of the Chilean system that has created these dynamics that is workers' obligation to contribute to the pension system. This has raised the public's attention and the regulatory authorities' that monitor the functioning of the financial markets. Prior to 1985 (when the investment of pension funds in stocks was authorized), the stock market was reserved for a very small proportion of the population. It can currently be argued that practically the entire working population, through their contribution to the pension fund system, has –or should have– an interest in a functioning capital market. As a result, pressure exists to increase the transparency and information available to the market.

The requirement for Chilean workers to register with the individual contribution system exposes the authorities to an extremely high cost in terms of economics and politics. The regulator will have more incentive to improve the oversight and regulation of financial markets, given that they are highly exposed to risks resulting from poorly functioning markets.

It is possible to identify regulations that PFAs have had a hand in creating. In 1985, very much in line with the needs of the new pension system, the obligatory risk assessment standard was created. After the Chispas case in 1997, the Public Acquisition Offer Law was passed, which regulated the

purchase of shares resulting in taking control of a company. The Fasa case, which is the most recent example (2009), fostered the passage of the Corporate Governance and Independent Directors Law by the authorities.

The enormous volume of resources that make up pension funds demand highly competent and professional management; this explains why in many cases the PFAs have stayed ahead of the market and the regulators by raising questions and demanding higher standards. For example, as a result of the Fasa case an intense debate began regarding independent directors and their roles in corporate governance in listed companies. Nevertheless, some years before that, PFAs showed the importance of independent directors, which is reflected in the changes to the director election process that they carried out in 2006. In addition, Provida and Habitat PFAs introduced the idea of imposing a time limit for the re-application of candidates to the board of directors, as well as a term limit.

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