

Politics of the implementing a Corporate Governance Reform: Some Lessons from The Chilean Experience

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1. BACKGROUNDS

The topic of corporate governance in Chile was relatively unexplored until 1997, when the so called “Chispas” case drew public attention. This episode involved Endesa España, a Spanish utility holding company, and Enersis, the holding company of Endesa Chile, at that time the largest private electricity company in Latin America. In early 1997, Endesa España met several executives of Enersis with the intention of consummating a strategic alliance in which Endesa España would take control of Enersis so it could control also Endesa Chile. Among these executives, was the CEO of Endesa Chile and President of Enersis. The objective was to acquire the so called “Chispas” stocks. The “Chispas” were a set of mini-holding companies, originally established as part of an employee stock ownership program. Their sole assets were shares in Enersis. These shares represented 29% of the ownership in Enersis which owned in turn 20% of Endesa Chile. Each Chispas had two classes of stock, Class A shares, that had almost 100% of the ownership but no voting rights and Class B stocks that represented little equity in the Chispas, but had all the voting power. Class A shares were owned mainly by a number of small shareholders and pension funds and Class B shares were in the hands of the above mentioned Enersis executives.

Endesa España wanted to acquire both classes of shares and launch a tender offer to acquire the Class A stock of the Chispas. The executives promoted among the shareholders the idea that the price offered by Endesa España was a good deal, but several market participants expressed their disagreement. Even though Endesa España was successful in acquiring the proportion of ownership needed, the operation reached unusual publicity because of the large price differential between class A and class B shares (the latter being priced 1.000% higher).

However, in October of that year some details of the acquisition strategy were made public by the press, because Endesa España had filed several documents with the US SEC and the Spanish CNMV, explaining the terms of the agreement (Endesa España shares were publicly traded in both countries). Among these terms, were payments to the executives, linked to profitability goals, the right for Endesa España to appoint a parallel CEO in both Enersis and Endesa Chile and the possibility of Endesa España operating in the Latin American region without the participation of its Chilean partner. The Board of Directors of Enersis, in which the only minority directors were those elected by the AFPs (Chile’s

Pension Funds), declared that the details of the alliance were unknown to them, and rejected it completely. The CEO was dismissed and Endesa España agreed to reconsider the agreement.

The main experiences of this episode were the asymmetric distribution of the control premium, evidenced in the different prices paid to Class A stock and Class B share of the Chispas, the capacity of shareholders with more negotiating power (i.e. Enersis executives) to obtain better prices for their shares, the disclosure of material information to foreign regulators while withholding the information domestically even though it critically involved a Chilean company, the lack of diligence of minority directors in controlling and monitoring managers, the subsequent squeezing-out faced by shareholders unwilling to tender their shares and, the power vacuum generated by ADR holders disabled by law to vote and elect directors.

2. THE THEORY BEHIND THE REFORM

As a consequence of this episode, the Chilean government set out to design a new regulatory framework for corporate governance and takeovers. To assist in this effort, the Ministry of Finance and the Superintendency of Securities and Insurance called the assistance of the IFC (International Finance Corporation) in order to have an external partner with recognition and experience.

The first task involved devising a theoretical framework that would support the entire design and subsequent debate of the bill. Therefore two main areas in corporate governance were identified: the agency problem and the private benefits of control. The first involving the different incentives faced by managers in contrast with shareholders and the latter, related to the fair distribution of value among the different shareholders.

At that time the main problem faced by the Chilean corporations was related to private benefits of control, since the ownership structure is ordinarily rather concentrated.

The problem of private benefits of control itself can be decomposed into two areas: firstly, transfer pricing and misdirection of corporate opportunities and secondly, takeovers.

The issue of transfer pricing implies that managers and directors selected by the controlling shareholders (insiders) enter into agreements on behalf of the corporation with parties in which the controlling shareholder have a greater share of the equity or some other sort of economic interest. For this reason, it is not uncommon for companies legislation and corporate statutes to require shareholder approval of sales of all or substantial part of corporation's assets.

The problem of misdirection of corporate opportunities is related to the capacity of controlling shareholders to appropriate for themselves commercial opportunities beneficial to the corporation. The classic case is when a potentially profitable business opportunity is proposed to the corporation and the controlling directors redirect the business toward another firm in which they somehow have a greater economic interest.

A number of mechanisms have been put in place in different contexts to deal with the problem of concentration and the resulting problems of transfer pricing and misdirection of corporate opportunities. Among them: the one share-one vote principle, the reinforcement of the voting rights, the requirement of high quorums for shareholders meetings and the existence of preemptive rights and withdrawal rights. Some of them were already existent in Chile by the time of Chispas case, but others were included or reinforced in the new regulation.

A takeover is another type of mechanism through which insiders or controlling shareholders can benefit privately at the corporation's expense. Clearly, takeovers are efficient mechanisms to discipline the management and the new regulation was designed in the sense of not to discourage them, although clear and defined procedures and rights were set.

Takeovers are carried out when the bidder believes it can extract benefits from the acquisition. Those benefits are related to the capacity to generate higher cash flows for the corporation (in that case the transfer is said to be efficient) or to the capacity to extract private benefits at expense of the corporation (being an inefficient transfer).

When a takeover is initiated, the bidder offers to pay a price per share higher than the current market price with the expectation that its controlling position would allow him to create more value than the incumbent. A central issue is who is the beneficial owner of that

differential, known as the “control premium”. The central argument in the design of our regulation was that a stock is worth the present value of its cash flows and therefore if the control premium is due to an efficient transfer, then it must be allocated equally among all shareholders. On the other side, if the control premium is due to an inefficient transfer (private benefits for the insiders) then it also must be allocated among all shareholders since those private benefits are extracted from minority shareholders.

3. THE REFORM

Having set the theoretical framework and the principles to be followed, the Chilean government designed the bill on Tender Offers and Corporate Governance that included the following central topics:

Tender offers: A tender offer must be made whenever the acquisition allows one person or group acting in concert to control the corporation. The price per share must be the same and prorated for all shareholders. Additionally, the controller is required to carry out a tender offer for the remaining shares, whenever its interest reaches two thirds of the voting shares. Also, when the intention is the attainment of the control of a subsidiary, a tender offer for that subsidiary must be made tendering for the shares of the holding company.

Related party transactions: These transactions must be approved by the board of directors, those with interest in the transaction are not allowed to vote, and be consistent with standards of fairness similar to those that normally prevail in the market.. The option of an independent assessment appraised is required in certain circumstances.

Auditing Committee: The creation of these committees is required for corporations with a stock value greater than US\$ 45 million. The committee must be composed mainly by independent directors when possible, and their tasks are the examinations of reports of independent auditors, executive compensations, related party transactions and other tasks established in the company's by-laws.

Derivative lawsuits: Derivative lawsuits were included to allow a shareholder or group of shareholders of a company, holding at least 5% of the company's shares, or any director of the company, to claim, in the name and on behalf of the corporation, for a compensation of the losses caused to it by anyone which has violated the Corporations Law, its regulations or the company's by-laws.

Rights of ADR holders: ADR holders are allowed to vote at shareholders meetings, and to exercise withdrawal rights and preemptive rights¹.

The new regulation on corporate governance resulted in a modern legislation in accordance with the current principles on this issue. As such, Chile has been highly rated by international entities in the degree of shareholders protection. For instance, the Santander Central Hispano bank rated Chile first among the major Latin-American markets in shareholder protection; McKinsey&Company highlighted the low shareholder protection premium required for Chilean stock, implying reduced ground for improvement and the World Bank's ROSC report observed that Chile broadly observed all of the principles on corporate governance set by the OECD.

4. THE POLITICS OF IMPLEMENTING A CORPORATE GOVERNANCE REFORM

The Chilean government initiated the discussion of the law on corporate governance in early 1998 and, in early 1999, the bill on Tender Offers and Corporate Governance was presented to the parliament for discussion. Undoubtedly, it was a long and complex task, but a number of factors that affected the success of a reform on corporate governance were taken into account.

Circumstances: public opinion is importantly affected by the circumstances surrounding the discussion of regulation on corporate governance. For example, depressed stock markets and public awareness events raise the public attention in the direction of regulatory action. The latter was the case of Chile, where the Chispas case reached such a public notoriety that there was a broad consensus that some regulation must be erected relatively soon.

Interest groups: An important part of the initial opposition to some aspects of the bill was based on lack of adequate knowledge of the initiative. Some of the most common criticisms

¹ The bill also included topics not related to corporate governance: The reform set the ground work for the creation of an emerging market for small companies, the liberalization of requirements for mutual funds (minimum equity, number of shareholders, participation in shareholders meetings, short sales and allowable investments), the creation of funds for qualified investors, the liberalization of investment management for investment (closed -end) funds, the creation of stock options and the increase of resources for the Superintendency.

were that the new regulation would imply an expropriation for current insiders, that it would deter foreign investment, that it would bring about the de-listings of corporations or that it would merely imply greater costs for shareholders. Therefore, it was very important to carry out a promotional effort. That task was carried out by campaigning with the objective of reaching some critical mass of advocates to share their positive views with other market participants. In that sense, investors were especially active in advocating the reform. SVS² organized meeting with top executives of Pension funds, investment funds and foreign investors with entrepreneurs and legislators in order to convince them of the benefits of the initiative. Political parties, of course, were the central players in the process. The vision of the initiative had to be centered and balanced, since right-wing political factions would immediately oppose a bill with anti-entrepreneurship connotations and, on the other side, the center-left parties would not support timid initiatives³.

With the passing of time, the principles underlying the proposed reform were understood by most of the parties and, most importantly, these were perceived to be fair. When persons perceive something is fair it gets difficult for them to oppose to it.

Ownership structure: Regulations protecting minority shareholders rights can face strong opposition from controlling shareholders. This happens to be the Chilean case where the major corporations are controlled by shareholders owning around 70% of voting shares. But that is precisely the reason why a reform was so important, since the development of participative stock market requires clear regulations for all constituencies and especially for minority shareholders. Nevertheless, minority shareholders can be comprised by institutional investors, like Pension Fund, Mutual Fund, Investment Fund or Insurance Companies, which are more sophisticated and are able to monitor their investments more efficiently producing positive externalities to the market. These are particularly listened to by regulators and legislators. Recent privatizations experiences are important also. Legislators worry about the protection of small shareholders and the governance structure of newly privatized companies.

² SVS is the Chilean Securities and Insurance Commission

³ The Executive was represented by a center-left coalition and the Parliament had a balanced representation of government and opposition. To approve the bill it was necessary to create a majority in each chamber including votes from both the opposition and the official political parties.

Design of the bill: In Chile, the contribution of external advisors was important, since they helped to build a good theoretical base and enriched the discussions thanks to their experience in the implementation of similar regulations. The good name of recognized international organizations and persons also contributed to promote the initiative. The presentation of the bill was rigorous and included theoretical discussions, international experiences and detailed analyses of cases and scenarios. Additionally, some consideration must be given to the inclusion of topics different from corporate governance, in Chile the the bill on Tender Offers and Corporate Governance included a set of others instruments aimed at liberalizing and promoting the capital market. That was an additional measure that contributed to add support to reform, because the bill had to be approved as a whole. Finally, the inclusion of a transition mechanism can be useful when facing reforms felt by some to be too radical if implemented at once, in the Chilean case, a three-year opt out provision was included⁴.

Integration with the world: To the extent a country is more integrated with the rest of the world the more necessary it is to adopt best practices especially in the capital. When politicians and interest groups are aware of the need to attract foreign investment, the process of adopting corporate governance rules becomes easier. In Chile, an important part of the argumentation in favor of the new rules was based on the need to reinforce access to foreign equity by improving the protection of overseas investors. Moreover, the adoption of shareholder protection rules is vital for stock exchanges looking to reinforce of their presence in the region. The Chilean stock exchanges understood that loose protection mechanisms would intensify the migration of Chilean corporations abroad.

Communication policy: The SVS relied heavily on the publicity of the bill in order to expose its vision of the reform and to put the topic of corporate governance friendly on the public agenda. The Superintendent attended to an important number of seminars and the SVS published a book including the opinion of several academics in relation to the reform.

Negotiations: The political position of the government was complex, since it was necessary to navigate between two different approaches. each associated with one political coalition. For instance, right-wing parties wouldn't support a bill that from one moment to another

⁴ This is a three year exemption of mandatory tender offer.

would withdraw the control premium from the controlling shareholders. That was one of the final obstacles in reaching a consensus. Therefore, the government had to negotiate with these senators the possibility of a transition mechanism that would allow the current controlling shareholders to opt out from the regulation on tender offers for a period of three years. Harshly criticized for some congressmen of the ruling coalition, the opt out provisions almost caused another important delay in the approval of the law. With hindsight though, there were no avalanches of takeovers, which was the effect that some expected as a consequence of the provisions. As this article is being written, the opt out period is about to finish and a definitive and sound regulation on tender offers will be fully in place soon.

4. CONCLUSIONS

If a bill on corporate governance is promulgated according to the basic principles on this issue, so it is not substantially changed along its way through the congress, we can say we were successful in creating a strong regulation on corporate governance. Also, success implies that reform must be understood, accepted and faithfully complied with.

In order to meet the proposed goals, a number of factors can play in favor or against and the government must be prepared to strengthen the positive aspects and to deal with the adverse ones. These factors include: (a) the circumstances that chronologically surround the discussion; (b) the existence and weight of interest groups; (c) the degree of integration of the market with the rest of the world; (d) the communication policy and (e) the process of negotiations among the parties.

Public opinion is affected by the prior events and by the way these are informed and interpreted by the media. The public influences the legislators, who are also influenced by other groups with different interests. It is important to coordinate alliances with institutional investors so these can turn into active promoters of the reform, not only toward legislators but also toward the parties against it.

In the design of the bill, the existence of a solid conceptual base is of fundamental importance, allows attracting the debate toward this direction and, in some way, to move it away from partial considerations or from power battles.