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Focus

Reforming Corporate Governance: Experiences with Public Takeover Bids in Chile and Panama

Álvaro Clarke de la Cerda
Carlos A. Barsallo

Prologue by Mike Lubrano



Global
Corporate
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ACKNOWLEDGMENTS

The Global Corporate Governance Forum wishes to thank both Álvaro Clarke de la Cerda and Carlos Barsallo for their leadership in promoting and advancing corporate governance in Latin America. Both of these men are former securities regulators in their respective countries, and have generously devoted their time to enhancing the quality of public debate on corporate governance, and, in so doing, have boosted its impact in Latin America today. Their outstanding essays afford an accurate insight into the different factors and outcomes at stake when it comes to corporate governance reforms.

This publication would not have been possible without the generous support and enthusiastic cooperation of the following:

- Mike Lubrano, Executive Director - Corporate Governance, in Cartica Capital LLC and former Manager of the Investors and Corporate Practices Unit of the International Finance Corporation (IFC), for his valuable observations, analysis, and comments on this publication.
- Nancy J. Metzger, Michael Kelly, and Santiago Chaheer, a Corporate Governance Consultant, who helped with editing and translation.
- Pilar Salgado for her comments on this publication.

This issue of *FOCUS* is part of a series of practical guides to corporate governance reform.

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PROLOGUE

By Mike Lubrano

In the wake of highly publicized scandals related to poor governance, there followed demands for some kind of legal/regulatory response. As seen after the East Asian crisis in 1997, the series of corporate collapses in the United States, starting with Enron, and the Royal Ahold and Parmalat scandals in Europe, investors and other stakeholders strongly urged governments, legislators, and regulators to “do something about it.” But what should be done? The circumstances surrounding each crisis were different and only rarely were there obvious solutions at hand. Politicians, regulators, and businessmen usually disagreed as to the underlying causes of the scandal in question and therefore had different views regarding the recipe to avoid a repetition of the situation. And of course, policymakers do not operate in an environment unconstrained by political, economic, and practical constraints. When one reviews the last 10 years of corporate governance-related scandals in Asia, the Americas, and Europe, what emerges is an impressive variety of policy outcomes. In some cases, governments acted precipitously; in others, they acted very slowly. Some reforms were comprehensive in scope; others more narrowly targeted. Some governments and regulators devised responses in the framework of longer-term strategies, while others engaged in blatant opportunism. Naturally, both the outcomes and the reactions of the community and the market were mixed; to this day, they are the subject of fierce criticism and intense debate.

Over the past 10 years, Latin America has had its own corporate governance scandals, followed by public opinion reactions and reform initiatives. Shenanigans related to non-voting shares, takeovers, and withdrawal of listings prompted Brazil's efforts in 2000 to reform legislation on companies and securities. The TV Azteca case, and other instances of improper treatment of minority investors, triggered the subsequent reform of Mexico's stock market laws and gave rise to the Investment Promotion Corporation (IPC), a completely new legal entity for companies that were listed on the stock exchange and those that were not. There were also major, albeit partial, reforms in Argentina, Colombia, and Peru. Since 2000, the protagonists of all these public and private sector efforts have been meeting regularly to exchange ideas and experiences at the Roundtable on Corporate Governance of the OECD, co-organized from the start with the IFC and supported throughout by the Global Corporate Governance Forum (GCGF).

I am sure that most Roundtable participants, and those active in Latin America's capital markets, will regard Chile's response to the "Chispas" scandal of 1997 as the "grandmother" of the region's corporate governance reforms. While the dust was still settling on the improper large-scale appropriation of shares by company officers with insider information, Chile's Ministry of Finance formed a team of regulators, economists, attorneys, international experts, and others to investigate the problem's roots and propose solutions. This paper's author managed the team and, in his capacity as the Superintendent of Securities and Insurance, was in charge of implementing the recommendations. The story that Álvaro Clarke tells in this paper is the result of reflective analysis, extensive consultation, strategic planning, monitoring of political realities, and a resolute determination to achieve the best possible results. As shown by Chile's capital market figures, as presented by Mr. Clarke in this publication, the reform that was finally enacted attained all the proposed objectives — fair treatment of shareholders and the restoration of credibility to Chile's capital market, with very few undesired negative consequences. Although not necessarily in terms of content, but certainly in terms of process, Chile's experience constitutes a model of how to carry out corporate governance reforms in post-crisis situations. If only one could say the same about many other like reforms elsewhere in the region and throughout the world!

It is a professional and a personal honor for me to have been one of the advisors representing the IFC on the special commission established by the Ministry of Finance in response to the Chispas scandal. I am pleased to know that, in spite of all the time that has elapsed, Álvaro Clarke still regards our intervention as important to the ultimate success of the law on public takeover bids and corporate governance. However, it is also only fair to mention that, on more than one occasion, our team had certain doubts about the political viability of the scope of reforms that Mr. Clarke and his team intended to embark on. Initially we believed, based on the experience of markets we regarded similar to Chile's, that the general requirement that a takeover bid be open to all shareholders at the same price as that paid to the controlling shareholder, would encounter strong opposition. We recommended that the commission consider other options that, although less fair to minority shareholders, would in our opinion be more likely to be approved by the legislature. Don Álvaro, ever the gentleman, listened patiently to our advice. He then reminded us, with equally firm conviction, that the commission had not been established to propose halfway measures and that although the compromise solution was inevitable, he and his team were certain that the commission and its members would be able to manage the political forces at play. In the end, it turned

out that we, the international advisers, had underestimated the ability of intelligent, talented, and determined people — such as those led by Mr. Clarke — to achieve a major step forward in the development of capital markets. It was a valuable lesson for all the external consultants and one that I will not forget.

Mike Lubrano

Former Manager of the IFC Investor and Corporate Practice Unit

February 12, 2009

INTRODUCTION

The Forum has the benefit of seeing how equally well-intentioned corporate governance reforms usually have dramatically different results from one country to another. This is often because each market has its own culture, individual and institutional players and, consequently, its own reform agents and factors.

This issue of *FOCUS* — covering the experiences of the Chispas case and Public Takeover Bid (PTB)-related reforms in Chile and then comparing them with PTB-related reform experiences in Panama — affords a rare insight into this dynamic market. It shows how stakeholders, through different actions and reactions during the reform processes, have an impact on the final outcome.

The Chispas case presented in the first half of this publication is the classic case of a reform that was triggered by a scandal in Chile to protect minority shareholders. Panama's experience is both a paradoxical comment on the Chilean experience and a case of reform to protect minority shareholders introduced by the Panamanian securities regulator (Comisión Nacional de Valores). The stakeholders reacted by rejecting the reform in theory and having the initiative quashed by the courts; but they accepted it and observed it in practice, and they continue to do so today.

The Forum is privileged to have the two former presidents of their countries' securities commissions, Álvaro Clarke in Chile and Carlos Barsallo in Panama. They were the principal actors and instigators of the corporate governance reforms in their countries, sharing in this publication their reflections on what they learned from the reform experiences. Along those same lines, we invite you, as you read this publication, to examine and consider why and how the actions and reactions of each market agent and factor shaped and influenced the outcomes.

THE CHISPAS CASE AND CORPORATE GOVERNANCE REFORM IN CHILE

By Álvaro Clarke de la Cerda

1. INTRODUCTION

This article explores the impact of corporate governance regulatory reform on Chile's capital market in 2000. After eight years of the new law's implementation, we now have a more informed view of the positive and negative consequences that can stem from strengthening corporate governance regulations.

The first part of the article analyses the background to the new law, focusing on a controversial matter in Chile, the Chispas case, which triggered the need to strengthen corporate governance especially for takeovers. This section introduces the Chispas case in some depth before proceeding to an analysis of the shortcomings that the new regulators had to correct. Finally, the analysis looks at the new law's principal constituent parts.

The second part examines the reform process, specifically all the elements that interacted during the period in which the new law was studied, debated, and processed. It looks at the political aspects involved, the different opinions that arose, the strategy pursued to promote the reform, and the model that finally prevailed.

The third part addresses the principal effects that the new legislation had on the Chilean market, after taking a close look at the Chilean Supreme Court's settlement of the Chispas case. I examine the cultural changes in the business and financial community that came with the new regulation's implementation. Other interesting takeover and corporate governance cases are analyzed as they provide a broader view of the new scenario in the Chilean capital market.

2. BACKGROUND

In December 2000, Chile's Congress adopted a major reform of the capital market legislation, known as the "PTB and Corporate Governance Law" (PTB Law). This marked the beginning of a new stage in financial regulation and the closing of another — all as a result of the controversial Chispas case.

2.1 *The Chispas Case*

In 1997, Endesa Chile, which was then the largest private electricity-generating company in Latin America, caught the attention of Endesa España, a Spanish electricity-generating company. The latter began negotiations with its parent company, Enersis, regarding the possible takeover of Endesa Chile. The

Chispas Series B shares, representing 0.06 percent of the equity, had effective control of the company, according to its statutes ... These shares were entirely in the hands of the general manager and 13 other shareholders, the so-called "key managing partners"

negotiations were initially conducted in secret between representatives of Endesa España and the so-called "key managing partners," who included the then-general manager of Enersis, the president of Endesa Chile, and other senior Enersis executives who, moreover, had major stakes in the so-called Chispas shares.

Chispas was a generic name for a set of companies owning 29 percent of the Enersis holding company (see Table 1). For its part, Enersis owned 20 percent of Endesa Chile. Moreover, the Chispas shares consisted of two distinct series.

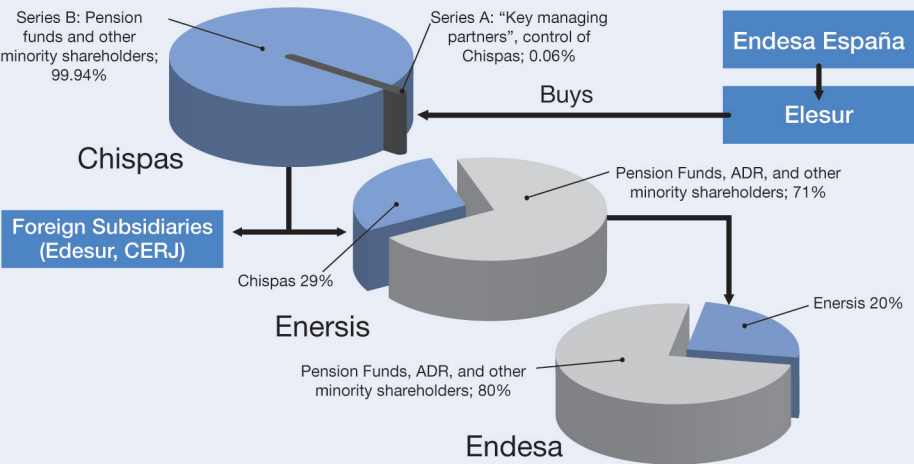
The Series A shares represented 99.94 percent of the outstanding Chispas shares and Series B shares, representing 0.06 percent of the equity. The Series B shares had effective control of the company, according to its statutes. The Series A shares were in the hands of minority investors, especially pension funds and employees or former employees of the Enersis group, while the Series B shares were entirely in the hands of the general manager and 13 other shareholders, the so called "key managing partners."

This ownership structure was the result of the company’s privatization at the end of the 1980s, when Endesa’s workers were offered the chance to purchase shares in the company as part of a settlement plan. Furthermore, the “key managing partners” acquired a stake in Chilectra, the former state-owned controlling company for Enersis. In a convoluted maneuver, the Enersis statutes were amended to create an arrangement whereby the Chispas companies exercised control.

The stake owned by the Chispas companies (29 percent of Enersis) entitled them to appoint two of the seven directors of Enersis and to participate in the appointment of the directors of all Enersis subsidiaries. Consequently, and in accordance with the legal definition of “corporate control,” the Chispas companies controlled Enersis.

The “key managing partners”, as the owners of approximately 20 percent of the Series A shares) and all of the Series B shares were the effective controllers of the Chispas companies, electing at least two of the seven directors of Enersis and exercising considerable influence over the appointment of the directors of its subsidiaries. At the same time the “key managing partners” had won the support and confidence of the shareholders in Enersis and Endesa Chile, which allowed them to elect themselves to the boards of those enterprises, which, in turn, made them the effective controllers of Enersis and Endesa Chile.

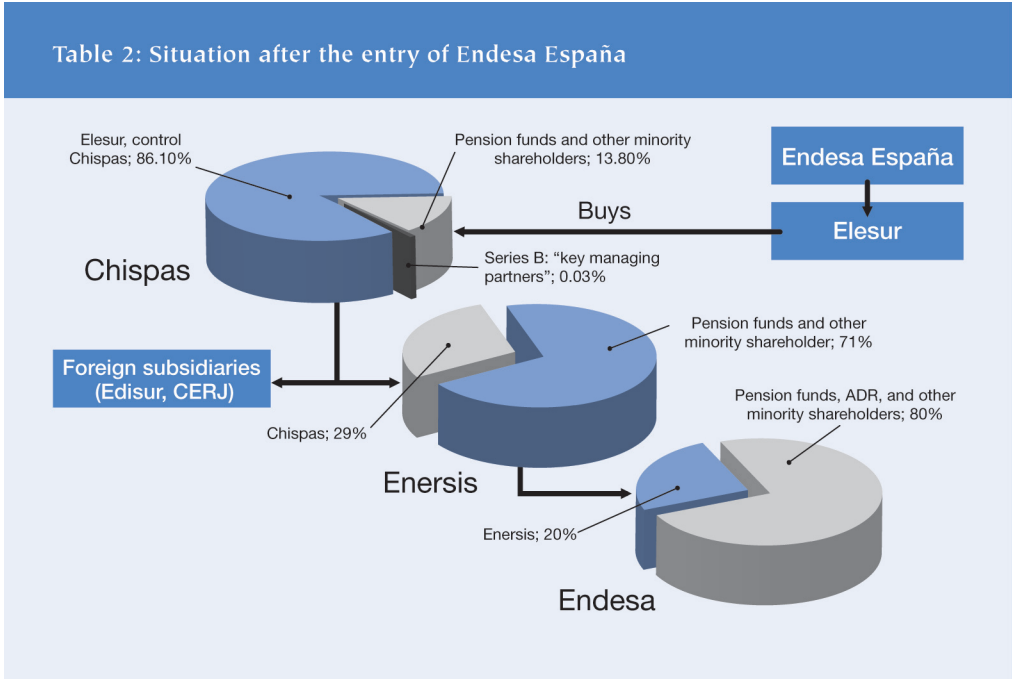
Table 1: Situation prior to the entry of Endesa España



Endesa España sought to acquire half the Series B shares from the “key managing partners” for \$500 million but only on the condition that they would successfully acquire the Series A shares as well.

The “key managing partners” tried to persuade the Chispas shareholders to sell their shares at the price offered by Endesa España because the latter had conditioned its purchase of Chispas Series B shares on success in also purchasing Series A shares.

They included a clause to that effect in a contract signed with the “key managing partners”. The Series A shares would therefore cost Endesa España approximately US\$1 billion. Under that strategy, the “key managing partners” attempted to persuade the Chispas shareholders to sell their shares at the price offered by Endesa España. To accomplish this, Endesa España would establish a purchasing power of attorney (*poder comprador*) in the form of a company called Elesur, through which it would purchase the Chispas shares that would enable it to control Enersis, and thus become the largest private electricity-generating company in Latin America.



The ultimate goal of Endesa España was not the Chispas companies themselves, but the acquisition of effective control of Eneris and all its subsidiaries through Elesur. As we will see below, under the secret contracts signed with Eneris and Endesa España, the “key managing partners” committed themselves to exercise their management control in such a way that Endesa España could have a much greater influence over the management of the Eneris group than the shares they held would have warranted.

In August 1997, Endesa España opened the call option to purchase the Chispas shares and within a few weeks had acquired a majority of those shares as well as a 25-percent stake in Eneris. The size of the takeover and the special nature of the operation generated huge publicity, particularly because of the big difference between the prices offered for the Series A and Series B shares. The price of the various Series A shares, representing 99.94% Of all outstanding shares, varied with Endesa España paying an average US\$.053 per Series A share for a total of approximately \$1 Billion. For the 49 percent of the Series B shares, which represent just 0.03% of all outstanding shares, it paid US\$250 million.

If we were to look at these amounts in relation to percentage points of ownership, the Series A shareholders received approximately US\$10 million for each percentage point, while the Series B shareholders received the mathematical equivalent of US\$8.33 billion for each percentage point, that is to say 833 times the value of the Series A shares. The difference was the value of control over those companies. Despite this huge disparity in share price, the share purchasing process was legal as there was not yet any regulatory framework governing takeovers.

The size of the takeover and the special nature of the operation generated huge publicity, particularly because of the big difference between the prices offered for the Series A and Series B shares.

Reflecting the doubts regarding the prices paid, a stock exchange broker opened a purchasing power of attorney, parallel to the purchasing power of attorney opened by Endesa España, for one of the Chispas companies called Luz,

A group of investors opposed the sale of the Luz companies to Endesa España, recommending that shareholders retain their shares or sell at a higher price,... thereby setting a precedent for shareholder activism in Chile.

which had a 2.86-percent stake in Enersis. Meanwhile, the investment fund Moneda Asset headed an initiative opposing the sale of the Luz companies to Endesa España, arguing that the price paid was insufficient. Moneda Asset recommended that shareholders hold their shares or sell them to the broker who had opened the other purchasing power of attorney and offered a better price. That operation meant that Endesa España was only able to acquire a 26.2-percent

stake in Enersis, instead of 29 percent of the total stake belonging to Chispas. The most important thing about this operation is that the group of investors led by Moneda Asset, set a precedent for shareholder activism in Chile.

In early October, more information emerged regarding the secret contracts. These details had been revealed in the documents that Endesa España had submitted to the Securities and Exchange Commission (SEC) of the United States (as issuer of American Depositary Receipts (ADR)) and the National Securities Market Commission of Spain; but they were not known in Chile.

One of the new details to emerge (see box) was a US\$60 million payment to the Enersis's senior executives, subject to the achievement of a certain level of profits for the 1997-2001 period. Furthermore, there was a provision that Endesa España could enter other markets if Enersis did not agree to do so jointly. Yet another provision allowed Endesa España to appoint an assistant general manager in Enersis and Endesa Chile.

The Secret Contracts between Endesa España and Enersis

There were four secret contracts signed between Endesa España and Enersis, represented by its general manager and one of the key managing partners. These are the:

- Strategic partnership contract;
- Management contract;
- Contract promising purchase/sale of 49 percent of the Chispas Series B shares; and,
- Purchase/sale contract for 51 percent of the Chispas Series B shares.

When these contracts were made public, the Enersis board rejected the agreements and Endesa España agreed to annul them. These contracts, although done in secrecy, were not illegal *per se*. What the Superintendent of Securities and Insurance would later regard as illegal was the behavior of the directors who signed those agreements, thereby contravening the provisions of the Law on Business Corporations and, in particular, their trustee responsibilities towards shareholders.

THE STRATEGIC PARTNERSHIP ALLIANCE

Under this agreement Endesa España stated its decision to purchase two-thirds of the voting rights of the Chispas Series A shares. The agreement further stipulated that the “strategic partnership” planned to invest in the Latin American energy sector and would establish, for that purpose, an investment company (Endesis), whose president for the first five years would be the general manager of Enersis.

THE MANAGEMENT CONTRACT

The “key managing partners” committed to continuing to perform their functions within the Enersis group for at least the first five years. Endesa España stated that the “key managing partners”, may exercise, as a group, corporate control over Enersis and the companies in its group. The “key managing partners” made commitments to policies for appointing the boards of Enersis and Endesa Chile. The parties agreed that, during the first five years, any substantial change in the investment, financing, and dividend policies of Enersis, Endesa Chile and their respective subsidiaries must be adopted by mutual agreement between Endesa España and the “key managing partners.”

THE CONTRACT PROMISING PURCHASE/SALE OF 51 PERCENT OF THE CHISPAS B SHARES

Endesa España would pay US\$255 million for these shares, as follows:

- Five annual payments of US\$39 million each, and
- One payment of US\$60 million in the fourth year provided that the sum of the net earnings of Enersis for the years from 1997 to 2001 exceeded US\$600 million.

If Endesa España were to lose control of Enersis within the five-year period, the “key managing partners” would lose the right to receive that part of the price still pending. The contract further stated that, for the “key managing partners,” all elements of the contract had been agreed to with the understanding that the parties were obligated to maintain absolute discretion and confidentiality.

THE CONTRACT PROMISING PURCHASE/SALE OF 49 PERCENT OF THE CHISPAS B SHARES

The purchase price was US\$250 million, which Elesur paid to the “key managing partners,” in addition to committing itself to purchasing Series A shares through a public offering to its shareholders. The sellers and the “key managing partners” committed to cooperating toward the successful purchase of the Series A shares. The contracts were disclosed by the Chilean press in the middle of the controversy surrounding the Chispas case. These disclosures prompted a sudden, decisive shift in the course of events, demonstrating the role that objective, incisive journalism can play in achieving sound corporate governance.

At a special meeting of the Enersis board, convened at the request of the Superintendent of Securities and Insurance, the directors elected by the minority shareholders (for example, the Pension Fund Administrators), stated that they had had no knowledge of the agreement between the “key managing partners” and Endesa España, and voiced their opposition to the “strategic partnership.” The Enersis board then asked for the general manager’s resignation and, Endesa España agreed to revise the agreements under the “strategic partnership.”

Several features that make this such a controversial case have to do with matters that were not contemplated in the legislation, including the takeover process itself. Despite these regulatory shortcomings, the negotiations carried out by the “key managing partners” and Endesa España were still bound by the existing regulatory framework and thus the Superintendent of Securities and Insurance charged that the “key managing partners” had broken the law in the following ways:

- (1) Violated the Business Corporation Law with respect to directors’ obligation to represent the interests of all shareholders and not just the interests of those who elected them.

Endesa España was found to have entered into agreements with the “key managing partners” irrespective of how favorable or unfavorable those agreements were for Enersis and the remaining shareholders. In particular, the agreements concerning the appointment of directors and executives to the Enersis Group; and those concerning the making of deals regarding investment policies, dividend distribution, and other equally important matters.

- (2) Broke the ban, established in the Business Corporations Law, on exploiting to one’s own benefit, or that of related third parties, commercial opportunities about which they had insider knowledge.

The Superintendent found that it was precisely the positions the “key managing partners” held that enabled them to know of Endesa España’s interest in acquiring control of Enersis and also allowed Endesa España to control the process by the purchase of the shares in the Chispas companies held by the “key managing partners”. The Superintendent further found that, concealed in the sales price of the Series B shares, was a clear reward for services, cooperative commitment, and loyalty to Endesa España.

The directors elected by the minority shareholders of Enersis stated that they knew nothing about the agreement between the “key managing partners” and Endesa España and voiced their opposition to the partnership. The Enersis board decided to request the general manager’s resignation and Endesa España agreed to revise the agreements under the “strategic partnership.”

- (3) Ignored the Business Corporations Law provisions which forbid giving precedence to the directors' own interests, or those of related parties, over the corporate interest when making decisions for the company, and which also forbids hiding information from the other directors and the shareholders.

The executives did hide information from the other directors and shareholders by not revealing to any of the boards of the Chispas companies, Endesa España's interest in acquiring a stake in Eneris. Neither did they reveal their intentions to sell the shares they held, or their agreements with Endesa España in the exercise of their management powers. Those same hidden contracts stipulated that, should Endesa España achieve effective savings in the payments made for the purchases carried out in the PTBs for the Series A shares, the first US\$16 million saved would be paid to the "key managing partners. The "key managing partners" also undertook to continue as executives in the Enersis group and maintain one or possibly two positions on the Endesa España board.

- (4) Broke the same law, which prohibits using a director's position to obtain personal privilege by transferring the control they exercised in the Enersis group through the sale of their Series A and B shares in the Chispas companies.

This arrangement enabled the "key managing partners" to retain for themselves one-third of the US\$1.5 billion that Endesa España was prepared to pay for the operation. If they had allowed for a direct public sale of Enersis' shares by the Chispas companies. Chispas shareholders would have obtained a higher price than the one they received in the PTB, because almost 100 percent of the US\$1.5 billion that Endesa España was prepared to pay for the operation would have been distributed among all Chispas Series A shareholders.

- (5) Failed to meet their due diligence obligations when they incorporated and/or permitted the incorporation of those clauses in the Strategic Partnership Contract that seriously compromised the development of Enersis. They also failed by disregarding the effects on Enersis and its subsidiaries triggered by the signing of the remaining contracts (incursion into other markets if Enersis did not agree to do so jointly, and Endesa España's entitlement to appoint an assistant general manager in Enersis and Endesa Chile).

(6) Finally, the Enersis general manager breached the provision in the Business Corporation Law that establishes that whenever a director has a stake in a negotiation, a contract may only be valid if it is:

- (i) Known to the board;
- (ii) Approved by the board; and,
- (iii) Conforms to normal market equity standards.

In this case, the provision covers the Enersis general manager who also served as an Enersis board member. He failed to recuse himself from handling the negotiations and signing the strategic partnership contracts on behalf of Enersis, while at the same time negotiating the sale of his own Series B Chispas shares and also signing other contracts in which he had a personal interest. Additionally, he did not inform the board of those negotiations.

The Superintendent of Securities and Insurance reaffirmed its position as follows:

“In short, the reciprocal commitments recounted above prove and clearly demonstrate the conflicts of interest of the “key managing partners” in acting for their personal gain and that of Endesa España. The people who acted as negotiators and/or representatives of Endesa España, in the contracts for this operation, have expressly and separately stated that the “key managing partners” had been entrusted with management of Endesa España’s interests regarding the Enersis group, and that those managing partners were to look after Endesa España’s interests.”¹

Thus, with these arguments, the Superintendent of Securities and Insurance imposed a fine of US\$66 million in December 1997 on the Enersis general manager (and president of Endesa Chile) and the other five members of the group of “key managing partners,” who in turn were directors of Enersis Group companies.

1 See SVS (1997)

The Powers of the Superintendent of Securities and Insurance used in the Chispas Case

The law establishing the Superintendent of Securities and Insurance grants it powers to interpret administratively the laws, regulations, and other provisions governing regulated persons or entities. Thus, the Superintendent enforces the provisions of the Business Corporations and Securities Market Law.

In performing its duties, the Superintendent may examine all the operations, assets, accounts, files, and documents of audited individuals or activities and require them or their managers, advisers, or staff to provide such background and explanations as it deems necessary for its information. The Superintendent may also call a special meeting of shareholders if the circumstances so warrant, as it did in the Chispas case. Nevertheless, at the time of the Chispas case, entities supervised by the Superintendent were not obligated to disclose the same information that they were required to disclose in foreign markets in their capacity as issuers. The PTB law terminated that shortcoming.

The Superintendent is further empowered to use external attorneys to represent it in the courts. Thus, during the litigation of this case, the Superintendent was able to rely on the services of an outside law firm, whose work was a key factor in the success achieved in court. Those services were partly financed by the Ministry of Finance. This also suggests how important it is that the regulator be able to rely unconditionally on adequate financial support during litigation.

2.2 Shortcomings in the Regulations and the New Law

The Chispas episode involved a series of developments that would later serve as a valuable lesson in determining regulations of takeover processes, and corporate governance in general.

Those lessons may be summarized as follows:

- (1) The possibility for an unequal distribution of the control premium, shown by the secret purchase offer for the Series A and Series B shares of the Chispas companies;
- (2) The capacity of shareholders with negotiation advantages to obtain better terms for the sale of their shares than other shareholders;
- (3) The inequity of the delivery of essential information to foreign regulators, with respect to a process involving a listed Chilean company, without the same obligation to disclose and provide that information to the local market;
- (4) The lack of procedures for adequately informing shareholders regarding a takeover;
- (5) The nonexistence of “exits” for those shareholders who decide not to sell their shares during a takeover; and,
- (6) The control gap implied by the fact that holders of ADRs have no voting rights. For Enersis, the statutes granted the right to vote to the board chairman, thereby increasing the power of the controlling shareholders.

The PTB law was created to provide adequate protection for minority shareholders. It contemplated such key issues as public offerings of mandatory shares in the event

of a change of control, better corporate governance in the form of obligatory implementation of Directors’ Committees, the regulation of operations between related parties and the rights of ADR holders.

The PTB law was created to provide adequate protection to minority shareholders. This law sought to align management’s interests with those participating in ownership.

Prior to the law's promulgation, a person could purchase control of a company listed on the stock exchange by paying a high markup to the majority shareholder and ignoring the other shareholders.²

Although PTBs had been carried out prior to the law's enactment, there were no standard procedures to guarantee adequate competition and equal rights for shareholders. For instance, sometimes the PTBs dispensed with the apportionment

Thanks to this set of legal provisions, Chile has the highest rating for corporate governance in Latin America (see Table 3).

criteria for example e.g., the takeover of Banco de Santiago in 1955. Moreover, some PTBs omitted certain information, such as its purpose and the percentage stake it sought to purchase. The period during which bids were accepted differed, and on some occasions they were extremely short (e.g., the takeover

of Banco de Santiago again). Not all shareholders were included (e.g., Banco de Santiago did not include ADR holders). PTBs were also performed for parent companies instead of subsidiaries, with a view to gaining control over the latter (e.g., the takeover by the Spanish company Ebro of Campos Chilenos, instead of the sugar company Lansa, in 1999).

Consequently, in most cases, the minority shareholder had the least say and negotiating capacity during the process and often had to watch control being transferred without its involvement because takeovers were not then always “public,” as they are now under the new regulations.

In this way, by establishing the responsibilities of those involved in the negotiations, the PTB law sought to align the interests of those participating in management and those participating in ownership — and to avoid such actions as the sale of a company's assets at prices different from those prevailing in the market, or the transfer of the company's business opportunities to third parties.

² This is what happened in the major takeovers prior to 2000. In the case of the takeover by Stet Internacional of the telecommunication enterprise Entel in which Stet Internacional negotiated with Chilquinta which at that time was the controlling shareholder in Entel. It also happened with the takeovers of Cruz Blanca Isapre and the Pension Fund Administrator, Santa Maria, by ING American Insurance Holdings, which negotiated the transfer of ownership in the United States with the controlling shareholders.

In light of these lessons, the need arose to conduct a reform of corporate governance, especially takeovers, aimed at striking a balance between the rights of different types of shareholders. The PTB Law addressed these factors by creating a set of legal provisions that:

- (1) Instituted mandatory, adequately informed and *pro-rata* public bidding procedures (PTB), especially if the share purchase could lead to a change in the company's control;
- (2) Set the requirement for a board resolution of agreement in the case of any transactions in which any of the directors has an interest, and the establishment of procedures for ensuring that the operation is fair;
- (3) Creates "Directors' Committees" (equivalent to audit or settlement committees) to ensure adequate supervision of the company, particularly in cases of operations with related parties;
- (4) Expands the grounds for the right to withdraw from the agreement to include such situations as the high level of concentration of ownership (2/3 of the shares) or the sale of a high proportion of assets;
- (5) Establishes the legal figure of a derived civil indemnification action; and
- (6) Recognizes voting rights for holders of ADR.

Thanks largely to this set of legal provisions, Chile has had the best rating in this part of Latin America and has been ranked very highly by international rating agencies.

Thus in 2001, Banco Santander Central Hispano awarded Chile the highest rating for its corporate governance regulations. Other countries mentioned included Argentina, Brazil, Colombia, and Mexico.

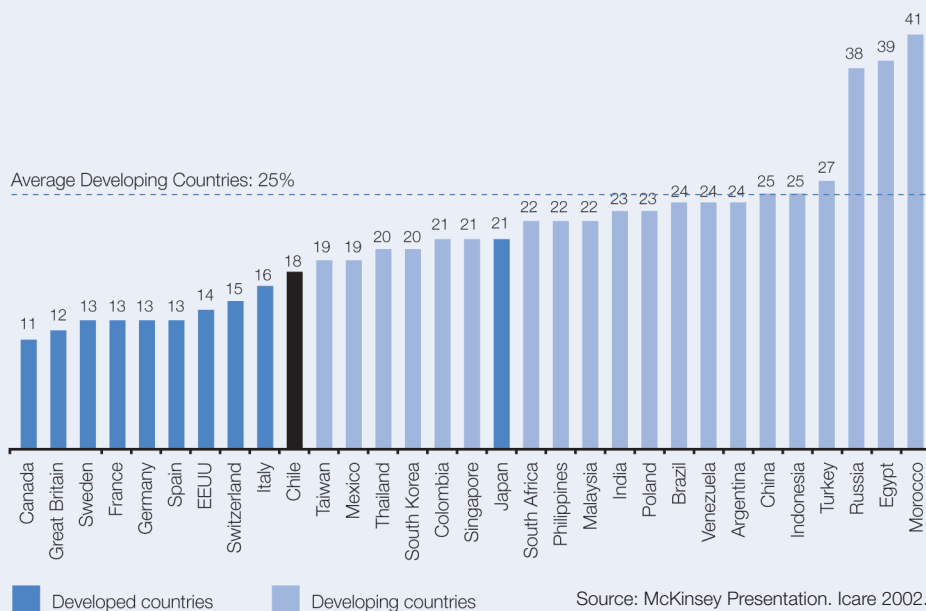
Table 3: Comparison of ratings regarding corporate governance regulation

Category	Argentina	Brazil		Chile	Colombia	México	
		Ley	Novo MP			Ley	CBCP
Multiple classes of shares	0	0	1	0.5	0	0.5	0.5
Certificates of deposit	0	0	0	1	0	0	0
One share, one vote	0	0	1	1	0	0	0
Proportional representation	1	1	1	1	1	0	0
Prior claims	1	1	1	1	1	1	1
Takeovers	1	1	1	1	1	1	1
Right to withdraw	1	0.5	1	1	0	0	0
Delisting	1	1	1	1	1	0	0
Free float	1	0	1	1	0.5	1	1
Call for special shareholders meetings	1	1	1	1	1	1	1
Shares not blocked prior to meeting	0	0	0	1	1	0	0
Protection for minority shareholders	1	1	1	1	0	0	0
Board independence	0	0	0	0	0	1	1
Board renewed each year	0	0	1	0.5	0	0	0
Audit committee	1	0	0	1	0	1	1
Access to corporate information	1	1	1	1	1	1	1
Quality of information	0.5	1	1	1	1	0	0
Arbitration	1	1	1	1	0	0	0
Overall Index	11.5	9.5	14	16	8.5	7.5	7.5

Source: Santander Central Hispano, 2001.

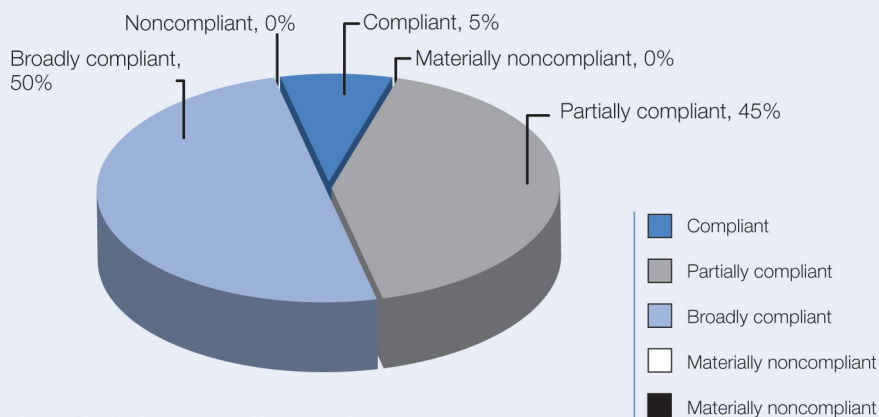
In 2002, the consulting firm McKinsey & Company estimated, following a survey of executives in various countries, that Chile ranked tenth out of 32 countries with respect to the risk premium that investors would be prepared to pay to improve corporate governance systems for their investments. That is an encouraging finding, because the better the current status of protection for investors, the lower the premium required.

Table 4: Investors' Premium for better corporate governance (Percentage)



During 2003 the World Bank analyzed the Chilean corporate governance system in its *Report on the Observance of Standards and Codes (ROSC) in Chile*.

Table 5: ROSC Report for Chile, 2003



That analysis underscored the fact that over half the OECD's corporate governance principles are broadly or fully complied with in the Chilean regulations. The World Bank concluded that there were no materially noncompliant or noncompliant aspects.

Takeovers

Economic theory has two ways of addressing takeovers, known as the “market rule” and the “equal treatment rule.” The market rule allows for the sale of a controlling holding at a price to be determined in a private negotiation between the bidding party and the outgoing controlling shareholder without any participation by minority shareholders. The equal treatment rule, by contrast, requires a PTB every time a controlling holding is sold. That being so, the bidder must grant minority shareholders terms equivalent to those of the outgoing controlling shareholder.

Chile opted for a combination of the two, which led to the adoption of the following arrangements for PTBs:

- A *pro-rata* PTB must be offered at the same price to all shareholders, especially when the purchase may bring about a change in the company's control.

Furthermore, the following restrictions apply:

- When the controlling shareholder acquires two-thirds of the shares, it must conduct a PTB to purchase the remainder.
- When the idea is to acquire control over a subsidiary, a PTB must first be conducted for that subsidiary and then for the parent company.
- In an attempt to make the market more transparent, information now has to be provided for a number of operations, including in particular:
 - A declaration of intent to acquire control at least 10 business days in advance of the planned acquisition; or as soon as negotiations have begun; or when information and documentation on the company has been handed over.
- All shareholders with 10 percent or more of the shares must report on subsequent purchases whether their intention is to take control or to make a financial investment.

- The company's directors must each issue a report with their opinion substantiating their views on the suitability of the bid to shareholders. Each director must also state his or her relationship with the controller and/or with the bidder and any interest he or she might have in the transaction. Those reports must be made available to the public together with the prospectus.

Even when it is stated that bids made are irrevocable, acceptance of the bid may be retracted either wholly or in part.

Basic Rules Governing Transfer of Control

According to Bebchuck (1994) and as explained above, theoretically there are two general rules for transferring control: the market rule and the equal treatment rule.

The market rule allows for the sale of a controlling holding and for its price to be determined in a private negotiation between the party bidding for control and the outgoing controlling shareholder, without any participation by minority shareholders.

The equal treatment rule, on the contrary, requires a PTB every time a controlling holding is sold. That being so, the bidder must grant minority shareholders terms equivalent to those of the outgoing controlling shareholder.

When operations are conducted using the market rule, the minority shareholders are not taken into consideration, so that transactions may be detrimental to them. The market allows transactions that are inequitable for the minority shareholders, because they maximize value for the outgoing controlling shareholder.

From a corporate point of view, the market rule allows for some transactions that are beneficial to minority shareholders, but also allows others that are detrimental to shareholders. To the extent that the incoming controlling shareholder can extract the same or lower value than the outgoing controlling shareholder, the transaction will favor the minority shareholders; if that is not the case, the transaction will be detrimental to the minority shareholders.

Under the equal treatment rule, inequitable transactions are avoided because the control premium must be given to each shareholder. Therefore, the transaction will

only be carried out to the extent that the incoming controller receives the desired value. However, there are operations that cannot be carried out even though they make good business sense, because the incoming controlling shareholder is unwilling or unable to pay the price the outgoing controlling shareholder had expected.

The equal treatment rule improves the situation for minority shareholders because they receive maximum value for their shares. However, as noted above, some transactions will not be carried out. Such cases should be less frequent once the Corporate Governance Laws are applied, since limits are set on the controlling shareholder's ability to extract value. Finally, it should be noted that, even though the equal treatment rule prevents more value from being extracted from minority shareholders, their situation does not improve per se.

(Adapted from Clarke, 2000)

Directors' Committees

The establishment of "Directors' Committees" is an important step for improving corporate governance because it allows for greater oversight within an organization.

The law stipulates that the Directors' Committee must contain a majority of independent directors. Furthermore, the formation of such a committee is mandatory in corporations with a stock exchange value equal to or greater than approximately US\$44 million.

The main functions performed by the committee are to:

- (1) Examine the financial statements;
- (2) Propose external auditors and risk rating agencies to the board;
- (3) Examine executive remuneration and compensation systems;
- (4) Examine transactions between related parties by means of a report on them; and
- (5) Perform any other functions established in the statutes or entrusted to it by a shareholders meeting or by the board.

Transactions between related parties

The principal provisions governing transactions between related parties are as follows:

- (1) If the transactions are for significant amounts, the board must rule on whether they conform to market terms;
- (2) If it is not possible to determine whether that is the case, the board may, with the abstention of any director who has a personal interest, approve or reject the proposed transaction, or else appoint two independent auditors;
- (3) The auditor' reports will be made available to the shareholders and the board for 20 business days;
- (4) Shareholders accounting for less than five percent of the shares may ask that a special meeting be convened to decide on the transaction with the assent of two-thirds of the shareholders.

These provisions ensure that transactions between related parties are transparent, and not detrimental to the minority shareholder.

Right to Withdraw

The grounds for the right to withdraw are expanded to provide adequate protection for investors faced with situations that could be detrimental to them.

The new grounds included are:

- (1) Sales of at least 50 percent of the assets;
- (2) The pledging of at least 50 percent of the assets as guarantees; and,
- (3) Companies with a concentration of more than two-thirds of the ownership.

Equal Rights of ADR Holders and Shareholders

The new legislation establishes that ADR holders will enjoy the same rights as the companies' shareholders. Such rights include:

- (1) Participation in PTBs;
- (2) Voting at shareholders meetings;
- (3) Preferential rights in capital increases; and,
- (4) The right to withdraw.

In this way, ADR holders can be sure that their rights are duly safeguarded.

Derived Civil Indemnification Action

The law allows for the possibility of bringing a derived civil indemnification action. This entitles any shareholder or group of shareholders with a holding of five percent or more, or any director, to demand compensation for damages from whoever is concerned on behalf of and for the company. This may be done when either the law or the company's statutes have been breached.

The idea was that the possibility of suing — on behalf of and for the company — those responsible for damage to the company would make it easier to bring lawsuits seeking compensation for damage done by the managers or third parties. In this way, shareholders would be able to safeguard their rights despite having only a minority share in the ownership of a company.

3. CONDUCTING A REFORM

When the Chilean Government decided, in the wake of the Chispas case, to introduce regulations to strengthen corporate governance, it entrusted leadership of the reform to the Ministry of Finance and the Superintendent of Securities and Insurance.

The proposed new regulations quickly gave rise to controversy in financial markets and political circles. While the authorities stressed the benefits of more modern and international regulations, opposing views emerged, with the critics usually arguing that:

- (1) New regulations would entail expropriation of existing controlling shareholders;
- (2) Mandatory PTBs would encumber capital markets;
- (3) New regulations would induce numerous companies to leave the stock exchange;
- (4) New regulations would dampen interest in investing in Chile; and,
- (5) Establishment of Directors' Committee (audits) would only add to shareholders' costs.

It had been obvious from the start that approval for the project would not be easy. What needed to be done to ensure that it would be adopted by Parliament? Who needed convincing? How to garner support for the project?

The Chilean Government set out to develop regulations to strengthen corporate governance. It commissioned the services of the IFC, a member of the World Bank Group, which became the government's chief advisor throughout the gestation of the project. ... The IFC represented an informed and technical opinion which was listened to and considered.

It was decided to opt for a three-pronged strategy based on:

- (1) Adoption of a technical approach;
- (2) A quest for points of consensus; and,
- (3) Achievement of a critical mass of support.

First, came the technical approach. The IFC's consulting services were tapped to help prepare the project. The IFC enjoyed a solid international reputation and had at its disposal teams of experts, who were not only well versed in theoretical aspects but also experienced in the practice of implementing corporate governance regulations in other markets. As it turned out, the IFC became the government's principal adviser throughout the project's gestation.

Another important input was the amount of knowledge about corporate governance accumulated in economic and legal literature. The arguments underpinning the project were supported by both the theoretical and the empirical studies of recognized experts. Likewise, the participation of outside experts (IFC) was also important because they, too, represented informed, technical views that were listened to and considered seriously.

The technical reports proved to be a useful tool for guiding debates on the proposals. They were structured to contain key elements that could serve as benchmarks, namely:

- (1) A theoretical framework or model to prompt a discussion;
- (2) Solutions suggested by economic theory based on different assumptions and/or scenarios;
- (3) Analysis of international experience in this field;
- (4) In-depth analysis of particularly interesting cases, or ones with aspects that made them comparable to Chilean cases; and,
- (5) The current situation in Chile.

Example: The Transfer of Control Debate

Control over a company is prized for two reasons. The first is that the controlling shareholder may add value to the company by implementing more efficient management. The second is that the controlling shareholder can appropriate flows that, strictly speaking, belong to all the shareholders, to the detriment of the minority shareholders.

When, the new controlling shareholder triggers more efficient management, that transfer is described as “corporate efficient”, because the present value of the flows resulting from its management exceeds the present value of the flows from the previous controlling shareholder.

The opposite occurs in the second case, in which the value of the enterprise declines *vis-à-vis* its previous situation. In this case, the transaction is “inefficient”, even though for the controlling shareholders it may have a high private value.

The difference between the value of a minority share and that of a controlling share is called a control premium. The question that badly needs answering is: Who does the control premium belong to? A new controlling shareholder may consider that it is capable of generating wealth thanks to its management expertise. It therefore regards the company as worth more, and is prepared to pay a markup on the price to all the shareholders. The control premium does not belong to any shareholder on its own or to any one in particular. It corresponds, rather, to the economic value assigned in a proper valuation of the company as a whole, with all its financial flows, assets and liabilities. Therefore the control premium does not belong to the controlling shareholders or to any shareholder in particular.

At the same time, if the premium arises out of the private benefits of control, those benefits belong to the minority shareholders from whom that value is extracted. Once again, in this case, the control premium does not belong to any one shareholder in particular.

In light of the above, the hypothesis that controlling shareholders have the right to a “control premium,” is based solely on expropriation of the company’s flows for the private interests of those controlling shareholders, to the detriment of corporate interests.

Those who favored distributing the control premium through a mandatory PTB argued that the essence of a business corporation consists precisely of equitable participation in both risks and earnings, in proportion to the capital contributed.

As the Executive Branch argued during the parliamentary procedures, “A transfer of control constitutes a radical change for the shareholders in an enterprise, because it could herald changes in future business, profit distribution, and new investment policies. The control premium, which usually encompasses such operations, reflects the value-creating capacity proposed by the new controlling shareholder. However, it is important to bear in mind that the transaction also entails a risk of failure and of costs associated with it that will be borne by all -majority and minority-shareholders. That is why the appropriation of the control premium by only a few clearly contravenes the guiding principle behind corporations, in which all should win or lose on an equal basis.”

It was also argued that a controlling shareholder is not being penalized because a company open to the market is worth more than a closed or individually owned enterprise. Therefore a controlling shareholder receives an added benefit just by opening up the enterprise.

Other arguments were based on dogmatic, rather than technical, considerations. In general, there was criticism of the rigid, mandatory nature of the PTB process.

In the course of the parliamentary proceedings, a three-year transition period was included, during which current controlling shareholders could either opt for the PTB mechanism or reject it in the event of a takeover.

Those who argued against the transition period claimed that it would allow control to be transferred to the major economic groups without sharing the control premium.

A second prong of the strategy was the quest for points of consensus, which, instead of imposing a particular view, seeks to reconcile the roles of the market regulator and the “facilitator of the development of the market”. There is a conflict between oversight or enforcement tools and the unregulated freedom to act, which economic agents would like to have in order to be creative. In theory, we can imagine two possible, radically opposed, solutions to this conflict: one would be allowed total freedom, with no intervention by supervisors, while the other would be excessively supervised. Presumably, the optimum level of supervision should be somewhere between these extremes, where, at least theoretically, the marginal social benefit of supervision does not exceed the marginal social cost of that supervision. It is best, as far as possible, to avoid supervisory instruments that inhibit market development.

Furthermore, it is essential to evaluate how well-implemented regulatory instruments function in practice, by comparing them against the objectives targeted. This feedback from private sector agents is crucial, because they are the ones who have to deal with implementation snags.

Once a legal reform project has been submitted to Parliament, strategies have to be devised to reach agreements that ensure that the reforms are adopted as quickly as possible. That means negotiating specific aspects of the project, isolating conflictive issues and nurturing a negotiation strategy based on judicious concession of certain aspects in order to consolidate others. During that process, the original project often undergoes changes that lead it astray from the technical criteria on which it was based. However, that is often better than no progress at all. The underlying goal of those promoting the project was to “socialize the issue,” that is to say, to analyze the reform project from the point of view of equity among shareholders. This strategy proved successful because, once the spirit of the regulations has been understood, it becomes more difficult for economic agents to oppose what they perceive to be fair.

As a result of negotiations with opposing parliamentarians, a provisional article (Provisional Article 10) was included that provided for the possibility of corporations being able to opt for the new takeover regulations. That option would expire three years after promulgation of the law, and that transition period could be useful for softening the impact of a very radical reform. However, in the Chilean case it was used rather as a negotiating tool.

The third prong of the strategy has to do with the achievement of a critical mass of support. In Chile, the Pension Fund Administrators (AFP), investment funds, and foreign investors turned out to be valuable allies in promoting the new regulations.

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The AFP, in particular, played an important part in support for the project by coordinating with the authorities to bring about meetings with politicians and entrepreneurs at which they would voice their support for the project.

Those institutions had already been hurt by operations in which shares changed hands at prices other than those set by the market, thereby impairing the funds they administered. Moreover, as the custodians of the Chilean workers' social security savings, the views of the AFP carried great weight with public opinion, legislators and the press.

At the same time, there was little doubt that the Chispas case drew attention to the need to regulate takeovers. The high prices paid for the shares of the controlling shareholders compared to the prices paid for common shares, the change in ownership of a historically Chilean enterprise to one owned by foreign shareholders, and the communication mechanism it triggered all created a kind of pressure or citizen support for the enactment of reform. This aspect is by no means trivial because, in many cases, the greatest difficulty lies in achieving a good "kickoff."

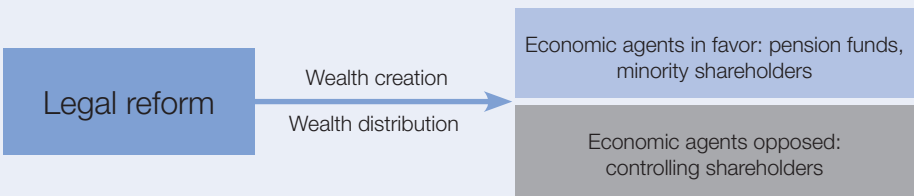
Often regulation initiatives fail
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yet perceived ... In the case of
Chile, there was agreement that
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and soon."

Often regulation initiatives fail because the need for them is not yet perceived, the possibility of legislating is rejected and debate on the issues is interminably protracted. In the case of Chile, there was agreement that "something had to be done... and soon."

Particularly in the case of regulations regarding takeovers, in which the control premium should be shared among all the shareholders, a tension was sensed as regards the redistributive dimensions of the reform. Up to then, controlling shareholders that sold their block of shares were used to receiving a premium over and above the market

value, which, under the new law, they had to share with the other shareholders. Obviously, that induced many large shareholders to oppose the legal reform. Nevertheless, an important mass of economic agents understood that, ultimately, the measure would benefit them in the long run, not just as potential sellers of shares but also as the owners of an asset whose price would go up thanks to better governance and better conditions for a sale.

Table 6



Accordingly, working with the media was one of the linchpins of efforts to disseminate and process the bill. The media communicate in different ways, through articles and chronicles designed to inform the public, interviews, and editorials designed to disseminate points of view, and inserts designed to analyze a topic in greater depth. Building up a capacity to reach the media on an ongoing basis requires a serious effort to create the right channels to help the media structure the news in this sector. Continuity is a key feature of the relationship with the media and it needs to be established personally with the journalists and editors in the financial sector.

Working with the media was one of the linchpins of efforts to disseminate and process the bill.

Finally, any strategy had to be directed towards winning the support of political parties, since it was they that would finally debate and vote on the bill. In the case of Chile it was necessary to be careful with the approach adopted. It was essential to explain that the reform of corporate governance was not directed against enterprises and in favor of small shareholders; it simply represented a mechanism for ordering the rights and duties of each of the parties which would result in a

more efficient and developed capital market. We were very conscious that certain political schools would probably oppose a project that had an anti-business approach from the start. In addition other political forces would seek a harder-line approach against the controlling shareholders and one that was, in general, less liberal. Some parliamentarians of the government parties did indeed oppose the

It was essential to explain that the reform of corporate governance ... simply represented a mechanism for ordering the rights and duties of each of the parties, which would result in a more efficient and developed capital market.

option provision. At some point in the debate it turned out that one of the government parties was the party most reluctant to vote for the bill.

The government decided to negotiate with the senators some formula that would uphold the spirit of the bill; in the processing of the bill before Parliament, the controversial provisional article was included, along with some other items which would be applied only for a given period of time after which they would automatically be repealed

on the assumption that the circumstances that had given rise to them had ended. This article, which became the tenth provisional article, provided for the possibility of the current controlling shareholders choosing to sell their controlling block of shares and avoid the PTB procedure for three years starting January 1, 2001. To take that option, companies had to convene a shareholders meeting and decide whether or not to take advantage of that provisional article.

Not taking advantage of provisional Article 10 meant that controlling shareholders who wished to sell their shares during this period would be sharing the control premium with the minority shareholders and risk not being able to sell their entire stake in the company. Wishing to sell a controlling block of shares could entail a larger payment by potential bidders or a reduction in the price paid per share, compared to the situation without the PTB law. In principle therefore it was logical that the controlling shareholders should exert pressure for companies to take advantage of the aforementioned article, as this gave them the option of negotiating a better price for their blocks of shares.

However, the option referred to above carried a potential cost, which was a possible loss of reputation *vis-à-vis* national and international investors. The fact that a company was taking advantage of the aforementioned article could suggest (rightly, in a way) less protection for the rights of minority shareholders. In 2001, it was argued that the shares of companies that had adopted the option in this article would undergo a write-down, due mainly to a lower weighting by Chilean and foreign institutional investors.

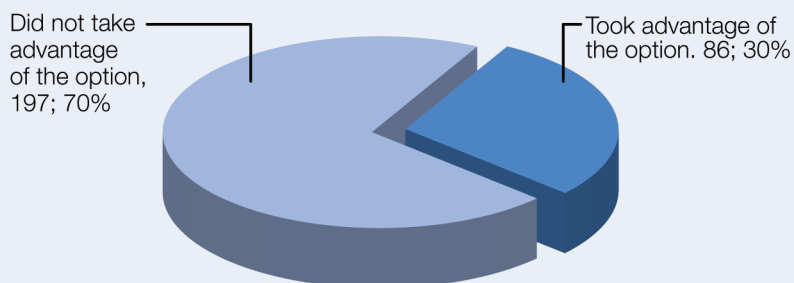
As the following chart shows (Table 7), of the 283 corporations registered with the securities registry of the Superintendent at end-2000 and which had public offerings of their shares, 86 public corporations (almost one third of the total) took advantage of provisional Article 10, while the remaining companies opted not to.

To summarize this section, Table 8 illustrates the work the government had to do in order to overcome a situation in which the bill was either rejected in Parliament or distorted in key aspects, and to achieve a situation in which the bill was approved in essence. The move from one situation to the other meant winning over economic agents opposed to the reform, and persuading them to support it.

To that end, the various tools analyzed (overleaf, Table 8) had to be deployed, from appropriate design and preparation, including a provisional clause, to the right communication strategies, to partnerships with influential groups, and finally arduous negotiations.

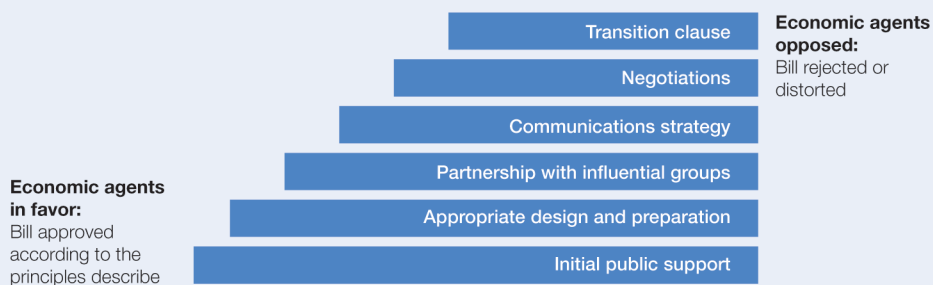
The Bill included a controversial provisional article according to which controlling shareholders (when the law was promulgated) could sell their controlling block of shares and avoid the PTB procedure for three years starting January 1, 2001. However, taking that option carried a potential loss of reputation *vis-à-vis* national and international shareholders.

Table 7: Companies that chose the provisional Article 10 option and those that did not



Source: Superintendent of Securities and Insurance, 2000

Table 8: Tools used



4. CAPITAL MARKETS AFTER THE REFORM

4.1 *The Chispas case settlement*

As mentioned in the initial section in December 1997 the Superintendent of Securities and Insurance fined the group of executives referred to earlier. In July 2002, the Civil Courts rescinded the fine imposed by the Superintendent, a ruling that was appealed by the Superintendent. In July 2004, the Court of Appeals of Santiago ruled in favor of the Superintendent.

Finally, in July 2005, the Supreme Court ratified the judgment of the Court of Appeals, thereby ending judicial discussion of this case. Consequently, the Supreme Court confirmed the fines imposed by the Superintendent of Securities and Insurance in 1997 in the amount of US\$66 million, and added US\$97 million in accumulated interest, which made the total US\$163 million, the largest fine ever imposed in the history of Chile. Under Chilean law, because those funds were a fine, they were paid to the Treasury within 30 days.

The Supreme Court confirmed the fines imposed by the SVS and accumulated interest, totaling US\$163 million, the largest fine ever imposed in the history of Chile.

The Chilean Supreme Court took into consideration various aspects of the negotiation that the “key managing partners” conducted with Endesa España. In its ruling the Court focused on the serious conflict of interest of the “key managing partners,” who acted in their own interests while still holding management positions in the Enersis Group.

The Supreme Court pointed out that the sales price of the series B shares of the Chispas companies contained a hidden payment for services that Endesa España was buying from the “key managing partners”, namely to exercise and keep control of Enersis.

The Court also pointed out that they concealed information from the other directors and shareholders of the aforementioned companies regarding Endesa España’s interest in acquiring ownership of Enersis and their intention to sell to it the shares

they held. They also concealed their commitment to exercise decisive influence in the management of Enersis to the benefit of the new controlling shareholder, Endesa España.

Consequently, the “key managing partners” allowed their personal interest to prevail over their duties and obligations as chair of the Board of Directors, directors, and manager of Enersis and of the Chispas companies and they handled the conflict of interest they faced in a manner that, in Chile, contravened legal provisions in force at the time.

Alongside the judicial battle triggered by the fine imposed by the Superintendent on the “key managing partners”, a second court case regarding the Chispas case is still under way. This case has to do with the punishment imposed on Elesur by the Superintendent in 1996 for the use of insider information.

As mentioned earlier, the purchase of shares of the Chispas companies was undertaken by Elesur, which, as explained above, was a Chilean company established by Endesa España for the purpose of taking control of Enersis.

One of the provisions of the “strategic partnership” established that Endesa España would have the option of buying all the shares of CERJ (a Brazilian electricity distribution company) as well as those of Edesur (an Argentine electricity distribution company), which were owned by the Chispas companies. The purchase price would turn out to be relatively beneficial for the Chispas shareholders.

The Superintendent argued that, if that information had been revealed to the public, the price of the Chispas shares would have gone up, reflecting favorable terms of purchase. That being so, the Superintendent imposed fines on Elesur in the amount of US\$3.5 million, accusing it of having used insider information in the purchase of the Chispas shares.

In July 2006, the Court of Appeals of Santiago ratified the fine imposed by the Superintendent. However, this judgment still has to be ratified or rejected by the Supreme Court.

4.2 A cultural change

This court judgment began a new era in the treatment of minority shareholders' rights in Chile. Those who had broken the law, who were directors and executives of one of the largest companies in Latin America, were in the end handed down an exemplary punishment.

The public has begun to understand that securities market regulations are applied to the abuses of both small participants and economic agents who may play key roles in the market. In short, citizens who owned shares either directly or indirectly (through their pension funds) have been able to see the enforcement in Chile, finally, of the rules that require compliance by directors and executives — with their duties of loyalty and due diligence to the companies they head, and to all their shareholders.

Today it is possible to observe how principal shareholders of listed companies appreciate the usefulness of having a more transparent and equitable regulatory framework.

Along with this framework comes an atmosphere of greater confidence for doing business and better access to capital.

Individual initiatives show how enterprises value sound corporate governance. Currently many companies are preparing their own corporate governance reports, and even reports on corporate social responsibility, that include the establishment of codes of ethics for behavior within companies and with other stakeholders. Also noticeable is the fact that, although the regulations do not require it, almost 100 percent of listed companies have an office responsible for relations with shareholders.

Citizens who own shares either directly or indirectly (through their pension funds) have been able to see the enforcement in Chile, finally, of the rules that require compliance by directors and executives — with their duties of loyalty and due diligence to the companies they head, and to all their shareholders.

Other private initiatives in this area, especially with respect to a private code of best corporate governance practices, have not materialized for a number of reasons. First there was a feeling, to a certain extent justified, that a private code could add little to an already luxuriant set of Chilean regulations. Second, a kind of collective

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complacency developed as a result of positive international perceptions of Chilean regulations regarding corporate governance. Finally, there may also have been some “change fatigue” regarding corporate governance regulations prompted by the extent of the changes required and the cost of processing the corresponding laws and subsequent implementation.

At the same time, pension fund administrators (AFP) have played a much more active role, compared to years prior, in the reform of corporate governance. In compliance with their duties as trustees, the AFP have demonstrated their ability to act in a

well-coordinated manner in company voting sessions and have played a key role in protecting the interests of minority shareholders in at least two large corporations. The first is a reference to the sale of Terra, a subsidiary of Telefónica Chile, to Telefónica España. The second case also involved Telefónica Chile and the sale of its mobile telephone subsidiary to its Spanish parent company. In both cases, the AFP made sure that the transfer prices were just and that the laws had been complied with.

In December 2006, the AFP had shares in 110 Chilean companies, in 19 of which they managed to elect at least one director. All in all, the AFP had 28 directors in listed public corporations.

The AFP have also been active with respect to the criteria for choosing directors who represent them, on the Boards of Directors of the companies in which they invest. In this way, they have worked together to restrict the maximum period for which the post of Director can be held.

The same is true of the maximum number of boards of which they can be members. In general, the AFP do not vote for directors who have had some relationship with the controlling shareholders, nor do they vote for company executives wishing to be on the board.

The same approach taken by the courts in the Chispas case was demonstrated in another controversial case, regarding Chile's largest private bank, Banco de Chile. In October 2005, the Supreme Court of Chile confirmed the conviction and fines imposed by the Superintendent of Securities and Insurance on seven individuals pertaining to the controlling group in Banco de Chile because they violated the ban on recommending, purchasing, or selling securities using information that had not been disclosed to the public, thereby breaching legal provisions on the use of insider information.

The case goes back to early December 2000 when Quiñenco, a major Chilean conglomerate, made an offer to the group of seven controlling shareholders to purchase their stake of 35 percent of the Bank in order to achieve control of it. Those shareholders rejected the offer. Ten days later Quiñenco informed them in private that it would conduct a PTB for Banco de Chile. The seven shareholders rushed to increase their stake in the Bank by buying shares on the stock exchange. In the end they managed to sell their block of shares to Quiñenco at a higher price (Banco de Chile had taken advantage of the provisional article, so that different prices could be offered for the shares purchased).

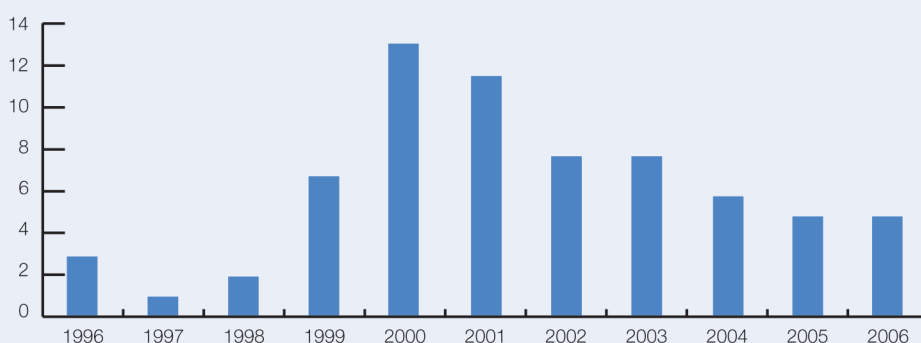
Seeing what had happened, the Superintendent of Securities and Insurance considered that the controlling shareholders had had insider information with regard to the future PTB by Quiñenco and, as a result, expected an increase in the share price. However, according to the accused, their objective had been to strengthen their shareholding in the Bank to prevent Quiñenco from taking control of it, that is to say, they had adopted a purely defensive strategy.

At the same time, pension fund administrators (AFP) have played a much more active role compared to years prior to the reform of corporate governance.

4.3 Takeovers

Takeovers have increased considerably since the PTB law was enacted, with the average number surpassing the annual average prior to 2000. This clearly demonstrates that the new regulations have not discouraged mergers and acquisitions as some observers had feared.

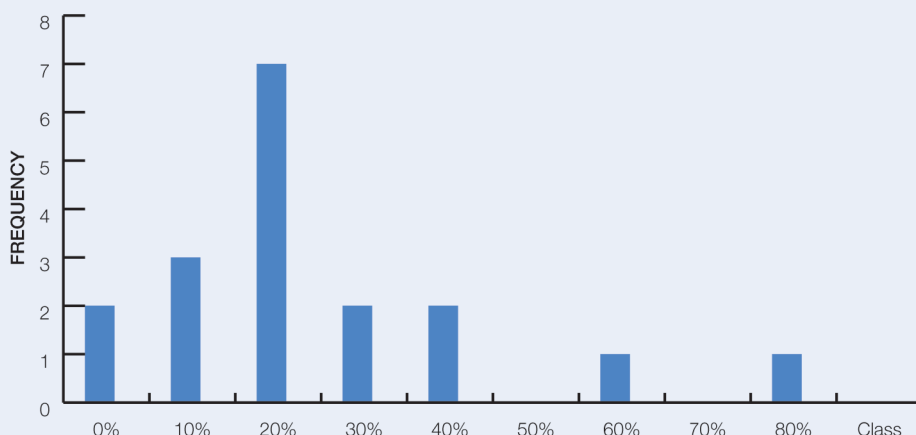
Table 9: Number of takeovers 1996-2006



Currently takeovers have become a matter of interest to all shareholders and not just to controlling shareholders. Since they are eligible to receive some of the control premium, small shareholders and institutional investors are showing greater interest as reflected in numerous articles in the press and in high demand for analysts' recommendations.

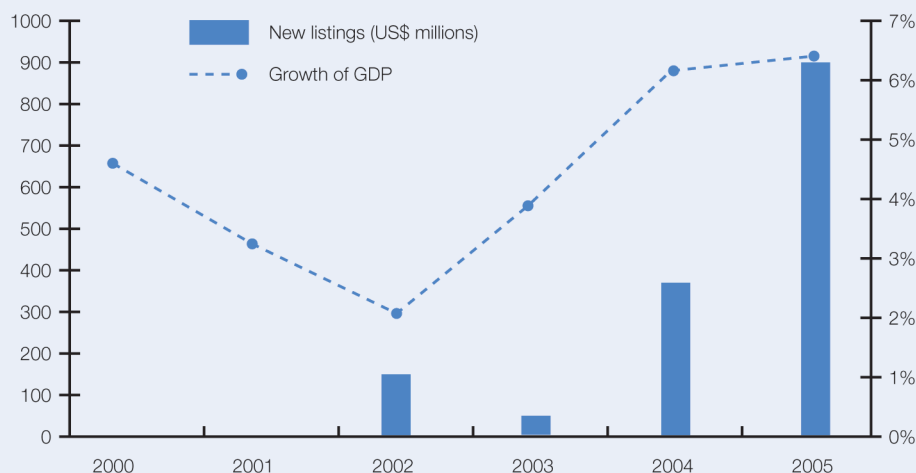
As the following chart shows, the premiums paid over and above market prices between 2000 and 2005 have averaged 23 percent; prior to the promulgation of the law such premiums went only to the controlling shareholders.

Table 10: Control premiums 2005



Furthermore, the fear and concern that regulating PTBs and corporate governance would discourage the listing of new companies on the stock exchange has proved to be unfounded. On the contrary, as the following chart shows, there has been a strong upward trend in listings on the stock exchange, closely correlated with the overall thrust of the economy.

Table 11: New listings of companies on the stock exchange



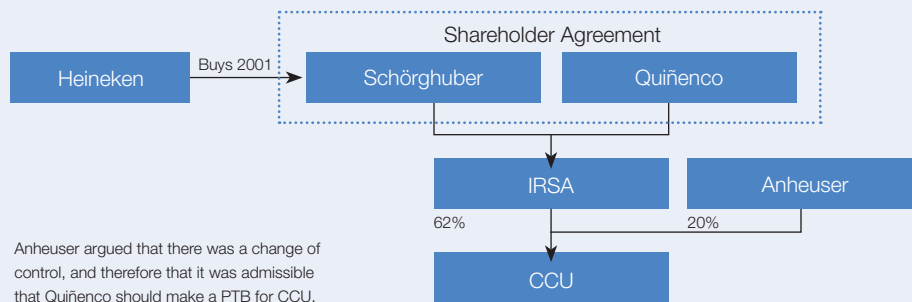
The PTB law has also demonstrated its effectiveness in the regulation of more complex takeovers, as in the case of the takeover of the Almacenes París department store in 2005 by the Cencosud holding company. There were three special features of this PTB for the Chilean market: it was the first securities swap PTB, the first hostile PTB, and the first competitive PTB.

The Almacenes París PTB was hostile because the department store's controlling shareholder until then, Quiñenco, did not wish to lose control of the company. In fact, within a few days of the first swap PTB, Quiñenco launched a competitive PTB in cash to which Cencosud responded with a new PTB in stock, on more attractive terms for the Almacenes París shareholders. Thus, the competition for control of Almacenes París ended up benefiting its minority shareholders.

Another important case was that of the change of a controlling shareholder of an entity that in turn controlled Compañías Cervecerías (CCU), a large Chilean brewer.³ In 1994 Quiñenco and Schörghuber, equal partners in IRSA, signed a shareholders' agreement to control CCU through IRSA, with 62 percent of the shares (see Table 12). In 2001, Schörghuber agreed to transfer its stake in IRSA to a new partner, the Heineken brewery. The Heineken Group was a partner in Cervecerías Chile, CCU's principal competitor in the Chilean beer market. CCU considered that such an agreement would have a major impact on the company's development, so it sought arbitration.

3 This case was taken from Lazen *et al.* (2004).

Table 12



In 2003, Quiñenco and Schörghuber agreed that Heineken could buy Schörghuber's stake in IRSA, but that Heineken could not compete with CCU in Chile and Argentina.

Once that agreement had been reached Anheuser-Busch, the largest brewer in the United States, which at that time had a 20 percent stake in CCU, appealed to the Superintendent of Securities and Insurance claiming that there was a change of control and therefore that CCU should carry out a PTB for the CCU shares.

The Superintendent stated that it was inadmissible to require a PTB because there was no acquisition of control of CCU, just a change of one of the members of the controlling group; this without prejudice to the fact that this provision did not impose an obligation to conduct a PTB on the purchaser of the shares of a "member of the controlling group" but only on the purchaser of the shares of the "controlling group", and "... provided that said acquisition allowed it precisely to obtain direct or indirect control of the company making a public offering of its shares", which was not the case here. Consequently, to prove its case that there was no change of control, the SVS argued that, since both parties had an equal stake in IRSA, Heineken could not control that company, so there was no change of control. Anheuser-Busch took its case to the Court of Appeals. Finally, in December 2003, the Court of Appeals of Santiago ruled in favor of the SVS.

5. CONCLUSIONS

Almost six years after the Public Takeover Bid (PTB) and Corporate Governance Law was enacted, it is now possible to make an impartial assessment of how it has functioned. The outcome has been favorable if we take into account that the objectives that gave rise to the PTB law have been met. Chile now has a transparent framework governing corporate takeovers and in which investors are adequately informed; prudent time limits are set for conducting the bid; a uniform and prorated price is required; and the operation is carried out in such a way that controlling and non-controlling shareholders have equal opportunities. The new regulations have been put to the test in complex competitive or hostile takeovers, and have proven to be effective.

The successful adoption of the corresponding bill in 2000 depended on the reform being understood and accepted. Accordingly, the discussion leading up to the law focused on three main objectives:

- (1) The adoption of a technical approach;
- (2) The quest for points of consensus; and
- (3) The achievement of a critical mass of support.

That shift involved winning over economic agents who opposed the reform, and persuading them to support it. To that end, the various tools analyzed above had to be deployed, from an appropriate design and preparation, including a provisional clause, to the right communication strategies, partnerships with influential groups, and arduous negotiations.

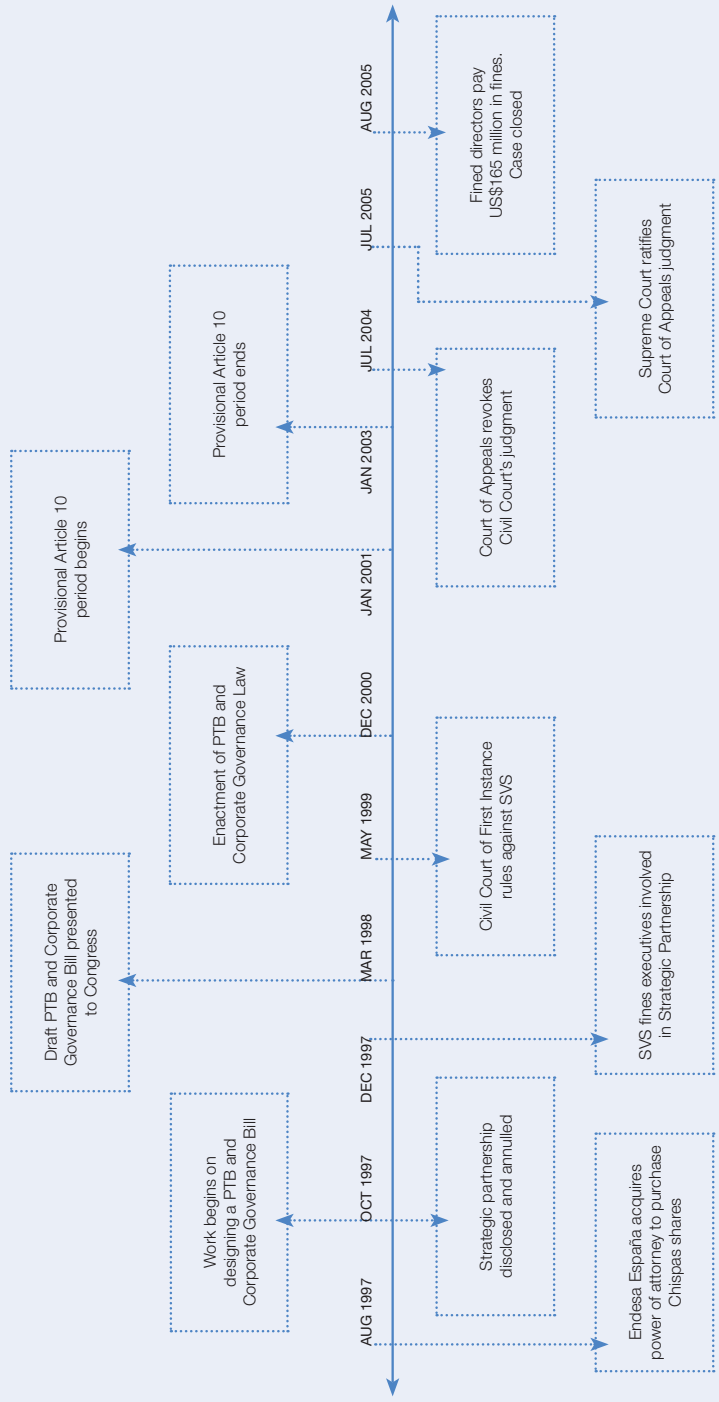
However, perhaps the most important development was the cultural change that came with the new regulations. The reformers helped to generate concern for the rights of investors. The reform also strengthened the general public's perception that securities market regulations are enforced for both the abuses of small participants and those of economic agents exercising major influence over the market.

Table 13: Chronology of important developments in the Chispas case

August 1997	Endesa España opens power of attorney to purchase Chispas shares
October 1997	The Strategic Partnership is disclosed and annulled
December 1997	SVS fines the executives involved in the Strategic Partnership
May 1999	The Civil Court of First Instance rules against the SVS
December 2000	Promulgation of the PTB and Corporate Governance Law
July 2004	Appeals Court revokes the Civil Court's Judgment
July 2005	Supreme Court ratifies the Appeal Court's ruling
August 2005	The directors pay US\$5 million in fines and the case was closed.

Citizens owning shares, either directly or indirectly, are gradually understanding the rules that demand compliance by directors and executives with duties of loyalty and due diligence to the companies they direct and to all their shareholders. At the same time Pension Fund Administrators (AFP) have played a more active role, compared with the years prior to the reform, in corporate governance. With that has come an atmosphere of greater confidence for doing business and better access to capital. In short the judiciary, institutional investors, minority shareholders and the business community have understood the importance of proper treatment of the rights of shareholder, workers and other stakeholders.

Table 14: Chronology of the Chispas Case and legislative reform



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PTBS IN PANAMA: SOME LESSONS LEARNED IN A PARADOXICAL SYSTEM

By Carlos A. Barsallo

1. INTRODUCTION

In Panama, the process for taking over companies registered at the National Securities Commission (Comisión Nacional de Valores, CNV) changed from a total lack of regulation (except for rules to defend against hostile bids established in Decree 45 of 1977, which is still in force and subsequently confirmed in Article 103 of Decree Law 1 of 1999) to an optional or voluntary public takeover process introduced in Decree Law 1 of 1999, which established the CNV and regulates Panama's securities market.

PTBs are, therefore, not obligatory in Panama and, in a stock market where the concentration of shareholder control is in the hands of very few shareholders, they are not essential as a takeover mechanism. Despite this nonobligatory environment, PTBs are now a major feature of the Panamanian stock market. The following discussion of the contradictory — and sometimes even paradoxical — features of the history, regulation, and practice of PTBs in Panama will attempt to explain this outcome and provide useful lessons for markets elsewhere.

2. UNIQUE CHARACTERISTICS OF PANAMANIAN PTB'S

PTBs are a new and increasingly popular phenomenon in Panama, nearly 20 percent of the joint stock companies registered with the CNV have undergone a PTB.

In most cases, the shareholders were paid a total of more than \$2.79 billion in cash through public, transparent transactions. This development has caught the attention of specialists and the general public both in Panama and abroad.

In Panama, nearly 20 percent of the joint stock companies registered with the CNV has undergone a PTB.

Table of PTBs Carried Out in Panama, 2000-2006

Date	Bidder/Object of the Bid	Total shares offered	Minimum shares offered	Market price (US\$)	Price bid (US\$)	Final acceptances (%)	Amount paid
15/05/00	Banco del Istmo, S.A./ Primer Grupo Nacional, S.A.	15,172,536	7,738,007	14.50	17.00	99.42	81,894,260
20/11/00	Corporación Incem, S.A./ Shareholders	4,412,062	1,147,136	60.00	61.00	47.40	127,570,361
20/11/01	Corporación de Cervezas Nacionales C. A.; Bravarfa, S.A.; Latin Development/ Shareholders Cervecería Nacional, S.A.	15,359,262	7,883,324	14.00	18.50	91.53	260,079,160
5/11/02	CA Beverage Inc./ Accionistas Cervecería Barú-Panamá, S.A.	3,844,114	(a)	12.00	14.60	99.60	55,899,568
55899	Coca Cola de Panamá Compahía Embotelladora, S.A./Shareholders	3,934,245	(a)	19.00	22.55	95.77	84,776,095
9/02/04	Banco Continental de Panamá S.A./Shareholders Grupo Wall Street Securities	3,368,677	1,718,026	16.00	16.65	99.60	55,864,118
18/10/04	Multi Holding Corporation/ Shareholders	16,865,737	12,817,961	18.60	21.72	99.20	363,393,217
20/09/06	HSBC Asia Holdings B.V/ Shareholders Grupo Banistmo, S.A.	33,629,730	21,859,325	48.50	52.63	99.98	1,769,578,703
	Total						2,799,055,482

2.1 CONTRADICTORY REGIMES

There are two sets of rules governing PTBs in Panama, with some contradictory and at times opposing philosophies and objectives.

One set of rules tends to favor, or at least not to obstruct, changes of control. That is the case with Decree Law 1 of 1999 and, especially, its enabling regulation, Agreement 7 of 2001, which regulates PTBs. This latter Agreement contains rules that facilitate takeovers of public corporations, or at least prevents measures designed to hinder such transactions. Thus, from the time the takeover target is notified of the PTB until the bidder announces the results, the board of the company being taken over must refrain from conducting any operation that is not part of the company's routine operations or that is designed to hamper the course of the PTB.

The second set of rules tend to make changes of control more difficult and to protect those who run public corporations. This is the case with — and *raison d'être* of — Decree 45 of 1977, the “rules to defend against hostile bids,” which applies both to companies constituted in accordance with Panama's laws and to those constituted under foreign laws that have their corporate headquarters, or are authorized to do business, in Panama.

In both cases, companies impacted by these rules must have more than 3,000 shareholders (a majority of whom are domiciled outside Panama). Additionally, these companies have to register voluntarily, or have been expressly registered for that purpose, with the CNV when Decree Law 1 of 1999 came into force. Finally, these companies need to have permanent offices in Panama, with full-time employees, and have investments in the national territory exceeding \$1 million.

2.2 Paradox: Voluntary by Law, but Obligatory in Practice?

The bidders in the eight PTBs that have taken place in Panama in the past seven years have behaved, in practice, as if the system did call for mandatory PTBs.

Although Panama's legal system does not contemplate mandatory PTBs, the bidders in the eight PTBs that have taken place in Panama in the past seven years have behaved as if the system did call for mandatory PTBs. The paradox strikes us as even greater if one takes into account the fact that market conditions do not appear to render PTBs indispensable as a mechanism for taking control of public

corporations. Control of Panama's public corporations is concentrated in the hands of a fairly small group of controlling shareholders. One may wonder whether the use of PTBs might not be due, instead, to the lack of other options for taking over control of a public corporation.

3. OTHER OPTIONS

PTBs, along with proxy fights and mergers, are mechanisms for taking over companies.

As the name suggests, PTBs are a public bid to purchase shares registered with the CNV.

Proxy fights consist of a shareholder or third party obtaining a sufficient volume of voting rights to exert control at shareholder meetings. This giving of voting rights is usually for a specific purpose, and does not affect ownership of the stock. In Panama, the procedure for obtaining requests for voting rights was regulated thoroughly and profusely by Agreement 16-2000 of the CNV. However, that Agreement was declared unconstitutional in a judgment of the Supreme Court of Justice, handed down on May 24, 2003.

The declaration of unconstitutionality was the result of a well-publicized case involving the Corporación La Prensa. La Prensa — Panama's largest circulation daily newspaper and a major journalistic enterprise registered with the CNV — has a fairly broad base of more than 1,500 shareholders.

In 2001 Prensa was about to hold its annual shareholders' meeting to elect directors and officers. A shareholder filed a complaint with the CNV, alleging that some shareholders and candidates for directorships and other positions in La Prensa were requesting voting rights in a manner that violated the requirements in Agreement 16-2000 of the CNV. In response to the investigation carried out by the CNV into the alleged violations, a member of the Board of Directors of La Prensa challenged before the Supreme Court of Justice the constitutionality of CNV's legal powers to regulate voting rights through Agreements.

Even though the CNV's right to regulate this matter is expressly stipulated in Articles 91 and 93 of the Decree Law on Securities, the plaintiff maintained that those articles were unconstitutional. This claim was based on Article 179 of the Constitution of Panama, which establishes that only the Executive Branch is empowered to regulate laws. The Supreme Court of Justice issued the following interpretation: that while the CNV was indeed authorized, under Decree-Law 1 of 1999, to issue Agreements, it was not empowered to issue Agreements regarding the voting requirements in respect to voting rights. This was because Articles 91 and 93 referred to "executive regulations" rather than to CNV's Agreements. It should be noted that the Decree Law on Securities does not distinguish between Agreements. As a result, so far there are no regulatory rules and for that reason the proxy fight mechanism is not, in practice, available.

Finally, there is the merger option. Mergers continue to be a common, fairly frequently used way of taking over companies, and more precedents exist for them than for the other options. Nevertheless, in mergers, unlike PTBs, the final decision rests with the company's shareholders meeting as a collegial body, not with any individual shareholder.

All the above mentioned mechanisms pursue the same goal, namely to take control of a company, through different routes. The choice of route made by the person seeking to take control of the company depends on the actual circumstances of each case, on what best suits him or her (in terms of cost and time), and on the legal provisions in force .

4. DISPERSED CONTROL?

Control is concentrated in the hands of a few shareholders: for instance, in an enterprise with 1,302 shareholders, nine own approximately 57 percent of the shares issued.

The Panamanian stock market is relatively immature and illiquid. Unlike other countries in Latin America, Panama did not use its stock market for any of its major privatizations.

In Panama relatively few people own shares, and the stock market lacks the liquidity and maturity found in markets in other countries. Although a trend can be seen in recent years to greater overall activity and more dynamism in the stock market, the number of companies with registered

common shares (the largest in Central America) has not increased. Unlike other countries in Latin America, during the “privatizing” period Panama did not use its stock market for any of its major privatizations, such as those in the telephone or electricity sectors.

The 33 companies with shares registered with the CNV have, all in all, more than 40,000 shareholders. Looking at the ownership composition of the stock in those 33 enterprises, we find that control is concentrated in very few hands. A typical case might be that of an enterprise with 1,302 shareholders, holding a total of 41 million shares. Nine of those shareholders own 23 million shares, that

In the case of Panama, the concentration of shareholder control does not suggest that it is difficult for an interested party to acquire control of an enterprise.

is to say, approximately 57 percent of the shares issued. On the other hand, 657 shareholders hold 78,000 shares which represent 0.19% of the circulating stock.

In the case of enterprises whose shareholding structure reflects dispersed control, the need for

the use of PTBs as a mechanism for taking control is obvious. It is the most practical way to reach the many stockholders in a timely and efficient manner. In the case of Panama, the concentration of shareholder control makes it possible for an interested party to acquire control of an enterprise privately from the few shareholders who exercise that control.

The use of PTBs in Panama would appear to indicate, then that it is legal requirements that force someone wishing to acquire control of an enterprise to launch a PTB. That supposition, however, is not correct. Panama's legal system does not provide for mandatory PTBs. The Panamanian system contemplates the so-called voluntary PTB.

5. REQUIRED BY LAW?

In those places where PTBs are legally obligatory, an entity wishing to purchase control of a company registered on the stock market, whether in one or multiple offerings, must issue a PTB through which control of the company could be affected.

In the case of Panama, the rules in force require that anyone, who makes a public bid to purchase 25 percent or more of the registered shares of a company, which acquisition would then give the bidder more than 50 percent of the issued stock, must notify the CNV of their actions. They must also comply with the provisions of Decree Law 1 of 1999 and with the agreements issued by the CNV on procedures for distributing the bidding documents, the information said documents should contain, and their form of presentation, in order to ensure an equitable process for all parties.

PTBs are not obligatory in Panama and the way control is concentrated in practice does not make it indispensable. Why, then, have there been so many PTBs in recent years?

So one may wonder: if PTBs are not obligatory in Panama and if the way control is concentrated in practice does not make them indispensable, why, then, have there been so many PTBs in recent years?

6. THE ROLE OF PUBLIC OPINION, THE MEDIA AND THE CNV

The part played by public opinion and the media has been significant. The media is an invaluable vehicle for the education of investors and is vital in countries with emerging stock markets.

The answer — as we shall attempt to explain in these comments — involves, in our opinion, a combination of factors, including, but not exclusively the following:

- (1) The opinion, or lack thereof, of the public as to the fairness of PTBs;
- (2) The needs of stakeholders (especially shareholders, directors, and managers of some enterprises);
- (3) The role of the media, especially the written press; and,
- (4) The CNV's as the regulator and supervisor of the securities market.

There is a lot of ignorance regarding the stock market, which translates into scant participation and mistrust. It is vital that the media report responsibly on developments in the stock market as an integral part of the country's financial system.

Inappropriate or sensationalist handling in the media of financial problems or operations, which may at times be novel (as PTBs were when they were first

introduced in Panama), sensitive or complex, can cause enormous confusion and mistrust in the general public, particularly if there is a tendency to generalize or oversimplify.

There is a lot of ignorance about the stock market and that translates into scant participation and mistrust.

A concrete example of the impact the media can have was the first

PTB to take place in Panama. As could be expected, it was a complete novelty and triggered ample media coverage. Numerous factors combined to make it a particularly interesting case. They included, among others:

- (1) The new securities regulations, Decree Law 1 of 1999, which was adopted on July 8, 1999 but did not take effect until 2000; and,
- (2) The fact that the CNV team had only recently been installed and had its own priorities, namely to organize itself internally and finish regulating the securities law.

However, market realities did not exactly fit in with the regulator's plans.

In May 2000, one of the three largest and most important privately owned banks in the country, Banco del Istmo S.A. (an enterprise with shares registered in the CNV and listed on the Panama Stock Exchange (PSE)) decided to launch a PTB for the shares of Primer Grupo Nacional S.A., which held shares in Primer Banco de Ahorros S.A., another of the three largest privately owned banks, which was also an issuer of stock with its shares registered in CNV and listed on the PSE.

The regulations to be issued by the CNV had not been completed. The CNV coordinated with the interested parties to ensure that the first PTB in the history of Panama's stock market would be carried out under appropriate regulations. Dialogue was essential and a regulatory agreement was reached, inspired by the rules governing stock markets in such countries as Peru and Costa Rica.

The CNV coordinated with the interested parties to ensure that the first PTB in the history of Panama's stock market would be carried out under appropriate regulations.

Another important factor that triggered interest in the first PTB was undoubtedly the fact that Empresa General de Inversiones S.A., which held shares in Banco General, another of the three largest privately owned banks in Panama, both of which had shares registered in the CNV and listed on the PSE, decided to take part with a competing PTB.

Then, something unprecedented happened, everything took place according to a regulated procedure based on several fundamental, clear, and novel objectives, which had never been previously contemplated, and could be summarized as follows:

a. Access to equal treatment for all the issuer's shareholders

The concept here is that all shareholders should to be treated equally in the event of a public takeover bid for registered shares in the amount of 25 percent or more of the shares outstanding or for a volume of shares that, if purchased, would give that person more than 50 percent of the outstanding shares.

b. Disclosure of important information regarding the bid

The concept here is simple — ensure the disclosure of the information needed by shareholders to determine whether or not to sell their shares.

This officially illustrated the regulators' concern to provide shareholders with all important and necessary information and to ensure complete transparency for the market while obtaining equal treatment for all shareholders, without distinction, those ultimately affected by the PTB and those who would be individually responsible for the final decision.

Never before had Panama's depositors, regulators — either of the banking system itself or for securities — or the general public, experienced these types

Initially, the media coverage prompted concern among certain sectors ... [T]hey feared that a prolonged takeover process, exposed to media coverage, could result in a run on the deposits of the banks involved, especially the bank targeted by the PTB.

of transactions with the enormous advantages of transparency and freedom of information.

The battle for control of Primer Grupo Nacional S.A. was fought in the CNV and the media. Initially, the media coverage prompted concern among certain sectors.

The banking regulator, understandably, feared that a prolonged takeover process, exposed

to media coverage, could result in a run on the deposits of the banks involved, especially the bank targeted by the PTB.

It is worth recalling that, for the good of the shareholders and their right to take a properly informed decision, Panamanian law establishes a minimum period of 30

days for the decision to accept or reject the PTB. During those 30 days, the law allows the shareholder to, first, revoke their acceptance without having to provide explanations and, second, authorizes (and favors) the initiation of competing PTBs, in which case the minimum acceptance period is extended. That can mean several months of uncertainty regarding the issuer's fate and, if banks are involved, this raises concern in the banking sector.

It is, therefore, up to the securities regulator, the CNV, to explain, at various levels, the purposes, mechanisms, and benefits of PTBs. It was necessary to take a very didactic approach. The curious and paradoxical aspect of the case is that people were not accustomed to so much information and transparency, and hence, for some it was not, and is still not, easy to handle.

CNV, must explain, at various levels, the purposes, mechanisms, and benefits of PTBs.

The competitors used the media constantly, attempting to underscore the benefits of their bid and the disadvantages of the competing bid. Their legal advisers attempted to use CNV forums to invalidate the other's bid, based on either technical or procedural arguments. Resorting to the courts, though, was never considered to be a viable alternative. The parties preferred the CNV administrative offices because it was a more flexible venue than others.

The competition ended with the withdrawal of the competing bid from Empresa General de Inversiones S.A. because its offer was considered to have not been made under the same circumstances as those of the original bidder. Nevertheless, the competing bid had a very beneficial impact for the shareholders of Primer Grupo Nacional S.A. Banco del Istmo S.A. increased their bid substantially, which meant that the shareholders obtained a better price for their shares than what had been originally offered.

It is worth noting that payment was in cash and in the bidder's shares. The purchasing company, Banco del Istmo S.A., remained registered with the CNV and listed on the PSE. Subsequently that company itself became the target of a PTB and was purchased by HSBC bank, which terminated its registration with the CNV to leave the PSE. Most (six out of eight) companies that were the objects of PTBs ultimately withdrew from the local market.

The first PTB was not the only case to prove our argument regarding the impact of public opinion and the media on PTBs in Panama. Another case that yields important lessons is that of the Cervecería Nacional PTB.

7. THE IMPACT OF PUBLIC OPINION: THE CERVECERÍA NACIONAL PTB

The initial takeover plans for this company by Compañía de Cervezas Nacionales C.A., Bavaria and others were developed, according to the media, to acquire control, through stock purchases, of Capitales Nacionales S.A., a public corporation acting as the holding company of Cervecería Nacional.

The shareholder composition of Cervecería Nacional S.A. was, albeit very similar, but not identical to that of its holding company, Capitales Nacionales S.A. Both companies' shares were registered with the CNV.

For the purchaser, the acquisition of the shares of Capitales Nacionales S.A. amounted to an indirect acquisition of Cervecería Nacional S.A. For those who

The PSE requested that the CNV intervene in the case ...to confirm and clarify the differences between the PTB rules — specifically the voluntary and voluntary nature of PTBs — and commonly held perceptions.

are shareholders only of Cervecería Nacional S.A., but not Capitales Nacionales S.A., this meant that they were excluded from the transaction.

For the purchaser, there was another important factor to consider: control of Capitales Nacionales S.A. was concentrated in the hands of only a few shareholders. A private, direct purchase of those shareholders' stocks would effectively result in the purchaser

having control of Capitales Nacionales S.A. and ultimately of Cervecería Nacional S.A. at a substantially lower cost than that of launching a PTB to acquire control of all the stock for Cervecería Nacional S.A..

There was a short but intense campaign in the media through which those Cervecería Nacional S.A. shareholders who were not shareholders in Capitales

Nacionales S.A. voiced their opposition to the transaction being carried out via acquisition of control of the Capitales Nacionales S.A. shares.

The PSE requested that the CNV intervene in the case. That intervention by the regulator served to confirm and clarify the differences between the PTB rules in effect — specifically the voluntary and not obligatory nature of PTBs — and the ideas that had been widespread and created by earlier PTBs. It also illustrated the regulatory shortcomings *vis-à-vis* cases such as this. This applied, in particular, to the problem of indirect acquisition of control via purchase of the holding company, which may be an enterprise registered with the CNV, an issue not addressed in Panama's regulations.

The local controlling shareholders, public opinion, and the media all made it abundantly clear that it was their intention and desire for the transaction to benefit all the company's shareholders equally.

One problem posed by the requirement that PTBs proceed only when shares are registered with the CNV is when control is acquired over a company holding shares that are not registered with the CNV but which owns shares in a company whose shares are registered in the CNV.

The outcome in practice is a change of control in the company whose shares are registered with the CNV but without giving rise to the conditions needed to generate the obligation to notify the CNV of a PTB.

Having said that, we should ask ourselves: What led the purchaser to launch a PTB when it was not legally required since it was quicker and easier to deal only with the relatively few major shareholders privately?

There is no precise answer because there are no statements or official replies by the people who took those decisions. However, what is public knowledge is the fact that the local controlling shareholders, public opinion, and the media played important parts and made it abundantly clear that it was their intention and desire for the transaction to benefit all the company's shareholders equally without distinction.

An important factor in understanding the reason for launching a PTB, is the historical interaction of the company and its ownership. In spite of being large, by local standards, the company existed of a country and market in which everybody knows each other. An additional factor to consider is the manner, purchase of control in the unregistered holding company, through which control of the intended company was accomplished.

Another factor to be taken into consideration is the stated interest of the controlling shareholders not to have their reputation impaired by an operation from which only

the majority shareholders stood to gain, leaving the minority shareholders unprotected. The latter were, as we have said, neither unknown nor strangers, and they had made their displeasure known.

The desire to uphold the reputation of the controlling [shareholders]...led to a PTB in the case of a company which, strictly speaking, could have been acquired without that mechanism.

This curious case, which involves more than just market and legal aspects, leads us to conclude that an important part was played by public opinion, the

media, and the desire to uphold the reputation of the shareholders in an apparently large enterprise (by local standards) with a shareholder base of well-known individuals. All this led to a PTB for a company which, strictly speaking, could have been acquired without that mechanism, albeit at a high cost to its reputation.

8. SOME LESSONS LEARNED FROM THE FIRST PTB

The upshot of the first PTB, from a regulatory point of view, was favorable and, as was to be expected, generated various lessons for all those who were involved. Let us look at a few of these lessons from the point of view of each shareholder.

8.1 *The Securities Regulator*

In the course of the PTB, the securities regulator produced a large number of legal opinions which, under Panamanian law, have the status of a regulation. These opinions made it possible to move ahead with the process in an expeditious and flexible manner. It also issued new Agreements amending the original Agreement

which it then submitted to the mandatory public consultation procedure, and produced a final document compiling the cumulative experience acquired by all the stakeholders who were especially invited to participate in the efforts to improve the initial regulations. This regulatory agreement proved to be satisfactory as well as, like any other human undertaking, improvable.

In the course of the PTB, the securities regulator produced a large number of legal opinions which ... made it possible to move ahead with the process in an expeditious and flexible manner.

One practical change made in the law was the decision by the CNV to charge a notification fee. In some markets, PTBs, an important source of revenue for some regulators, did not pay any tariff or fee to the CNV. After the initial PTB, following the abovementioned amendment the person giving notice of a PTB has to pay the CNV a one-off public takeover bid notification fee in the amount \$10,000.

8.2 Public Companies and Bids

The outcome of the first PTB served to clarify what the bidder should do in a PTB, and what the regulator should and can do. The specific exercise made it clear, contrary to what might be expected, that the bidder need not ask the regulator for authorization, nor should the CNV proceed, therefore, to grant authorization for a PTB.

The first and chief obligation of a person launching a PTB is to notify the CNV and comply with the provisions of the securities law and those of Agreement 7-2001 regarding procedures for distributing bidding documents, the information they should contain, and their presentation, in order to establish an equitable process for all parties.

Once it has been notified, the CNV will verify that the bid meets the procedural requirements. To that end it may request and gather any additional information it deems relevant. If the documentation submitted meets the requirements, no additional action by the CNV will be undertaken to approve or register the PTB. In Panama, unlike other markets, PTBs are not authorized.

The regulator's' power to control and supervise lies in its legal authority to suspend PTBs in very special cases in which, in his opinion, information is lacking or the information submitted is false or deceptive.

Enterprises that could be the objects of future PTBs and their legal advisers, began to study and design mechanisms which transformed PTBs into a mechanism for concluding a process that had already begun and had, to a certain extent, concluded prior to the PTB. The CNV has reacted to some of these mechanisms.

The CNV has established its administrative position regarding the effects of agreements between shareholders that have controlling blocks of shares in registered companies and potential purchasers. In several cases, the PTBs launched for all the shares were preceded by private pacts or agreements with the shareholders of those registered companies who, either individually or jointly with other shareholders, formed a controlling block of shares. In the cases that occurred, the purpose of such agreements would be to oblige shareholders to accept the bid. Penalties were even established should those shareholders not accept or revoke their previously manifested acceptance of the PTB.

The CNV considers that the effect of such prior agreements in connection with a PTB launched in accordance with current law runs counter to the letter and spirit of Decree Law 1 of 1999 by preventing free competition.

8.3 The Bank Regulator

The bank regulator, especially when the takeover target was the ownership of individual banks, reacted with its own rules and philosophy that differed from that of the securities regulator regarding takeovers of banks.

The differences in regulatory philosophy (complete and timely disclosure of information versus discretion and confidentiality in the proceedings) that are found all over the world between the banking and securities sectors became more marked given the attempt to accommodate the interests of bank shareholders (when they are publicly owned enterprises) and the need for information, transparency, and publicity in the market. This needed to be done without losing concern for the protection of the banking system itself, as well as the confidence, based on confidentiality and discretion, of the depositors in the banking sector.

8.4 The Media

The media, especially journalists specializing in financial matters in the written press, learned the lessons of the first PTB as evidenced by their coverage and handling of the seven PTBs that followed. The coverage is different to some extent. Since the topic has become somewhat more routine and has ceased to be a novelty, reporting on it is calmer and journalists are now playing a very important watchdog function.

8.5 Shareholders in Public Corporations

In our opinion, these are the stakeholders that have gained most. Shareholders have been able to observe and benefit from the advantages of PTBs as a mechanism for acquiring control of companies. The eight PTBs carried out have all been considered successful in the sense that the price paid for shares substantially exceeded the price that the market had assigned to those shares since the time they began being publicly quoted.

That does not mean that there are no unsatisfied shareholders. Some shareholders have filed complaints and denounced an alleged illicit use of insider information in some PTBs. The CNV has investigated all the allegations made, but has not been able to find evidence to confirm the complaints or denunciations.

It is possible to point to six advantages provided for in the regulations that, in our opinion, benefited shareholders in the PTBs that have been carried out. These were benefits which they did not enjoy before and which they could not have received under other takeover mechanisms. There may also be others.

Shareholders have been able to observe and benefit from the advantages of PTBs ... the price paid for shares substantially exceeded the price that the market assigned to those shares.

8.5.1 Right to Receive a Report from the Board of the Directors of the Issuing Company

The Board of Directors of the company issuing the shares that are the object of a PTB provides, at a minimum, a detailed report giving its opinion of the bid. In this report it must refer to the existence of any agreements between the bidder and the company, or its directors, officers, or executives regarding the PTB. That report and any other communication provided by the issuer on the PTB must be submitted to the CNV for inclusion in the public file and placed at the disposal of the shareholders of the issuing company at least five business days prior to expiration of the bid.

8.5.2 Right to be Given Sufficient Time to Take a Decision Regarding Acceptance of an Offer of a Bid

The time allowed for acceptance of a PTB may not be less than 30 days.

8.5.3 Equality of Terms and Conditions

All PTBs must be offered to all shareholders on equal terms and conditions and the same purchase price must be paid to all shareholders who accept the bid.

8.5.4 *Pro-Rata* Purchase

Should acceptances be received for a higher volume of shares than that stipulated in the PTB, the bidder must purchase the shares on a *pro-rata* basis from among the acceptances received. In the event that acceptances are received for a volume of shares greater than that stipulated in the PTB, the bidder may purchase, in whole or in part, the securities that exceed the amount of the bid. Otherwise, he must purchase the shares from all those who accepted the bid in proportion to the number of securities included in each acceptance received.

8.5.5 Ban on Purchasing Shares not Included in the Bid

No person or affiliate of a person making a PTB, including the issuer itself, may directly or indirectly acquire shares of the same class in a manner different from that stipulated in said PTB within the bidding period.

8.5.6 Right to Revoke Acceptance

Any shareholder that has accepted a PTB may revoke his acceptance before the bidding period expires.

8.6 The Government

The national government took a very specific fiscal approach to the subject of PTBs. From the time they were first regulated, PTBs enjoyed special tax treatment. It was established that shareholders were not liable for income tax on the profits, resulting from their acceptance of the PTB. This was a ruling that, undoubtedly, made PTBs attractive as a takeover mechanism.

The special tax treatment meant that, thanks to the law, none of the shareholders, who were paid in excess of \$2.79 billion as a result of the eight PTBs, paid income tax on their capital gains.

In the fiscal reform of 2005, shareholders were subjected to either a special 10 percent tax on profits made if they had held ownership of the shares for over 24 months, or their usual income tax (which may be as high as 30 percent of taxable revenue) if they held ownership of the shares for less than 24 months.

The tax laws were changed again in 2006 when a final and uniform formula for income tax on capital gains made by shareholders as a result of PTBs, was established, at five percent of the total value of the sale.

9. CONCLUSIONS

The optional PTB found in certain markets is usually characteristic of a well-developed capital market in which all the players, regulators, investors, courts and the general public have had years of experience. Mandatory PTBs have been more common in Europe and in Latin American countries. The latter is undoubtedly easier to understand, and desired by minority shareholders, even though some academics point out that it is not ideal.

We have the impression that Panamanian regulators are convinced that in Panama, we follow the mandatory and not optional PTB system. We are also convinced that the vast majority of Panamanian shareholders holding minority stakes wish for PTBs to be obligatory. By that is meant, specifically, that if someone wishes to acquire control of a company whose shares are registered with the CNV, he or she shall have the obligation to offer to buy them from all shareholders and not just from those exercising control.

However, the above is not what is expressly provided for under current law. Extra-judicial factors (for example, public opinion, the media, etc.), have led to PTBs in Panama that catered to the aspirations of all shareholders, so that ultimately what we have is a happy confluence of events. Nevertheless, since PTBs are not necessarily the reflection of the regulations problems could arise in the future should minority shareholders consider that the regulations do not support their aspirations.

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