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BY EMAIL

Hermes EOS Response to OECD LatAm White Paper on Corporate Governance

We at Hermes Equity Ownership Services recognise this as a strong and powerful paper which markedly moves the debate forwards in the region. These comments therefore take a step back from the paper itself and consider the issues from a slightly different perspective.

The core of making corporate governance effective must be ensuring an effective relationship between the board of the company and its investors. Indeed, the core of comply or explain governance codes is that there is an active dialogue between the two parties: explanations need to have investors who are active participants, receiving and considering those explanations and entering into dialogue with companies where they are deemed to be unsatisfactory.

We believe firmly that dialogue requires three things to be in place:

1. Better disclosure by companies – in the context of the many majority-held companies in Latin America, particularly giving minority shareowners the confidence that their interests are effectively protected
2. Active investors – who are prepared and able to participate fully in their portion of the comply or explain debate
3. Removal of the barriers between the companies and the investors

The following discussion considers these issues in a different order:

3. Removal of barriers

The barriers to voting in Latin America are well understood and well covered in the White Paper. These are such issues as blocking of voted shares, requirements for Powers of Attorney etc, and these are gradually (and helpfully) being addressed by different jurisdictions in the region.

But engagement extends far beyond merely voting at General Meetings, and the barriers to engagement are much less well understood. For example, in a number of markets in the region regulation requires or practice dictates that pension funds do not invest directly in companies at all (or at least in markets outside their domestic one); instead, they invest through pooled or mutual funds. This means that the pension funds are not shareowners in the underlying companies in which they invest their money, but are holders only of units in the relevant funds. Thus, they are disenfranchised: they can only be silent investors, can never play their part in the dialogue with companies which good governance requires.

In order for these pension funds properly to play their governance role, they need to invest more directly. This does not need to mean fully taking on all fund management internally, but it can be achieved through having segregated accounts at fund managers so that the pension fund is seen as the direct owner of the underlying assets rather than just having a share of a pool which is the holder of the stocks. If it is right for pension funds to act as active owners in domestic markets, it must also be right for this to happen internationally.

Perhaps this would not matter if the fund managers of these pooled or mutual funds could be relied on to exercise their proper role as owners of the underlying companies. However, experience indicates that these intermediaries cannot always be relied on properly to carry



out this role (see also below under 'Active Owners'). If pension funds do not wish to switch to segregated accounts, or to direct ownership, then as a minimum they should call their mutual fund managers to account for carrying out governance work effectively on behalf of their clients.

1. Disclosure by companies

As a generalisation, disclosure by Latin American companies remains poor. If companies want to win international investors they need to make their information publicly and freely available – the length and complexity of the investment chain, particularly for international investors, means that companies and investors cannot rely on information being passed efficiently through custodians and so on.

We strongly welcome two of the initiatives discussed in some detail at the Roundtable meeting:

- the representative of Chile's ministry of finance highlighted steps taken to ensure a greater focus by companies on promptly disclosing to the market developments and changes such that the market is informed in a timely fashion and a false market in shares does not develop. Such moves are a crucial element of building investor confidence in the fairness and efficiency of regional markets and in minimising the risks of insider trading which undermine confidence.
- the representative of the Brazilian securities commission talked about that organisation's very welcome steps to enhance the disclosures which companies make ahead of AGMs. In particular, these steps will ensure that companies make available to their owners the detail underlying the resolutions to be considered at General Meetings well in advance of those meetings so that they will be able to exercise their voting rights in time for relevant deadlines on the basis of full information.

These are very important developments and we believe that they should be replicated across the region. In combination they are significant steps towards building robust international investor confidence in Latin America's financial markets.

We fully support the model proposed by PREVI for the distribution of a proxy statement (*manual para Asamblea de accionistas*) in advance of any meeting to ensure all shareowners are fully informed. We note that, in the White Paper currently, emphasis is still placed on physical participation at shareowners meetings, or at least live participation via the internet. For many interested and active investors, in particular international institutions, such physical participation is impractical and the availability of information prior to the meeting is key. In order for investors to be able to make fully-informed voting decisions, we encourage the on-line publication of all necessary materials, both those highlighted in the PREVI document and those required to be available by law, to ensure that those who cannot physically follow proceedings or travel to the company's offices to obtain information can actively participate in the corporate governance of the company.

As somewhat of an aside from disclosure issues, we would note that we enthusiastically support the special corporate governance listing segments of Bovespa, and encourage the creation of such segments in other markets. We do have concerns, however, that certain companies cloud good governance by failing to act in the spirit of the segment or actively seek to circumvent the required governance improvements. We believe it is essential that regulators and exchanges address this issue through enforcement and ensure that the principles of higher levels of corporate governance in these segments are respected.

2. Active Investors

We recognise that many pension funds in the region recognise that they have a significant social purpose, and a duty to protect the interests of the societies which compulsorily contribute to them. This is a crucial focus and drives pension funds to take a particular interest in their domestic markets, acknowledging their role in seeking advancement of their domestic economies as a way of fulfilling that social function.



This is an important role for Latin America's pension funds, but we believe that there is a downside to this focus: there is a tendency among some schemes only to consider their role in their domestic markets and not in the wider region, let alone in the world as a whole. While schemes were relatively small, this might have been sustainable, but given the scale and the growth of these schemes, we are not sure that this domestic focus will be sustainable in the long run. We firmly believe that alongside their social purpose pension schemes need to focus also on their fiduciary duty to their underlying beneficiaries to maximise returns. There is now considerable evidence (not least that within Latin America itself) that improved corporate governance significantly enhances the performance and the value of companies. There is therefore a significant value opportunity for pension schemes in playing a full role internationally in the corporate governance debate. As Latin America's pension schemes grow in scale we believe that this is a necessary and inevitable step for them to take.

How can we best encourage this behaviour in the interests of the pension schemes' beneficiaries? We believe that active consideration should be given to the model laid out in the Walker Report recently released in the UK, which provides a framework through which engagement is directly encouraged. It does not substitute the regulators for active shareowners (we believe that this is the right decision as direct intervention by the regulators is likely to undermine company willingness to move from mere compliance towards best practice) but uses regulatory tools to encourage them to play their role more effectively. The Institutional Shareholders' Committee's 'Stewardship Code' provides a fine set of best practice guidelines for governance activities and the regulators are called on to see that investors disclose compliance; this is also used as an element of discussions on authorisation. Alongside this is a requirement for public disclosure so that beneficiaries as well as regulators can hold investment institutions to account. We believe that this model should be given active consideration by international markets, including those in Latin America.

