STRENGTHENING CORPORATE GOVERNANCE CODES IN LATIN AMERICA

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The report

- ***Draft version.*** For comments, please write to Daniel Blume (daniel.blume@oecd.org) and Santiago Chaher (schaher@cefeidas.com). Written comments received by **September 22nd** may be taken into account for the final version of the report.
- ***Respondents.*** Thanks to questionnaire respondents (Regulators, Institutes, Stock Exchanges), telephone interviewees for information (few companies and investors), and telephone interviewees for clarifications.
- ***Findings.*** The report's findings do not necessarily reflect the views of the OECD or its member countries.

Drafting and updating codes of Corporate Governance

Good practices

- Idea of using corporate governance codes to complement law and regulation in the adoption of good corporate governance practices: needs coverage, implementation, compliance and sanctions to be clearly specified.
- ***Risks.*** Formalistic approach to corporate governance where compliance is the objective and the quality of governance takes a secondary role in Boards, shareholders and stakeholders agendas.
- ***Risks.*** Good governance is a concept that depends ultimately on the behavior of those in charge of governing the company. Structures and practices' quality depends in the end on the integrity and seriousness with which they are implemented and acted upon.
- ***Risks.*** Falling into a "*one size fits all*" approach which can generate unwanted outcomes when a particular rule is disproportionate, costly, inopportune or harmful when applied in reality.
- ***Risks. Failing to fulfill objectives.*** Because of too many (awareness, culture, encourage best practices, or improve standards) or flexibility makes lose focus.

Drafting and updating codes of Corporate Governance

The process of creating a Code

- All the codes analyzed have had public-private sector dialogue in their creation process.
- Regulators always influence: indirect influence through law and regulation; opportunity to integrate voluntary CG practices; leading the process.
- There were mainly two forms of participation that the country's adopted in the creation of the code:
    - Committees or Working Groups
    - Public Consultation

Drafting and updating codes of Corporate Governance

Committees/Working Groups or Public Consultations

- **Committees:**
  - The code-drafting committees are generally created with a view to ensuring that **as diverse a range of relevant interests as possible are given a hand in the creation of a code.**
  - From country to country, the members of these committees were representatives from similar institutions.
  - Entities with a vested interest in the code that were not represented on the committee were consulted during the creation process.
- **Public Consultations:**
  - Usually involve posting the working draft of the code on the issuer's website, and inviting the public to make comments or suggestions in writing.

However, there's no evidence to suggest that one system provided more helpful feedback in the drafting processes. That said, committees provide focused knowledgeable and experienced feedback (vs. dispersed) and could allow for opinions explanations,a sk about rationale, voice dissent and present rebuttal and agree on mid terms.

Drafting and updating codes of Corporate Governance

Sources Used to Create Codes

- Every Latin American code surveyed was created with reference to at least one international source. The most commonly referenced source in the drafting process of CG codes was:
  - The G20/OECD Principles of Corporate Governance;
  - The Corporate Governance Guidelines laid out by the Development Bank of Latin America (CAF).
- Possible impact of the LART work.

Drafting and updating codes of Corporate Governance

How often codes are updated

- A code’s flexibility refers not only to its provisions, but also to its creation and updating processes (vs. rigid approval processes of law and regulation).
- The periodic review and update of a code is a signal of commitment to good governance.
- Main reasons given for updating a code are as follows:
  - changes to key sources, such as the G20/OECD Principles of Corporate Governance;
  - general developments in the global field of corporate governance;
  - changes to the national and international business landscapes.
- As well as European codes, all of the Latin American codes surveyed have been updated at some point.

If codes are not updated periodically, the regulator may be more likely to compensate for the dissatisfaction generated by the misalignment between the requirements of the code and the reality and move towards mandatory regulation.

Drafting and updating codes of Corporate Governance

Process of Updating a Code

- The process by which codes are updated, is largely the same as the one by which they were originally created (most of times old code is used as reference and sets the tone and many times carries the positives and negatives).
- However, in some cases, updating leads to an improvement in the process itself, when compared to its creation (ie. greater participation).
- ***Interesting case: Chile.*** Intention to review the code every two years in order to adapt the regulatory framework to the changing realities of the market.

Drafting and updating codes of Corporate Governance

The objectives a Code is Designed to Achieve

- It is only by having clear and defined goals that the design of the code will make sense when evaluated.
- ***Different players, different objectives.*** The Regulator might be looking to identify what specific measures it expects from directors for them to fulfil their fiduciary duties, so that, when a concrete case has to be judged, there is already a clear framework of what an ideal corporate governance structure is. Companies may decide to formally comply with every rule of a code just for the sake of avoiding future sanctions if the code is used as a main reference to judge.
- ***Importance of aligned incentives.*** If companies perceive that investors are not willing to pay a higher premium, they may not invest resources in reviewing and improving practices or providing good quality explanations → if explanations are not of good quality or providing sufficient information, investors may not devote sufficient resources to make use of the information in their investment decisions → in the absence of effectively functioning market incentives, this may increase the incentive of the regulator to move from voluntary codes to hard regulation.

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The Structure of a Code

- There are three kind of codes, according to the code's structure:

  - **Principles-Based Codes.** Companies are provided with guidelines for good corporate governance, and they are allowed some flexibility in the exact practices they choose to adopt, as long as they stay within the code's principles.

  Harder to assess if complied? More room for interpretation, flexibility and experimentation.

  - **Rules-Based Codes.** Rules-based codes usually consist of a list of more specific recommendations.

  Should be more open to explanations of non-compliance? (avoid one size fits all).

  "Markets for Lemons" problem: weak implementation can affect reputation of more committed companies due to lack of information.

  - **Hybrid Codes.** The code is structured using a combination of the two systems.

Drafting and updating codes of Corporate Governance

The content of a code:

- Each Latin American code is issued within a context of a broader set of legal and regulatory requirements.
- The fact that one country's code may give little or no emphasis to certain sub-topics may simply reflect the fact that the code developers have made an assessment that that particular topic is adequately addressed by the existing legal framework, and that additional good practices do not need to go beyond it. The more detailed recommendations in one country's code may reflect the absence of sufficient regulation in that particular area.
- Most Latin American codes surveyed divide the contents of their codes into a few key areas, with the areas chosen varying slightly from country to country.
- The content of codes not only vary in the topics they cover, but there are also some cases that include principles or recommendations for different types of companies.

Implementing Codes of Corporate Governance

The developer should make sure that:

- the instructions to apply the code are simple and easy to understand.
- the provisions are clear and suitable to implement.
- the explanations for not implementing a provision are expected to be of a certain quality.

To achieve this, the code developer often has to work on a series of awareness-raising and capacity building events that will underpin corporate governance knowledge.

It is important that companies, stakeholders and the developer all understand that a push for full compliance with the recommendations of a code is not necessarily a success since it could impose practices that are not consistent with the type, size, industry or stage of development of the company.

Implementing Codes of Corporate Governance

Systems of compliance:

- There are three major kinds of compliance requirements for corporate governance codes:
  - **Voluntary.** Companies have the option whether to implement the recommendations set in the code, as there is no legal or regulatory requirement to either comply with them or to disclose.
  - **Comply or Explain, variations:**
    - **Comply or Explain.** Companies have the option whether to implement the recommendations set in the code, as there is no legal or regulatory requirement to implement them. However, it is mandatory to disclose whether they do so or not. In case they do not implement the recommendation, they have to explain why they have taken this course of action.
    - **Comply or not and Explain.** In order to strengthen the "comply" aspect of these, some codes now look to receive an explanation not only on the recommendations which are not complied with, but also on those which are.
  - **Mandatory.** Companies must implement all parts of the code as a matter of regulatory or legal requirement.

Implementing Codes of Corporate Governance

Compliance reports

- In Latin America there are different systems by which companies disclose the degree of adherence and implementation of corporate governance practices:
  - **some monitoring authorities send an electronic questionnaire that companies need to respond to.** Allows to compare (progress and peers); aggregate information for statistical purposes and check the rate of compliance.
  - **there are authorities that require companies to upload the compliance reports to the regulator's website.** Usually only able to monitor whether companies present the reports and if the items in the code have been addressed.
  - **others ask to include it in a section of companies' annual reports.** A particular case is the Peruvian compliance report, which is incorporated as an annex of the annual report of companies (the "Memoria"/ an official document).

Implementing Codes of Corporate Governance

Measuring the extent of a code's implementation

- Measuring the implementation of a code is an important element to support its success. **The challenges and solutions to measuring the implementation of the code once it is launched are not always considered as a key factor at the time of creating codes and designing their creation process.**
- For example: Comply or Explain code where level of compliance with the code is only measured by number of recommendation adopted → incentive to get 100%. Influence of rankings, indices or awards.
- A 100% compliance might raise the question if the code's provisions are weak (a minimum and not a "best" practice) or required by law and redundant.

It was surprisingly difficult to determine what improvements have been seen in Latin American companies which have implemented a code of corporate governance. This is not to say that there were no improvements, but rather that very few of the regulators, institutes and stock exchanges responsible for overseeing the codes were able to provide any insight into the actual effects that their codes were having.

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Assessing Codes of Corporate Governance

Current assessments of Corporate Governance codes in Latin America

- The majority of respondents could offer no information at all on the improvements seen in companies that have adopted the code's recommendations.
- Creating a code requires a significant amount of work and organization: there is inevitably a temptation for its **creators to view it in an overly positive light.**
- To identify a code's effects on companies in a rigorous manner, it is necessary to **establish a causal (rather than merely correlative) link** between the implementation of a code's practices and a change in company performance or market perception. This can be difficult.

The low number of detailed responses to the surveys on this topic indicates a lack of established mechanisms for making assessments of corporate governance codes in Latin America. Latin American authorities seem to be largely unaware of the ways in which corporate governance practices have improved, at all, as a result of their codes, and therefore unaware of how successfully the codes are working.

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Assessing Codes of Corporate Governance

Current assessments of Corporate Governance codes in Latin America (cont.)

- It is important to note that the success of monitoring not only depends on the monitoring body that carries it out, **but also on the techniques used:** ie. selecting some topics of corporate governance to monitor, to selecting only a sample of companies.

  - A good example of monitoring system is the Swedish Stock Exchange. In this system they monitor the whole set of companies but assess only one third of them per year, rotating their sample. Monitoring bodies are not constrained to these techniques only, as they can utilize other complementary approaches to the reports such as interviews or soliciting further information in writing.

Assessing Codes of Corporate Governance

Assessing Corporate Governance Codes Using Compliance Reports

- Most Latin American countries have a mandatory disclosure requirement, which obliges firms to disclose the extent to which they have complied with the code´s practices.
- Not everyone use these reports to assess the level of compliance in general or promote improved practices. Few cases in LAC.
- The methodology used to give input to those reports is important as well: ie. questionnaires could serve as a guide for implementation vs. statements that allow more freedom to fully explain but could omit information or complicate comparisons.
- If the market does not follow and allocate the resources to monitor compliance with the code, the code loses its impact and generally may encourage the regulator to step up and fulfill that task instead (not always with all necessary resources) → high reputational risk for the one who monitors.

Assessing Codes of Corporate Governance

The "Box-Ticking" Problem

- Some respondents seem to be actively against using compliance reports alone to make assessments of the value and impact of the codes. This is because they think compliance reports cannot be relied upon to accurately reflect the impact that a code has had on a company's corporate governance practices.
- Many times, companies simply treat compliance reports as a "box-ticking exercise", in which they feel compelled to comply with the codes' practices because they **have been told to do so** (fear to non-compliance), **the market pressures them** (wrong market incentives), or they simply **have not explored other more suitable alternatives** (lack of knowledge and commitment).
- ***Huge problem.*** **A compliance report with a high percentage of implemented practices is not necessarily indicative of a strong commitment to good corporate governance.**

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Assessing Codes of Corporate Governance

Possible Causes of the Box-Ticking Problem

- **Not sufficient evidence to conclude but… responses to the survey indicate a correlation between rule-based codes of corporate governance and the development of the box- ticking problem.**
- Ruled-based codes, **may encourage a "one size fits all"** model on companies, which does not suit their size or development, leading to the box-ticking problem.
- If the extent to which companies' have implemented the practices contained in a rules-based code is the only thing valued by the monitoring body (leaving explanations out), **shareholders and stakeholders may well be tempted to over-value near-total implementation rates**, even if certain practices are not beneficial for the company.

If the monitoring body does not assess the quality of reporting by the company, the only valuable answer becomes the compliance with the recommendation, which in turn generates an incentive to box-ticking. To resolve this issue there have been some suggestions that monitors should come up with a set of guidelines on how to write the explanations, thus enhancing the quality of reporting.

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Possible Causes of the Box-Ticking Problem (cont.)

- One way to overcome this problem is to, on top of educating those under the scope of the code, educate the market on the meaning of the compliance system and the importance of flexibility with respect to implementation of the code's recommended practices.
- Another interesting approach has been the one implemented by Portugal: In this case, to promote a more reliable correspondence with the logic of 'comply or explain' and to avoid 'box-ticking', percentages are avoided and the quality of explanations is closely analyzed. Although, in some cases, companies may express non-compliance with certain recommendations, if they explicitly present alternatives and duly justified solutions considered as functionally equivalent to the implicit objective of each of the referred recommendations, they are subject to a valuation equivalent to a "comply". (EcoDa Report)
- **Caso Peruano.**

Assessing Codes of Corporate Governance

Assessing Corporate Governance Standards Without Using Compliance Reports

- Many countries have developed more sophisticated systems of monitoring overall governance standards across domestic companies.
- Examples in LAC:
  - 1) The Peruvian stock exchange's Good Corporate Governance Index;
  - 2) The Brazilian national stock exchange's Sustainability Index;
  - 3) The Colombian regulator annual ranking;
  - 4) The *"IR Recognition Program"*, by the Colombian stock exchange;
  - 5) The Mexican Corporate Sustainability Index.

Assessing Codes of Corporate Governance

Assessing Corporate Governance Standards Without Using Compliance Reports (cont.)

- As Latin American countries become more sophisticated in corporate governance, the investor community **ideally** will start to pay more attention to compliance of codes and their reporting, and to **consider them as a factor to be weighed in investment decisions.**

- The role of the investor community, especially institutional investors, has the potential to become then a lever in monitoring good practices based on codes. However, this monitoring **is not exempt from the risks of box-ticking exercises when investors and proxy advisors do not devote the necessary resources to understand the -- many times justified -- explanations provided by companies,** and only look for compliance with the recommendations (whether by assessing the reports directly or -more commonly- by relying on the information of indices and rankings).

Conclusions

- The active involvement of Latin American regulators and various stakeholder → ongoing interest throughout the region in raising the standards and practices of CG.
- Monitoring the implementation of codes → room for improvement. There is a widespread problem across the region:
  - Many companies do not take corporate governance seriously;
  - Companies view codes as burdensome lists of practices to be complied with which all too often do not suit the reality of their situation;
  - "Box-ticking" attitude as a problem.
- One key to creating a well-functioning reporting system will be in finding an effective compromise between checklists and descriptive reports.
- Once this compromise has been reached, corporate governance authorities may have a better shot at creating genuinely useful corporate governance assessments, rankings and indices.
- **Ultimately, the effectiveness of code recommendations and reporting will hinge upon the value that market participants see in making use of them.**

Muchas gracias.

Implementing Codes of Corporate Governance

Launching the Code and training

- The launch and dissemination of Latin American codes has varied in method and reach, but has always combined a public presentation (usually involving the press) with direct communication with those potentially interested parties.
- Once launched, the companies and stakeholders will look for support in the form of capacity building for the implementation of the practices detailed in the code, but few countries provided specific trainings for those affected by the codes.

Implementing Codes of Corporate Governance

Systems of compliance in Europe (cont.)

- According to the OECD Corporate Governance Factbook (OECD, 2015), which studied corporate governance codes in 41 different jurisdictions, including most OECD members, 73% of country codes surveyed used a comply or explain (including "Comply or not and Explain") compliance requirement, 12% of codes were employed with a mandatory compliance requirement, while the remaining 15% used a voluntary code.
- The Dutch Corporate Governance Code, known as the Tabaksblat Code, is an interesting example of how a comply or explain code has achieved a high level of implementation of its practices based on good monitoring and incentives.
  - A Corporate Governance Monitoring Committee releases an annual report (based on companies reports) highlighting key corporate governance issues under debate in the country, noting where companies have least applied the best practice recommendations, and also noting the extent to which explanations of non-appliance were inadequate, in other words, non-compliant.
  - This report is taken then into consideration by a relatively active group of institutional investors and also used by the Enterprise Chamber to answer requests presented by shareholders, companies or other stakeholders who are looking to determine if companies have behaved in an objective and fair manner.

Assessing Codes of Corporate Governance

Assessing Code of Corporate Governance

- It is important to ensure that the codes are functioning effectively.
- It is not necessarily the case that a high average rate of compliance with a code across a country indicates an improvement in the standard of corporate governance as a whole across that country.
- So, it is vital to separate mechanism to monitor each of these two aspects of the code: compliance of the companies; and the corporate governance improvement in the country.
    - One possible solution could be the involvement of various parties in the monitoring of the success of the code.
    - Regrettably, due to resource constraints, many of the actors who potentially could contribute to an effective monitoring system have not done so.

Assessing Codes of Corporate Governance

The "Box-Ticking" Problem (cont.)

Companies which think of compliance reporting as a box-ticking exercise often do not look to genuinely improve their corporate governance, but instead try to tick off every recommendation on the compliance report with the least effort or cost possible.

As a result, compliance rates can improve while the actual standard of corporate governance stays the same or even gets worse by implementing practices not suitable for the company. It is for this reason that respondents seemed to think that compliance reports for codes which tend to create "box-ticking" corporate governance cultures cannot be relied upon as accurate measures of the success of those codes.

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Assessing Codes of Corporate Governance

A Peruvian Solution to the Box-Ticking Problem within a Rules-Based Approach

- The Peruvian regulator has introduced a reporting system which is significantly different from other approaches taken in some other Latin American rules-based jurisdictions. Under this system, companies are required to submit a report in four sections:
  - a) A letter to explain the improvements in corporate governance practices; b) Questionnaire consisting of 87 questions, under the system “Comply or Explain”; c) documents which explicitly evidence good corporate governance practices; d) This section is optional, to provide any additional documents which illustrate the company’s advances in corporate governance.
- The Peruvian regulator argued that one way to supervise the compliance with the corporate governance practices is including the compliance report in the company annual report. This requirement adds an important element of accountability to the creation of the compliance report, increasing the likelihood that it will be both objective and accurate.
- There is a checklist, but it is supported by a web of explanations and hard documentation which together build a more complete portrait of a company’s corporate governance practices.