DISCUSSION DRAFT:

LATIN AMERICAN ROUNDTABLE TASK FORCE ON RELATED PARTY TRANSACTIONS MEETING OF JUNE 19TH, 2013

This report on "Adapting Good Practices for RPT Oversight to Differing Corporate Ownership Patterns" has been prepared for the June 19th meeting of the Latin American Corporate Governance Roundtable's Task Force on Related Party Transactions as background for discussion in the last session of the meeting. It has been written by Daniel Blume, Senior Policy Analyst, OECD, with drafting and analytical support from Mike Lubrano. Special thanks for input to the Task Force company survey from CPFL Energia, CCR and Iochpe-Maxion of Brazil, Bancolombia and Seguros Bolivar of Colombia, Grana y Montero of Peru and Grupo Popular of Dominican Republic, and to Grant Kirkpatrick for his work on corporate groups. Please send any written comments to Daniel.Blume@oecd.org.

ADAPTING GOOD PRACTICES FOR RPT OVERSIGHT TO DIFFERING CORPORATE OWNERSHIP PATTERNS

1. The Latin American Roundtable's Task Force on RPTs agreed by consensus on the components that make up a sound framework for reviewing and reporting related party transactions and preventing abusive RPTs (See Box 1). This consensus reflects a recognition that RPTs can be efficient and beneficial for a company, but that these benefits must also be weighed against the risks created by conflicts of interest and the potential that such transactions benefit certain parties (e.g. controlling shareholders or management) at the expense of others (minority shareholders or the company's overall interests). The consensus safeguards for reviewing and reporting on RPTs are seen as a way to balance these interests.

2. However, it is also frequently noted that there is not a single one-size-fits-all solution and that different ownership patterns may lead to different calculations of the benefits and risks. Different ownership patterns may merit different practices in relation to degree or level of disclosure, types of review mechanisms, and requirements related to who participates in decisions and who may be required to recuse themselves from participating.

3. Therefore, the Task Force decided to look more closely at the treatment of RPTs by companies with the following differing ownership structures and their implications for good practice:

- Companies with dispersed ownership;
- Companies with a controlling shareholder;
- Companies with several major block shareholders;
- Companies with state ownership or control;
- Companies that are part of a larger company group whose members have differing shareholder compositions (e.g. cross-shareholding or pyramid structures)

4. As input to this process, the Task Force's moderators sent a questionnaire to members of the Roundtable's Companies Circle and other companies active in the Roundtable and received seven responses providing detailed information on their policies and practices for dealing with related party transactions. Key findings included the following:

- The reasons reported for conducting related party transactions were those generally cited in the Task Force's earlier work on the topic.
- Only one respondent reported that its policy is to avoid RPTs. The remainder regard engaging in RPTs as relatively common and potentially beneficial for the company and its shareholders. One respondent noted that it accorded a preference to companies within the group.
- All the respondents stated that their general standard was that RPTs should be conducted on market terms.
- Disclosure of RPT policies and IAS 24 disclosure in financial statements was virtually universal. However, no respondent reported that it makes some form of continous disclosure of RPTs.
- All respondents lodged responsibility for reviewing the fairness of RPTs with the Board (sometimes assisted by a Board committee). In all but one case, conflicted Board members are excluded from *both* participation in deliberations and voting.
- Only exceptional RPTs (e.,g., mergers and acquisitions) were reported as ever having been submitted to shareholder review.

- Most respondents to the questionnaire were members of an identified company group. In general, the group had a single over-arching RPT policy, but in some cases such policies were adapted to the special requirements of a particular group member.
- One respondent noted that on occasion RPTs occurred within the group on unequal terms. In such cases, some form of compensation was accorded minority shareholders of the disadvantaged company.
- One respondent reported a system for review of transactions with members of its controlling shareholders that was specifically tailored to its ownership structure and the industry in which it and its controllers belonged.

5. A majority of the companies responding belonged to corporate groups, and their answers to the questionnaire raise a number of issues that merit further consideration and discussion regarding what may be considered best practice .

Box 1. CONSENSUS GOOD PRACTICE REQUIREMENTS FOR PREVENTING RPT ABUSE

a. Requirements for immediate and adequate disclosure of RPTs that meet reasonable materiality standards. Members of the Task Force all consider the adoption of IFRS (including IAS 24) across the region as a positive force for better RPT transparency. But financial statement transparency is only one element of an adequate disclosure framework. Each country must also have in place an effective continuous disclosure regime that ensures that shareholders and the markets can monitor the company's RPT practices and make their own informed judgements about whether transactions are conducted on market terms and are in the best interests of the company and all its shareholders.

b. Board responsibility. All Task Force members agreed that the legal/regulatory frameworks throughout the region should continue to provide that the Board of Directors bears primary responsibility for ensuring the transparency and fairness of RPTs. In order to be effective and credible, the rules for Board review and approval should ensure that conflicted directors are excluded from the process. Boards need to have sufficient business knowledge and experience among their members and access to appropriate independent outside expertise to effectively carry out their responsibilities. The legal/regulatory framework should ensure clarity as to what constitute *de minimus* or ordinary course transactions that need not be subject to one-by-one Board review in those jurisdictions that provide for such exceptions. While some Task Force members recommended as good practice to give independent Board members a stronger legal role in reviewing and making recommendations on RPTs, there was not consensus on this point.

c. Shareholder approval of exceptional RPTs. While there is broad consensus within the Task Force that the Board should bear primary responsibility for RPT oversight and approval, there was also consensus that instances arise where shareholder approval may be appropriate in addition to Board approval because of the special nature of the transactions (e.g., mergers and acquisitions) or where circumstances bring into question Board independence. Most Latin American countries that have adopted such provisions (Argentina, Brazil and Mexico) generally exclude interested shareholders from the vote (majority of the minority) to reinforce the credibility of the process. But there was not consensus across the Task Force on this point, considering that Chile allows interested shareholders to vote but requires a two-thirds majority. The legal/regulatory framework should clearly set out the criteria for when RPT approval requires the additional step of a shareholder vote. Shareholder review and approval should not, however, be used as a means of absolving the Board of its responsibility to act in the best interests of shareholders.

d. Quality and independence of auditors and valuation experts. Boards, shareholders and the financial markets inevitably rely on the quality of the opinions and valuations provided by third parties. Reliance on their opinions and valuations requires confidence that these are not tainted by conflicts of interest. Accordingly, it is of central importance that the regulatory regime and professional standards provide clear criteria for independence and high standards for ethical conduct.

e. Effective enforcement and ability to seek compensation for damages. Enforcement remains a challenge throughout the region. Members of the Country Level Task Forces generally agreed that to be effective, the enforcement regime must empower the supervisor to investigate and sanction violations and initiate civil and criminal actions against wrongdoers. The legal/regulatory framework should also provide avenues for aggrieved shareholders to seek restitution for losses resulting from RPTs that are not conducted on terms fair to the company and minority shareholders.

Special considerations for different types of companies

Companies with dispersed ownership

6. This type of ownership structure is uncommon in Latin America (although Brazil does now have some large listed companies that would fall under this definition), and is most often found in the capital markets of Australia, the UK and the US. Without a controlling shareholder, here the strongest focus is on management and other corporate insiders, to ensure that significant transactions involving management or their related parties are reviewed by the board or the audit committee, and that non-executive board members play the determining role through the audit committee or within the board as a whole.

Companies with a controlling shareholder

7. The Task Force's recommendations set out in Box 1 have been developed with this type of ownership structure in mind, considering that the vast majority of Latin American listed companies have a controlling owner. However, moving beyond this overall characteristic and broad set of recommendations, there is additional interest to consider several sub-categories generally overlapping with this category, to consider whether further distinctions can be made regarding good practices.

Companies with several significant shareholders comprising a majority

8. The particular case of CCR, which offers some of the strongest protections against abuse of related party transactions known in the region, is well known. As described in the IFC/OECD's 2006 Latin American Companies Circle publication, "Case Studies of Good Corporate Governance Practices," CCR, a Brazilian toll road operator, has 4 significant shareholders (three Brazilian construction companies and a Portuguese tollroad operator) with equal shares of approximately 18%. The remaining shares are traded on the Novo Mercado listing segment and held as free float by a wide range of shareholders. According to the Companies Circle case study report, the company's related party transaction policy requires all contracts over R$ 1 million (approximately USD 470,000) with related parties and any other with a third party over R$ 2.7 million (approximately USD 1.26 million) to be approved by the Board of Directors. In addition, any contract over R$ 1 million with a related party could be preceded by an independent evaluation, if requested by any company director. If, in spite of a positive conclusion by independent analysts, doubts remained, a provision was set where 25% of the Board of Directors could veto the contract.

9. While the CCR example is relevant, it is important to note that its policies emerged out of a specific need to reassure the market because its main shareholders were huge Brazilian groups that also operated in the construction business, and who therefore were the main suppliers for Brazil's highway authorities. With obvious potential for conflicts of interest clouding the possibilities for returns to non-controlling shareholders, CCR had an uphill battle to fight to establish credibility. Therefore, CCR intentionally brought in a shareholder from Portugal whose interests were not aligned with the others to ensure the credibility of the RPT review process, establishing a structure that allows for checks and balances across differing interests that lead to credible protection of the interests of all shareholders.

10. However, for a company with a group of several controlling shareholders whose interests may be more closely aligned, adopting such a policy for RPT review would need to ensure that minority shareholders are able to elect at least 25% of the board in order to provide a similar level of assurance to the market of minority shareholder protection.

Groups

11. Related party transactions within corporate groups is a key issue for the Task Force's further consideration, considering the predominance of conglomerate structures in the region. The group structure

raises many complex issues. On the one hand, one of the reasons behind the formation of such groups may be the synergies and efficiencies obtained through transactions and allocation of resources among companies within the same group, especially when financial institutions are involved, reducing the need to rely on outside sources of finance. Information asymmetries may also be reduced, allowing for companies to work together based on established relationships. All of this suggests that incentives for RPTs may be higher and more prevalent within groups than for stand-alone corporations. From this perspective, excessive constraints or regulatory burdens placed on such transactions will reduce the efficiency gains that group structures can potentially achieve.

12. On the other hand, pyramid structures and cross-shareholdings within groups may allow for controlling owners to exert disproportionate levels of control that are much higher than their actual economic interest in the individual companies that they control. This divergence between control rights and cash flow rights has been documented in academic research to increase the incentive and tendency of the controlling shareholder to seek and reap private benefits of control. Obtaining private benefits can occur through related party transactions but also through many other means, such as excessive remuneration or channelling of profits into companies where the controlling owner's interest is highest at the expense of dividends to minority shareholders.

13. Balancing these two sides of the coin raises particularly complex issues for Board members, particularly in terms of the exercise of their legal duties, which may form the basis for public or private enforcement actions. In the case of a stand-alone company, the traditional duties of loyalty and care to the company are relatively clear. But the board member's duties may become fuzzier when they sit on the Board of a company within a defined company group (especially if they are appointed by the controlling shareholder). Should such Board member's duty of loyalty run exclusively to the individual company on whose Board he or she sits, or is there room for consideration of the interests of the wider group? Some countries such as Israel have attempted to clarify this by asserting that in group structures as well, the board member duty of loyalty is to the company and not to the wider group. Israel has also forbidden the participation of financial institutions in corporate groups as a way of reducing the potential for conflicts of interests within such group structures.

14. On the other hand, in countries such as France and Belgium and to some extent in Italy, a jurisprudence doctrine has been developed known as the "Rozenblum doctrine," establishing a framework for considering compensation between companies within groups. The doctrine admits a group defence for directors regarding loyalty if there is: a group characterised by capital links between the companies; there is a strong, effective business integration among the companies of the group; and financial support for one company to another has an economic quid pro quo and does not break the balance of mutual commitments between the concerned companies; the support from the company must not exceed its possibilities or in other words it should not create a risk of bankruptcy for the company.

15. EU member states also established a High Level Group of Company Law Experts (the "Winter Report") in 2002 that suggested that transactions beneficial to the group but not in the direct interest of the subsidiary can be considered as legitimate for directors provided that the interest of that company are safeguarded on balance. The Group stated that the parent corporation could be vested with a right and also a duty to manage the group and its constituent companies in accordance with the overall interest of the group. However, some members of the Group suggested that the board of the parent company should have a duty to manage the group only if they choose to.

16. Applied in the Latin American context, the Task Force could consider a number of options for clarifying how related party transactions could be handled in the group structure, either through regulatory requirements or as best practice recommendations in corporate governance codes:

Disclosure:

- The Winters report (2002) found that "especially with respect to non-financial disclosure, it should be ensured that – especially where listed companies are involved – a clear picture of the group's governance structure, including cross holdings and material shareholders' agreements is given the the market and the public."

- To implement this, annual reports, corporate governance statements or a company web site should describe the main features of a company's group structure in a clear and investor-friendly manner. Annual reports should provide specific information when companies enter or exit from a group, not only on the changes in the group structure, but with an explanation of the group structure itself.

- Non-listed companies within a group could be required to meet the same disclosure requirements as listed companies in the group (as is required in Israel). Or alternatively, should disclosure requirements apply only to companies involved in related party transactions with listed companies within the group?

Group privileges and responsibilities

- Should the Rozenblum doctrine be applied in Latin America, providing some flexibility for RPTs to favour one company over another in the interests of the group for a particular transaction, as long as a quid pro quo or overall balance is maintained? How could this best be implemented?

- Should the parent company in a group be vested with the right (or duty) to manage the group and its constituent companies in accordance with the overall interest of the group? If so, how should minority shareholders whose interests in a particular company are diminished in favour of the group be compensated for this loss (if at all)?

- Should groups, or even individual companies within groups, be permitted to decide for themselves whether they will or will not avail themselves of a Latin American version of the Rozenblum doctrine?

Compensation

- Should there be a compensation principle? (i.e. if directors of a company are permitted to approve transactions in the interests of the group rather than the individual company, they must also require compensation for minority shareholders negatively affected by the transaction?

- Is it reasonable to expect that in such cases, directors will have the capacity to evaluate both the disadvantage caused the company by the RPT and the value of the compensation (if not in cash)?

Techniques for ensuring fair transactions or compensation

- Should independent directors be given specific rights to request compensation for minority shareholders when RPTs are not conducted according to market conditions? Should this be in the form of cash compensation, or may services rendered also be considered compensation, and if so, how should the value of such services be assessed?

- Should audit committees or individual board members be given specific rights to request independent valuation reports for transactions when they suspect it is not being undertaken at prevailing market rates?

- Should the establishment of a fiduciary duty of controlling shareholders to all other shareholders of the company group that they control be considered (as done in Israel)?

State-owned companies

17. The Task Force has previously identified companies with state control as an additional ownership structure that raises special concerns for related party transactions. During the process to update IAS 24 guidance on disclosure for related party transactions, there was considerable debate over the question of whether such standards should be applied to state-owned enterprises. It was noted that in some contexts, virtually all of an SOE's business is with other parts of the government or related parties, making reporting requirements excessively burdensome.

18. Nevertheless, when a state-owned company is listed and has minority shareholders, these minority shareholders have the same interest as in any other company of ensuring that the majority shareholder acts in the interests of all shareholders and not just the majority shareholder.

19. However, defining what constitutes a related party to the state can also raise difficult questions: should the relationship be defined solely in terms of institutions that the state controls through ownership? If the relationship is based on political connections (e.g., if the owner of a company involved in a transaction with a state-owned company is a major donor to the political party controlling the government, is this an RPT?), what thresholds can be established to define and determine what constitutes a significant political relationship with the state?

20. On the other hand, SOEs, particularly those that are 100% owned by the state, often raise the contrary concern: that they are bound by cumbersome public procurement requirements that limit their flexibility and reduce their efficiency in awarding of contracts, leaving them at a disadvantage in competing against private sector companies.

21. It also is important to consider that when the state has a significant minority stake in a company (e.g. sufficient voting rights to elect a board member), that business conducted with the state or with other companies in which it has a significant ownership stake should also be considered as a related party transaction and involve review processes that help to ensure that such transactions are conducted on fair market terms. Consideration of the state's ownership stake should also take into consideration pension funds or development banks that are controlled or strongly influenced by the state.

Further issues or questions for discussion and follow-up:

- Are the questions raised above for possible legal and regulatory requirements and best practices for different types of companies the right ones? Are there additional recommendations or distinctions that should be considered?

- Is there consensus within the Task Force to issue these as recommendations?

- Should the issues raised concerning RPTs for state-owned companies be brought to the Latin American SOE Network for further discussion and development?

- Should the Latin American Companies Circle be invited to further consider these issues in the context of its Working Group on Company Groups?