I. GENERAL BACKGROUND AND MOTIVATION

The growing interest in corporate governance practices around the world has also reached Latin America, both from positive and normative perspectives. In the case of Chile, the large and controversial control premiums, paid in several acquisitions of control stakes of flagship Chilean companies by foreign companies, have triggered legal reform and investors awareness of the problem. In spite of this recent interest and the relative development of Chilean capital markets in comparison with other countries of the region, corporate governance in Chile is far from perfect. Although, recent studies such as Klapper and Love (2002) and Lefort and Walker (2003b) provide some approximate indicators, a major problem remains in that we do not have a precise measure of the relative strength of our governance mechanisms nor of their importance in explaining firm value and performance.

A standard framework to analyze corporate governance practices is provided by the OECD principles. These principles acknowledge not only the importance of legal protection, but also of other mechanisms of corporate governance. The principles are structured in 5 categories that look at shareholders rights, board responsibilities and disclosure of information among others. Based on the analysis of the Chilean legal framework, market participants opinions and conglomerate structure, Lefort and Walker (2003a) show that a preliminary review to corporate governance practices in Chile indicates that 11 out of the 16 OECD principles reviewed are adequately complied with. These results indicate a 69% compliance.
In addition, Klapper and Love (2002) construct corporate governance indices using information produced by the Credit Lyonnais Securities Asia, for a list of 25 emerging economies. They find out that using a sample of 12 Chilean firms, Chile scores one of the highest values of the sample considered (61.63%). However, they also found that the two Latin American economies considered (Chile and Brazil) present the lowest correlation between firm performance and governance quality. These are not the only studies that find that Chile scores well in corporate governance measures. Using the La Porta, Lopez-de-Silanes, Shleifer and Vishny (1998) anti-director rights index, Chile would score 5 for a maximum of 6.

The fact that Chile scores relatively well in corporate governance measures, compared to other emerging economies, and the early development of its capital market (fueled in part by the early reform to its pension system) in comparison to most Latin American economies, makes the study of the effect of corporate governance measures on corporate performance in Chile an interesting subject for the region.

In particular, the Chilean (and Brazilian) case presents at least three interesting features that make its study specially relevant in terms of policy recommendations for this country and others in the region. First, the Chilean corporate structure presents highly concentrated ownership, widespread use of pyramid structures to separate cash from control rights and opaque ultimate ownership identification. Second, from the legal point of view, the Chilean system has a civil origin with inexistent self-regulation practices regarding capital markets. Recently, an amendment to Securities Market Law and Corporation Law, better known as the OPA Law, was passed with the intention to improve corporate governance in Chile. Finally, the Chilean capital market is relatively developed with a large participation of institutional investors for more than two decades.

Although legal reform has been implemented recently in Chile (and Brazil) following what is understood to be the world’s best corporate governance practices, we think that convergence towards the developed economy model will occur only very slowly. However, there is indication that some type of functional convergence, where private contracting under the actual corporate structure may improve investor protection in our economies. Institutional investors, ADR’s and creditors are important stakeholders in Chilean (and Brazilian) firms and they understand that good corporate governance practices are valuable. They are crucial players in order to translate better corporate governance practices into lower cost of capital for firms.

Accordingly, our research proposal has three main objectives. First, we plan to build an extensive data base at the firm level comprising standard corporate governance charter
measures. This database will include qualitative variables (binary type) measuring transparency, accountability and other aspects of corporate governance, as well as quantitative variables measuring ownership structure and separation of cash and control rights. The database will comprise annual data for the period 1990-2002 for all listed companies in Chilean stock markets. This database will be made public for the use of investors, analysts and academics. An aspect of this dataset that needs to be highlighted is the careful consideration of conglomerate or group ties. Indeed, this will allow us to precisely identify conglomerate structures and organizations in Chile. This makes it possible to build "consolidated conglomerate-level financial statements". With the exception of the work done by the authors of this proposal, who partially consider this for limited number of years (Lefort and Walker, 2000), most other studies that have used Chilean data (such as Agosin (), Abarca et al (1998) and Khanna and Palepu ()) have the problem of ignoring the intricate nature of groups, which implies both double counting and underestimation of indirect control of firms by conglomerates. In some sense, we believe to be able to create nearly-ideal measures of conglomerate in order to identify more precisely the functioning of groups and the separation of cash-flow from political rights. An important output at this stage will be a descriptive analysis of the evolution of conglomerates in Chile. Of particular interest is to clarify the new aspect of conglomerates after the takeover wave.

Secondly, we will perform panel data regression analysis to estimate the impact of these corporate governance variables on different measures of corporate valuation, corporate performance, corporate strategy, agency costs and trade volumes. Among other things, we are interested in determining the effect of conglomerate in an emerging economy on corporate governance and performance. The "incremental" role of banks in this context (conglomerates under US-like restrictions for banks) will also prove interesting.

Finally, we will perform a comparative analysis including both Chilean and Brazilian firms in a joint work with the Brazilian team of researchers Ricardo Leal and Andre Carvalhal da Silva. The purpose of this comparative study is to look at the impact on the above variables of different arrangements of corporate governance and ownership structures.

Although this is a single research proposal, it is likely that in the future we present our results in at least three separate papers, as described above.
II. CHILEAN CAPITAL MARKETS AND INSTITUTIONAL ENVIRONMENT: AN OVERVIEW

The Chilean capital market is characterized by high market capitalization and low turnover. By 2002, approximately 250 different stocks were traded on the Santiago Stock Exchange, with a total market value of near $60 billion dollars or 85 percent of GDP. However, the turnover ratio is low and has been decreasing to 7.5 percent of market capitalization. Capital issues have also decreased since 1997, averaging $1.2 billion per annum over the last five years, with only $270 million in 2001 or 3 percent of fixed capital formation. De-listings have increased and since 1997 there have been no new listings in the Chilean stock market, confirming a trend that indicates a fall in the importance of the Chilean stock market as a source of funds for companies. Among the 60 most traded stocks 68% of equity is held by the controllers. The concentration level is even higher in the case of less traded stocks. Therefore, free float is around 32% in the case of the most traded stocks and 14% overall. However, about 25% of the free float is held by domestic pension funds that do not trade much their holdings. Another 25% of market value not held by the controllers is in custody for depositary receipts. Therefore, only between 10 and 15% of issued stocks are generally traded in the domestic stock exchange.

Groups are the predominant form of corporate structure in Chile. Lefort and Walker (2000) show that around 70 percent of non-financial listed companies in Chile belong to one of approximately 50 conglomerates controlling, as a group, 91 percent of the assets of listed non-financial companies in Chile. There is no clear decreasing trend in these figures. Cross-holdings are prohibited in Chile and dual class shares, although allowed, are seldom used by Chilean corporations. By far, the most common way of separating control from cash-flow rights in Chilean conglomerates is through simple pyramid schemes. The 1986 Banking Law imposed restrictions on related lending and prohibited banks to own shares from corporations. These regulations have notably decreased the importance of banks for conglomerates.

On the other hand, institutional investors are very important in Chilean securities markets. The main institutional investors are pension fund managers with over $35 billion in assets and insurance companies managing $12 billion in assets. Although pension funds were allowed to invest in equity only after 1985, during the nineties the value of their stock holdings reached a peak of more than a 30 percent of the total market value of pension funds. Because the Chilean pension fund system is mandatory and of the “defined contribution” type several capital market regulations have pursued the development of an adequate capital market where...
pension funds could safely and efficiently channel retirement savings. In addition, the authorities have developed appropriate supervision institutions that control the compliance of this regulatory framework.

The Securities Market Law and the Corporations Law comprise the legal framework governing capital markets and the actions of listed companies in Chile. The main body of both the Corporations Law and the Securities Law was written in 1981. They were both amended in 1989 and more deeply in 1994. More recently both laws were amended by the Law Nº 19,705 of year 2000 known as the Corporate Governance Law. In 2001 the Securities Market Law was again amended. Although, the Chilean legal system follows the tradition of French Civil Law, the Securities Market Law and the Corporations Law were written and reformed mimicking their homologues in the US. Since the Chilean Judiciary system does not have the flexibility of a judiciary under Common Law, some tension arises between the spirit of the Law and its application. However, sharp differences in ownership concentration, market liquidity and law enforcement between Chile and the US persist. Convergence is not evident.

Three main supervisory entities overlook different aspects of financial markets in Chile. The Superintendence of Securities and Insurance (SVS), the Superintendence of Banks and Financial Institutions (SBIF) and the Superintendence of Pension Fund Managers (SAFP). The Central Bank also participates actively in the financial system regulatory and supervisory process, especially in issues regarding international transactions and foreign market participants. The main supervisory entity, the SVS was created in 1980 as an autonomous public organization that relates to the Chilean Finance Ministry. It regulates all issuers of securities, the stock exchanges, the insurance industry and all capital market participants with the exception of pension fund managers and banks. The Superintendent is elected by the President. More than 200 people work at the SVS. Recently, the SVS received a budget increase in order to improve its enforcement capacities.

Self regulation is not important in Chilean capital markets. Regulations are imposed by the appropriate authorities, in the Civil Law tradition. Public corporations must be registered at the Securities Registrar administered by the SVS. In Chile, all shares are registered. At the moment of the initial public offering, a public corporation must sell at least 10 percent of its registered shares. As a continuing obligation, listed companies must provide all relevant information to the SVS on a timely fashion and prepare quarterly financial statements, which must be externally audited in December. The stock exchanges impose no additional requirements to listed companies. However, they may stop transactions at any time provided that there is reasonable suspicion of the existence of relevant information not revealed to the
market. The stock exchange must inform the SVS within 24 hours. Transactions may remain suspended for up to 5 days.

The SVS has taken the lead in recent reforms promoting minority shareholder protection and more disclosure. In December of 2001, the Securities Market Law and the Corporations Law were amended. The amendment was known as the Corporate Governance Reform and introduced changes in five areas of the law. First, the market for control was regulated requiring that transactions involving changes of control were performed through a tender offer under a version of the equal opportunity rule. Second, the regulator increased the information and disclosure requirements to listed corporations, especially in the case of transactions with related parties. Third, large listed corporations were required to form a committee with a majority of board members non related to the controlling shareholder. The functions of this committee were specified by law. Fourth, share repurchases were allowed in order to implement stock option packages as an incentive to executives. Fifth, equal treatment of foreign shareholders was guaranteed by law especially in matters regarding voting procedures. The amendments included a transitory rule that allowed firms to postpone the adoption of the new regulations regarding changes of control for three years. Most large companies have filled for the transitory rule. Additionally, the SVS is promoting the adoption of a Best Practices Code for Corporate Governance and the creation of an Institute of Directors.

III. CONCEPTUAL FRAMEWORK AND WORKING HYPOTHESIS

It is well known by now, against popular wisdom, that the standard Bearle and Means (1936) firm characterized by dispersed ownership is a rare phenomenon in most economies (La Porta, Lopez-de-Silanes, Shleifer and Vishny (1999). In fact, most firms in emerging economies are linked in some way or another to an economic group or conglomerate that exercises tight control over the firm and owns a large fraction of its shares.

As a consequence, a growing literature in corporate governance and corporate strategy has shifted its focus away from the standard agency problem between managers and dispersed shareholders, and looked closely to the relationship between minority and majority shareholders. This is especially relevant in the case of emerging economies such as Chile and Brazil. In particular, it has been argued that concentrated structures or economic groups are prone to carry inefficient investment and generate minority shareholder expropriation, especially when the controlling shareholders of these groups exercise control through complex
mechanisms such as pyramid schemes, cross-holdings and dual class shares. In those cases, the agency problem is exacerbated because, on the one hand, ownership concentration insulates the controller from the market for corporate control, and on the other hand, control is executed by a shareholder that holds a relatively small fraction of the cash-flow rights (Bebchuck (1998), Bebchuk et al. (1999) and Wolfenzon (1999)). An incomplete list of papers analyzing the effect of conglomerate in corporate governance and firm performance in emerging economies includes Khanna and Palepu (1999), Ghemawat and Khanna (1998) and Lefort and Walker (1999b, 2000) for the case of Chile, Valadares and Leal (2000) for Brazil, Castaneda (2000) for Mexico, Khanna and Palepu (1999a, b, c) for India, and Claessens et al. (1999, 2000) for most East Asian economies (and Chile).

Interestingly, many of these studies recognize that one of the most salient characteristics of conglomerates in emerging economies is that they are persistent in time, and able to adapt to most changing situations. Khanna and Palepu (1999) for India and Chile and Lefort and Walker (1999b) for Chile have shown that conglomerates have been able to grow and increase their scope and self-intermediation practices even during times of fierce economic reform and deregulation. This kind of evidence has supported a more favorable view of conglomerates in emerging economies sustaining that economic groups are a natural and efficient way for firms to deal with imperfect capital markets, poor institutions, corruption and other imperfections that plague emerging economies. In this context, economic groups arise in order to fill the voids left by (or to take advantage of) poor institutions. In particular, internal capital markets, that is, the headquarters allocation of funds to the different business units of the conglomerate creates value in a credit constrained world (Stein (1997)). Other financial synergies arise because of the possibility for conglomerates to liquidate assets of specific units in response to a general downturn (Shleifer and Vishny (1992)), and because of risk diversification that might be valuable to investors in economies with imperfect capital markets. There are also operational synergies generated through conglomerations. They might be related to economies of scale and scope in product and factor markets arising because of poor basic services like power, postal or others. It might be also related to poor consumer protection and the advantage of group branding. One of the most cited reasons for conglomerates in emerging markets is the advantage they create to deal with a corrupt government, a highly regulated economy and a poor judiciary system (Khanna and Palepu (1997)).

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1 See Khanna and Palepu (1997).
We have now a better understanding about the ownership and control structure of firms in most emerging economies, and we have at least two competing conceptual frameworks in order to explain the costs and benefits of conglomerates in emerging markets. It is not surprising, then, that an empirical literature has developed to try to ascertain whether the affiliation to a conglomerate constitutes good news for investors. Some of the most important contributions trying to explain the performance of business groups in emerging markets include: Khanna and Palepu (1999a, 1999b) find that group affiliation improves firm economic performance in India and Chile. They also find that the degree of diversification of the conglomerate increases performance only after it has reached a certain threshold. Khana and Palepu (1999c) find that in Chile and India the performance of groups increased after economic reform was performed, indicating that part of the benefits of affiliation are not related to poor economic environment. Khanna and Rivkin (2000) look at firms in 18 emerging economies finding that affiliated firms perform better in 6 countries, worse in 3 and equally in 5. They also find that returns of firms belonging to the same conglomerate tend to move more closely when compared to other firms. Claessens, Djankov and Klapper (2000) find that East Asian group structures are used to diversify risks, while Claessens, Djankov, Fan and Lang (2000) show that East Asian firms affiliated to conglomerates present a 4% average value discount, and that this discount arises in firms whose owners have more voting than cash-flow rights. Thomsen and Pedersen (2000) look at the 435 largest European companies and find that ownership concentration has a non-linear relationship with performance, where too much concentration reduces performance. Finally, Lefort and Walker (2002) find preliminary evidence for Chile that firm affiliation to a group tends to decrease firm value and that this effect is partially reduced when there is little separation between cash flow and control rights.

IV. DATA SOURCES

There are several data sources available. Complete accounting and financial information is provided by the FECUS plus database prepared by the Santiago Stock Exchange for all listed companies. In some cases it may be necessary to either contact firms directly or to use other public records in order to complete missing information. This database also provides information about main shareholders, board members and a set of corporate features and policies. Information regarding bank property structure is obtained from the SBIF (Bank Superintendence) database. Some historical market information for these companies can be obtained from ECONOMATICA or directly from the Santiago Stock Exchange. The SVS (main supervisory entity) provides data on corporate actions and material information reported
to the SVS. We also have the “Official Gazzette Database” (Diario Oficial) that allows us to identify the different investment companies used by conglomerate ultimate owners to control firms. This is an important input in the conglomerate consolidation procedure.

In addition, we intend to complete the information through a questionnaire on corporate governance practices to be sent to corporate stakeholders of all listed firms. The questionnaire will be an adaptation to the Chilean market of the CLSA questionnaire used by Klapper and Love (2002).

A crucial aspect of corporate governance mechanisms in Chile has to do with ownership structure. Conglomeration and widespread use of pyramids to separate cash from control rights constitutes an important measure of incentives structure and of the likelihood of agency costs. We propose to revise and expand Lefort and Walker (2000) database considering the universe of Chilean corporations registered at the Superintendencia de Valores y Seguros (SVS) for the years 1990-2002. We will complete the information for odd (and check the even) years and include also financial services firms. None of this been done so far as extensively by other authors. The database comprises over 300 public companies listed at least one year during the period considered. We will analyze at the balance sheets and shareholder identification information submitted by these firms to the SVS, and use this information jointly with the Diario Oficial Database to build the “property chains” that characterize Chilean conglomerates through a detailed analysis of groups’ direct and indirect holdings in each corporation. Through this procedure we will obtain consolidated economic balance sheets at the group level, allowing us to avoid double counting certain investments. We will also construct market value balance sheets at the individual firm level.

The first step in building the chains of property consists in identifying corporations associated to specific conglomerates. We will use the definition of group as in Lefort and Walker (2000) and extend it for the years 1991, 1992, 1993, 1995, 1996, 1997, 1999, 2000, 2001 and 2003. In this procedure we consider a list of 50 different economic groups of very diverse nature in terms of size number of public companies controlled, identity of the controller and others. In using this definition, we exclude groups that are only comprised of “closed” (non-public) companies that are not consolidated by any public company. It may well be the case that a group in our sample has only one public company. Obviously, in some cases we will not be able to consolidate the non-public companies belonging to the groups in the sample. In spite of this consideration, this study will add a considerable amount of new information with respect to previous studies for Chile. Also new will be to bring the financial institutions into the same picture.
An important aspect of the consolidation procedure is the identification of all companies controlled by a group. In most cases, these companies are linked through pyramid schemes that must be properly identified in order to avoid double counting group assets. As Lefort and Walker (2000) showed pyramid schemes are the most common way of achieving control in Chilean conglomerates, since cross-holdings are forbidden by law and dual class shares are relatively rare. In order to determine minority and controlling shareholders' investments in subsidiary and parent companies we will use the information about the 12 most important stockholders provided by corporations to the SVS. We will use public information from the “Diario Oficial” to identify the owners of investment companies among the 12 largest shareholders of each corporation, and associate them to different groups. It is possible that we underestimate the controlling shareholders’ stake, since some of the group holdings may be materialized through investment vehicles that do not appear among the 12 largest shareholders. However, considering that the 12th largest shareholder holds on average less than one percent of total shares, and that the 12 largest investors usually hold at least 80% of the company shares, it is very unlikely that this may introduce a substantial bias. Through this tedious procedure we will be able to compute several entries of consolidated balance sheets such as controlling shareholders’ direct and indirect investments in the parent company and subsidiaries. In both cases, the specific investment vehicles used by group members have to be identified through the official company registration in the “Diario Oficial”. A more detailed explanation can be obtained in Lefort and Walker (2000).

V. EMPIRICAL PROCEDURE

We intend to relate several measures of firm performance and strategy to corporate governance indicators at the firm level and a series of controls. Among the indicators of firm performance, we consider firm market valuation using Tobin’s q and ROA, dividend payout policy and investment.

The variables measuring corporate governance mechanisms will include:

(i) Separation of voting from cash flow rights at the firm level. We will measure separation considering direct and indirect holdings of controllers and the existence of dual class shares. We hypothesize that higher separation is associated with lower valuation, lower payout, lower investment and higher use of external credit.

(ii) Firm affiliation to a conglomerate. As we mentioned before there are competing hypothesis with respect to affiliation. However, we hypothesize that after controlling
for separation of rights, affiliation to a conglomerate in emerging economies is value
enhancing due to internal capital markets, information sharing and other synergies.

(iii) Separation of voting from cash flow rights at the group level. We consider different
measures of group affiliation. In addition to a standard dummy variable we use a
measure of groups’ cash flow rights constructed as the ratio between total consolidated
equity capital in hands of the group’s controllers and total consolidated assets of the
conglomerate. By using the SVS definition of conglomerates we are assuming that for
all relevant purposes the conglomerate is controlled by the group, family or dominant
company. Therefore, a higher cash-flow rights ratio implies that the cash-flow/voting
rights ratio of the conglomerate is also higher, and hence the incentives for minority
shareholder expropriation are less severe. We hypothesize that higher separation is
associated with lower valuation and payout.

(iv) Board independence and commitment. We plan to produce measures of board
interlocking and other features that serve as proxy for board independence and
responsibility. More board independence is expected to be associated with higher
valuation and payout. We will also consider measures of board involvement in
committees.

(v) Most of the existing literature has summarized corporate governance mechanisms
through imperfect measures of separation of cash and control rights. Although this
indicator is certainly important, other components of a good corporate governance
practice must be considered when evaluating investor protection and its effect on firm
performance. We also intend to generate indicators of senior management
independence and fairness, corporate transparency, and corporate respect for
stakeholders among others. The basic hypothesis is that higher investor (stakeholder)
protection is associated with higher firm valuation and payout.

(vi) The main control variables at the firm level are time dummies (or GDP growth), 8
industry dummies, firm size, debt-equity ratio at market values, return on assets, risk of
assets, presence of institutional investors, among others.

(vii) In terms of conglomerate level variables we use a measure of group diversification,
group size, and controller identity.

(viii) An additional hypothesis that can be verified is that of a better performance of firms
belonging to conglomerates that also own banks. Since banks cannot hold equity and
since their related lending is severely restricted, this eventual higher profitability can be
associated with information - based advantages.
The empirical model will, therefore, be of the type:

\[ y_{it} = \alpha + \beta_1 (sep_{it}) + \beta_2 (daffil_{it}) + \beta_3 (daffil_{it} \cdot group\_sep_{it}) + GOV_{it} \cdot \Phi + ZF_{it} \cdot \Gamma_1 + ZG_{it} \cdot \Gamma_2 + \varepsilon_{it} \]

Where:

- \( y \): a firm performance and value indicator such as Tobin’s q, ROA, dividend payout and investment.
- \( sep \): separation of cash from control rights at the firm level.
- \( daffil \): affiliation to a conglomerate dummy.
- \( group\_sep \): separation of cash from control rights at the group level.
- \( GOV \): a set of measures of corporate governance at the firm and group level.
- \( ZF \): a set of control variables at the firm level, including Tobin’s q in the investment equation, and time and industry dummies.
- \( ZG \): a set of control variables at the group level.

For estimation purposes we will consider a panel data comprising all listed companies (around 300), unless they barely trade, over a 13 years’ time horizon. We will consider pooled, fixed or random effects estimation when required, and will provide heteroskedasticity - consistent estimators. We will also control, when appropriate, for potential endogeneity of explanatory variables through instrumental variable procedures. In particular, a negative relationship between higher separation of rights and firm value may be explained by two different hypothesis. On the one hand, lower separation may indicate lower agency costs and, hence, higher firm value. On the other hand, conglomerates may be choosing to invest more in firms with higher market value.

**Chile and Brazil**

As we mentioned above, we will also analyze jointly a large sample of Chilean and Brazilian firms using a model of the same type as the one already discussed. There are several reasons why comparing the Chilean and Brazilian situations is interesting. Among other things, they have the two most developed capital markets in Latin America and they have led the region on legal reform in corporate governance. However, from the point of view of this research and that of policy implications, the most interesting aspect is the existing differences in corporate structure in both countries. While Chilean groups control firms and separate cash
from voting rights mostly through pyramid schemes, Brazilian corporations widely use dual class shares for that purpose. We are interested in comparing corporate governance mechanisms in firms belonging to different countries (other things equal) and try to understand which institutional factors may have provided the incentives for the different mechanisms employed. Finally, through regression analysis we expect to determine the effect of such different practices on corporate valuation and traded volumes. This research will be developed jointly with Ricardo Leal and Andre Carvalhal.
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