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Convergence and Integration

The Case of Chile”

Guillermo Larrain and Vicente Lazen

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# Financial Markets in Latin America: Convergence and Integration. The case of Chile<sup>1</sup>

Guillermo Larrain

and

Vicente Lazen

## Abstract

This paper studies the Chilean experience in financial integration, addressing three main aspects: 1) the Chilean path toward financial integration; 2) the characterization of the Chilean financial market; and 3) the initiatives aimed at strengthening the Chilean financial industry's integration with the rest of the world.

In the first part, we analyze the Chilean path toward financial integration and we propose that the gradual but persistent approach Chile has taken to integrate with the global economy first based on trade of goods and non-financial services linkages and later and more gradually on financial issues, has been a success. We showed the high degree of integration of the Chilean financial market by observing the high correlation among Chilean and rest of the world interest rates and stock prices. This gradual approach, however, has not been without costs. First, integration in terms of the financial industry was carried out in a later stage and therefore limited competition during several years created strong local financial institutions where competition among them was insufficient. A second cost was that the financial sector development became dependent on legislative and normative advances.

In a second part, we present a characterization of the Chilean capital market with an emphasis on market instruments and Chilean institutional investors, banks, and stock exchanges. In addition, we present an evaluation of the market regulatory framework, where the Chilean securities regulation is compared with International Organization of Securities Commissions principles, as well as with the main accounting and auditing international standards. An analysis of the domestic treatment of foreign capital flows and tax regulations is considered afterwards.

Finally, we offer a set of initiatives aimed at reinforcing Chilean adherence to international financial standards. Among these initiatives are: strengthening the regulatory capacity of the exchanges, improving clearing and settlement regulatory framework; lifting bank secrecy for investigation purposes; developing certification standards for industry professionals; reinforcing the autonomy and governance of the securities regulator by changing its governance arrangements, improving information sharing with foreign regulators; implementing International Financial Reporting Standards in entities related to the securities market; and establishing a public oversight body for statutory auditors. In fact, some of these initiatives are under some degree of development.

**JEL Codes:** G2, G15, G18, G28, O16.

**Key Words:** Financial Markets, Securities Markets, Regulation, Latin America, Chile

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## GLOSSARY OF TERMS

ADR	American Depositary Receipt
AFP	Pension fund (Administradora de Fondos de Pensión)
APV	Ahorro Previsional Voluntario (Volunteer Previsional Saving)
BCS	Bolsa de Comercio de Santiago
BCU	Chilean Central Bank Bonds issued in Fomento Units (Bonos del Banco Central de Chile Emitidos en Unidades de Fomento)
BEC	Bolsa Electrónica de Chile
BITs	Bilateral Investment Treaties
BOVALPO	Bolsa de Corredores de Valparaíso
BOVESPA	Bolsa de Valores de Sao Paulo
CCC	Colegio de Contadores de Chile (Chilean Accountants Association)
CCR	Risk Rating Commission (Comisión de Calificación de Riesgo)
CSD	Central System Deposits
CTC	Compañía de Teléfonos de Chile
CPSS	Committee on Payment and Settlement Systems
DCV	Central Securities Deposit (Depósito Central de Valores)
FCT	First Category Tax
FECU	Uniform Codified Statistical Form
FICE	Foreign Capital Investment Fund
FDI	Foreign Direct Investment
FTSE	Financial Times Stock Exchange
FUT	Fondo Utilidades Tributales
GAAP	Generally Accepted Accounting Standards
IAS	International Accounting Standards
IFAC	International Federation of Accountants
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
IPSA	Chilean Stock Price Index (Índice de Precios Selectivo de Acciones)
ISA	International Standard on Auditing
LMV	Securities Markets Law (Ley del Mercado de Valores)
MF	Mutual Funds
NASDAQ	National Association of Securities Dealer Automated Quotation (Stock Exchange)
NGC	General Regulations of the SVS (Normas de Carácter General de la SVS)
NYSE	New York Stock Exchange
OECD	Organization for Economic Cooperation and Development
PRC	Promissory Notes with Coupon payments (Pagarés Reajustables con pago cupón)
ROSC	Review on Standards and Codes
SAFP	Superintendencia de Administradoras de Fondos de Pensiones
SBIF	Superintendencia de Bancos e Instituciones Financieras
SCL	Chilean Clearing and Settlement System (Sistema de Compensación y Liquidación de Chile)
SII	Internal Revenue System (Servicio de Impuestos Internos)
SME	Small and medium enterprises
SRO	Self Regulatory Organizations
SVS	Superintendencia de Valores y Seguros
UF	Unidad de Fomento
WB	World Bank

## CHAPTER I. INTRODUCTION: THE CHILEAN PATH OF INTEGRATION TO WORLD FINANCIAL MARKETS

In principle, access to financial markets should smooth consumption patterns isolating them from the dynamics of output. However, the international experiences of the last 30 years do not support this hypothesis. In the early seventies, several Latin-American countries including Chile, Mexico and Argentina, liberalized their capital accounts but suffered enormous recessions when capital inflows abruptly disappeared. Lately, in the nineties Mexico while complying with the conditions to enter into the OECD liberalized the capital account and soon after suffered a major recession after both political uncertainties and macroeconomic imbalances. The Asian tigers also suffered major recession some time after opening their capital accounts. In most cases, output dropped significantly mainly due to an adjustment in investment but in all cases consumption, both private and public, were major parts of the adjustment process.

Behind this failure to reach the “promised land” of consumption smoothing can be encompassed by three reasons: unsustainable economic policies, lack of adequate domestic institutions and poor financial regulation. In the case of macroeconomic policies, when prices like the real exchange or interest rate are misaligned due to expansionary monetary policies, foreign capital is allocated relatively more to sectors not able to generate resources to pay capital back once misaligned prices converge to their long term level. In its turn, loose fiscal policies induce excessive aggregate spending and capital inflows whose correction can also create trouble either through cutting public outlays or increasing taxes. Finally, poor domestic regulation poses wrong incentives for local financial institutions. This is more troublesome in times of cheap foreign financing, as external inflows intermediated by local institutions are poorly allocated resulting in trouble when capital payments are due.

In this context, the Chilean approach towards integration to world markets has been cautious, especially concerning financial integration. Indeed, in the seventies, against a background of unilateral and aggressive cut in tariffs and the elimination of non tariff distortions to external trade, capital account liberalization came only after trade openness was achieved and, in any event, was more timid at the time than capital account liberalization in countries such as Argentina<sup>2</sup>. The 1982-83 recession in Chile marked significantly domestic financial supervision and regulation, given that the *laissez-faire* character that prevailed prior to it was a major cause of the recession. As we shall see from then on, a prudent approach to financial regulation was adopted. Over time, this has gradually been modified in order to give more room to the private sector improvement in corporate governance and establish a more credible self regulatory environment.

In the nineties, when foreign capital resumed after a decade, Chile once again adopted a prudent policy. Indeed, the country chose to impose a tax on capital inflows (a reserve requirement, called *encaje*) such that it discouraged short term capital inflows compared to long term capital inflows. Apparently, there was no effect on the size of total inflows or on the exchange rate only on its composition and the interest rate differential<sup>3</sup>. The *encaje* was de facto eliminated only in 1998 once, in the midst of the Asian crisis, foreign capital disappeared and the circumstances that justified it ceased to be there.

Moreover, the Asian crisis induced a modest recession in Chile and the causes of it threw light on several institutional and policy adjustments that were implemented between 1998 and 2000 which have finally allowed, as we shall see, a significant subsequent financial integration of Chile to world capital markets in a sustainable way.

First, on the fiscal side, despite of the fact that Chile had run fiscal surpluses since 1986 without interruption, by 1998 it was not possible to rely on the reputation of responsible fiscal management in order to implement a

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<sup>2</sup> In the sequencing literature that appeared in the eighties, Chile and Argentina became symbols of two polar approaches: while in Chile trade openness preceded capital account liberalization, Argentina did it the other way around. See Sebastian Edwards “The sequencing of structural adjustment and stabilization”, ICS Press, 1992

<sup>3</sup> See De Gregorio, Edwards and Valdes (2000), and Gallego, Hernandez and Schmidt-Hebbel (2002).

countercyclical fiscal policy. In order to deal with this issue, the Government adopted in 2000 a new fiscal policy, called Structural Surplus, which considered an explicit and credible commitment to run a 1% of GDP fiscal surplus measured with long run parameters<sup>4</sup>. This allowed a significantly countercyclical fiscal policy to be implemented between 2000 and 2003 without risking credibility.

Second, during the nineties Chile's exchange rate policy consisted in a band. Theory predicted that such a policy, if credible by agents due to strong Central Bank commitment, should have stabilizing effects (the Krugman's *honeymoon effect*). It did not happen in Chile and, on the contrary, several realignments took place over the years. This induced the market to believe that the Central Bank's commitment with the extremes and the level of the band was weakening. Hence, during 1998 when the Asian crisis reached Chile, the country suffered three massive speculative attacks against the band. By the end of that year, the Central Bank recognized such lack of commitment and eliminated the band<sup>5</sup>. Since then, Chile's exchange rate policy has consisted in a floating regime with only few episodes of intervention.

Third, during the nineties the Central Bank was embarked in a fight against "structural" inflation. In so doing, it adopted an informal *inflation targeting approach* which consisted in an always decreasing target for the CPI measured in December each year. In 1999, the Central Bank declared victory against structural inflation and adopted a formal inflation targeting scheme with a permanent target of 3% for projected core inflation in a 12 month horizon and the same number for total CPI in a 24 months horizon.

The three reforms greatly enhanced the flexibility and credibility of fiscal, monetary and exchange rate policies. This coupled with the strong reputation of the three financial supervisory agencies, set the ground for a successful process of financial integration of Chile to world markets during the first decade of the new millennium.

### *The long path to financial integration*

In order to show how the process of financial integration has taken place consider that arbitrage conditions should increasingly explain movements of capital as barriers and distortions to capital flows decrease. Indeed, if only taxes to capital inflows were present, there would be a wedge among prices of similar assets but the co-movement could be similar. If however, there are other distortions in markets, such as minimum stay periods, bureaucratic requisites and the like, arbitrage cannot work properly and co-movements do not appear necessarily. On the contrary, if one observes that in the case of prices that can be arbitrated, co-movements of similar asset prices increase over time, this could be considered an argument in favor of the improved financial integration. Let's consider two of those prices, equity prices and interest rates.

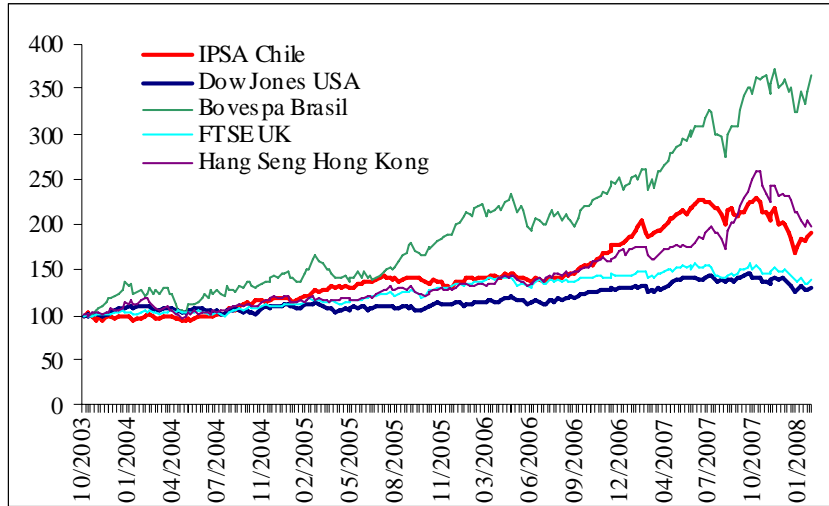
The following graph shows the weekly evolution of five stock market indexes: Dow Jones, Bovespa, FTSE, Hang Seng and IPSA.

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<sup>4</sup> Two separate commissions with expert economists were formed, one for estimating potential output and another for long term copper price. These parameters were used to simulate long run tax revenues and spending was determined basically as 1% of GDP less. Actual tax revenues could of course differ and the actual balance could well be a deficit, as it eventually happened. See Marcel, Tokman, Valdes and Benavides (2001).

<sup>5</sup> See French-Davis and Larrain (2003).

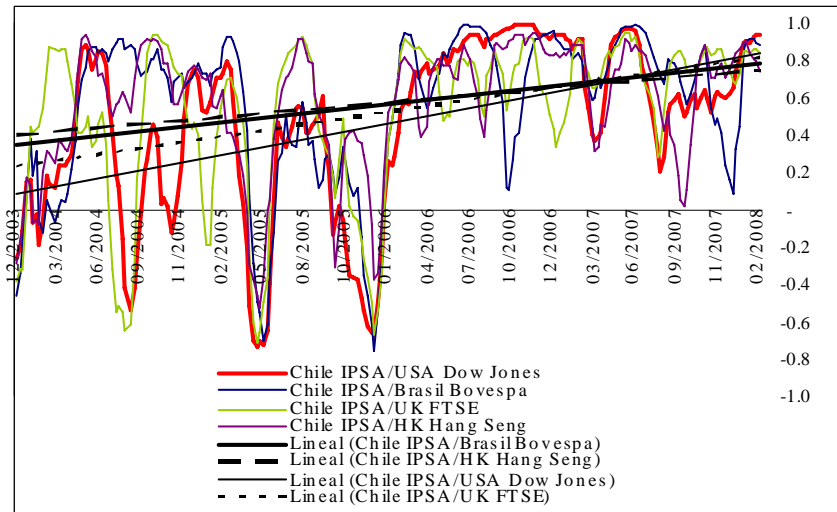
**Weekly evolution USA Dow Jones, UK FTSE, Hong Kong Hang Seng and Brazil Stock Exchange Index BOVESPA versus IPSA**



Source: Bloomberg

We suggest that correlation coefficients among those prices should increase as economies get close to each other, all the rest being constant. The following graph shows correlation coefficients for IPSA with each of the other indexes. Despite significant variance, the upward sloping trend lines suggest that prices behave more in line with each other over time.

**Correlation Coefficients and their trends Dow Jones/IPSA, Hang Seng/IPSA, FTSE/IPSA and BOVESPA/IPSA**

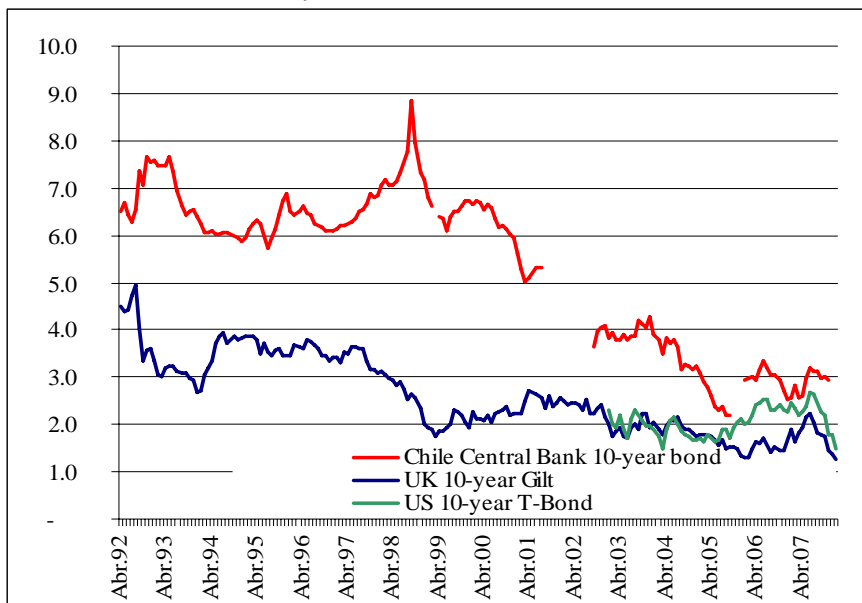


(Correlation coefficient for four-week moving samples)

Source: Own calculation

Consider now real interest rates computed from indexed bonds available for Chile, the UK and the US. We prefer real rather than nominal interest rates in order to isolate idiosyncratic shocks to inflation. The following graph shows the level of real interest rates (i.e., inflation indexed) for 10-year Chilean bonds and 10-year Treasury bonds issued by the US Treasury and 10-year bonds issued by the UK Government.

### 10-year bond rates Chile-USA-UK

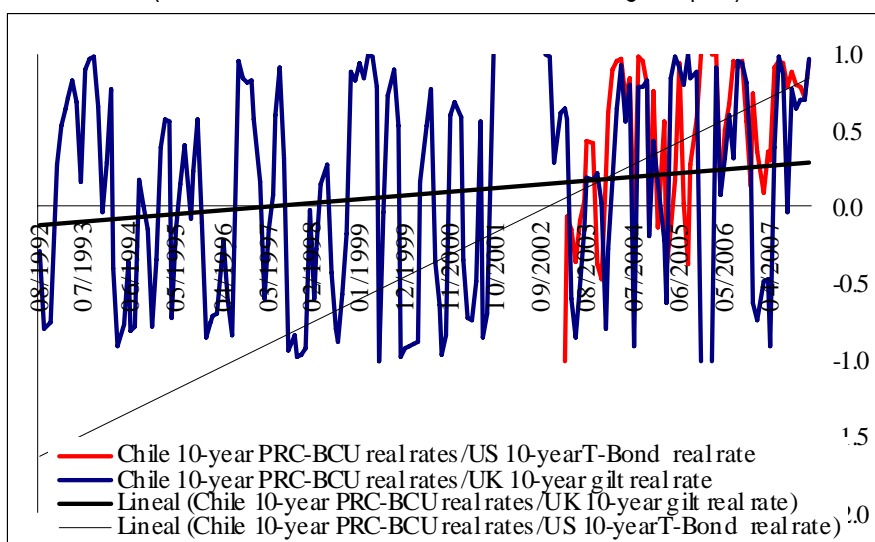


(US 10-year bond real rates available only from 2003)

Source: Bloomberg, US Federal Reserve.

As in the previous exercise, we now compute correlation coefficients. The results, as suggested by the upward sloping trend lines, indicate that long term real interest rates do tend to move increasingly closely between the selected countries, an outcome that is consistent with an increased degree of financial integration with international capital markets.

### Correlation Coefficient 10-year bond rates Chile-USA-UK (Correlation coefficient for four-month moving samples)



Source: Own calculation

The greater co-movements of equity prices and interest rates suggest that, over time, the integration of Chile to world financial markets has increased. Has this been a successful integration? In general, the answer is yes. We propose to consider successful a financial integration process if the “golden dream” of consumption smoothing is more likely now than in the past. In cases of credible financial integration, one should expect that shocks that affect primarily output (for instance, external shocks to exportable sectors or capital inflows) should impact less domestic consumption.

One way to first approach the problem is to examine the behavior of the variance of consumption and output. To simplify, we assume that output and consumption growth follow an AR(1) process and we model the conditional variance of each process as a generalized autoregressive conditional heteroskedasticity (GARCH) model.

The two estimated equations are shown in the following table. The models appear to work well under the assumptions used. Variance equations show first, that both output and consumption variances have changed over time, in particular consumption. The main explanatory variable for this has been the capital account liberalization introduced since 2000 (dummy D1).

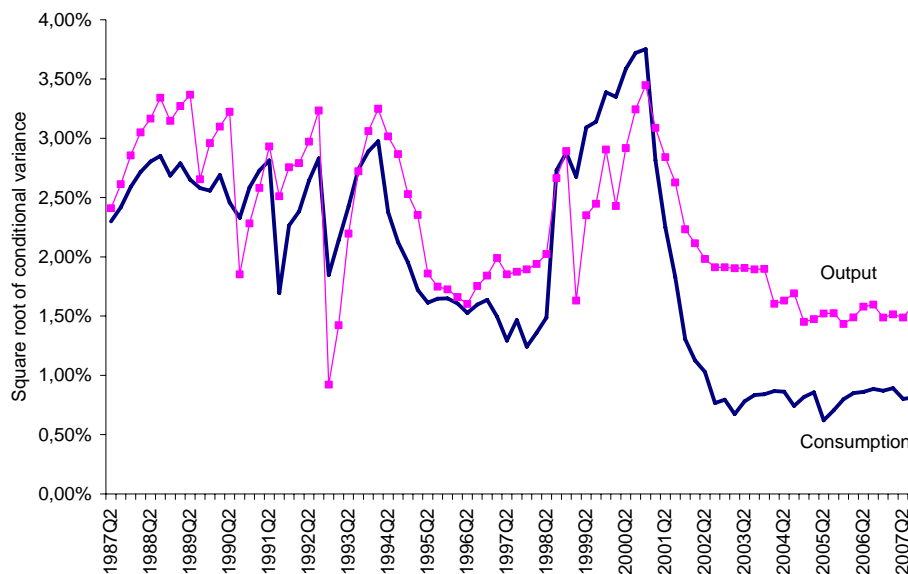
Output equation				Consumption equation			
Method: ML - ARCH (BHHH) - Normal distribution				Method: ML - ARCH (Marquardt) - Normal distribution			
Sample (adjusted): 1987Q2 2007Q3							
GARCH = C(3) + C(4)*RESID(-1)^2 + C(5)*GARCH(-1) + C(6)*D1 + C(7)*D2 + C(8)*D3 + C(9)*D4							
	Coefficient	Std. Error	Prob.		Coefficient	Std. Error	Prob.
C	0.011047	0.004745	0.0199	C	0.012638	0.003474	0.0003
DPIB(-1)	0.788792	0.067382	0.0000	DCONS(-1)	0.811550	0.049625	0.0000
Variance Equation				Variance Equation			
C	0.000363	0.000356	0.3078	C	0.000347	0.000125	0.0054
RESID(-1)^2	-0.217531	0.249310	0.3829	RESID(-1)^2	-0.118802	0.077918	0.1273
GARCH(-1)	0.752106	0.199879	0.0002	GARCH(-1)	0.597190	0.082400	0.0000
D1	-0.000325	0.000319	0.3080	D1	-0.000583	0.000240	0.0153
D2	0.000275	0.000253	0.2773	D2	0.000501	0.000224	0.0256
D3	-0.000242	0.000181	0.1816	D3	-0.000282	0.000174	0.1060
D4	1.99E-05	7.88E-05	0.8010	D4	5.07E-05	0.000162	0.7542
R-squared	0.629770				0.680476		
Adj R-squared	0.589197				0.645460		

Note: The Dummy variables included in the specification are: D1, when the Central Bank liberalizes the capital account (encaje set at 0 and no one year minimum of stay), D2, the Central Bank starts widening the exchange rate band (coincides with the Russian and LTCM crisis), D3, when institutional investors are allowed to invest internationally and D4 when Chile received its investment grade status.

Source: own elaboration

The following graph shows the (square root) of the conditional variance of both output and consumption. We see that after several years of strong association of both variances, the integration of the Chilean economy to world financial markets has implied that consumption and output processes have decoupled from one another, as one could have expected in theory. The graph suggests that consumption has become a more stable process than that of output, with its variance being reduced in a statistically significant way. Moreover, the more significant element to explain this change is the elimination of taxes to short term capital inflows.

### Output and Consumption: Square Roots of Conditional Variance

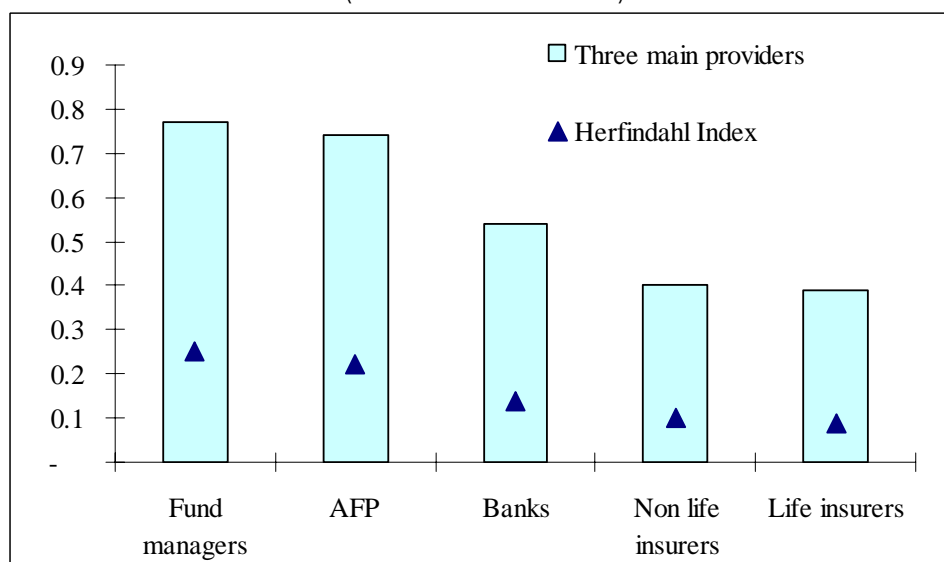


Therefore, it seems that the gradual but persistent approach Chile has taken to integrate with the global economy, first based on trade linkages and later and more gradually on financial issues, has been a success. Gradualness, however, has not been without costs.

First, integration with the rest of the world introduces competition to local businesses. In the case of financial industries, the fact that foreign competition was limited for several years created strong local financial institutions but competition among them was insufficient. As in other countries, for example small European countries, the financial sector is concentrated but abnormal returns disappear and are transferred to consumers. In Chile this is not necessarily the case.

### Industry concentration in the Chilean financial sectors

(data as of December 2007)

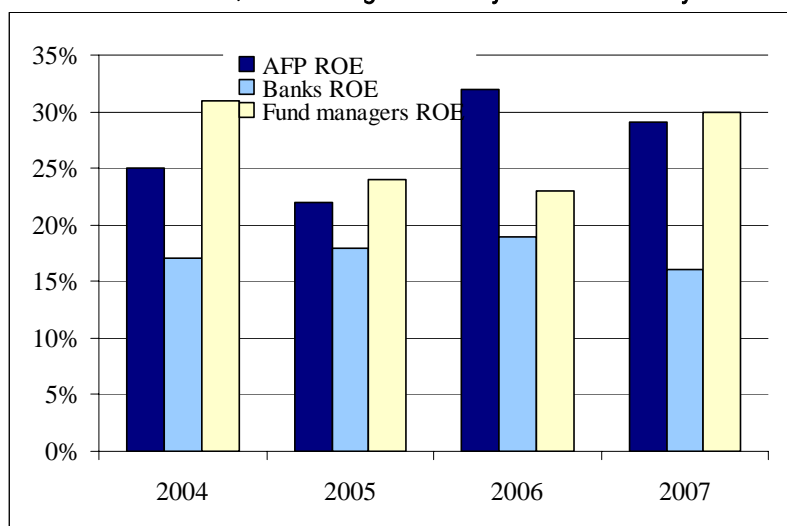


For fund managers data used is total income; for AFP total assets under management; for banks total lending; for insurers total reserves.  
Source: Own calculations based on information from SVS, SAFF and SBIF

In the pension funds administrators sector, the presence of significant economies of scale coupled with peculiar characteristics of consumers which makes them not sensible to prices, has induced a concentration of the industry and no entry despite significant abnormal profits<sup>6</sup>.

In the banking sector, ROEs are on average significant, around 20% but they are much larger in larger banks. Despite having enjoyed from some entry towards specific niches, ROEs have not decreased towards normal levels.

**ROE Banks, fund managers industry and AFP industry**

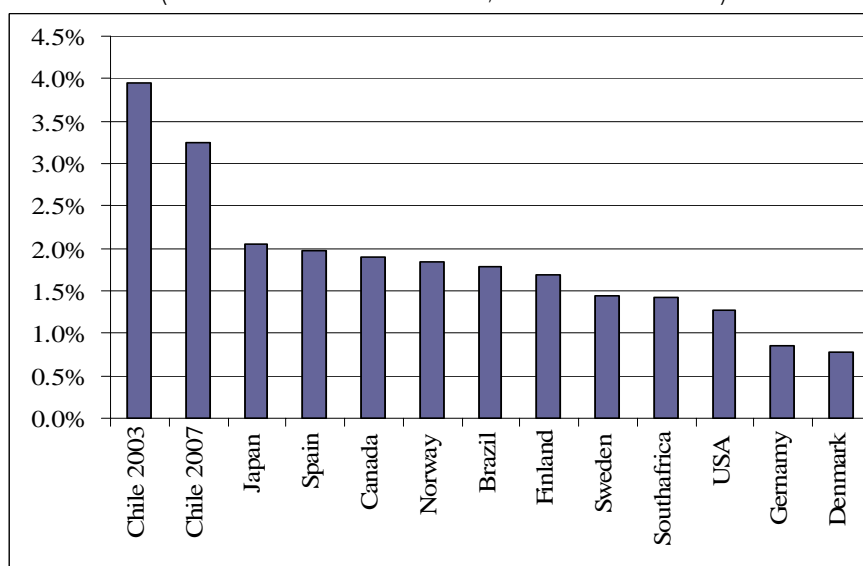


Source: SVS, SAFF, SBIF

In the mutual funds industry, fees charged in Chile exceed the ones charged elsewhere in Latin America and other developed countries, in particular, in the variable income segment.

**Costs charged by equity mutual funds**

(data as of December 2007 for Chile; 2004 for other countries)



Source: SVS and Lazen (2004)<sup>7</sup>

<sup>6</sup> The Pension Reform introduced in 2008 takes various steps towards increasing competition among providers. The outcomes of these efforts remain to be seen.

<sup>7</sup> See Lazen, V. "Competividad de la Industria de Fondos Mutuos en Chile" Serie Documentos de Trabajo, Superintendencia de Valores y Seguros. May, 2004

Finally, competition among stock exchanges has been limited as well. The Bolsa de Comercio de Santiago counts for a disproportionate share of both equity and fixed income markets. The threat of competition from Bolsa Electrónica has helped in keeping trading fees relatively low, but it has not induced a more aggressive business approach in terms of financial innovation and making initial public offering more attractive for firms.

The second cost of the gradual approach followed, after the lack of competition, has been that financial sector development became dependent on legislative and normative advances. This has reinforced the slow path of financial sector reform in recent years, as shown by the fact that it took 5 years between the launch of the second reform to capital markets in the Lagos administration and its final approval under the Bachelet administration. In the meantime, several countries have introduced significant reforms, some as a result of public initiatives, as the Self Regulatory Authority of the Colombian Securities Market, or private initiatives such as the demutualization of the Sao Paulo Stock Exchange. The outcome is that the leadership that Santiago once clearly had in financial development has eventually been handed over elsewhere. This does not mean that Santiago has lost a war, but clearly has lost a battle. It still enjoys several strong characteristics such as sound macroeconomic policies, solid institutions including supervisory agencies, low corruption and criminality rates, good connections with the rest of the world, skilled human resources and strong local institutional investors. Its future as a relevant regional financial centre is not guaranteed, but it is certainly still possible.

The Chilean experience suggests that a successful financial integration with the rest of the world is not an easy task. It requires taking policy actions in several fronts, including macroeconomic policy and several institutions. Sustainable financial integration is not the outcome of just opening the capital account. The movements of capital that result from that single measure need to be allocated properly to sectors in the economy with the capacity to repay their debts, the interest and exchange rates movements derived from capital movements should be manageable by local agents, both financial and non financial, and macroeconomic policy must not be lose credibility by such price changes nor should it encourage speculation about the sustainability of those same policies.

## CHAPTER II. REVIEW OF THE CHILEAN CAPITAL MARKET

This section reviews the Chilean capital markets by describing the main financial instruments negotiated in Chile: Namely stocks, fixed income securities, derivatives as well as structured products (securitized bonds). Following this revision, a brief characterization of the main Chilean institutional investors is presented, analyzing pension funds, insurance companies and investment funds.

The Chilean securities markets accounts with more than one century of existence. The Santiago Stock Exchange and the Valparaiso Stock Exchange (BOVALPO) were created in the late XIX century. In spite of its longevity, by 1980 the total exchange market capitalization was only US\$ 6,800 million (21% of GDP), and the total value of share trading during the same period was slightly more than US\$ 360 million. During the early 80's, a deep economic transformation that included the entire economic activity, also affected the securities industry and its regulation. Market access was liberalized, privatizations brought some important companies to the stock exchange and regulations were strengthened. In 1981, the Securities Market Law and the Corporations Law were enacted. After some modifications, they are still in place today.

Unfortunately, in January 1982, as a consequence of the worsening of the price of commodities and an unexpected surge in international interest rates, followed by the interruption of incoming foreign capital flows to Latin America, economic authorities had no choice but to float the exchange rate that had been kept fixed for more than 5 years. The following depreciation of the peso gave way to a solvency crisis not only in the real sector but also in the financial sector, especially in the banking sector. The existing economic conglomerates at that time worsened the crisis. Having a bank inside the conglomerate, the rest of the companies could access cheap financing in US dollars through that intermediary. The same happened with mutual funds that were administered by entities related to these conglomerates; while investing in bonds and shares issued by these related companies. The consequences of this crisis on the securities market were deep. By 1983, due to the collapse of big companies whose shares were part of the mutual funds portfolios, assets under management went down to US\$ 118 million from a total of US\$ 797 million in 1982.

Nowadays the Chilean securities market has experienced a considerable development in comparison with the early 70's. In terms of size, total market capitalization of listed shares has reached 126% of current GDP and last year, more than US\$ 45 billion was traded in shares, more than one thousand times the volume traded in 1974. A similar trend can be observed in the debt market where the total value of corporate bonds reached more than US\$ 18 billion last year. Additionally, individual investors have benefited from important advancements in the securities industry, especially the mutual funds industry, which maintains more than US\$ 23 billion in assets under management.

### Securities Market Indicators

US\$ million of each year

	1977	1981	1983	1990	1995	2007
Market capitalization	2,970	6,828	2,632	13,764	73,939	214,392
As % of GDP	13%	21%	13%	44%	104%	126%
Total value of share trading	30	363	59	772	11,059	45,507
Annual yield of IPSA (1) (5-year moving average)	126%	45%	6%	51%	41%	26%
Stock in place corporate bonds	32	96	299	1,392	2,478	18,237

(1) IPSA is the Santiago Stock Exchange selective stock price index  
Source: SVS, Santiago Stock Exchange

The participation of the institutional investors in the securities market has been a key factor. In 1975, total assets under management were only US\$ 2 billion (mainly mutual funds and insurance companies), in 2007, this figure was US\$ 155 billion.

### Total assets under management institutional investors

Million US\$ of each year

	1974	1981	1983	1990	1995	2007
Institutional investors	2	1,180	1,802	9,573	37,760	155,273
<i>As a % of GDP</i>	<i>0%</i>	<i>4%</i>	<i>9%</i>	<i>30%</i>	<i>53%</i>	<i>91%</i>
Pension funds	-	305	1,380	6,683	25,419	103,315
Insurance companies	-	194	304	1,854	7,120	28,315
Mutual funds	2	681	118	864	2,803	23,262
Closed end funds	-	-	-	-	-	4
FICE (1)	-	-	-	172	2,418	377

(1) FICE stands for "Foreign Capital Investment Funds"  
Source: SVS, Santiago Stock Exchange

### The Chilean indexed unit: *Unidad de Fomento*

Before going forward it is important to highlight the importance of indexation in the Chilean capital market. This practice has allowed the development of longer term bond issuances as well as mortgage based loans. As a result of the indexation unit's success, the Chilean capital market is deeply indexed in terms of past inflation. The inflation indexed unit: "*Unidad de Fomento*" (UF), in place since the early sixties, is the currency unit in which most fixed income securities are issued. The value of the UF changes in a daily basis according to the calculated variation of the consumer price index (IPC) during the last month.

The following table shows the prevalence of the indexation in the financial instruments in Chile. As can be seen, most of the instruments are still strongly indexed as they are expressed in UF. Two exceptions are Central Bank bonds and commercial paper. In the first case, the Central Bank has been carrying out efforts aimed at the "desindexation" of the financial system, being one of the main initiatives the issuance of bonds denominated in Chilean pesos.

#### Penetration of indexation in financial instruments in Chile

Issuer/manager	Instrument	Total Stock (US\$ million)	Total expressed in UF
Life Insurance Companies	Annuities	22,780	100%
Securitization Companies	Securitized bonds	1,811	59%
Corporations	Corporate bonds	18,237	97%
Corporations	Commercial paper	774	5%
Central Bank	Central Bank Bonds	17,353	55%

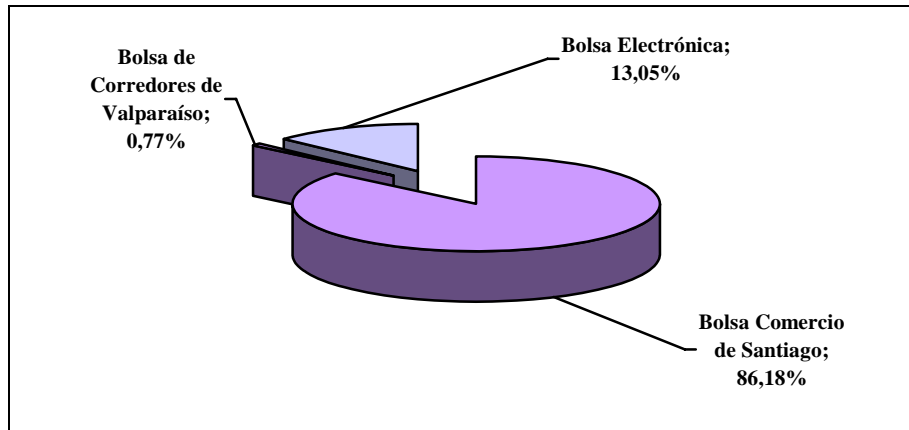
Source: Own elaboration

## CAPITAL MARKET INSTRUMENTS

The public offering of securities as well as stock exchanges and its intermediaries, are regulated by the Securities Market Law (LMV, according to its Spanish abbreviation), as well as by the General Rules ("Normas de Carácter General") and Circulars of the Superintendencia de Valores y Seguros (SVS), and by the provisions enacted by the stock exchanges.

Three are the exchanges currently operating in Chile: Bolsa de Comercio de Santiago (BCS), Bolsa Electrónica de Chile and Bolsa de Corredores de Valparaíso. BCS's market share of total share transactions reached 68% in 2007, with Bolsa Electrónica accounting for virtually all the rest. The Bolsa de Corredores de Valparaíso remains marginal and accounts for about 0.1%. In terms of fixed income, BCS accounts for more than 95% of total transactions.

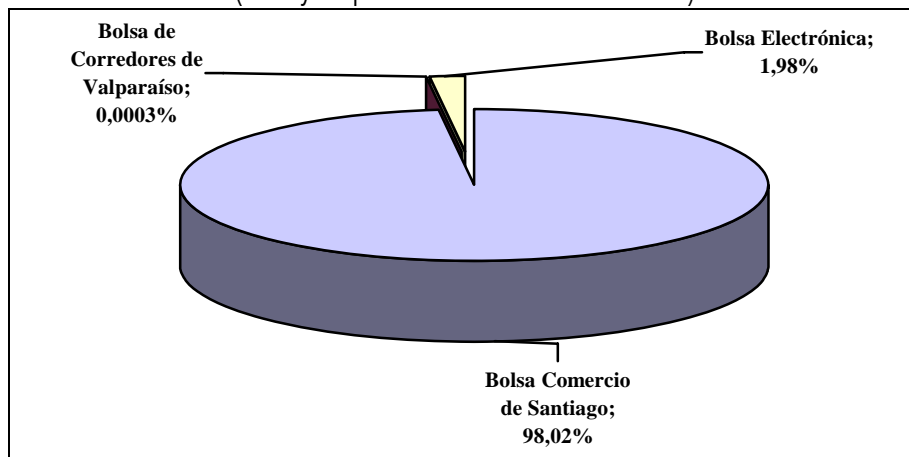
### Stocks traded in Chilean stock exchanges (2007)



Source: SVS

In the long term fixed income market, mainly corporate and government bonds, BCS also accounts for the majority of transactions with 98% of the total volume traded.

### Long term debt traded in Chilean stock exchanges (mainly corporate and Central Bank bonds)

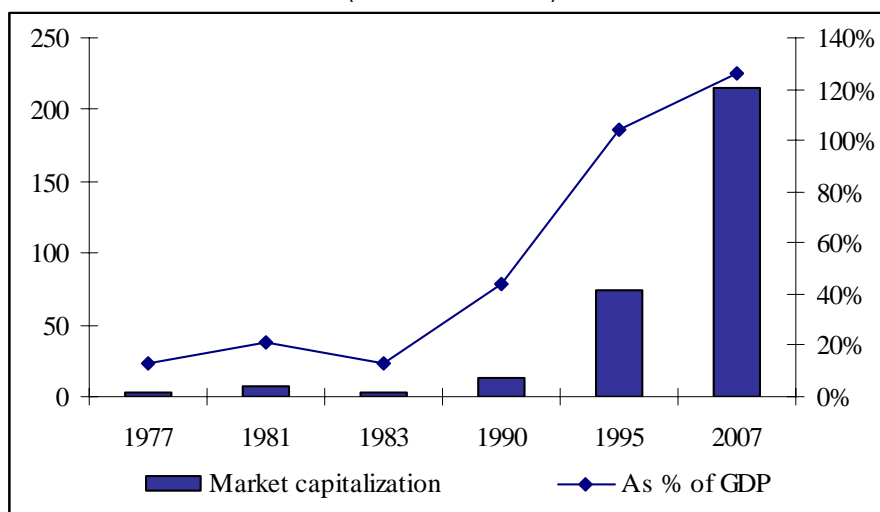


Source: SVS

### Stock market

The Chilean stock market has showed an outstanding development as seen from a regional perspective. The market capitalization in the BCS reached US\$ 214 billions as of December 2007, representing 126% of the country's GDP.

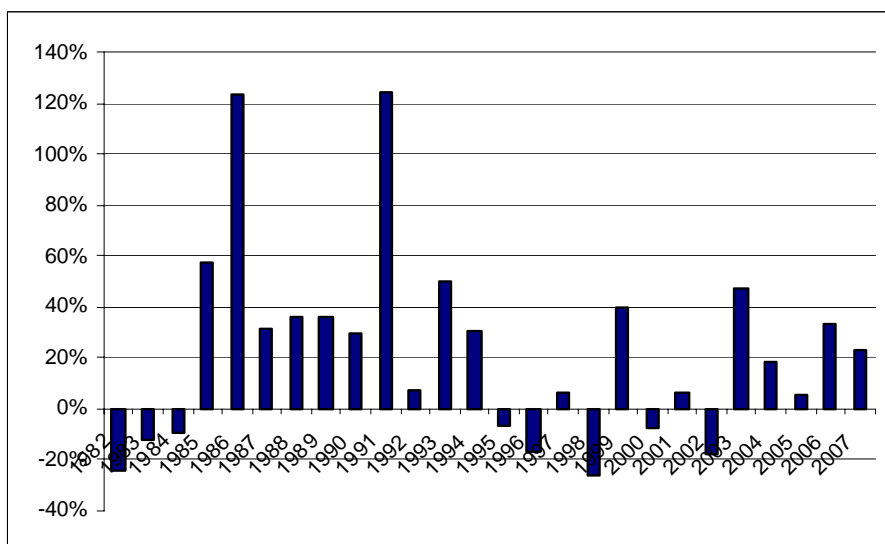
### Market capitalization of companies listed in BCS (US\$ million and %)



Source: SVS

As many other exchanges in the region, the stock market has experienced a sustained growth during the last 5 years. IPSA, the selective price index of the BCS, which measures the price variation of the 40 most traded stocks, has experienced an average yearly variation of 26% in real terms during the last 5 years and 10% in real terms during the last 10 years. This trend is originated on different reasons. The sustained economic growth during the last years, with only one negative year of growth in 2000, as well as the economic stability has nurtured an appropriate environment for enterprise growth and profitability. This combines also with a return of foreign flows to emerging markets after the Asian crisis during the late nineties.

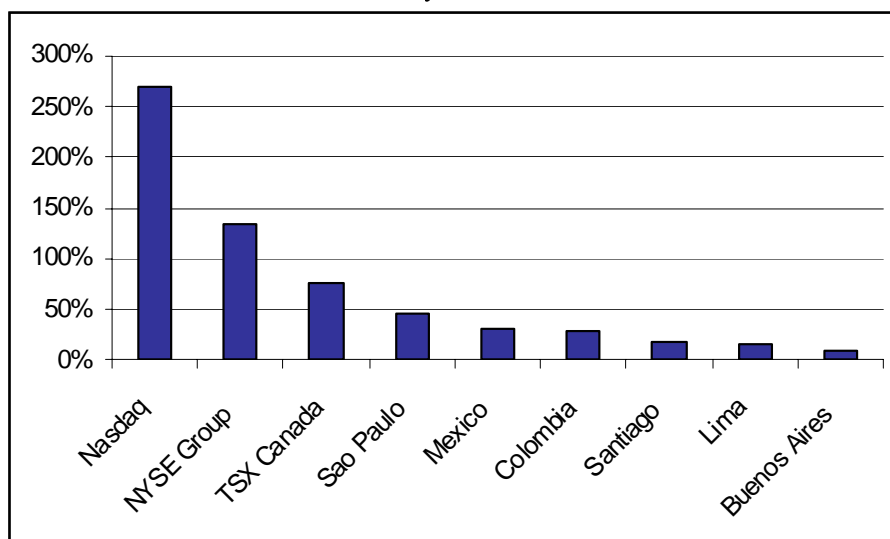
### Annual variation IPSA in real terms



Source: BCS

Nevertheless, Chilean equity markets are concentrated and illiquid in relative terms. The annual turnover velocity ratio (total annual share trading volume as a proportion of total market capitalization) of listed companies is lower than 10% annually, a low indicator even under a regional perspective as showed in the following graph.

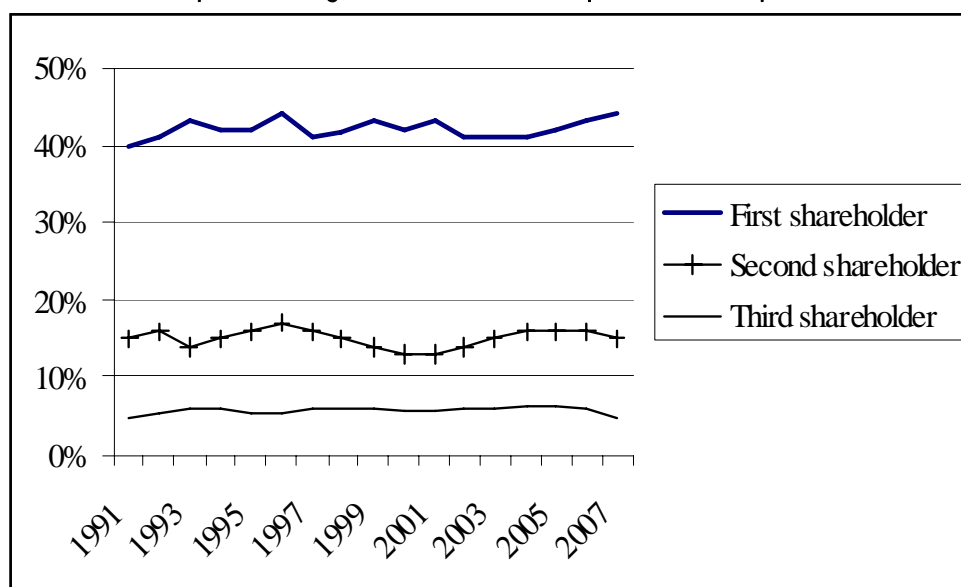
### Stock market turnover velocity in some Latin American countries



Source: WFE

One of the more important factors that explain low liquidity is the concentration of ownership in Chilean corporations reducing the available free float of companies. This indicator, which reflects the proportion of the companies' market value not owned by controlling shareholders, is around 25% of total market capitalization. This result is mainly originated in the fact that almost 70% of the shares of the 60 most actively traded companies are held by controlling shareholders. In the Chilean market the largest shareholder maintains around 44% of the corporate ownership and the second and third largest keep approximately 14% and 6% of ownership respectively. At the same time, a factor that might have certain importance in the high percentage of controlling stakes is the existence of supermajorities for the approval by shareholders of certain important corporate decisions.

### Participation of largest shareholders in corporate ownership in Chile



Source: Own elaboration based on SVS information

A recent study carried out by the SVS relating liquidity to corporate governance has suggested a link between the current takeovers regulation and ownership concentration in Chile<sup>8</sup>. The study suggests that the

<sup>8</sup> See Morales "Determinantes de la Concentración de Propiedad Accionaria y Ley de Oferta Pública de Adquisición de Acciones". Superintendencia de Valores y Seguros. Mimeo.

requirement of carrying out a tender offer when a controlling party reaches 2/3 or more of the company ownership tends to induce more concentration in the companies. Also, the study found that the easiness of accessing bank debt or bond financing determines the degree in which the company taps the stock market to access capital. Since large companies in Chile can access bank or bond financing easily, they tend to make use of shares issuance less frequently.

The demand side of the market is also relatively concentrated with six private pension funds being the largest institutional investors (three of the six control over 70% of assets under management) and, as “buy and hold” investors, they further exacerbate the lack of market liquidity. The internationalization of Chilean companies also can help to explain the lack of liquidity in the market.

### **The fixed income market**

In Chile, the fixed income market includes Central Bank Bonds, Treasury Bonds, Corporate Bonds and Bank Bonds. The benchmark bonds are the ones issued by the Central Bank, which are the main instruments for monetary policy management.

Among the instruments issued by the Central Bank are debt instruments with maturity that goes from 30 days to 20 years denominated in Chilean pesos and Unidades de Fomento. The instruments are: BCU (Bullet Bonds in UF), BCP (Bullet Bonds in Pesos), PRC (Pagaré Reajustable in pesos), PRD (Pagaré Reajustable in US dollars), PD (Pagaré Descontable) y BCX (Bonds in US dollars).

In the domestic market the Tesorería General de la República issues BTP (Treasury Bonds in Pesos) and BTU (Treasury Bonds in UF). Foreign issued Bonds consist of 6 bonds issuances for a total value of US\$ 3,750 million.

The Chilean fixed income market is relatively sophisticated in terms of diversity of maturities and issued volume. The corporate bond market is of recent but marked development. According to Braun and Briones (2007), its size passed from 3% of GDP in 1999 to more than 12% of GDP in 2005, while the size of the typical corporate bond has increased threefold. Corporate bonds maturities go from 5 to 25 years with the average corporate bond exceeding 16 years maturity. Almost 93% of them are denominated in UF.

As of December 2007, the stock in corporate bonds was US\$ 18,237 million. They are usually issued by the largest companies in order to finance investment projects or debt restructuring. The possibility of larger companies financing their projects issuing bonds at competitive rates and long maturities is a result of adequate supply and demand conditions. On the demand side, the availability of long term and continuous flows of funds from institutional investors has been a key issue. On the supply side, the enactment of the new Securities Market Law as early as in 1981 has been the other success factor. In this area, regulations in relation to investors information (e.g., prospectuses, periodic disclosures requirements), governance and representation of the investors (e.g., bondholders assembly, role of the trustee) as well as the legal safety of the issuance (e.g., indenture as the main pillar of the issuance, insolvency issues) have resulted in a predictable environment for investors and issuers. Regulations in the operational side (e.g., underwriting, shelf registration) also have played an important role<sup>9</sup>.

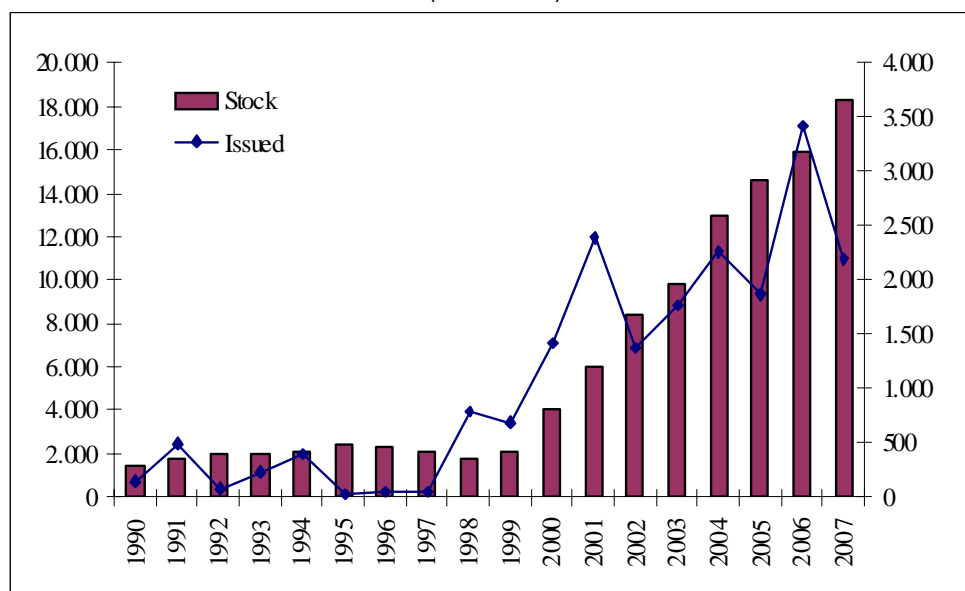
An important surge of corporate bond emissions since the early 2000 (see graph) is a result of a mixture of the natural growth of the assets managed by the pension funds and insurance companies in particular as well as

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<sup>9</sup> In addition, Braun and Briones (2007) explore the determinants of corporate bond issuance in Chile. They find that the most significant single explanatory variable is firm size and then higher leverage ratios. This suggests that bank financing is the first step in obtaining financing. One important element is that publicly listed companies are less likely to issue bonds, suggesting that stock and bond financing are substitutes.

an important influx of issuances connected with the financing of public infrastructure projects under concession arrangements. A declining supply of central bank bonds might also be an additional explanation.

**Corporate bonds issuance and stock**  
(US\$ million)



Source: SVS

During recent years the importance of corporate bonds has had the effect of leaving the Central Bank bonds in a second place. During 2007, the total stock of corporate bonds surpassed the total stock in place of Central Bank bonds. Banks are also very active players in the bond market.

**Stock of main fixed income instruments**  
(US\$ million)

Bond type	2006	2007	Var %	% of market in 2007
Central Bank	16,847	17,353	3%	28%
Corporate	15,847	18,237	11%	32%
Banks	6,145	12,924	110%	21%
Securitized	1,698	1,811	7%	3%
Mortgage loans	10,524	10,147	-4%	17%
<b>Total</b>	<b>52,586</b>	<b>61,571</b>	<b>17%</b>	<b>100%</b>

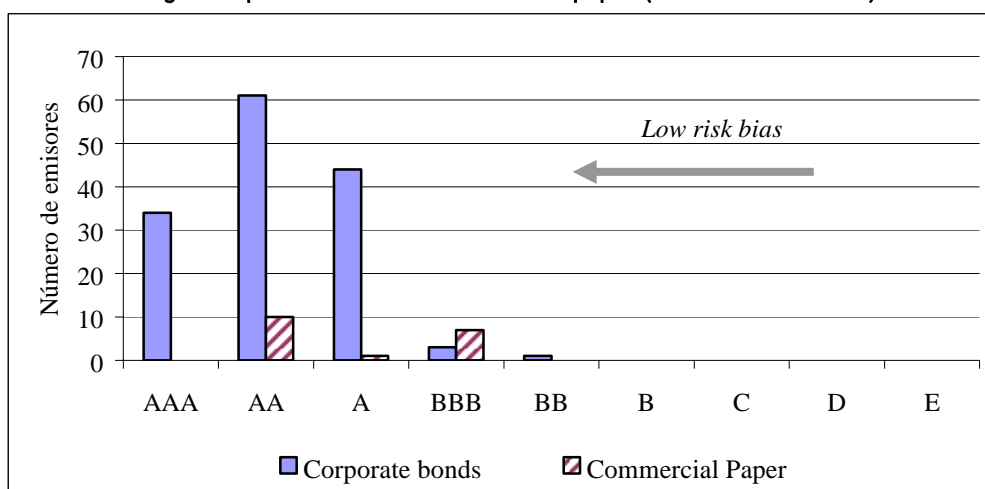
Source: Larraín Vial

The risk profile of the Chilean corporate debt market is strongly influenced by the investment needs of pension funds and insurance companies. This is due to the importance of these institutional investors in terms of assets under management. Therefore, it is uncommon in Chile to find issuances with risk ratings lower than BBB, due to the fact that AFP's regulation requires such a minimum risk rating to be eligible for investments by these entities. Mutual funds can invest in bonds with risk rating of B as a minimum (the Securities Market Law requires corporate bonds to conduct two risk ratings), whereas insurance companies are restricted to up to 5% of their investments in securities with risk rating lower than BBB. Although the motivation of regulators is focused on

risk mitigation some observers indicate that Chilean regulation should move towards the concept of “prudent person” leaving more room to self policing of institutional investors.

The effect of the minimum risk rating requirements for corporate bonds is to impede issuances with a lower risk rating (and higher expected return). The bias against this type of bonds (see graph) play against the goal of developing a more complete market, which must offer a more continuous range in the risk/return relation.

**Risk rating of corporate bonds and commercial paper (*efectos de comercio*) 2007**

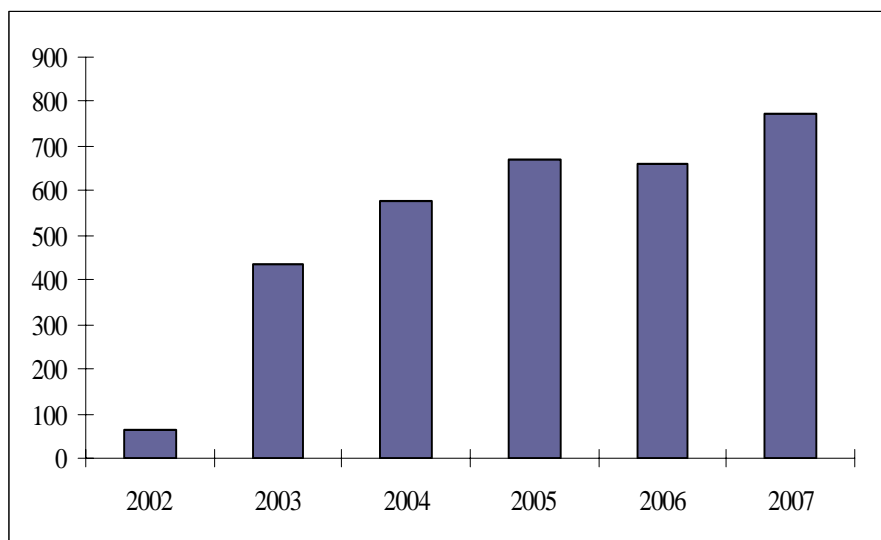


Source: SVS

Bond financing has acquired greater importance in relation to bank financing. According to balance sheet data from corporations presented to SVS, in the year 2000 the ratio of long term bank debt to corporate bonds was 4 to 1. Last year, this same relation was almost 1 to 1.

**Commercial paper has proved highly sensitive to tax considerations and issuers' solvency assessment.** Commercial paper has been an alternative of financing since at least 1977. As of 1981, there was a stock of commercial paper of US\$ 300 million in place. Since then, and until the early nineties, risk ratings were not employed; therefore the issuers' solvency assessment was a very difficult task. The economic crisis during 1982 closed out the access to commercial paper financing for a long time as a consequence of the default of practically all of the issuers of commercial paper at that time. During the late eighties some issuances were carried out, nonetheless, the higher relative issuing cost in relation to bank debt couldn't be compensated by the relatively better financing rates. In 2001, a legal reform limited the stamp duty tax to pay by the issuer to the tax rate times the value of the entire commercial paper program (which includes many issuances). That measure leveled the playing field against bank financing.

### Commercial paper stock (US\$ MM)



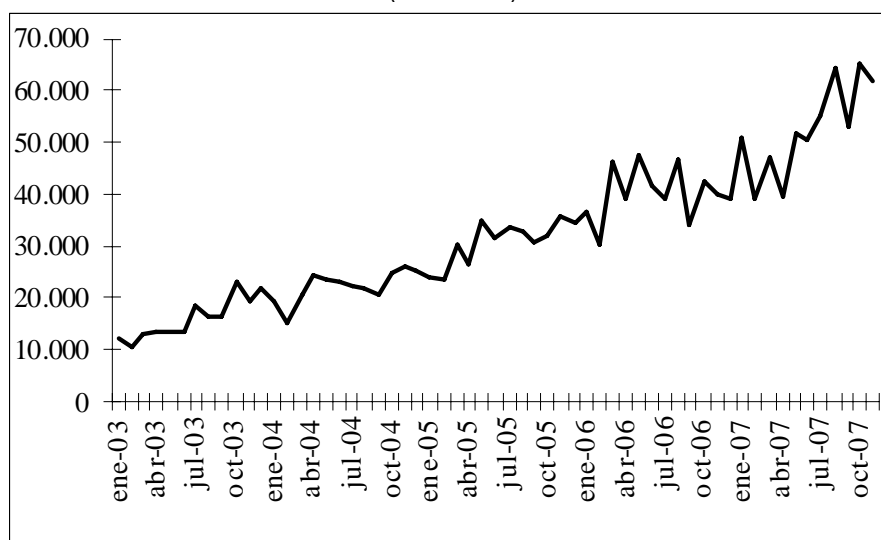
Source: SVS

### Derivative instruments

The derivatives market development has concentrated only in the OTC interbank market. Although in Chile, the BCS has pioneered the implementation of US dollar and IPSA futures and some options on some blue chip stocks, launching their transaction in December 1990, virtually no trading have occurred as of today. Therefore, in Chile derivatives have been traded OTC only and specially among banks although securities brokers are also important OTC traders specially in US dollar forwards where they account for about 20% of the overall market.

The main derivatives traded in Chile are the peso/US dollar forward contracts and UF/US dollar forward contracts. In 2000, the Central Bank authorized banks to trade forwards with foreign counterparts, in operations involving Chilean currency (pesos or UFs). Banks were also allowed to hedge credit risk associated with their fixed-income portfolio and commercial loans with residents, using derivatives, both for local and foreign currency. The annual forward contract Turnover velocity in the interbank sector rose from US\$47.8 billion in 1996 to US\$140.5 billion in 2000 and US\$645 billion in 2007. Peso/US dollar forward contracts accounted for 76.8% of total Turnover velocity in this market. The balance corresponded to UF/US dollar forward contracts.

Monthly traded volume forward Ch\$/US operations  
(in US\$ MM)



Source: Central Bank

Derivatives contracts based on fixed income also are relatively dynamic in Chile. The “*swap promedio cámara*” is an interbank rate swap used mainly by banks in order to match balance sheet stocks.

Other type of derivative instrument that is widely used is “inflation insurance”, which consists of a forward purchase or sale of UF, at a fixed price. This instrument allows investors coverage for a range of future inflation rates, or to provide coverage for policies in Chilean pesos. Quotes for this instrument also include an estimate with respect to inflation expectations in the financial market.

There is also an important amount of activity in the “fixed income forward” market. With this type of instrument it is possible to fix underlying rates (BCU and PRC), with the goal of considering both buyer and seller. This last case opens up a new possibility of operations for market participants, since there is practically no short sale market for debt instruments.

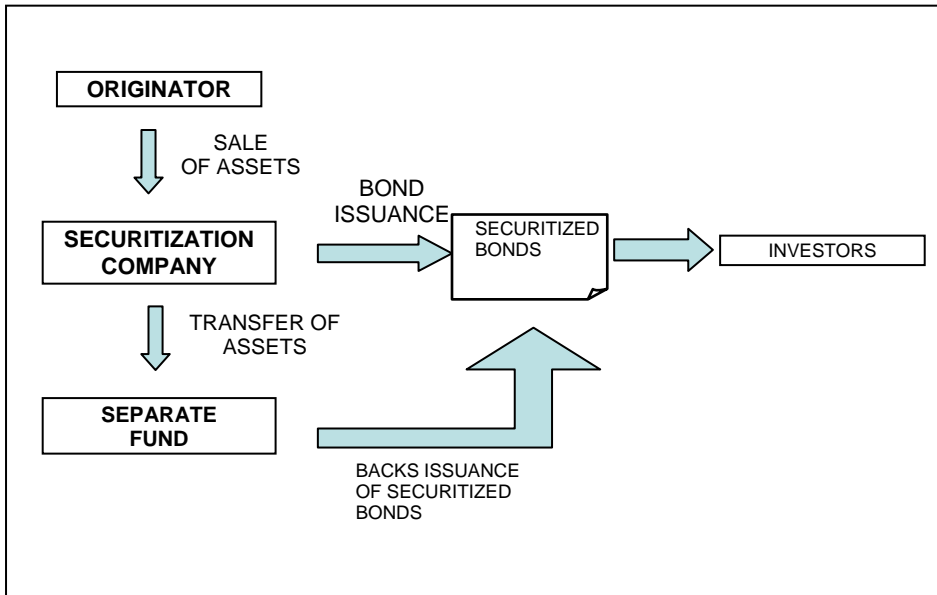
The BCS, during the year 2004, began transactions in its futures market. There are two products that have a trading platform at this entity: BCU-5 and BCU-10 futures. The development of this market is still new, and it has been slow to take off. In fact, transactions were only made during its first month of operation.

### Securitization

Securitization Companies (“Sociedades Securitizadoras”) are unique purpose corporations registered with the SVS. Securitization Companies buy assets or rights on asset cash flows with which they create a separate fund that backs up the issuance of a securitized bond publicly offered in the market.

In Chile, securitization requires the issuance of “securitized Bonds” which are authorized and regulated by the LMV. The securitization structure involves a true sale of the asset by the originator, which acts as a seller meanwhile the final buyer is the separate fund that is represented by the Securitization Company. The main requisite for securitization is that assets are not subject to prohibitions, guarantees or legal restrictions on their transfer.

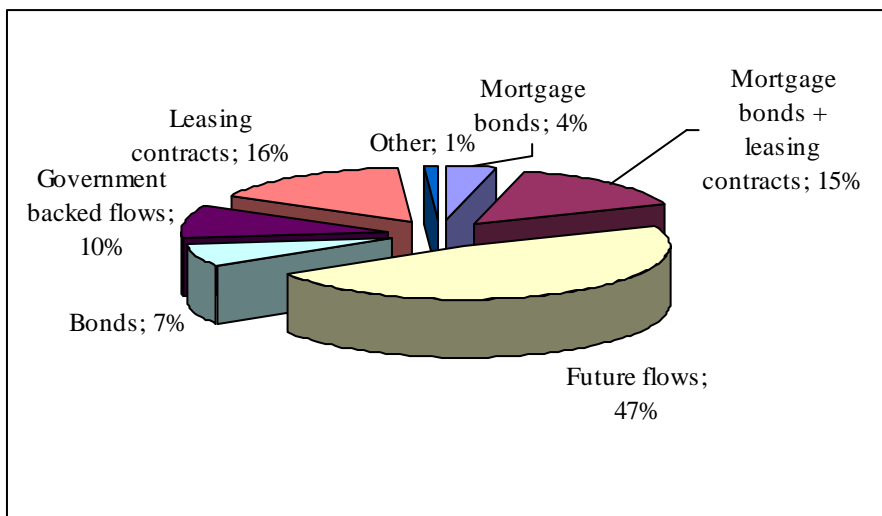
### Structure of securitization in Chile



Source: Own elaboration

Securitization started in the early nineties as an alternative investment for insurance companies which needed long term bonds in order to match liabilities cash flows originated in annuities obligations, with asset cash flows. Pension funds have traditionally been important investors also. Nowadays, future flows have replaced mortgage instruments as the main assets securitized. This trend has been fueled primarily by credit card receivables as well as debt receivables of retail companies.

### Assets securitized in Chile

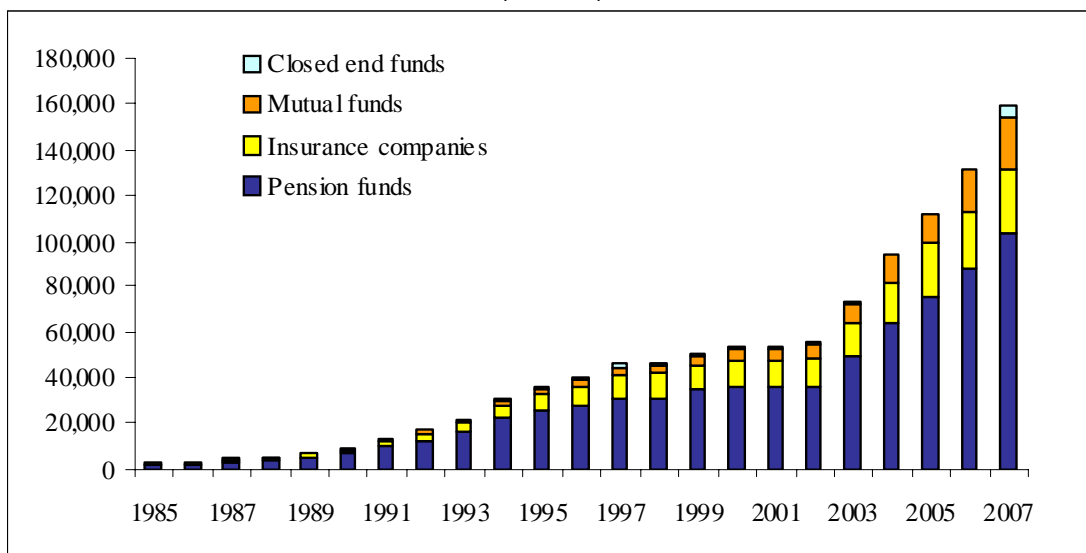


Source: SVS

## INSTITUTIONAL INVESTORS AND BANKS

Pension funds are by far the most important institutional investors in Chile comprising 65% of total assets managed by local institutional investors. Insurance companies hold 18% of the total and mutual funds 15% of the total. Other relevant institutional investors are investment (closed end) funds.

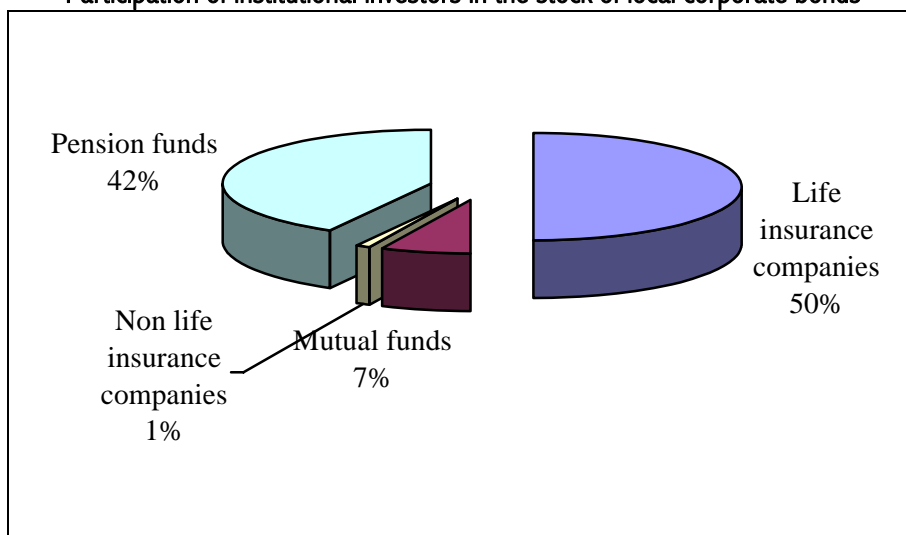
**Assets under management institutional investors 2007**  
(US\$ MM)



Source: SVS

Insurance companies, especially life insurance companies, are the main investors in corporate bonds, mainly because of the need to back up liabilities cash flows originated in the sale of annuities as commented in the last section.

**Participation of institutional investors in the stock of local corporate bonds**

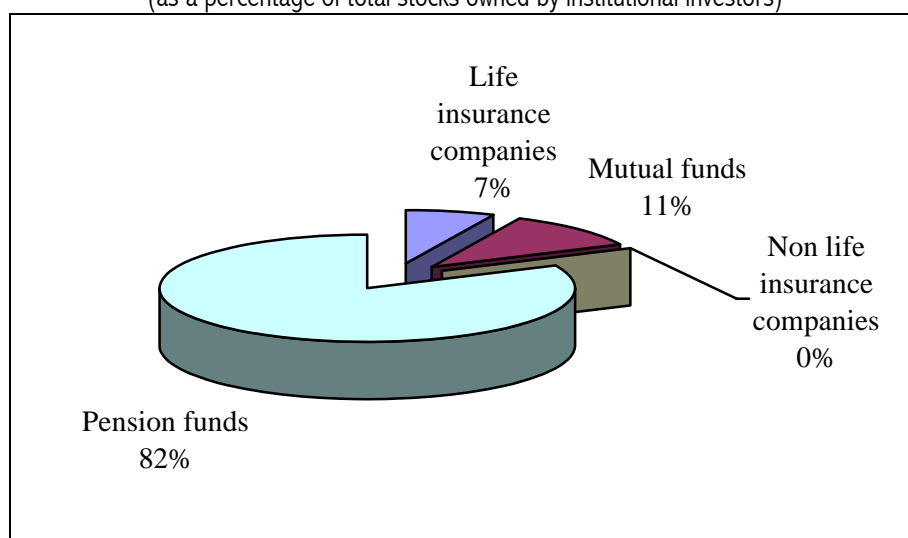


Source: SVS and SAFF

The high participation of insurance companies in corporate bonds is a result that has gained more importance lately due to the record low levels of domestic interest rates, situation that has made life insurance companies to invest more heavily in relatively higher fixed income returns although with a cost in terms of higher portfolio risk.

On the other side, pension funds are the main investors in local stocks. At the same time, they are the main non controlling shareholders, being able also to place board members in many of the corporations they invest in.

**Participation of institutional investors in local stocks**  
(as a percentage of total stocks owned by institutional investors)



Source: SVS and SAFFP.

## Banking industry

The banking industry includes 21 banks established in Chile (including one state owned bank: Bancoestado) and 6 branches of foreign banks. Banking industry is regulated under the General Law of Banks and the norms that on credit, financial matter, and international exchange, the Central Bank of Chile dictates. The Supervision of the industry is carried out by the Superintendencia de Bancos e Instituciones Financieras (SBIF).

The orientation of the SBIF has been to move towards risk based supervision. This process began with the reform to the General Law of Banks in 1986, once the financial crisis of beginnings of the 80's was surpassed. This process was fortified with the modifications to this law in 1997 incorporating recommendations in the First Agreement of Capital of the Basel Committee of Banking Supervision of 1988, or Basel I, and with diverse measures in recent years. These include the complementation of Basel I with the approach on market risk, the data collection and estimation of provisions by risk of credit, the identification and control of factors of operational risk on the part of the banks, and the participation of their boards in the definition of policies and procedures of pursuit and risk control.

On the other hand, the SBIF together with the Central Bank of Chile introduced in 2005 the main directions towards New Capital Framework of Basel II. Complete implementation of Basel II is due in 2008.

A trend toward concentration in this industry can be observed in the last decade. Of the 40 banks operating in 1995, today only 27 are operating under the same legal form. In part, this is one results of the sprouting of "megabancos", originated in mergers of important banks. These banks are characterized by a corporative strategy of multiple products and services for diverse national and foreign markets.

However, it is not less certain that the "niche banks" are also arising, that is to say, those specific banks that have a strategy of businesses based on products and services for the market niche that they privilege to develop, as observed by Wigodski and Torres (2004)<sup>10</sup>. Department stores have entered into the banking business creating bank subsidiaries also orientated mainly to specific socioeconomic sectors. Credit cards loans

<sup>10</sup> Torres, C., Wigodski, T. "Análisis Estratégico de la Industria Bancaria Chilena". Santiago, Chile. Universidad de Chile. 2004.

granted by these department stores represented a key business line in this industry and have come to account for an important proportion of their total income. This trend has had the effect of raising the attention of bank regulators who included department stores credit cards into the menu of regulated businesses.

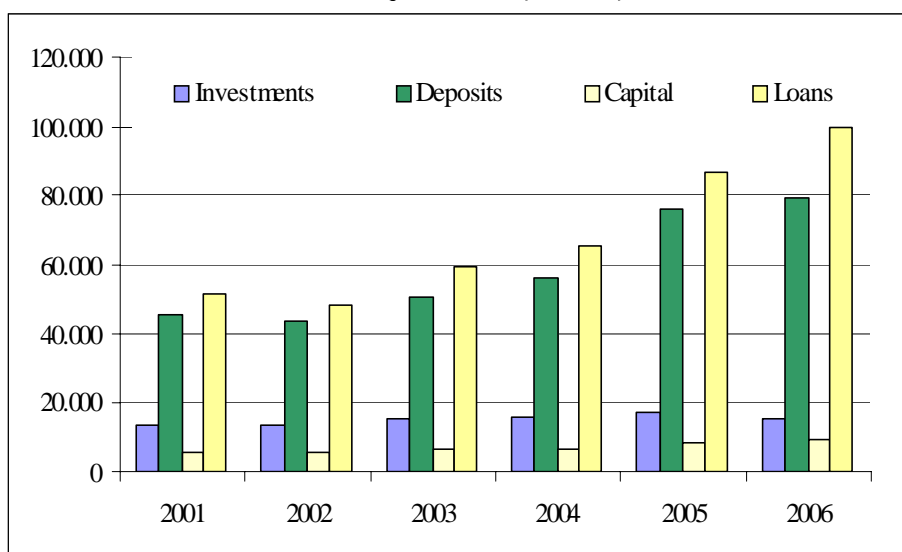
The Chilean bank industry is recognisably solid under an international comparison. The IMF 2006 Global Financial Stability Report places Chile at the top of the emerging nations, in the place 21 between 60 countries. The foundations on which this appraisal was made are the stable legal framework, fiscal discipline and clients portfolios with lower risk exposition.

Chilean banks rest very strongly on financial margins, understood as the difference between lending and borrowing rates. In effect, it represents between 70% and 75% of the 87 gross margins of the banks, reason why around two thirds of banks profits are originated in financial margins. Return on equity has been around 15% during the last years.

Banks are authorized to create subsidiaries for other types of financial services, such as non-retirement insurance intermediation subsidiaries, leasing companies, factoring companies, financial consultants and securities companies.

Additionally, in 1997, a General Law of Banks reform authorized physical expansion abroad, through the opening of bank branches and subsidiaries, the purchase bank holdings, or the setting up of representative offices, and it allowed foreign investment in the same businesses that they were authorized to operate internally.

Main banking indicators (US\$ MM)



Source: SBIF

Although bank concentration in Chile is not especially different from most developed markets, some authors have found that the Chilean industry shows some signs that suggest there is room for improvement in competition. For instance, Bernstein and Fuentes<sup>11</sup> found evidence of sluggishness of adjustment of the bank-lending rates to changes in policy rate.

## Pension funds

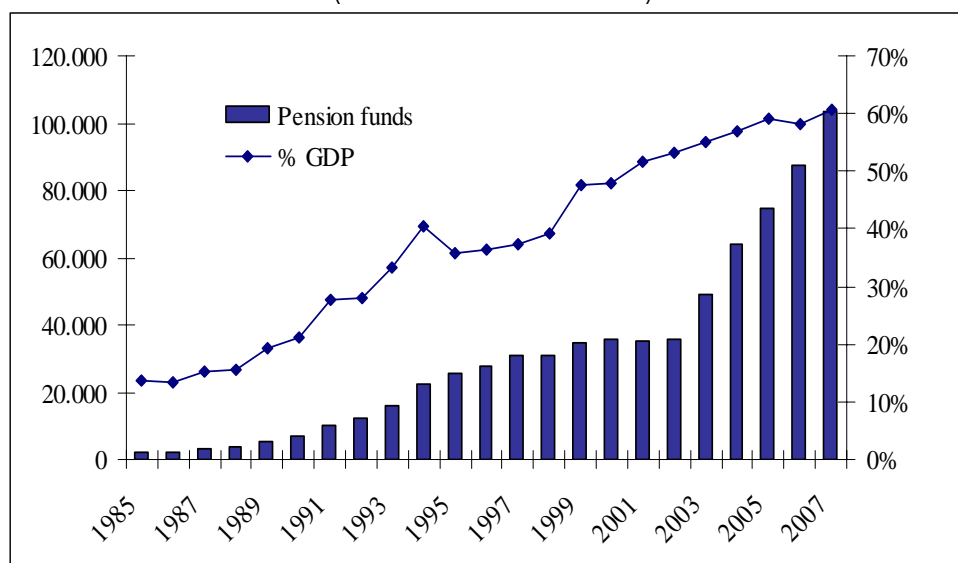
<sup>11</sup> Bernstein, S. and Fuentes, R. "Is there Lending Rate Stickiness in the Chilean Banking Industry?" Central Bank of Chile, Working Papers N° 218, Agosto 2003.

The Chilean pension system structured under the individual capitalization/defined contribution scheme started operations in 1980. Under this system each participant (*afiliado*) owns an individual account where contributions are made. Contributions are around 10% of current salary plus the fund manager commission of around 2% of current salary. Contributions are invested in local and foreign securities. At retirement, the accumulated savings are returned to the participant under some pension scheme. The amount of the pension depends on the accumulated savings.

A law liberalizing operating conditions for the AFPs, Law 17.279, became operational at the beginning of August 2002. It enabled AFPs to create five types of portfolios with different levels of risk/profitability to suit the needs of different age groups and different levels of risk aversion. Fund A, which has the higher expected risk and return combination, must have between 40% and 80% of its assets in variable income securities; and it is open to male investors up to age 55 and female investors up to 50. Fund B must have between 25% and 60% of its assets in stocks; Fund C, between 15% and 40%; Fund D, between 5% and 20%; and Fund E cannot have any assets invested in stocks.

The law also removed various restrictions on AFP investments and authorized the Central Bank to set the maximum amount of assets under management that AFPs may invest abroad. The Central Bank set the current limit at 40%. The Central Bank can raise this limit to 80%. The law lets AFPs participate in the derivatives market by lending assets and hedging their foreign currency and interest rate risks through futures, forwards and options. In addition, the law enables AFPs to participate in the expanded market for voluntary savings that arose from the 2001 financial deregulation package.

**Investments of Chilean pension funds**  
(in US\$ MM and as % of GDP)



Source: SAFP

AFPs invest only in a handful of Chilean companies, almost all of them in the Chilean blue-chip index (IPSA). This is not only due to conservative investment approaches that favor large-cap growth stocks, but also the lack of sufficient free float across the majority of stocks including large and smaller cap companies. Thus, in the local markets the AFPs find it difficult to take substantial positions in many stocks. Although, they invest in the stocks comprising the index, they don't replicate the index (using market-cap weights). The top 10 companies in the index make up about 65% of the total market capitalization of the index, which would require that 65% of any increase in pension fund equity investments to flow into these stocks, where there is very limited room available in the market to meet such demand. Such purchases would also push the funds' holdings closer to the single exposure limits.

**Investments of Chilean pension funds by asset class**  
(% of total, as of November 2007)

<b>Government instruments</b>	<b>13.09</b>
Chile Central Bank	7.78
Chilean Treasury	1.91
Retirement bonds	3.40
<b>Financial instruments</b>	<b>27.13</b>
Mortgage Bonds	4.49
Term deposits	17.49
Bank bonds	4.30
Shares of financial institutions	0.83
Forwards	0.01
<b>Real sector</b>	<b>27.37</b>
Shares	16.14
Bonds	7.84
Closed end funds	3.33
Commercial paper	0.06
<b>Foreign sector</b>	<b>32.30</b>
Closed and open end funds	31.63
Debt Instruments	0.38
Other	0.30
<b>TOTAL ASSETS</b>	<b>100.00</b>

Source: SAFF

In 2001 a legal reform authorized new form of voluntary investment programs. This is called “*Ahorro Previsional Voluntario*” (APV) and is similar to individual retirement accounts, IRA, implemented in the United States, these are designed to be voluntary supplements to the mandatory private retirement system (AFP). APV accounts can be managed not only by pension fund managers, but also by banks, insurance companies, investment fund managers and brokers. Each product is independently regulated by the government agency responsible for regulating the entity offering the product.

### Open and closed end investment funds

The Chilean funds regulated by SVS are: mutual Funds, Closed end Funds, Foreign Capital Investment Funds (FICE) and Housing Funds. In general terms, funds are managed by a special corporation named fund administrator. These administrators obtain resources from the public and issue shares that give shareholders the right to participate in the profits of the funds.

#### Mutual Funds

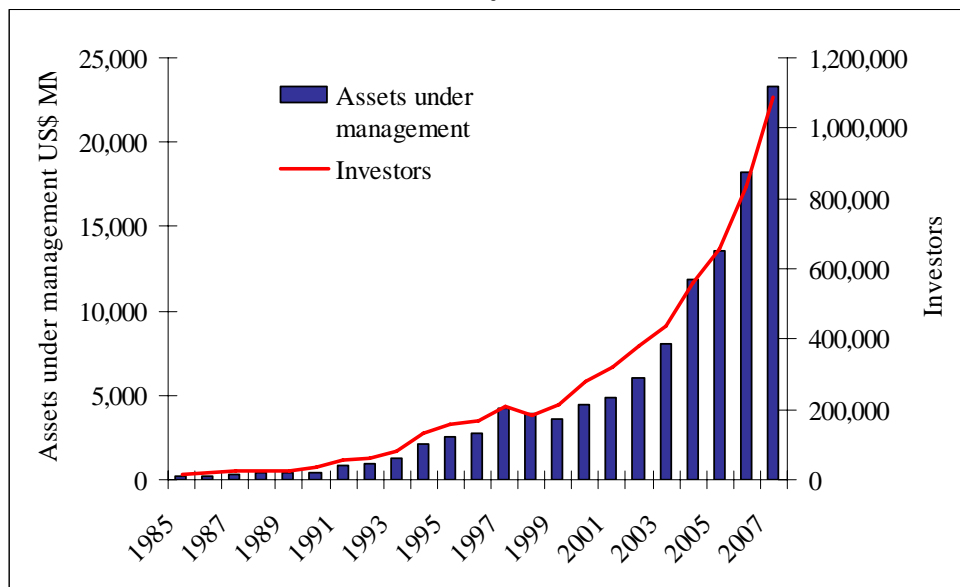
Mutual Funds (MF) are composed by a pool of money contributed by legal and natural persons for their investment in public securities. The assets of each mutual fund are divided into redeemable shares, of identical characteristics and value. Additionally, there may be different share series within the same fund.

There are eight kinds of MF, which, depending on the case must add the expression foreign or local: MF of investment in short term debt instruments with maturity dates equal or lower than 90 days; MF of investment in short term debt instruments with maturity dates equal or lower than 365 days; MF of investments in long and

medium term debt instruments; mixed MF; MF of investment in capitalization instruments; free investment MF; structured MF and, MF for qualified investors.

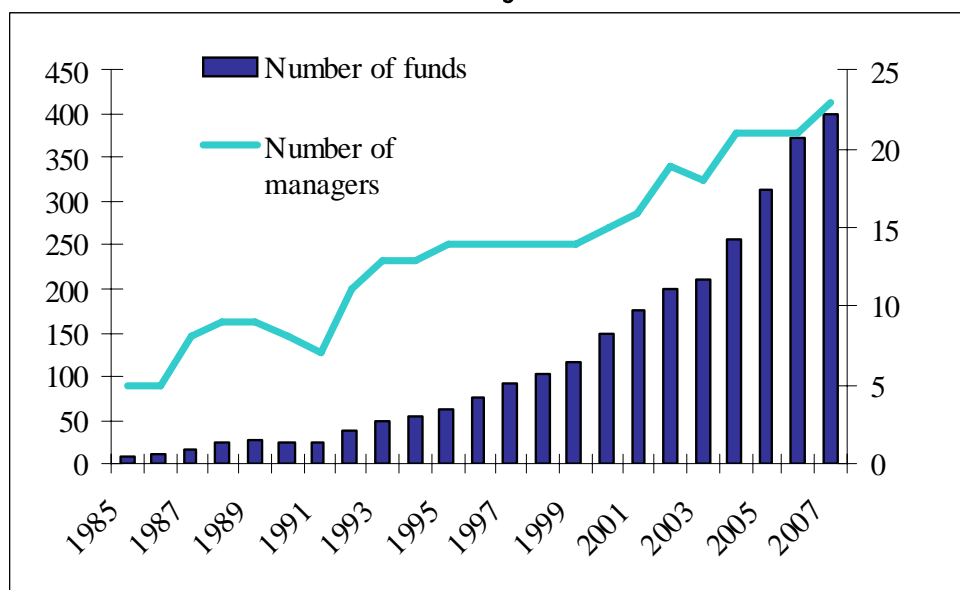
The number of MF investors has grown considerably which at the same time has contributed to the increase of the MF total assets under management.

Evolution of assets under management and number of investors



Source: SVS

Evolution of mutual fund managers and administered funds



Source: SVS

Chilean law imposes a number of investment restrictions on MF. They may not invest more than 10% of fund assets in one issuer or hold more than 25% of the total market value of a single issuer. Because of the interlocking ownerships that exist among most Chilean companies, funds also may not invest more than 25% of fund assets in the securities (debt and equity combined) of companies of one business group or 10% of fund assets in fixed-income securities of a business group. Also, this concentration is only permitted if the debt has an “A” rating or better from two private rating agencies. Overall, funds are not permitted to invest in any fixed-income security unless it has a minimum of a “B” rating from two private rating agencies.

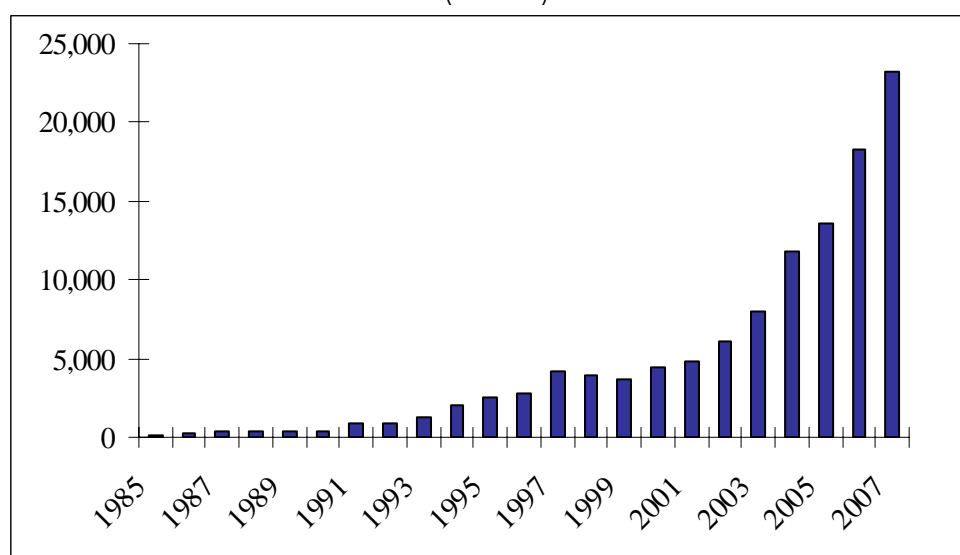
## Investment Funds

Investment funds are closed end funds composed by contributions of legal and natural persons to invest in securities and assets authorized by the Investment Funds Law. The fund is managed by a corporation at investors' risk and expense. The contributions are expressed in shares that are not redeemable before the liquidation of the fund.

The issued fund shares become public securities, reason why they must be previously registered in the Securities Registry, and in at least one Chilean or foreign securities exchange, to allow the formation of a secondary market for those shares.

Since the promulgation of law 19,705 in year 2000, called *Ley de Opas* (Tender Offer Law), categories of open-end investment funds were eliminated along with the investment limits, being only subject in this aspect to what are established in the bylaws of each fund.

**Investment funds assets under management**  
(US\$ MM)



Source: SVS

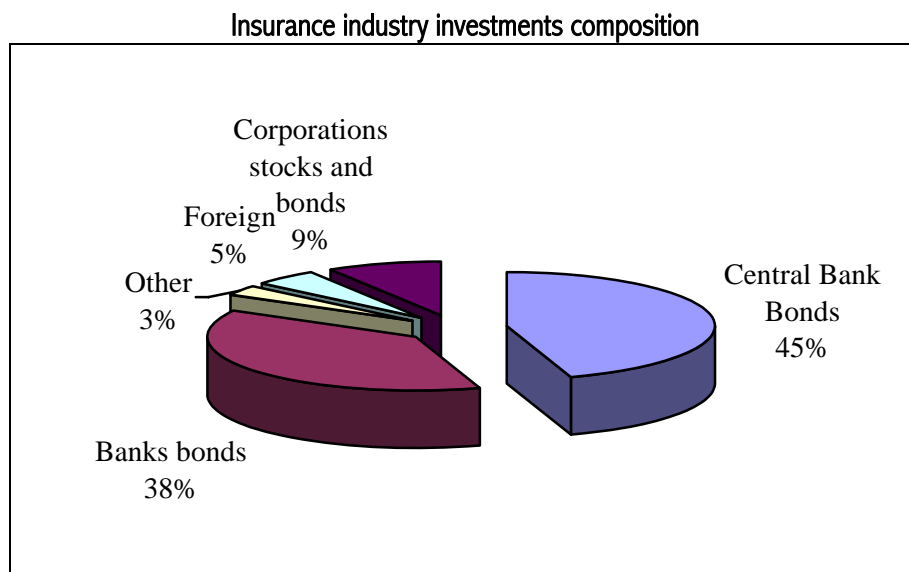
## **Insurance Industry**

They are the second most important investor with regards to the amount of investments that they manage. Insurance companies sell either life insurance or general insurance. The former, in addition to selling life insurance, also offer annuities, a business which has proved highly profitable, and whose profits are for the most part invested in long term debt instruments. General insurance companies are more short term investors, as a result of the nature of their line of business.

The Chilean insurance industry consists of 18 general insurance and 30 life insurance companies. The first one covers the loss or damage of goods or property; while life insurance companies provides coverage for individuals, or at least guarantee, within or at the end of the policy term, capital and a settlement or income for the insured party or his beneficiaries. In some cases, personal accident and health risks may be covered by both types of companies.

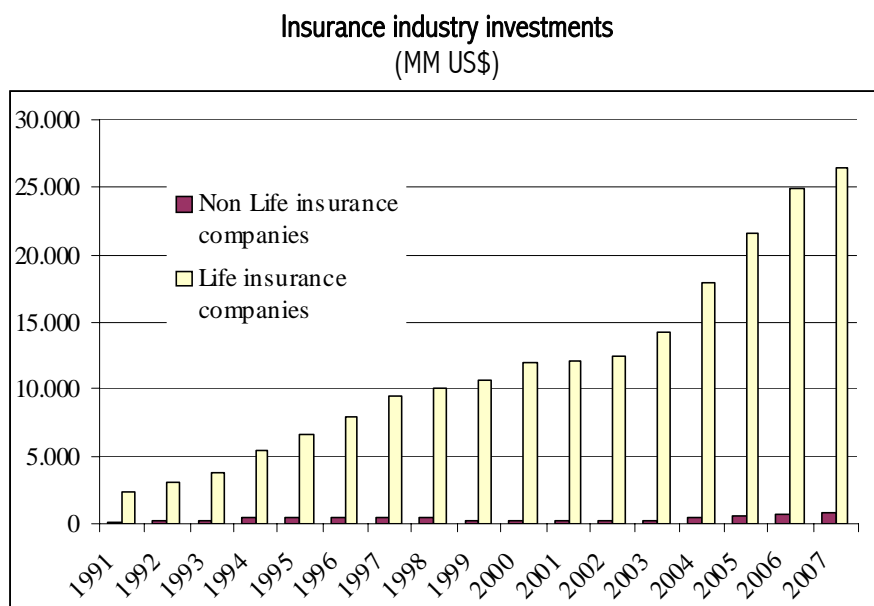
During 2006, the general insurance sector listed a direct premium sold at US\$ 1,564 billion, while the life insurance sector registered US\$ 3,177 billion. As it can be seen in the graph, the Industry made investments of

US\$ 25,543 billion, representing a significant increase in these figures, which have remained high since 2004 due to their high profitability.



Source: SVS

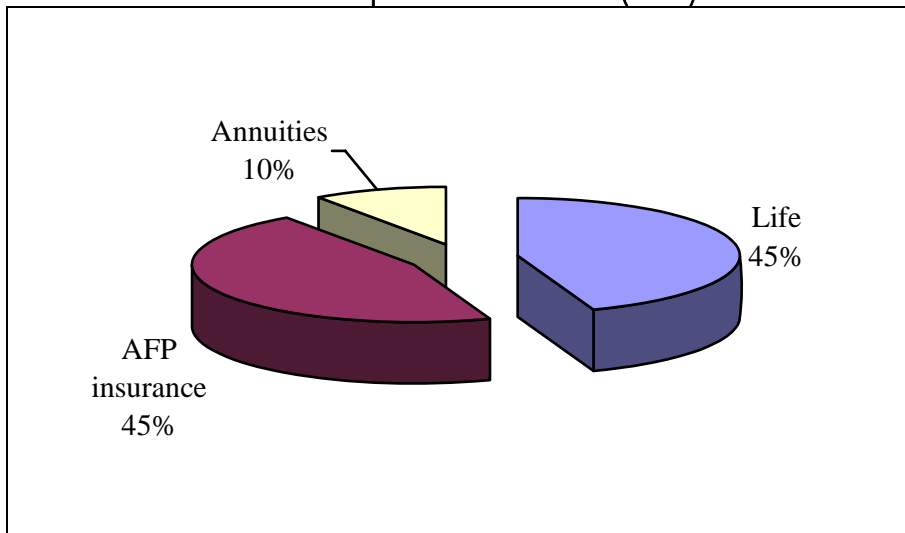
As can be seen in the previous graph, although insurance companies are authorized to invest 20% in foreign securities, only 5.8% of their portfolios are foreign-based, while the remaining percentage is divided fairly evenly between financial instruments and those of the Government.



Source: SVS

As the following graph demonstrates, the amount of annuities sold represents over 55% of the total premiums sold by life insurance companies during the year 2007.

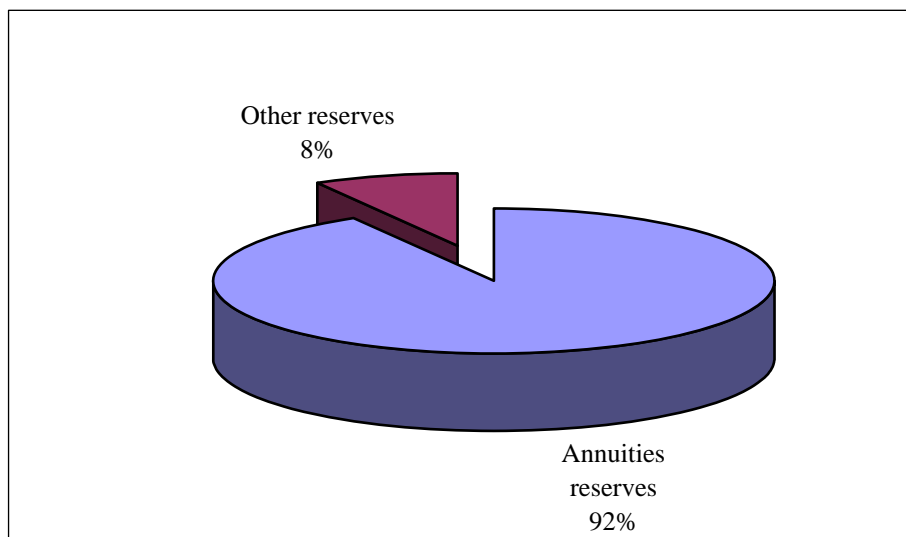
Premium composition Life Insurance (2007)



Source: SVS

The influence of the pension market on the life insurance industry can be appreciated by looking at the great importance of reserves (liabilities) originating from the annuity agreements by life insurance companies. In fact, life insurance companies have liabilities of nearly US\$ 19 billion that come from this, representing 92% of total reserves of these companies.

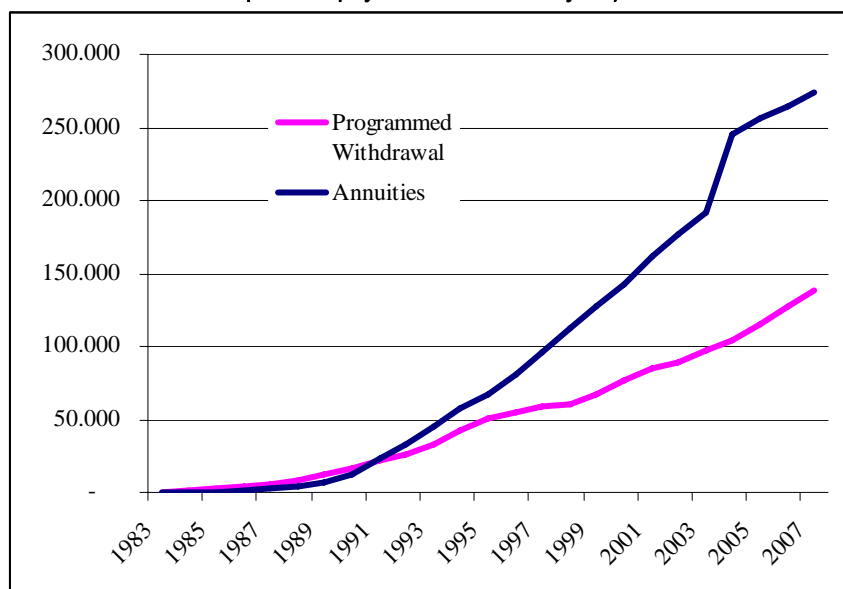
Composition Life Insurance Reserves (2007)



Source: SVS

This result comes from the high participation of annuities in the pension system, in comparison to the alternative offered by the AFPs, that is, planned retirement.

## Participation of annuities and programmed withdrawal in anticipated and normal pensions (Number of pension payments as of each year)



Source: SAFP

## STOCK EXCHANGES AND SECURITIES INTERMEDIARIES

Securities intermediaries are legal or natural persons who carry out security brokerage operations. Having met the minimum capital and technical requirements established by law and those determined by the SVS, these persons can trade on their own account.

Other entities and agents, such as stock exchanges, clearinghouses and central securities depositories are also engaged in intermediation activities.

Those intermediaries acting as stock exchange members are called stock brokers, and those operating outside the market, securities broker-dealers. To become member of a stock exchange, securities brokers must meet legal requirements, stock exchanges rules and acquire one share of the stock exchange where they intend to participate in.

Securities brokerage can only be carried out by registered brokers. However, they might also perform other complementary activities authorized by the SVS such as:

- Securities custody
- Third party portfolio management
- Financial advising
- Specific commission for purchasing and selling of securities in foreign securities markets
- Consulting services or elaborating specific investigations; representation of foreign or national, natural or legal persons, in certain matters
- Performing "forward agreements" and,
- Managing Voluntary Retirement Saving accounts.

One of the primary intermediaries' obligations is the personal responsibility of assuring the delivery and payment of securities derived from their clients operations.

Banks and Financial entities might also perform security intermediation activities, according to the authority granted by the Banking General Law. Yet, banking entities that operate directly in the market must do it through subsidiaries, which are obliged to register themselves in the Stock Brokers and Securities Broker-Dealer Registry of the SVS being, therefore, subject to its supervision.

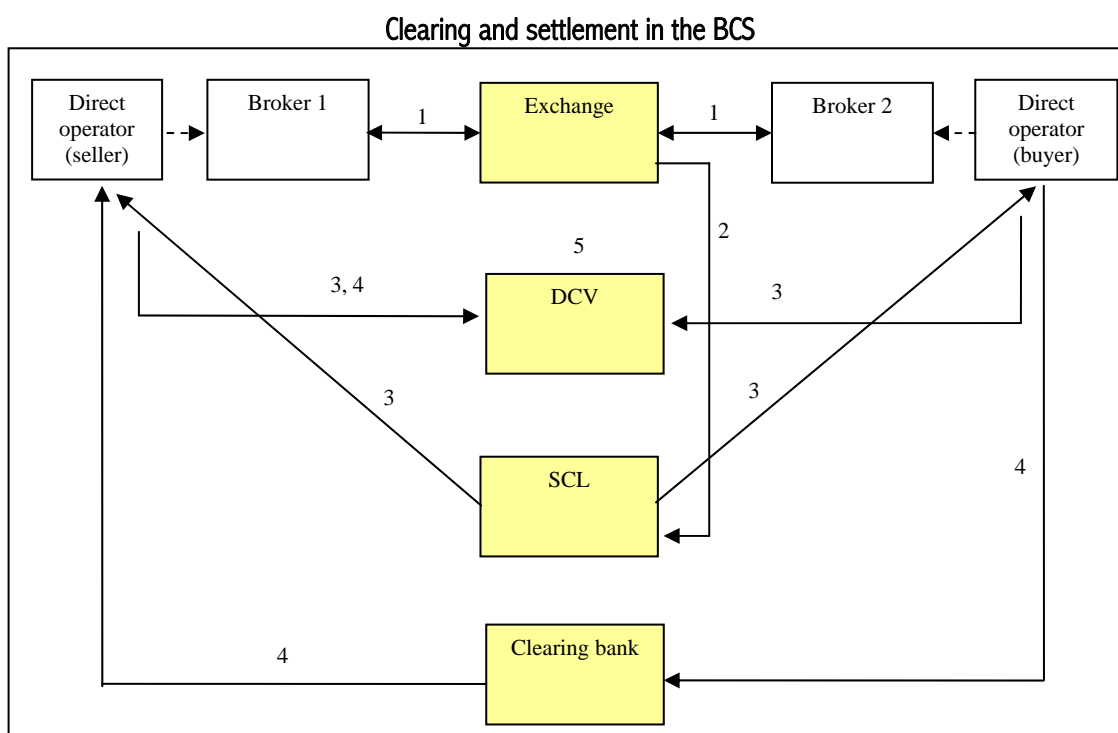
## Stock Exchanges

Stock exchanges are entities whose purpose is to provide their members (brokers) with the necessary instruments to perform securities transactions efficiently throughout permanent mechanisms of public auctions; and to perform the other securities intermediation activities pursuant to the law.

Stock exchanges self-regulate their stock market activities and those performed by stock exchange brokers, overseeing the strict enforcement of the rules, in order to assure the existence of a competitive, organized and fair market. To set up a stock exchange, a previous authorization of the SVS is required, proving a minimum paid-up capital of UF 30,000 and a number of broker members, not inferior than 10.

The Central Securities Depositories are institutions specialized in the custody and transference of securities on accounts. Even though, the law do not limit the number of participants, there is only one company of this kind in Chile, called *Depósito Central de Valores S.A.* (DCV in its Spanish abbreviation, Central Securities Deposit), which was legally incorporated in 1993. The DCV is a special corporation governed by Law N° 18,876 which rules such activities. The main function of the DCV is the immobilization, transferring and the custody of the securities that are traded in secondary markets.

In 2005, the BCS initiated the operation of a new liquidation and claims system, known as the “Guaranteed Clearing and Settlement System” (SCL), which replaced the previous “Clearing Unit”. Using instruments of debt, the SCL will clear all operations with net multilateral amounts, and later report the securities balances and pending payments of each broker to the DCV. In this way, the DCV debits and credits the respective accounts of their counterparts. In this system, operations are compensated with net multilateral amounts, on the side of securities as well as payments. In this last case, the participation of a collecting bank is understood (see figure).



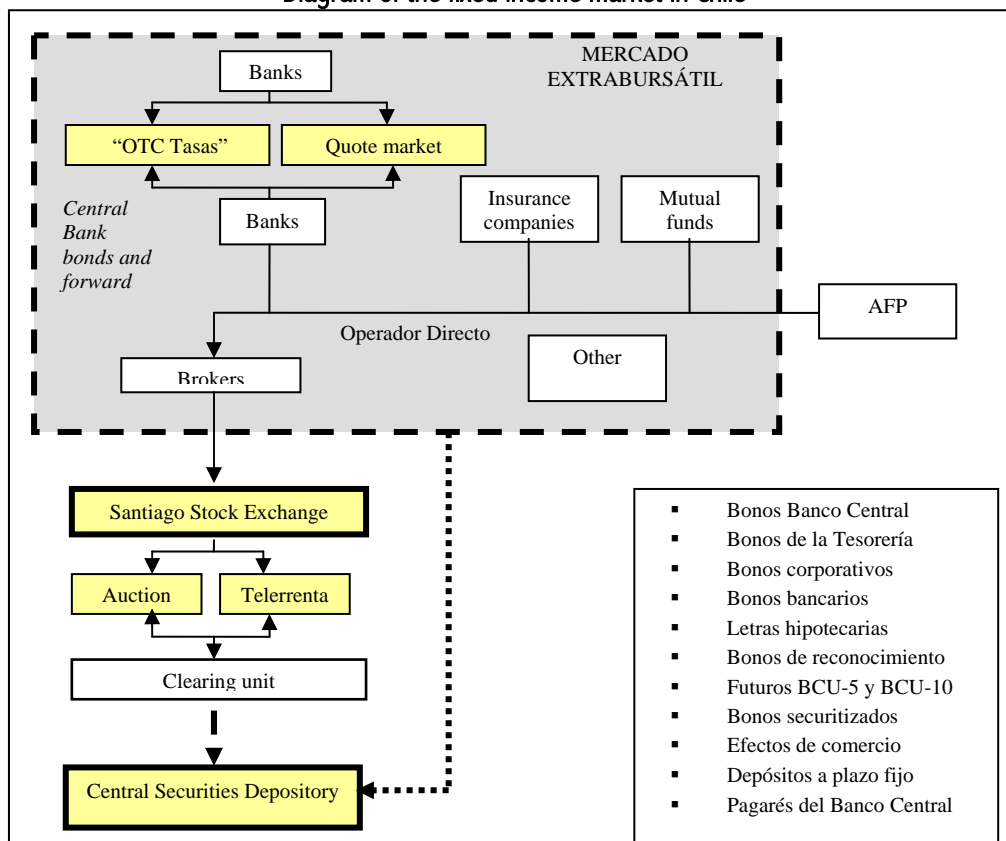
Example for an institutional investor operating directly in the Exchange as a “direct operator”

1. Investors execute transaction in the Exchange and get a confirmation
2. SCL receives details of the transaction
3. SCL calculates payments and securities obligations under a net multilateral basis and sends report to clearing agents, who must report trades to the DCV.
4. Selling investor ensures availability of securities in DCV and buyer ensure financing through clearing bank
5. DCV transfer securities between accounts once the payment confirmation is received

Source: Lazen, V. “El Mercado Secundario de Deuda en Chile” (2005)

The fixed income trading is concentrated in the BCS, but the Central Bank bonds market is segmented and most of the trading is carried out over the counter. Banks in these markets do not only trade by phone but also over screen based systems, where the software has been provided by the Bolsa. Although prices at the end of the day are posted (often an average), the matching of trade and pricing data is not possible. Over time, this lack of information could also inhibit the monitoring of any “market making” systems the authorities may decide to put in place.

**Diagram of the fixed income market in Chile**



Source: Lazen, V. “El Mercado Secundario de Deuda en Chile” (2005)



The LMV is made up by 27 titles and 238 articles which embrace diverse matters: Objectives, Supervision and Definitions; Securities Registry and Information; Periodic and Confidential Information; Secondary Market; Stock Brokers and Securities Broker-Dealers; Stock Exchanges, Prohibited Practices; Information on Takeovers Procedures; Liabilities, Sanctions; General Provisions; Risk Rating Activity; Economic Groups; Corporate Controllers and Related Persons; Issuance of Long-Term Debt Securities, Issuance of Short-Term Debt Securities; Securitization Companies; Clearinghouses; Fund Management Companies Liabilities supervised by de SVS; Inside Information; Guarantees; Miscellaneous Provisions; Public Offering of Foreign Securities in the Country; Shares Tender Offer; Tenders Offer of Foreign Shares or securities convertible abroad; General Management Fund Companies, and Transitory Provisions.

The scope of this law includes the public offering of securities and their respective markets and intermediaries, which included stock exchanges, stock brokers and securities broker-dealers, issuers and public offering securities as well as the secondary markets of such securities traded in or outside of stock exchanges, enforcing this law to any transaction of securities originated from public offerings or carried out by the intermediation of securities brokers-dealers. In addition, the LMV entrusts the SVS the responsibility to oversee the compliance with the provisions of the Law

In accordance with the current regulation, public offering of securities can be made only when the issuer and the securities are registered in the Securities Registry of SVS. In this Registry the following entities are included:

- Issuers of public offering securities.
- Public offering securities.
- Shares of Corporations in which at least a 10% of the subscribed capital is owned by a minimum of 100 shareholders, excluding those that individually or through other natural or legal persons, exceed such percentage, or those which have 100 shareholders or more.
- Shares issued by companies that voluntarily request their registration

The registration in the SVS registries obliges the issuer to provide any information that allows documenting the compliance with the requirements established by the LMV and by regulations and circulars enacted by the SVS. Likewise, the issuer is under the obligation to provide information on a regular basis to the regulator and to the marketplace. This notwithstanding, issuers must comply with the provisions established by stock exchanges in which they are registered so that they can trade their securities.

A public offering of securities is defined as any offer made to the general public or to specific sectors or groups of them. A “security” is defined as any transferable instrument, including shares, put and call options, bonds, debentures, mutual fund shares, savings plans, commercial papers and, in general, any instrument of credit or investment. In the case of banking issuers, the supervision is in charge of the SBIF, which shall adopt the regulations enacted by the SVS and supervise its compliance.

Registration does not apply to securities issued or guaranteed by the Government, by centralized or non-centralized public institutions nor by the Central Bank of Chile. The SVS can also exempt from some duties established in this law to Sports as well as Charities entities. The SVS is also entitled, on a founded basis, to exempt entities exclusively engaged in educational activities from the obligation to inform, as well as from the accounting control system.

Since 1985, risk ratings are required for local bond issuances. In that year, the Risk Rating Commission (CCR) was created due to the need of establishing solvency standards for corporate bonds eligible for investment by pension funds created in 1981. CCR is a quasi governmental agency. Its board is composed by officials from the financial regulators and from the private sector. Its labor is to authorize investments for pension funds, having

as a base the risk ratings given by the private agencies. In 1987, a legal reform created the private risk rating agencies. When the first agencies were launched they turned into the first rating agencies in Latin America.

### **Recent Developments in Regulation**

In 2001 several legal reforms the capital markets laws took place, under the so called “First Capital Markets Reform” or MK1.

Some of the novelties brought by MK1 included the creation of a voluntary pension savings scheme, the third pillar of the pension system, based on a tax incentive. This one consisted in deducting from the tax base the part of the salary the person saves in a special pension account. Such account can be managed by any of the eligible entities, not only pension fund administrators. MK1 also eliminated the capital gain tax for shares whose trading activity was high, i.e., superior than a given threshold. Also the tax on interests on fixed income instruments invested by foreign investors was reduced to 4% from 35%.

The same reform created a new figure, the General Fund Manager, which is an umbrella entity that is allowed to manage different types of funds (e.g., closed and open end funds).

Another reform to the pension system, comprised in MK1, was the creation of “multifunds”. Before MK1, each AFP could offer it clients only one portfolio, independently of the risk preferences of the consumer. The multifunds reform expanded the number of portfolios offered to costumers to 5, each of them with different composition of variable risk instruments (80% in the riskiest portfolio, 0% for the most conservative, see section on institutional investors).

In March 2007, Congress approved MK2, the second reform to capital markets. This reform included some unfinished part of MK1, such as a reform to corporate governance law. Its most important component was an incentive to venture capital and SME financing. Concerning venture capital, the reform considered a tax exemption on the capital gains on the sale of “Venture Capital Corporations” (according to their formal definition). This exemption is directed to the entrepreneurs and the investors who enter the Venture Capital Corporations on a first stage; on the other hand, the same tax incentives were granted to the investors of “Venture Capital Investment Funds”. Additionally, the Chilean state agency of enterprise promotion, CORFO (Corporación de Fomento de la Producción), was authorized to invest in Venture Capital Investment Funds.

The law also created a new corporate figure denominated “Sociedad por Acciones” which, with a structure of capital similar to a limited partnership maintains the general structure of an open corporation.

The law improved SME financing improving the conditions for collaterals. Indeed, it created the figure of a “Guarantee without Displacement” that simplifies the previous norms respect to collaterals and creates a central registry for them.

In another aspect, this legal reform had greater exigencies safekeeping of securities and strengthens the faculties of the SVS in case of financial weakness of the supervised institution.

Finally, the Law facilitated the listing of foreign securities in Chile by eliminating the requirements of participation of the issuer in the offering and by reducing legal and information requirements. A local sponsor would take charge of presenting certain minimum information of the issuers and of the securities.

Therefore, the regulatory framework of Chilean capital markets is characterized by solid supervisory and regulatory agencies, even though they could still be improved further. Recent reforms to capital markets have been helpful in improving market conditions for sustainable growth and international integration of the financial sector.

## SECURITIES REGULATION COMPARISON WITH IOSCO PRINCIPLES

This section presents an assessment of the Chilean securities regulation under the comparison with IOSCO Principles on Securities Regulation (2003).

### **Principle 1. The responsibilities of the regulator should be clear and objectively stated.**

The LMV as well as the SVS Organic Law provides the SVS with important legal tools. The SVS is authorized to regulate the issuance of securities, mandate initial and periodic corporate disclosure, require registration and authorize continuing oversight of securities markets and securities intermediaries.

### **Principle 2. The regulator should be operationally independent and accountable in the exercise of its functions and powers.**

The SVS Superintendent is nominated by the President and is appointed for an open period of time by the Minister of Finance. Usually the appointment period coincides with the presidential term. The SVS is independent from other government agencies on policy issues. Its budget is an annual appropriation incorporated into the overall Ministry of Finance budget. SVS staff, performing official functions, does not have comprehensive legal protection. SVS staff has been sued recently in two separate private suits alleging failures to adequately perform their duties. Any SVS regulatory action may be subject to judicial review. SVS disciplinary actions are subject to a formal judicial proceeding and appellate court review of that proceeding. The Chilean Comptroller General has the authority to review the SVS budget and expenditures.

The SVS issues an annual report describing its mission, priorities and activities and informing the public of its workload, productivity and accomplishments.

### **Principle 3. The regulator should have adequate powers, proper resources and the capacity to perform its functions and exercise its powers.**

The SVS has the legal authority to register and monitor brokerage firms and mutual funds managers, publicly-held companies and require periodic disclosure of material information. Approximately 120 employees are responsible for securities regulatory duties. The annual budget is US\$15 million.

### **Principle 4. The regulator should adopt clear and consistent regulatory processes.**

The SVS solicits public comment on draft rules for those it considers are most relevant. All SVS rules are published and available on SVS' website. Judicial review is available for all SVS actions. The SVS has an established policy of providing informal interpretive guidance on request.

### **Principle 5. The staff of the regulator should observe the highest professional standards including appropriate standards of confidentiality.**

The Organic Law establishes some prohibitions, such as staff using confidential information as well as having interests in regulated entities. The SVS does not have a code of conduct for its staff. Also the LMV provides criminal sanctions for violations of confidentiality standards. The Internal Controller has the role of monitoring staff activities, though in practices it focuses on the supervision of the international financial management.

An Internal Code of Conduct for SVS staff has recently been developed in which it includes matters related to the use of information; dealings with securities and managing conflicts of interest.

**Principle 6. The regulatory regime should make appropriate use of Self-Regulatory Organizations (SROs) that exercise some direct oversight responsibility for their respective areas of competence, and to the extent appropriate to the size and complexity of the markets.**

The Chilean LMV explicitly authorizes creation of SROs and four of them exist, three stock exchanges and the DCV. Under Chilean law, these entities may license and inspect member firms and may take appropriate disciplinary action for violations of law or SRO rules. Under Chilean law, issuers are approved for listing by the SVS and an exchange must then list the securities of the issuer.

The Bolsas have ample authority under the law to inspect their members and impose disciplinary sanctions for instances of non-compliance with the LMV and related regulations as well as the exchanges' own regulations. The following provisions of the law vest the exchanges with broad self regulatory powers, including the power to sanction members.

- a. Art. 39—Stock exchanges shall regulate their exchange activity and the activity of stockbrokers, monitoring their strict compliance to ensure the existence of a fair, competitive, orderly, and transparent market.
- b. Art. 42—Every stock exchange shall demonstrate to the SVS' satisfaction:
  - i. That it is organized and has the necessary capacity to carry out the functions of a stock exchange in accord with the law;
  - ii. It has adopted internal regulations required by law;
  - iii. It has the necessary capacity to enforce and to ensure that members comply with the provisions of this law, its complementary rules, and its by-laws and internal rules.
  - iv. It has the necessary means and the appropriate procedures to ensure a unified market that permits investors the best execution of their orders; and
  - v. It keeps the books and registries and maintains all other information required by the SVS, which shall be available for the SVS's examination or verification.
- c. Art. 43—The stock exchanges shall, at a minimum:
  - i. Ensure that members strictly comply with the highest principles of business ethics and all the legal and regulatory provisions applicable thereto; and
  - ii. Carry out the other activities authorized by the SVS, or activities that the SVS may require pursuant to its supervision and enforcement powers. (Emphasis added.)
- d. Art. 44—The stock exchanges shall include rules on the matters indicated below:
  - i. Rules designed to promote just and equitable principles in trading on exchanges and to protect investors from fraud and other illegal practices;
  - ii. Fair and uniform procedures by which the members of a stock exchange and their partners/employees may be penalized, suspended or expelled should they violate this law and its complementary rules or statutes or internal rules.

Liability for Non-Performance of Supervisory Duties: Similarly, the Art. 56 of the Law specifies liability for the directors or managers of a stock exchange that do not exercise their supervisory duties, either with regard to the market that operates on the exchange or the persons involved therein, and they shall be subject to administrative penalties applied by the SVS.

**Principle 7. SROs should be subject to the oversight of the regulator and should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities.**

The 3 stock exchanges and DCV are regulated by the SVS. These entities have the powers to take disciplinary action for violations, although this authority in practice has not been applied. The exchanges may suspend trading of listed securities for up to five days (but suspensions are usually for 24 hours). The DCV only carries out regulatory functions in terms of operations management but never in terms of disciplinary actions. As commented, the stock exchanges do not apply sanctions and their disciplinary processes are usually performed confidentially in the Board room. The Bolsa's Board doesn't have independent directors.

Initiative: Propose alternatives for improving corporate governance of the exchanges. Conduct an expert study focused on providing regulatory mechanisms for reinforcing regulatory capacity of the exchanges. This could include necessary modification to its governance arrangements.

#### **Principle 8. The regulator should have comprehensive inspection, investigation and surveillance powers.**

The monitoring and investigative attributions of SVS, allows it to inspect regulated entities thoroughly and require compulsory testimony to any person related to any transaction of public offering securities. The SVS has the authority to require information on account holders, transactions history and obtain this information. Formal investigations may include compelling testimony or production of documents (equivalent of an investigative subpoena). Nevertheless SVS does not have the authority to require access to bank information due to banking secrecy regulations.

Initiatives: Carry out a formal petition to solicit a change of law allowing the SVS to require bank accounts records when conducting administrative investigations.

#### **Principle 9. The regulator should have comprehensive enforcement powers.**

The SVS has many enforcement powers, which as mentioned, includes the ability to compel the production of documents. The SVS may impose administrative sanctions, including monetary penalties, and suspensions or bars. All sanctions are appealable to the Chilean courts. All violations to civil and criminal matters are litigated, because the SVS doesn't have the legal authority to negotiate and settle any case. In Chile, criminal securities violations have not usually been brought to courts, in part due to the high standard of proof in the case of criminal cases and the low expectation of a favorable ruling. Nevertheless, SVS has been more successful in the civil judicial prosecution of cases of securities violations.

#### **Principle 10. The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance program.**

The SVS has ten litigations against brokers or their employees, issuer disclosure violations and individual officers or directors, and 8 cases charging an auditor with a deficient audit. Inspections are carried out in a cyclic basis, although the SVS is implementing a new supervision approach centered on risk basis analysis. Brokers and mutual funds are not required to have in place compliance programs, and there are no general suitability standards. There are some large firms, subsidiaries of international banks that have compliance programs.

Initiatives: Require compliance programs to regulated entities as well as risk management programs.

#### **Principle 11. The regulator should have authority to share both public and non-public information with domestic and foreign counterparts.**

Although SVS is not explicitly authorized to share information with other Chilean regulators, it has traditionally shared information under an assumption of "superior interest"; and requiring due reserve of that information. On the other side, the SVS is authorized by law to share information with foreign regulators.

**Principle 12. Regulators should establish information sharing mechanisms that set out when and how they will share both public and non-public information with their domestic and foreign counterparts.**

The practice of information sharing among Chilean regulators is rather informal. Coordination is more visible in terms of strategic approach to common regulations and macro-systemic issues.

Chilean regulators have put in place a General Secretariat in charge of coordinating common efforts in market development and supervision. This secretariat has been formally created by law.

**Principle 13. The regulatory system should allow for assistance to be provided to foreign regulators who need to make inquiries in the discharge of their functions and exercise of their powers.**

As commented the SVS is required to comply with a duty of reserve that, depending on the interpretation of the law, might impede its sharing of non public information with foreign regulators. Although the SVS is authorized by law to share information with foreign regulators, some might interpret that this cooperation does not include personal non public information. In any case, some clarification is needed.

Initiative: Authorize explicitly the SVS to share any type of information with any foreign regulatory agency. A legal reform should authorize the SVS explicitly to share information with foreign regulators as well as with domestic regulators.

**Principle 14. There should be full, accurate and timely disclosure of financial results and other information that is material to investors' decisions.**

The Securities law requires the registration of all the publicly issued securities and their issuers as well. According the Rule (Norma de Carácter General) 30 the registration statement must include financial and legal information on the issuer, two years of audited financial statements, a description of the issuer's business, information about directors and management, and the identity of the twelve largest shareholders. On a periodic basis, the issuer must add any additional material information necessary to make the required statements, in the light of the circumstances under which they are made. Debt securities issuers are required to obtain and include with its registration statement, credit ratings from two private rating agencies (commercial paper requires only one rating). His rating requirement is continuous.

Public companies are required to file annual and quarterly financial statements with the SVS. The annual report must include operations and results of operations, its management and its financial condition, including audited financial statements for the preceding fiscal year. The second quarter report must have audited financials. All periodic reports are available on the SVS web site. The Securities Law requires issuers to file special reports of any material information promptly.

Officers and directors and holders of 10% of the issuers stock must disclose all transactions in company securities within five business days.

**Principle 15. Holders of securities in a company should be treated in a fair and equitable manner.**

Any change of control must comply with the OPAS (Oferta Pública de Adquisición de Acciones) regulation. In short, a tender offer must be made whenever the acquisition allows one person to control the corporation. The price per share must be the same and prorated for all shareholders. Additionally, it is required to carry out a tender offer for the remaining shares, whenever the controlling shareholder reaches two thirds of the voting shares. Also, when the intention is the attainment of the control of a subsidiary, a tender offer for that subsidiary must be made before taking over the holding company. In terms of Related party transactions, these must be

approved by the board of directors and be consistent with standards of fairness similar to those that normally prevail in the market. The option of an independent assessment is required in certain circumstances. A 2003 World Bank ROSC on corporate governance in Chile recommended development of guidelines for the directors committees required by the OPA. Implementation of this recommendation would be an important step.

A recent Doing Business Report prepared by the World Bank places Chile in a good position in terms of “Investor Protection” indicator which measures transparency of transactions (Extent of Disclosure Index), liability for self-dealing (Extent of Director Liability Index), shareholders’ ability to sue officers and directors for misconduct (Ease of Shareholder Suits Index) and Strength of Investor Protection Index.

Indicator	Chile	Region	OECD
Disclosure Index	7	4.2	6.4
Director Liability Index	6	5.0	5.1
Shareholder Suits Index	5	6.0	6.5
Investor Protection Index	6.0	5.1	6.0

**Principle 16. Accounting and auditing standards should be of a high and internationally acceptable quality.**

Currently, Chile has its own accounting standards (Chilean GAAP). In Chile, the SVS has adopted a program of converging to International Financial Reporting Standards (IFRS). Starting January 2009, all registered companies with trading activity larger than 25% of the trading days (*presencia bursátil*) are required to prepare their financial statements in conformity with IFRS.

Chilean law requires external auditors of all issuers to be independent. However, the Chilean independence standard differs materially from other international requirements on independence. Under Chilean law, an accountant may receive monthly revenues from one client up to 15% of its total revenues in a month and the audit company may own not more than 3% of the audited company<sup>12</sup>.

**Principle 17. The regulatory system should set standards for the eligibility and the regulation of those who wish to market or operate a collective investment scheme.**

The main regulation of open end funds (mutual funds) is the Mutual Fund Law of 1976 (No. 1328). The main regulation of closed end funds (investment funds) is the Law 18.815 of 1989. Funds managing companies’ registered officers and executives must be at least 18 years old and be high school graduates. They may not have been declared bankrupt or convicted of a crime resulting in incarceration or of a violation of the securities laws. There is no specialized training or experience in mutual fund operations required and there are no continuing education requirements. The Fund Managing Company must have a minimum of 10,000 UF (around \$225,000 US) in assets and must present a guaranty equal to at least 1% of fund assets. Closed-end funds have an investor’s representative with some oversight responsibilities.

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<sup>12</sup> For more details, see section on Accounting and Auditing.

**Principle 18. The regulatory system should provide for rules governing the legal form and structure of collective investment schemes and the segregation and protection of client assets.**

The management of mutual funds in Chile is carried out by the fund manager in the case of mutual funds and closed end funds as well. Therefore, there is no such thing as an elected Board of Directors. Nevertheless, closed-end funds do require the creation of an investors committee with oversight responsibilities. According to a recently promulgated legal reform, fund managers are required to segregate fund assets in a separate sub account in its custodian account. Also, fund administrators must maintain a registry of the investors in each fund managed. All funds must be audited annually by an independent auditor.

Funds do not have in place internal controls or compliance systems. Also, there are no procedures for orderly termination of a fund and appropriate distribution of assets.

Initiatives: Another issue that should be addressed is a requirement that funds have in place internal controls or compliance systems. Also, funds should be required to disclose their participation and voting at those shareholder meetings, which would contribute to protect client assets.

**Principle 19. Regulation should require disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value of the investor's interest in the scheme.**

All funds must publish an annual report in a national newspaper. Also, the Chilean law also specifies the information that must be contained in a fund prospectus. This information must include a description of investment policy and fund objectives, the identity of the fund administrator, all fees and transaction expenses and compensation of the administrator. The SVS requires the filing of daily reporting of a fund's portfolio, monthly filing of the fund's financial statement and quarterly reporting of the fund manager's own financial statements.

**Principle 20. Regulation should ensure that there is a proper and disclosed basis for asset valuation and the pricing and the redemption of units in a collective investment scheme.**

Mutual funds must value their portfolio, mark to market, on a daily basis. This information should be submitted to the SVS. Since some fixed income instruments are not liquid, a self regulatory regulation issued by the Fund Managers Association under the sponsorship of SVS, establishes a mark-to-model type of valuation for this securities. Closed-end funds must disclose their Net Asset Value on a quarterly basis.

**Principle 21. Regulation should provide for minimum entry standards for market intermediaries.**

1. Article 26 of the Securities Market Law lists the basic qualification and informational requirements that must be satisfied by an applicant seeking registration with the SVS as a stockbroker or securities broker-dealer.
  - a. Subparagraph i) anticipates possible future requirements in that it states that the applicant shall satisfy "any other requirement determined by the SVS by general norms"; hence SVS may add new requirements as necessary.
  - b. Article 26 also authorizes the SVS to enact general norms to specify the form and content of information required by an applicant for registration.
  - c. Finally, Article 28 specifies that SVS will not register an applicant until any defects in the application have been remedied and/or responses made to any observations conveyed by the

SVS; meanwhile, the 30 day period specified for SVS action on an application is suspended until the missing information is submitted.

2. The Existing norm (Rule NCG 16: Registration of Brokers) lists the specific content of applications by natural and legal persons.

Observation: Very little of this information addresses the competency of the applicant—and his supporting staff—to engage in the range of business activities permitted to a registered stockbroker or securities broker-dealer, or their knowledge and capability to comply with the rule.

All brokers must register with the SVS. The key executives must be high school graduates and never have been declared bankrupt or convicted of a criminal law violation or any other violation related to securities law violation. Other than these fit and proper requirements there are no licensing standards for executives or employees of brokerage firms.

To register, brokers are required to have minimum capital of at least UF 6,000, unless it intends to trade for its own account, which raises the minimum capital to UF 14,000. In addition the firm must present a guaranty of at least UF 4,000, having their clients as potential beneficiaries

Initiatives: Set up a licensing requirement for executives or employees of brokerage firms. The Chilean regulation system should work in coordination with industry association or the exchanges to establish a certification system to admit participants to operate in this market.

**Principle 22. There should be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake.**

Brokers are required to maintain a minimum of UF 6,000 in liquid capital and UF 14,000 when trading for their own account. Liquid capital includes any securities that can be sold within seven days. In the case of stocks, it considered liquid when it has been traded on a minimum of 45 days of the immediately preceding 180 days. Brokers must take a 20% haircut on any position that does not meet this standard. Also brokers must maintain a minimum “coverage capital”, an amount equal to the minimum liquid capital assuming a 20% drop in the market value of all positions. Finally, brokers must satisfy a 5% leverage ratio. Brokers must submit audited financial statements on a quarterly basis. This has proved a very resilient regulation but also it doesn't contemplate recent market development as well as new risk assessment techniques. For instance, capital requirements for derivatives is relatively basic, also no matter the lines of business brokers are into they are required the same amount of minimum capital.

Initiatives: Improve capital adequacy regulation for brokers. This improvement should consider a redesign of haircuts for foreign securities, the inclusion of specific capital charges for derivatives, the inclusion of more accurate market and liquidity risk indicators and the differentiation of minimum capital requirements depending on the authorized lines of business.

**Principle 23. Market intermediaries should be required to comply with standards for internal organization and operational conduct that aim to protect the interests of clients, ensure proper management of risk, and under which management of the intermediary accepts primary responsibility for these matters.**

Brokers are not required to develop and maintain internal control and risk management systems or departments or units in charge of compliance. Additionally, there is not a suitability standard that should apply to dealings with clients, in especial regarding recommendations and discretionary asset management.

Initiatives: Develop a regulation requiring internal control and risk management systems. There is a need to require a regulation requiring the implementation of internal control systems for the main risks that affect a brokers' business. Also, brokers should be required to have a compliance function or department in place.

Secondly, establish a system to assess suitability standards for clients. Brokers must have record keeping requirements as well as a duty to collect and retain basic information on customer finances and investment objectives and risk tolerance.

**Principle 24. There should be a procedure for dealing with the failure of a market intermediary in order to minimize damage and loss to investors and to contain systemic risk.**

The first mitigating tool in this sense is the capital adequacy requirements which are applicable to the intermediaries. Also, as mentioned, brokers are required to maintain guarantees having their customers as beneficiaries. Additionally, the exchange share owned by the brokers can also be liquidated in case of failure. Nevertheless, there are no common guarantees or funds to be used to mitigate customers' losses caused by a failing firm.

Initiative: Promote an investors protection fund. Promote the creation of an investor protection fund to cover losses arising from the failure of one or more brokers.

**Principle 25. The establishment of trading systems including securities exchanges should be subject to regulatory authorization and oversight.**

Stock exchanges must be regulated by the SVS. Also, the Securities Law requires exchanges to self regulate the activities of their member brokers in order to ensure a "fair, competitive, orderly, and transparent market". Exchanges must demonstrate the capacity to function effectively, to have internal governing regulations, and the ability to enforce these laws. An Exchange must have a minimum of 10 shareholders and a minimum capital of UF 30,000. All brokers must own at least one share in an exchange. The exchange must have a governing Board of Directors with at least five members.

**Principle 26. There should be ongoing regulatory supervision of exchanges and trading systems, which should aim to ensure that the integrity of trading is maintained through fair and equitable rules that strike an appropriate balance between the demands of different market participants.**

Exchanges are subject to capital requirements including the reporting of every trading activity. The SVS reviews all exchange rules prior to adoption, including the creation of new products. Under Chilean law, once the SVS has approved the registration of a company and its securities, all exchanges must list the security. The SVS also has the authority to inspect and supervise exchange operations. It may also review all disciplinary actions taken by an exchange. The Securities Market Law empowers the SVS to restrict the activities of an exchange or suspend or terminate its operations for violations of the law.

**Principle 27. Regulation should promote transparency of trading.**

Transactions carried out in the exchanges present adequate pre trade transparency characteristics. All size and price details are posted on line in the proprietary exchange screens in accordance to the requirements by the SVS. In the interbank fixed income OTC market, pre trade transparency is adequate since quoted prices are exposed in the screens in real time. In relation to post trade transparency, the exchanges provide transactions details in the screens as soon as the trade is executed. Nevertheless, this level of post trade transparency is not available in the OTC market.

Initiative: Improve transparency in the OTC fixed income market. The OTC market should be subject to certain regulatory requirements, being one of them, the increase of its transparency.

**Principle 28. Regulation should be designed to detect and deter manipulation and other unfair trading practices.**

The Chilean law prohibits fraudulent and manipulative trading practices. Both the SVS and the Chilean exchanges have on-going market surveillance programs designed to detect misconduct. The SVS currently relies upon a proprietary surveillance system.

**Principle 29. Regulation should aim to ensure the proper management of large exposures, default risk and market disruption.**

Market disruption due to the failure of a broker is not explicitly addressed under Chilean law, being the Chilean bankruptcy law the main regulation governing the disposition of activities by a market participant that fails.

The SVS and the exchanges do not have the capacity to monitor “large exposures” or take action to limit exposure by a participant. It is possible to obtain this information from brokers or through the CSD registry or by monitoring the activity of institutions that have direct trading privileges on the exchanges.

Initiative: Develop regulation and formal mechanisms to deal with system failures. Regulators must have in place protocols to react in case of this type of market crises. Also, the Chilean law must recognize the rights of customers to assets held by a firm or its custodian as superior to a general creditor, and the SVS or some other body must have the capacity to appoint a receiver to assume responsibility for the orderly termination of business by a failed firm.

**Principle 30. Systems for clearing and settlement of securities transactions should be subject to regulatory oversight, and designed to ensure that they are fair, effective and efficient and that they reduce systemic risk.**

An expert assessment carried out during 2002, in relation to the compliance with CPSS/IOSCO Recommendations for Securities Settlement Systems, found the following observations: “1) Chilean law should be clarified to ensure that netting arrangements are recognized and enforceable, to make explicit when finality in a trade occurs, to facilitate securities lending by the DCV, to promote dematerialization of securities; to promote the use of a standard master agreement in repo transactions; 2) The SVS, the stock exchanges or the DCV should have a program to oversee firm’s risk management programs and apply risk control techniques to limit the possibility of systemic failure; and, 3) Comprehensive record-keeping requirements should be adopted throughout the industry to document all firm and customer assets and their location.

Initiatives: Reinforce the Clearing and Settlement regulation in the terms specified above.

## **ACCOUNTING AND AUDITING FRAMEWORK**

The current regulation (Corporations Law) requires the preparation of annual financial accounts in accordance with Chilean generally accepted accounting principles (GAAP). Also, registered corporations must be audited on a yearly basis by an independent auditor. The Corporations Law Regulations (Reglamento de Sociedades Anónimas) requires that auditors apply generally accepted auditing standards (GAAS) and, specifically for open corporations, to follow any instruction issued by the SVS on matters of auditing. The annual financial statements of all registered companies must be audited and filed with the SVS within 60 days after the calendar year-end. Audited financial statements must be submitted in a standard format, the Uniform Codified Statistical Form (Ficha Estadística Codificada Uniforme, FECU).

SVS requires also the filing of quarterly financial statements that must be presented to the SVS within 45 (half year) and 30 (other quarters) days after the period-end. Open corporations are required to publish their audited balance sheet and income statement in a high circulation newspaper between 10 and 20 days before the shareholders' annual general meeting in which the financial statements are expected to be presented for approval. The SVS also publishes on its website the full financial statements of all of the companies it supervises (under the FECU format).

### Financial Reporting Standards<sup>13</sup>

Currently Chilean GAAP show significant discrepancies with IFRS. The main documented areas of discrepancy are:

- **Provisions** – Chilean GAAP do not require the existence of an obligation for a provision to be recognized. One example cited in presented reports is with regards to termination benefits. IAS 19, Employee Benefits, requires that an entity should recognize termination benefits as an expense “when, and only when: (a) the entity is demonstrably committed to either terminate the employment of an employee or group of employees before the normal retirement date; or (b) provide termination benefits as a result of an offer made in order to encourage voluntary redundancy”. The report states that “Chilean GAAP allow accruing for termination benefits without such conditions being met; in effect, this gives more latitude to management to decide when to record these types of cost and may lead to distort the economic performance of an entity as measured by the income statement. This is precisely the reason why IAS 19 is quite restrictive on when such provisions can be recognized”.
- **Foreign investments in hyperinflationary or unstable economies** – Chilean GAAP states that financial statements of foreign subsidiaries whose activities do not constitute an extension of the Chilean operations, or which operate in countries that are exposed to significant risks, restrictions or inflation/exchange fluctuations, are re-measured using the U.S. dollar as the functional currency and then translated into Chilean Pesos, at the year-end exchange rate. IFRS would permit such treatment only if it could be demonstrated that the U.S. dollar is the measurement currency that best reflects the economic substance of the foreign subsidiary’s transactions.
- **Financial instruments (IAS 32 and 39)** – External reports have indicated that Chilean GAAP does not require the explicit recognition of investments in financial assets as one of the following three types of investment: (i) held to maturity; (ii) held for trading; or (iii) available for sale. Additionally, investments in marketable securities are not necessarily accounted for at fair value, being valued at the lower of restated cost or market value. Also, unrealized losses on such investments are reflected in the income statements, while under IAS 32, Financial Instruments – Disclosure and Presentation they would be excluded from the income statement. Furthermore, Chilean GAAP does not require the recognition of the so-called “embedded” derivatives (i.e., specific provisions in a contract of a commercial type that create rights and/or obligations similar to those of a derivative contract).
- **Price-level accounting** – Under Chilean GAAP, financial statements are restated to reflect the effects of the change in price levels on the financial position and results of operations of reporting entities. According to expert opinion, price-level accounting is the appropriate treatment under IFRS for companies operating in hyperinflationary economies. Advisors indicated that Chile is not in such a situation at the present time, and therefore, the treatment is not in accordance with IFRS.
- **Segment reporting** - The notes to the financial statements do not provide sufficient data in relation to a reporting entity’s economic performance, particularly for those entities with diversified operations in terms of industries or geographic regions.

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<sup>13</sup> This section draws many topics from a public ROSC Report on Accounting and Auditing published in 2003.

Finally, it is worth noting that ROSC review carried out during 2003 confirmed that there is a culture of compliance with the rule among Chile's business community. Nonetheless, the review noted a relative lack of precision in the information provided in the FECUs, especially on accounting policy for maintenance costs; the nature and amortization policies of intangible assets; the potential losses associated with contingencies.

### Adoption of IFRS for entities regulated by SVS

In October 2006, SVS gave instructions to all its regulated entities formalizing its compromise to require adoption of IFRS (circular Letter N° 368 . October 16, 2006). In that instruction, SVS instructed regulated entities to present financial statements under IFRS starting in 2009 according to a certain schedule. SVS also encouraged entities to familiarize with IFRS and to evaluate the effects of its application in the companies' financial statements.

In August 2007, the SVS presented the definitive schedule for convergence to IFRS. Starting January 2009, all registered companies with trading activity larger than 25% of the trading days (*presencia bursátil*) are required to prepare their financial statements in conformity with IFRS. The rest of the entities are required to present financial statements according to IFRS according to the schedule presented by the SVS.

IFRS implementation schedule in Chile

INDUSTRY	PROPOSED DATE
Banks	01-01-2009
Pension Fund Administrators	01-01-2009
Pension Funds	01-01-2009
Companies with >25% frequency of trading, and/or with Audit Committees, and voluntary implementation	01-01-2009
Other Securities Issuers	01-01-2010
Other Supervised Companies	01-01-2011
Securities Companies	01-01-2010
Fund Administrators	01-01-2010
Mutual Funds	01-01-2010
Investment Funds	
Housing Funds	
Foreign Capital Investment Funds	
Securities Agents	01-01-2010
Stockbrokers	
Products Brokers	
Insurance Companies	01-01-2010
Insurance Intermediaries	01-01-2010

Source: SVS

Part of the work in progress in this area is the preparation of formats for the presentation of financial statements, which is due the first quarter of 2007. The SVS also is working on technological platforms for IFRS data management. In particular, XBRL is the most important work in progress in this area. The idea is to adequately validate, codify, an electronically transmit financial information.

This plan is part of a broader agenda carried out along with other government entities including the rest of the financial regulators, the Internal Revenue Service (SII) and the Central Bank. This effort is aimed at identify legal and regulatory modifications needed to implement IFRS and to coordinate the adoption of IFRS in financial conglomerates with entities regulated by different regulators.

## Auditing Standards

Chilean auditing standards<sup>14</sup> (Generally Accepted Auditing Standards, GAAS) are issued by the Chilean *Colegio de Contadores de Chile* (CCC) and the *Instituto de Auditores*. Although, they are relatively well developed, there still remain significant differences with ISA. Among them are:

**Issues not considered in Chilean GAAS** - Chilean GAAS are silent on the consideration of error and fraud (ISA 240), knowledge of the business (ISA 310, which underlines the importance for auditors to properly identify and understand the company's transactions and practices as well as events that may have a significant impact on the financial statements), communication with the directors' committee (ISA 260), initial engagements (ISA 510), and information systems environments (ISA 401). Although in terms of quality control, Chilean standards are less specific and demanding than ISA 220.

**Lack of implementation guidance** – Chilean GAAS are rarely accompanied by guidance to facilitate their implementation meaning that this increases the chances that a standard may be misinterpreted and/or applied inappropriately.

**Chilean GAAS stipulates that, in the absence of a national standard covering a specific matter, auditors should apply the relevant ISA standard.** However, in the absence of an active enforcement within the auditing profession, it is difficult to ascertain its compliance. Expert assessment has found that in practice, most international firms, especially the largest ones, have made significant investments and assigned considerable resources to ensure the implementation of international auditing standards.

**Auditors are allowed to own shares in a client company - Independence is defined as “not possessing, directly or indirectly, more than 3% of a company's subscribed capital”.** This is not in line with international best practices on independence requirements, which generally prohibit external auditors, whether individuals or firms, from owning any shares in a client company whatsoever. Nevertheless, in practice, international audit firms require and apply international independence requirements more stringent than Chilean requirements.

## FOREIGN EXCHANGE AND CAPITAL FLOWS REGULATION

One of the main foreign capital inflow mechanisms in Chile is the Chapter XIV of the Central Bank's foreign exchange which does not contemplate the subscription of an investment contract, but only the authorization by the Central Bank of Chile. The contributions can only be materialized in foreign currency, and it does not give the investor rights or special benefits as the alternative regime of tributary invariability, off-shore account management, among others. Nevertheless, this is flexible and less formal mechanism which is used by many foreign investors when carrying out portfolio investments rather than foreign direct investment (FDI).

When carrying out FDI, most investors prefer to enter Chile through Decree Law 600 (Foreign Investment Statute), because it entails the signature of a formal contract with the Chilean state, represented by the Foreign Investment Committee (*Comité de Inversiones Extranjeras*). This contract provides a guarantee to access to foreign exchange at market rate for the repatriation of capital and profits. Also, investors who enter funds under this arrangement may opt for a guaranteed tax rate of 42% for ten years. Investments above US\$50m, including those in the mining sector, may opt for the same guaranteed rate for 20 years.

The Foreign Investment Statute guarantees a non discriminatory treatment against foreign investors regarding access to local credit. The Foreign Investment Committee is the only institution empowered to accept foreign investments covered by the Foreign Investment Statute and to set the terms and conditions of corresponding contracts. Its members include the minister of economy, the minister of finance, the minister of foreign affairs,

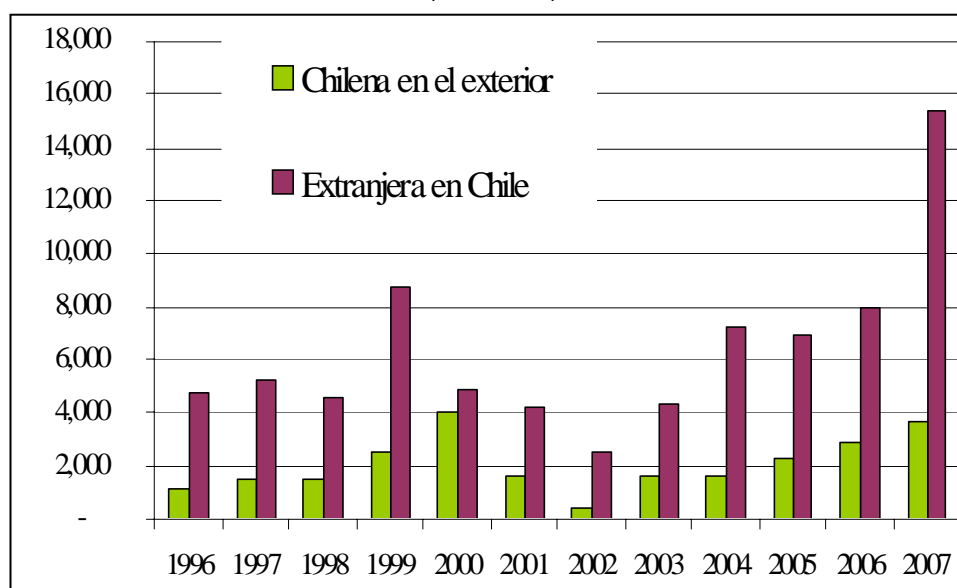
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<sup>14</sup> Normas de Auditoría Generalmente Aceptadas

the director of the National Planning Office, the president of the Central Bank of Chile and the ministry relevant to the project or investment. It has an executive vice president who may authorize investments below US\$5 million. The Foreign Investment Statute governs new foreign investment in freely convertible currency, as well as in assets (machinery and equipment), either new or used; technology in its various forms; and investment-related credits and capitalized earnings with a right to transfer abroad. On behalf of the Chilean state, the Foreign Investment Committee signs a separate contract with each investor. Contracts last indefinitely, but the investment must enter the country within eight years. In the case of mining investments, this may extend to 12 years if exploration activities must be undertaken. In all other areas, the possible extension period is generally three years. Foreign Investment Committee approval is required for the following investments: (1) those exceeding a total value of US\$5 million; (2) those related to sectors or activities that are normally developed by the public sector; (3) those involving the media and sea transport; and (4) those made by foreign governments or by foreign public entities. Under article 14 of Supreme Decree 1272 of 1961 (as amended by Decree Law 326 of 1974), individuals or legally constituted societies (national or foreign) may bring capital in foreign currency into Chile. The Central Bank must approve the contribution and grant a certificate to the investor, which allows investors to freely sell their foreign currency through commercial banks or other authorized entities.

Foreign investors in Chile can own up to 100% of a Chilean-based company. They are guaranteed access to all productive activities and sectors of the economy, except for a few restrictions in areas that include coastal trade, air transport and the mass media. In the case of fishing, restrictions are subject to the rules of international reciprocity.

**Foreign Direct Investment**  
(in US\$ MM)



Source: Foreign Investment Committee

### Foreign exchange regulations

In relation to foreign exchange regulations, the Central Bank of Chile allows its currency, the Chilean peso, to float and adjust automatically to market forces. In September 1999, the Central Bank eliminated the exchange-rate band, allowing the peso to float freely. However, in an extremely limited number of cases, the Central Bank has intervened to provide liquidity and smooth excessive daily or short term fluctuations<sup>15</sup>. Chile formally has a two exchange rate regimes, but the free-market “dólar observado” is the relevant rate since it is used in import/export operations as well as for tax purposes and financial operations. It is determined by the closing

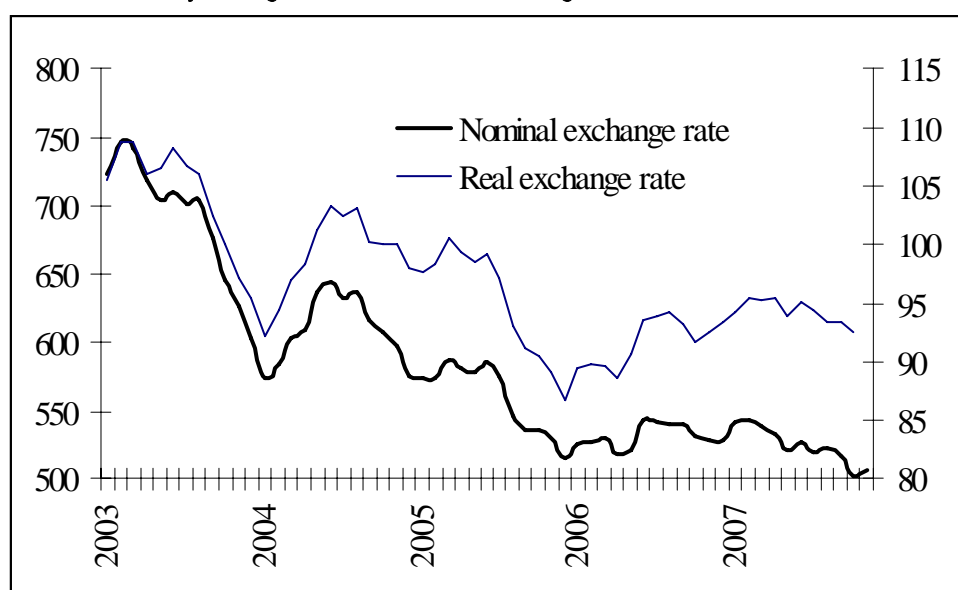
<sup>15</sup> Since the Chilean peso floats, the Central Bank has intervened only in cases of “extreme” depreciations of the currency. So far, it has allowed the peso to appreciate without any signal of a hidden threshold level for the currency.

exchange rate in the interbank market—dólar interbancario— the previous business day. Also there is the dólar acuerdo, which is a daily reference exchange rate, used for some long-term contracts in place. The rate will be eliminated once these contracts expire. The dollar acuerdo varies in accordance with changes in some other currencies (US dollar, euro and yen) and the inflation differential between the respective countries and that of Chile.

The so called “informal market” rate (dólar informal) is actually perfectly legal. It is composed by operators trading outside the banking market. It has been identical to the interbank rate (dólar interbancario) for years because of arbitrage activity that has effectively unified the two markets, but it continues to be reported in the press as if it were an independent exchange rate. By end-November 2007, the dólar observado was at \$508/US\$1.

In conclusion no modifications are required in the foreign exchange regulation, in order to reach international convergence in this matter.

Monthly average real and nominal exchange rate Chilean \$ / US Dollar



Source: Banco Central de Chile

Foreign exchange is readily available for imports and importers can purchase spot exchange before the payment date. Imports on deferred payment terms (*cobertura diferida*), for example, on credit terms exceeding 360 days, no longer require prior Central Bank authorization.

## Internationalization of the Securities Market

### Issuing securities abroad

In 1990, the then recently privatized Compañía de Teléfonos de Chile (CTC), the telephone company, issued the first ADR (American Depositary Receipt) by a Chilean company and the first of a Latin American company in 25 years. This was placed in the New York Stock Exchange, for the amount of US\$ 98 million. This issuance opened up the doors to many Chilean companies to list in NYSE or NASDAQ. In the beginnings, local issuers were looking for access to financial resources and later there was a quest for international status and prestige. Nevertheless, the later liberalization of the capital account (see previous section), especially in terms of foreign portfolio investment as well as the large source of local financing contributed to reduce the need and interest for issuing abroad. The last ADR issuance was made in November 2004.

In 1991, CTC also placed the first foreign bond issued by a local company, being this a Yankee Bond for US\$ 72 million. In 1996, Enersis placed the largest bond issued by a local company in foreign markets for a total of US\$ 800 million. During the past decade 17 placements were made abroad for a total of US\$ 5,000 million. One factor that contributed to the capacity of foreign financing by local companies was the good sovereign risk rating of Chile which was given investment grade by the risk rating agency Moody's in 1992, and by the rest of the rating agencies the following year.

In sum, Chilean securities market had the opportunity to internationalize in a relatively successful way. On one side, Chilean companies were able to issue stocks and bonds abroad, and on the other side, foreign investors, through the use of FICE and ADR were able to access the Chilean securities market directly.

#### Foreign companies issuing securities in Chile

In 1999, another legal reform created the Foreign Securities Registry which intended to set a platform for the public offering of foreign issuers by requiring differentiated financial and legal information. The trading of foreign securities would be carried out in a special segment of the stock exchange commercially called off-shore exchange ("bolsa off-shore"). In practice, this Foreign Securities Registry allowed to open up a distribution channel for the offering of foreign investment funds shares in Chile.

#### Foreign investors trading securities in Chile

A foreign investor that operates in the Chilean market, generally, will be able to operate through the local intermediaries authorized, with the endorsement of a bank that is subsidiary or has agreement with financial institutions of the country in which it resides or it operates this investor. Some foreign agents (institutional and intermediary investors) will be able to operate using the figure of the "Direct Operator", which allows them to have a "direct access" to the trading book of the stock exchanges (their orders enter directly), but a previous subscription of an agreement with a local stockbroker is required. This agreement establishes the legal responsibility of the broker who in fact appears as the operator and also is responsible to the settlement of these operations.

According to the Securities Market Law, foreign securities being traded in Chile can be registered and deposited in the local securities depository (DCV). Therefore, a foreign investor might make use of custodial services of locally traded securities offered by any financial entity or securities intermediary that has an open account at the DCV.

### **TAX REGULATIONS**

According to the Income Tax Law, residents or persons domiciled in Chile are subject to income tax on incomes derived from domestic and foreign sources, while non-residents are taxed only on income generated in Chile. An individual who establishes domicile or residence in Chile is taxed only on income from Chilean sources during the first three years in the country.

As indicated by the Chilean tax authority, the Servicio de Impuestos Internos (Internal Revenue Service, SII in Chile), Income Tax is built around three basic principles: *"First, it is ultimately individuals who are taxed, and taxes paid by an enterprise are only paid on account of the taxes that the owners of the enterprise will finally pay. Secondly, the tax base must consist of all incomes received or accrued by an enterprise during the tax period (generally known as the global income principle). Thirdly, resident and non-resident business owners only pay taxes for the profits withdrawn from the enterprise; therefore, if profits remain in the enterprise, personal taxation is postponed."*

First Category Tax (FCT) is a tax applied to physical persons and can be used as a credit against Complementary Global Tax (residents) or Additional Tax (non-residents) to which its owners are liable when they

receive dividends or make profit withdrawals - whether they are shareholders in a corporation (“sociedad anónima”), partners in a private partnership (sociedad de personas) or the head office of a permanent establishment. A special ledger, known as Fondo de Utilidades Tributables (FUT) is required to keep track of retained profits and the corresponding tax credit. The rate of First Category Tax is 17% and applies to income, which is calculated on a received or accruals basis.

The Second Category Tax is applied to natural persons, being a tax on income derived from dependent employment, while Complementary Global Tax is levied on total income obtained by an individual, and any Second Category Tax paid or First Category Tax related to dividends received is creditable against it. Both taxes have the same rate and tax brackets, therefore, a person receiving wages or salary and a person receiving remuneration for independent work will be taxed at the same level.

The Second Category Tax (applied to income from dependent employment, such as salaries, pensions and other remuneration) is progressive and is charged at rates ranging from 0% to 40%. The income base is the total salary and remunerations and social security payments are deducted. The tax is withheld and paid monthly by the employer. In order to maintain the progressive nature of this tax, workers with more than one employer must add all income received from different sources and include it in the corresponding rate bracket. The tax must then be re-calculated in April of the following year when filing a tax return. However, an employee with only one employer, and no other income in a given tax year, is not required to submit an annual tax return.

Income from independent professional activities or any other lucrative occupation by an individual which is not subject to Second Category Tax, is liable to pay the Complementary Global Tax (residents) or Additional Tax (non-residents). Residents are normally subject to a withholding of 10% of gross income. The withholding received by the tax authority can be used as a credit against Complementary Global Tax and, if the tax withheld is more than tax due, reimbursement can be claimed by the taxpayer.

The Complementary Global Tax is the annual tax that is applied to individuals domiciled or resident in Chile and is charged on the total taxable income. It is calculated on a progressive scale ranging from 0% to 40% (rates and brackets are the same as those for Second Category Tax, but on an annual basis).

The Additional Tax, which is 35%, is levied on individuals or legal entities that are not resident or domiciled in Chile and applies to income derived from Chilean sources. Depending on the type of income, returns must be filed annually or monthly. Among the incomes that are taxed with this Additional Tax rate of 35% are dividends, withdrawals and/or remittance of profits from Chile by corporations or private partnerships. Taxes paid in foreign countries on certain commercial activities can be used as a credit against First Category Tax (business profits tax) in Chile. Any unrelieved tax credits may be used as deductible expenses or carried forward against future tax liabilities. If there is a Double Taxation Agreement in force, all taxes paid in one country are creditable in the other. The tax relief in Chile is also augmented to up to 30% against personal tax. As a signatory of the Washington Convention of 1965, which created the International Centre for Settlement of Investment Disputes, Chile has negotiated several Bilateral Investment Treaties (BITs), of which 32 were in force.

An investment platform law (“Ley de Plataforma de Inversiones”) was issued in 2002. It aims to induce multinationals to use Chile as their regional base through a special regime granting tax-free status to earnings from their international operations, although the law is designed to prevent the use of Chile as a tax haven. Companies applying to this investment platform regime must be set up as Corporations or, if they are closed, they must be subject to the reporting requirements for open companies under the supervision of the SVS. These companies are not allowed to invest in countries defined by the OECD as tax havens at the time of the investment. Companies applying to this investment platform regime must also accept wider control on transfer prices by the local tax authorities.

The income of shareholders in investment platform companies, who are domiciled or resident in Chile, is subject to the general tax regime established in the Income Tax Act and, in other words, they are liable to pay First

Category Tax and Global Complementary Tax. However, they are entitled to use the Additional Tax of 35% paid by the platform company on income generated in Chile as a credit against these taxes. In order to access this regime, platform companies must be registered as such with the Internal Revenue Service. This procedure replaces the business start-up statement required to develop economic activities in Chile.

It has to be noted also that Law 19,738 of 2001, limited the amount of interest payments accepted as expenses for tax purposes as of 2003. This was done by introducing the concept of “excessive indebtedness”, defined as total debts three times more than a company’s own capital. The Internal Tax Service also has the power to examine the terms of “back to back” credits (credits fully guaranteed by deposits designed to artificially reduce tax liabilities by inflating expenses), which are regarded as one of the main tax avoidance schemes used in the country, especially by local subsidiaries of foreign companies.

#### Tax asymmetries in productive areas

The Chilean tax system contemplates some sectoral incentives. Among them are accelerated depreciation which is available in mining, metallurgy, chemicals, wood pulp, and some machinery and equipment industries. Also, firms involved in hydrocarbons exploration and production are eligible, under Decree Law 1820, for 10-100% tax and tariff cuts on imported machines, materials and spare parts used in their operations. Personal earnings of foreign subcontractors involved in petroleum operations face a single 20% tax and are not subject to additional levies. Corporations exploiting forest land enjoy fiscal incentives under Decree Law 701. Such companies pay no real-estate taxes and receive a 50% reduction in additional tax. The additional tax is a 35% levy on distributed income that corporations pay after an initial first-category tax on net income. Their shareholders receive a 20% rebate on dividend withholding taxes. Small copper-mining firms are subject to a reduced tax rate of 2-4%, depending on world copper prices. Merchant marine activities are promoted through Decree Law 3059, whereby 35% of profits are exempt from income and other taxes.

#### Tax asymmetries from the perspective of the investor in financial instruments

Tax benefits for the investment in certain financial instruments are rare. Capital gains are generally taxed as regular income, but according to Section 18 bis of the Tax Code, gains deriving from the exchange of highly traded local stocks (“presencia bursátil”) are exempt for foreign investors and domestic investors. On other cases, capital gains are considered normal. A flat tax of 17% (set at the same level as First Category Tax) is applied if certain characteristics of the transaction are present (e.g., shares have been held for more than one year and the operation is not part of the seller’s habitual business). Another exemption also contemplated in Section 18 bis is the one that exempt foreign and local investors from the payment of the capital gain tax for the sale of Chilean open end (mutual) funds shares as long as these funds are invested at least 90% of the portfolio in highly traded local stocks. The same treatment is given to the sale of closed end investment funds whenever these funds’ shares are highly traded (this has not happened yet as closed end funds’ shares are rarely traded on a secondary market).

Dividends are always taxed as well as interest on the investment, of fixed income instruments and saving accounts (consider minimum threshold to apply the global tax to natural persons explained in the next section).

#### Tax asymmetries from the perspective of the issuer of financial instruments

In Chile, in the case of enterprises, interest expense is considered an expense necessary to produce income and therefore can be deducted from total income in order to compute net profit for tax reporting purposes. This does not apply to dividends.

The Stamp and Duty tax is levied to all credits but in the case of renegotiations of mortgage debt bonds by individual mortgage borrowers this tax is not levied. A proposal to eliminate this tax to SME loans is under discussion.

## CHAPTER IV. ENTRY AND EXIT BARRIERS TO THE CAPITAL MARKET

Regarding the capital market, the legal framework is applied to foreign as well as local companies in the same way. In fact, a foreign company must be legally incorporated in Chile; therefore, it is considered a Chilean company for every legal and tax purposes. An important number of foreign players are present in the Chilean financial markets, including the bank industry (Citi, Santander Central Hispano, BBVA, etc), the insurance industry (MetLife, ING, etc) and the securities market (Itaú, Legg Mason, Citi, etc).

In relation to the cross border provision of financial services, Chile has included provisions in this direction in several free trade agreements signed, among them with the US, Mexico, Canada, and the European Union. Nevertheless, an effective offering of financial products under a cross border basis is still very incipient. In the banking industry, it is limited to provision of export-import services. In the insurance industry, it is limited to the provision of cargo and freight insurance. In the securities industry, as explained in the “Regulation (...)” section, mutual funds and investment funds in general, as well as intermediation services can only be provided by locally established companies. Nevertheless, foreign issuers have a way to carry out public offering of securities under the compliance of the Securities Registry dispositions in the Securities Law. These provisions were recently modified to allow the SVS to require a lower regulatory burden to certain issuers from certain foreign markets. The SVS is currently developing new administrative regulations to implement these simplifications. In short, it is expected that securities already listed in the main world markets could be publicly traded in Chile under the sponsorship of registered “sponsor” and information requirements could be reduced to the minimum. The same criteria could also be applied when the securities offered, although already listed in markets different from the ones mentioned above, when offered to qualified investors only.

As indicated in Chapter II, there are few restrictions on foreign ownership of local companies. Exceptions to these are companies related to the petroleum industry, uranium mining and other special mineral resources. Activities relating to the exploration, exploitation, refining and selling of petroleum and its by-products are undertaken exclusively by the National Petroleum Company (Empresa Nacional del Petróleo—ENAP) and are closed to private enterprise, notwithstanding the right to assign risk contracts to private investors (including foreign investors) for the exploration of designated areas. The investor may be paid with a percentage of the sales or in kind, with the government retaining a first option to buy the crude and gas at market prices. Uranium is subject to similar regulations.

In addition, there are restrictions in relation to the communication industry. The holder of a telecommunications concession must be a legally constituted entity under Chilean law; the owner of a radio concession must be Chilean and is considered such if 85% of the equity capital or ownership rights are held by domestic individuals or companies. The president, directors, managers, administrators and legal representatives of owners of commercial television stations must be Chilean.

In relation to the ability of non residents to bring in foreign capital to Chile, these are not subject to any official restrictions. Therefore, borrowing from abroad as well as raising capital from abroad are activities that only should follow certain formalities required by the Central Bank as well as the SII according to the regulations issued by these institutions. Among these, is the requirement of nonresidents to complete the necessary paperwork with the Internal Tax Service to get a Chilean tax number (RUT). This procedure was recently simplified and streamlined.

### Costs of operating or issuing securities in the Chilean Capital Market

In the case of local or foreign institutional investors one of the direct costs to operate in the stock market is originated in the charges made by the stockbrokers by concept of trading as “direct operators” (see section on

“internationalization of the securities market”) to the institutional investors or foreign investors, in order to access the exchange’s trading book directly. Depending on different variables, mainly of the volume of operations, but also of the offering of ancillary products offered to their clients, the costs for the direct operators oscillate between 1 and 2 basis points on the operated monthly volume.

A second direct source of costs is the costs of deposit of the instruments in the DCV, as well as the cost by each operation settled through DCV. The following matrix depicts the cost structure of the DCV according to what is established in its statutes.

#### Costs of operating at DCV

Instrument	Custody	Deposit	Transfer
Fixed income	Between 0,009% and 0,013% per year	Between 0,001% and 0,008% and UF 0,02 for each deposit	Between UF 0,026 and UF 0,077
Short term fixed income	Between 0,0015% and 0,003% per year		UF 0,02
OTC fixed income	N/A	N/A	UF 0,05
Repos	N/A	N/A	UF 0,02
Shares	0,00250 % per year	No cost	Between 0,001% and 0,005%

<sup>1</sup> UF (unidad de fomento) = US\$ 32 aprox.

Source: DCV

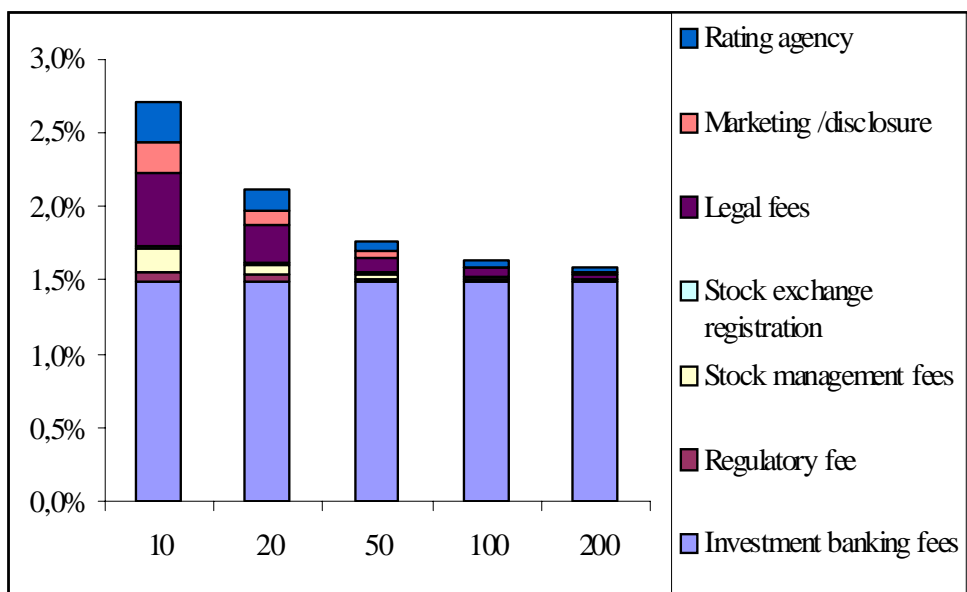
#### Issuing costs

A recent investigation by the World Bank<sup>16</sup>, indicated that to issue a simple bond (plain vanilla) of US\$ 20 million, the cost associated is 4.55% of the value of the bond. That figure seems to be large in regional comparison. The same study indicated that in Mexico the same issuance involves a cost of 1.99%. In Chile, a third of the cost is explained by the stamp tax (the tax charged on credits). The costs of investment bank (underwriting) fees, on the other hand, explain 40% of the cost.

<sup>16</sup> Zervos, Sara. “The Transactions Costs of Primary Market Issuance: The Case of Brazil, Chile, and Mexico” March 2004. World Bank Policy Research Paper 3424, Washington, D.C.

The above mentioned study indicates that the costs of issuing equity that on aggregate, the fees for a US\$200 issue fall around 1.6%, and for small issues of US\$10 still only come to around 2.75% of face value. **Costs of an**

**IPO**  
(by size in US\$ million)



Source: Based on Zervos

(2004)

## CHAPTER V. POLICY PROPOSALS

This section includes a number of policy proposal aimed at improving the legal and operational environment of Chilean capital markets. In addition, some initiatives are included in relation to the strengthening of the Chilean capital market integration to the international financial community. Those initiatives whose development are under way are individualized with an asterisk (\*) sign.

Some of these initiatives are currently included as part of a reform package led by the Ministry of Finance and SVS (informally known as MK III). Other initiatives in this package that are not listed below include: 1) Redesign of the closed-end investment funds law, allowing the development of exchange traded funds and adding more flexibility to the creation and management of these type of funds; 2) Lessening of regulations of mutual funds internal bylaws, allowing management companies to deposit their bylaws in SVS instead of going through a exhaustive checking and approval by SVS; 3) Flexibilization of the securitization law, and 3) Adoption of a capital-at-risk regulation to insurance companies, which leaves aside prescriptive rules and will have the effect , among others, of generating more demand for domestic securities with greater expected return and risk.

Other initiatives are presented below.

### INITIATIVES ON INTERNATIONAL INTEGRATION

**Reduce regulatory burden on public offering of foreign securities in Chile\***. Reduce requirements for the public offering of securities in Chile when the securities are already registered in certain jurisdictions. A local sponsor may be authorized to register the securities.

\*Progress: The SVS is currently developing new administrative regulations to implement these simplifications. In short, it is expected that securities already listed in the main world markets could be publicly traded in Chile under the sponsorship of registered “sponsor” and information requirements could be reduced to the minimum.

### INITIATIVES ON CORPORATE GOVERNANCE AND CORPORATIONS

**Reinforce certain corporate governance regulations\***. They include: 1) Reinforce legislation applicable to insider trading; 2) Improve financial reports by including management discussions, strategic objectives, change on equity, and risk factors. Tend to assimilate to the SEC Rule 20 F; 3) Allow simplification of the identification of final beneficiary owners of corporations; and 4) Publish the voting of institutional investors.

\*Progress: A new bill that makes amendments in the area of insider trading is under discussion in Congress. This law grants additional investigative powers to SVS, includes additional persons assumed to have insider information and requires corporations to adopt internal programs to deal with price sensitive confidential information as well as fair disclosure of information. In addition, the bill strengthens the role of non-controlling shareholders by requiring the existence of at least one director not chosen with the votes of the controlling shareholders (i.e., an independent director under the Chilean law).

### INITIATIVES ON SECURITIES REGULATION STANDARDS

#### Secondary markets

**Improvement of corporate governance of the exchanges.** Conduct an expert study focused on providing regulatory mechanisms for reinforcing regulatory capacity of the exchanges. This could include necessary modification to its governance arrangements.

\*Progress: a conference on Stock Market Development has been called for June this year. One of the most critical issues is the corporate governance of self regulatory organizations, such as exchanges.

**Improve clearing and settlement regulatory framework\***. The areas are: 1) Chilean law should be clarified to ensure that netting arrangements are recognized and enforceable, to make explicit when finality in a trade occurs, to facilitate securities lending by the DCV, to promote dematerialization of securities, and to promote the use of a standard master agreement in repo transactions; 2) The SVS, the stock exchanges or the DCV should have a program to oversee firm's risk management programs and apply risk control techniques to limit the possibility of systemic failure; and 3) Comprehensive record-keeping requirements should be adopted throughout the industry to document all firm and customer assets and their location.

\*Progress: A bill that formally recognizes the clearing and settlement entity as well as strengthening certain legal elements is under discussion in Congress. A new division within the SVS has been created and has the mission of leading the development of and supervising the clearing and settlement infrastructure.

**Improve capital adequacy regulation for brokers.** This improvement should consider a re-design of haircuts for foreign securities, the inclusion of specific capital charges for derivatives, the inclusion of more accurate market and liquidity risk indicators, and the differentiation of minimum capital requirements depending on the authorized lines of business.

### Supervision

**Lift bank secrecy prohibition for SVS investigation purposes.** Carry out a formal petition to solicit a change of law allowing the SVS to require bank accounts records when conducting administrative investigations.

**Compliance and risk management programs.** Require compliance programs to regulated entities as well as risk management programs.

**Develop certification standards for industry professionals\*.** The Chilean regulation system should work in coordination with industry association or the exchanges to establish a certification system to admit participants to operate in this market.

\*Progress: SVS is developing a plan in coordination with BCS and BEC in order to issue rules allowing exchanges to require certification exams to market operators.

**Develop regulation and formal mechanisms to deal with systemic failures\*.** Regulators must have in place protocols to react in case of this type of market crises. Also the Chilean law must recognize the rights of customers to assets held by a firm or its custodian as superior to a general creditor, and the SVS or some other body must have the capacity to appoint a receiver to assume responsibility for the orderly termination of business by a failed firm.

\*Progress: The aforementioned progress in the area of clearing and settlement supervision and development includes the strengthening of mechanisms to deal with failures in infrastructure facilities.

### Investor protection

**Develop a regulation on suitability.** A legal amendment must be made in order to contemplate the inclusion of suitability standards in the offering and advice of securities to the public.

**Promote an investors protection fund.** Promote the creation of an investor protection fund to cover losses arising from the failure of one or more brokers.

**Regulate the function of investment advising.** This function is not explicitly regulated in the Chilean laws. A regulation that includes mechanisms to deal with conflict of interest as well as minimum standards to deal with investors must be developed.

**Require clients' accounts in central depository.** Clients' accounts must be individualized in the securities depository with the objective of reducing the risk of mismanagement and fraud.

### Regulatory institutions

**Autonomy and governance of SVS\*.** One of the essential elements of a good regulator is its independence. In Chile, there is a space to improve independence in three main areas: budgetary, governance, and regulation creation. These requirements could be fulfilled under several institutional arrangements. One of them could be the creation of a Commission with a Board of Governors. It might be nominated by the Executive Power with some type of approval by Congress. Also, it is necessary to add more capacities to regulate by the SVS while reducing the importance of the law in the securities regulation, and strengthening the importance of administrative regulations. Finally, more budgetary autonomy is needed to guarantee an effective independence.

\* Progress: The SVS in coordination with the Chilean Ministry of Finance is exploring mechanisms to provide SVS with more autonomy. This project includes changes to the governance of this entity (i.e., Commission type structure); its accountability (i.e., Relation with the Congress) and financing (i.e., Industry participation).

**Information sharing with foreign regulators.** Authorize explicitly the SVS to share any type of information with any foreign regulatory agency. A legal reform should authorize the SVS explicitly to share information with foreign regulators as well as with domestic regulators.

**Develop a long term Strategic Plan\*.** The SVS should present to the public a strategic plan that would inform about long term objectives and the way to carry them out.

\*Progress: A long term strategic plan is being developed and is expected to be published during 2008.

**Implement process development techniques\*.** The SVS should implement process development techniques that would allow it to improve its own bottlenecks in areas such as regulation development and feedback with regulated entities.

\*Progress: A recent reorganization of SVS created new divisions and units and redesigned roles and objectives. This new organization is expected to have significant impact on efficiency.

### **Regulation of Financial Conglomerates**

Develop mechanisms between regulators aimed at exchanging information and monitoring conglomerates. Create an executive secretariat in charge of providing technical support and create working groups in order to carry out investigation in areas of common interest. Define formally "financial conglomerate" and require one of the entities of the conglomerate to represent it in front of financial regulators. Carry out integral auditing and set a leader regulator. Relax some "Chinese Walls" such as the impediment to share infrastructure and common distribution channels.

## INITIATIVES IN ACCOUNTING AND AUDITING INTERNATIONAL STANDARDS

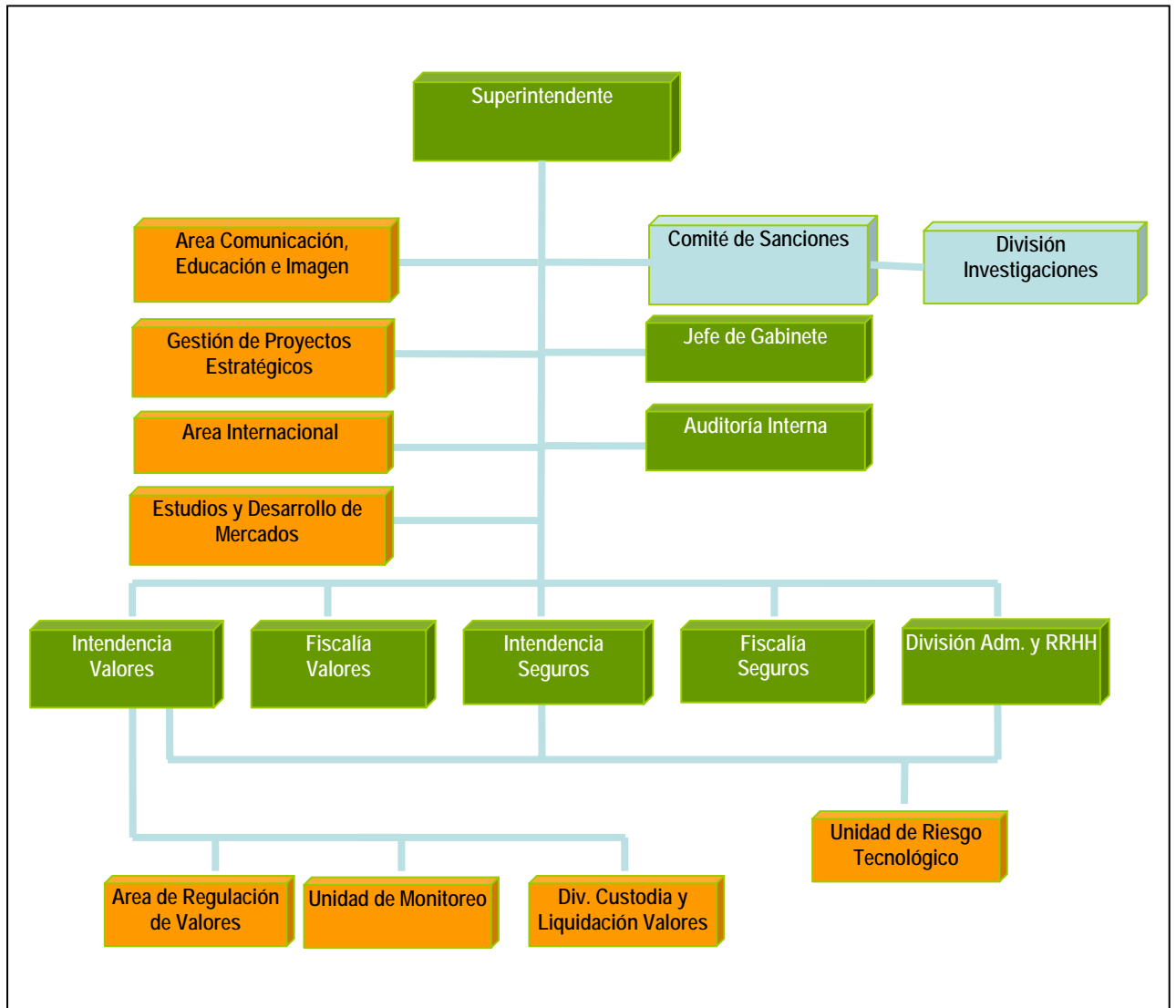
**Implementation of IFRS in entities related to the securities market\***. Require the implementation of IFRS on Chilean entities related to the securities market. This would allow comparability among industries and at an international level and reduce information costs to Chilean entities.

\* Progress: In August 2007, the SVS presented the definitive schedule for convergence to IFRS. Starting January 2009, all registered companies with trading activity larger than 25% of the trading days (*presencia bursátil*) are required to prepare their financial statements in conformity with IFRS. The rest of the entities regulated by SVS are required to present financial statements according to IFRS according to the schedule presented by the SVS.

**Establish a public oversight body for statutory auditors.** An “Audit Oversight Board” would be in charge of: 1) The qualification of statutory auditors; 2) Setting professional standards for statutory auditors; and 3) Enforcement of auditing and ethical standards. This organization should be established by a law that defines its governance and main responsibilities.

**Support the CCC's initiative to establish a certification process for public accountants consistent with IFAC standards, by recognizing it as the basis for licensing statutory auditors.** The certification process would include a professional examination and the demonstration of sufficient experience in the accounting practice, consistent with internationally observed best practices and IFAC recommendations.

Annex 1. Organization of the Superintendencia de Valores y Seguros (SVS)



## Annex 2. Securities Market related entities regulated by SVS

Entities	Legal Reference
Securities issuers Corporations	Law N° 18,045 Law N° 18,045 and Law N° 18,046
Securities Broker-Dealers	Title VI, Law N° 18,045
Stock Exchange brokers	Title VI, Law N° 18,045
Stock Exchanges	Title VII, Law N° 18,045
Mutual funds management companies and managed funds	DL N° 1,328, of 1976
General fund management companies and managed funds	Title XXVII, Law N° 18,045
Investment funds management companies and managed funds	Law N° 18,815
Foreign capital investment funds management companies and the managed funds	Law N° 18,657
Risk rating agencies	Title XIV of Law N° 18,045
Securities custody and depository companies	Law N° 18,876
Independent external auditors	Art. 52, Law N° 18,046
Residential Leasing: housing funds management companies, funds administered by them, and real state companies	Law N° 19,281
Securitization companies	Title XVIII, Law N° 18,045
Clearinghouses	Title XIX, Law N° 18,045
Foreign securities issuers (Securities Deposit Certificates , CDV)	Title XXIV, Law N° 18,045
Agriculture Products Exchange	Law N° 19,220 and Law 19,826
Solidarity fund for university loans	Law N° 19,287

### **Annex 3. Agreements on double taxation**

(Source: Internal Revenue Service, SII)

#### **In place**

Argentina  
Brazil  
Canada  
Croatia  
Denmark  
Ecuador  
France  
Mexico  
Norway  
New Zealand  
Peru  
Poland  
South Korea  
Spain  
Sweden  
United Kingdom

#### **Signed**

Colombia  
Ireland  
Malaysia  
Paraguay  
Portugal  
Russia  
Thailand

#### **Negotiation Concluded**

South Africa

#### **Under Negotiation**

Australia  
Belgium  
China  
Cuba  
Czech Republic  
Finland  
Holland  
Hungary  
India  
Italy  
Kuwait  
Switzerland  
United States  
Venezuela