

Mexico

Corporate Governance Institutions, Practices and Developments

1. Key Institutional Features of Corporate Governance and Company Profile in Mexico

1.1 Background

There are two key laws affecting corporate governance: the Company Law (LGSM), and the Securities Market Law (LMV). The LGSM, enacted in 1934 and most recently amended in 2009, establishes basic company forms and shareholder rights. The LMV, which regulates public companies, was introduced in 1975, but major amendments went into effect in 2001.

Also in recent years, there have been a number of major reforms related to corporate governance in Mexico, including the drafting of an early voluntary code of best practice (1999) and the redrafting of key provisions of the Securities Market Law. In efforts to address the problems of poor corporate governance and a weak financial market, a new Securities Market Law (LMV) was enacted in Mexico in 2006.

The progress that has been made in promoting good corporate governance has been set against the concentrated ownership and control structure of many Mexican firms, weak enforcement of shareholder rights and concerns about reform fatigue.

In addition to encouraging corporate governance, the LMV promotes venture and private capital flows into small and medium-sized companies, through increased transparency, disclosure and better board structures, procedures and clearly defined responsibilities of boards and individual directors. More specifically, the new LMV intends to improve the regulation of information disclosure and minority shareholder rights. It reorganizes and clarifies the duties and liabilities of the board of directors and the relevant officers

Also, Mexican committees now need to create at least one committee which acts as an audit and corporate practices committee. These committees must consist of only independent directors (with the exception of controlled companies, which may have a corporate practices committee comprised of a majority of independent directors). The board has to be comprised of, at least, 25% independent directors.

According to the 2007 Financial Sector Assessment Program (FSAP) Update by the International Monetary Fund (IMF), the law changed the securities market framework in three broad areas. It expanded the CNBV's authority, it introduced significant changes in the corporate governance of publicly listed companies; and it created "two new corporate vehicles, designed to facilitate the ability of small and medium-sized companies to raise capital and transition to public listed company status".

Another area where progress has been made concerns the foundation of a director training organization. The 2003 World Bank's ROSC had noted the absence of such an institution as a

key missing ingredient in Mexico's corporate governance reforms. The Center for Excellence in Corporate Governance (Centro de Excelencia en Gobierno Corporativo, or CEGC) was founded in March 2004. Its objectives are to provide board members and executives with information, methodologies and best corporate governance practices that will increase efficiency and transparency levels, facilitate compliance with existing regulations, and generate greater investor confidence to enhance their economic and social value.

1.2 Trends

The stock Exchange (Bolsa Mexicana de Valores –BMV) is a member-owned, for-profit institution. The 2007 IMF update on its original FSAP notes that between 1995 and 2001, trading activity as well as the number of listed companies on the BMV declined. As the IMF notes, Mexico's equity market remains relatively small and illiquid, and is not a major source of financing for most companies. Among the eight largest economies in the Americas, relative to GDP, Mexico nonetheless has the second smallest stock market. After a number of compulsory delistings by the CNBV, the number of listings declined to 132 (155 listed stocks).

The daily trading volume on the BMV is highly concentrated in a very small number of issuers. Four stocks (Telmex, AMX, Walmex, and Cemex) comprise approximately 50% of the primary equity market index (Indice de Precios y Cotizaciones, or IPC). Overall, the IMF notes, market capitalization of the BMV has grown from US\$104 billion in December 2002 to US\$236 billion at the end of 2005. According to the World Federation of Exchanges (WFE) website, market capitalization reached US\$336.7 billion in January 2010. There are 406 listed companies, of which 125 are domestic and 281 are foreign. The value of shares trading on the BMV was US\$10.1 billion, whereas the value of the 244 bonds trading on the market in January 2010 reached US\$13.1 million.

1.3 Key Corporate Governance Rules and Practices

See Key Corporate Governance Rules and Practices in Mexico, p. 159.

2. Development, Enforcement and Assessment of Implementation of Corporate Governance Rules

2.1 Development of Corporate Governance Rules⁸⁴

The capital market regulator is the CNBV. It is a supervisory arm of the Secretariat of Finance and Public Credit (Secretaría de Hacienda y Crédito Público, or SHCP) and supervises banks and the securities market and enforces shareholders rights. The CNBV is headed by a 10-member Board of Governors. Five members, including the President of the Commission, are appointed by the SHCP, three members are appointed by the Central Bank, and the pension regulator and the insurance regulator each appoint one member.

2.2 Enforcement of Corporate Governance Rules

The World Bank assessments note that progress in establishing a successful structure and culture for good corporate governance has to account for the concentrated ownership and control structure of many Mexican firms, and, at least at the time of the assessments, weak enforcement of shareholder rights.

⁸⁴ "Rules" refers to requirements for corporate governance however they are designated; e.g., laws, regulations, stock exchange listing requirements, or principles in obligatory codes.

As the Institute of International Finance (IIF) notes, traditionally, most large companies have been organized as business groups, which are conglomerates owned and controlled by families and/or consist of holding companies that invest in other companies characterized by vertical or horizontal integration. The resulting cross-shareholding between firms and the exchange of positions in boards of directors result in various interlocking directorates. Consequently, while members of the board may come from outside the corporate structure of the firm, they are not necessarily independent.

The IIF cited several studies that indicated that adherence to the principles of the Corporate Governance Code was not commonly observed in the areas of board composition, independence of the audit committee, existence of a committee of compensation and evaluation, and disclosure of compensation schemes for executives. However, especially in the area of director independence, progress in promoting the inclusion of independent board members and establishing audit committees as part of firms' control functions was already under way at the time of the 2003 assessments, and has been further advanced since.

This is especially due to the passage of the new 2006 Securities Market Law, which gives many corporate governance provisions the statute of law. However, structural change is slow, as noted in a 2009, the Mexican business environment is still characterized by concentrated ownership, interlocked boards of directors, inadequate insider trading enforcement, and an overall poor protection of minority investors.

Since 2008, the CNBV has imposed at least 32 sanctions on different entities under its supervisory and regulatory scope. These entities comprise, but are not limited to: financial entities; officers of financial entities; natural persons acting as investors; issuers; natural persons acting on behalf of issuers; companies providing services to investment societies; investment societies; officers of companies providing services to investment societies; members of the board of investment societies; and officers of investment societies. Sanctions are made public. For better references please visit the following website: http://www.cnbv.gob.mx/seccion.asp?sec_id=543&com_id=0

As for failure to comply with corporate governance rules and ulterior delistings, up to now, although some companies have been delisted at least since 2007, there has been no delisting due to factors directly linked to the non-compliance of any corporate governance issue.

2.3 Assessment of Corporate Governance Practices

In 2003, a Report on Standards and Codes by the World Bank benchmarked Mexico's observance of corporate governance practices against the OECD's Principles for Corporate Governance. According to the World Bank report and a report by the Institute of International Finance released the same year, major progress had been achieved in establishing a successful structure and culture for good corporate governance. The World Bank rated most Principles as either "largely observed" or "partially observed", indicating either only minor shortcomings or a legal and regulatory framework that complies with the Principles, but suffers from diverging practices and a lack of enforcement.

In its 2003 ROSC, the World Bank rated Mexico's observance with the sub-principles of Principle II as follows: "Basic Shareholder rights" and "Control Arrangements should be allowed to function" were rated as "Largely Observed", indicating that only minor shortcomings are noted, and that these do not raise questions about the authorities' ability and intent to achieve full observance in the short term. "Rights to participate in fundamental decisions", "Shareholder's Annual General Meeting Rights", and "Disproportionate Control Disclosure", were rated as "Partially Observed", indicating that while the legal and regulatory

framework complies with the Principle, practices and enforcement diverge. Finally, the sub-principle labeled “Cost/benefit to voting” was rated as “Materially Not Observed”, indicating that, despite progress, shortcomings are sufficient to raise doubts about the authorities’ ability to achieve observance.

The 2003 World Bank report made the following recommendations: rules blocking shares should be clarified; voting procedures for all kind of investors should be made as simple as possible; and large transactions should require shareholder approval. Also, to strengthen the rights of small shareholders, a small number of shareholders should be able to force resolutions onto the agenda and request a formal poll. A minimum interval should be established between first and second meetings, and legal provisions that define share types and rights should be simplified.

In its 2003 Corporate Governance Country Assessment of Mexico, the World Bank rated Mexico’s observance of the sub-principles of Principle III as follows: “Prohibit insider trading” was rated as “Largely Observed”, indicating that only minor shortcomings are observed which do not raise questions about the authorities’ ability and intent to achieve full observance in the short term. “Equitable treatment of shareholders” and “Board/management discloses interests” were rated as “Partially Observed”, indicating that while the legal and regulatory framework complies with the Principle, practices and enforcement diverge.

The report made a number of recommendations. In order to strengthen minority shareholder rights, the World Bank assessment team proposed the harmonization of existing thresholds at a level sufficient to allow minority shareholders to effectively exercise their rights.

In its 2003 ROSC, the World Bank rated Mexico’s observance with Principle IV as follows: “Access to Information” was rated as “Observed”, indicating that the economy has fully implemented the principle. “Legal Rights of stakeholder are respected”, “Stakeholder Redress for violation of rights”, and “Performance enhancing mechanisms” were rated as “Largely Observed”, indicating that only minor shortcomings exist, and these do not raise questions about the authorities’ ability and intent to achieve full observance in the short term.

In its 2003 ROSC, the World Bank rated Mexico’s observance with Principle V as follows: “Fair and timely dissemination” was rated as “Observed”, indicating that the economy has fully implemented the principle. “Disclosure standards” was rated as “Largely Observed”, indicating that only minor shortcomings are observed, which do not raise questions about the authorities’ ability and intent to achieve full observance in the short term. “Standards of accounting and audit” and “Independent audit annually” were rated as “Partially Observed”, indicating that while the legal and regulatory framework complies with the principle, practices and enforcement diverge.

In its 2003 Corporate Governance Country Assessment, the World Bank rated Mexico’s observance with the sub-principles of Principle VI as follows: “Access to information” was rated as “Observed”, indicating that all essential criteria are met without significant deficiencies. “Ensure compliance with law” was rated as “Largely Observed”, indicating that only minor shortcomings are observed, which do not raise questions about the authorities’ ability and intent to achieve full observance in the short term. The sub principles “Acts with due diligence and care”, “Treat all shareholders fairly”, “The board should fulfill certain key functions”, and “The board should be able to exercise objective judgment” were rated as “Partially Observed”, indicating that while the legal and regulatory framework complies with the Principle, practices and enforcement diverge.

3. Awareness and Advocacy for Good Corporate Governance

Given the endorsement by APEC ministers in 2008 of the OECD Principles of Corporate Governance, this section reviews developments aimed at advancing the understanding by company and governing authority officials and the public of the OECD Principles of Corporate Governance and status of commitments to improving corporate governance in the economy.

3.1 Company Directors

There are some private bodies currently operating in Mexico, which are intended to foster corporate governance practices. However, there is no obligation for a company, public or not, to have a membership in any of these bodies. It is worth mentioning that the National Banking and Securities Commission does not endorse nor directly participate in any of these bodies. These centers or bodies offer training seminars and courses specially dealing with corporate governance issues.

3.2 Media

There are no formal educational programs aimed at building awareness of corporate governance issues.

Some specialized journals, magazines and other publications that regularly report on corporate governance issues and their developments. Corporate governance concerns have existed in Mexico for some years. The media, and also the relevant communication channels of the government or stock exchange, report on these topics any time there is something relevant or important to discuss.

3.3 Educational System

Some universities and the Mexican Stock Exchange may have formal training seminars and courses in corporate governance, but this is outside the scope of competence of the National Banking and Securities Commission. However, some universities and post graduate institutions in Mexico may be offering training in corporate governance issues.

3.4 Stock Exchange

On a regular basis the Mexican Stock Exchange offers training seminars in corporate governance. This organization also collaborates with other institutions and organizations devoted to the spread of corporate governance awareness.

4. Corporate Governance of State-Owned and Family-Controlled Enterprises

4.1 State-Owned Enterprises

Since the early nineties, Mexico has followed a privatization policy, including almost all state-owned companies. In the case that the Mexican government was interested in investing in companies, it would be the Ministry of Finance and Public Credit (Secretaría de Hacienda y Crédito Público), the predominant Ministry in charge of verifying government's investment in companies. Once the investment has been made, the governing authority as for corporate governance issues, would be the corresponding "Head Ministry", e.g., for investments in the government-owned petroleum company, the Ministry of Energy.

Generally speaking, state-owned companies are subject to different norm than those applicable to private companies. This also applies to practices in corporate governance. However, the intention of the Mexican government is to improve corporate governance in state-owned companies, and align it to prevailing practices in the private sector.

For instance, the economy's petroleum company PEMEX intends to orient its corporate governance policy not only to the principles already into force in Mexico but those at the international level.

4.2 Family-Controlled Enterprises

The Mexican Stock Markets Law defines family controlled companies or controlling shareholders, as those shareholders who have, individually or as a group, at least 10% of the issuer's equity. In this regard, they also face limits as precluded in the most basic guidelines in terms of corporate governance. For instance, as for "Related party transactions" which are defined as transactions celebrated between the company and "related persons", which in turn are defined as "(i) any person who having control or significant influence over an entity that integrates the corporate group or group of the issuer, and the directors and relevant officers of said entities; (ii) a person with decision making authority over an entity that forms part of the corporate group or group of the issuer; (iii) spouse or family members of an individual mentioned in paragraphs (i) through (ii) herein; (iv) legal entities that integrate the corporate group or group of the issuer; (v) legal entities controlled by an individual mentioned in paragraphs (i) through (iii) herein; or (vi) legal entities over which an individual mentioned in paragraphs (i) through (iii) has significant influence".

The Mexican experience is one of important family-owned companies, and a highly concentrated market, unlike the US or some European economies. To counteract this situation, since 2006, Mexico has introduced a series of clauses and policies aimed at protecting minority shareholders, and by doing so enhance incentives to newer entrants and promote the listing of companies with more atomized capital. Mexico's legislation was amended to incorporate changes in the composition of the board and the ability to summon a general assembly by a minority.

Recent newer legislation has adapted enforcement from equity investors and from financial institutions, which in turn has meant increased pressure for nonpublic (family-owned) corporations to adopt some corporate governance best practices.

In order of preference, the following measures are being requested:

- A formal Board with some external and independent members;
- Implementation of an Audit Committee similar in composition to that requested by the Sarbanes Oxley act.
- Pressure to have a succession plan, approved by family members and/or by the controlling groups (in some instances approved by external investors and financial supporters)
- The implementation of modern internal control practices supported by much more modern and sophisticated information technology systems.
- Pressure by external auditors to use information technology as part of their auditing procedures.

5. Role of Professional Service Providers in Corporate Governance

For most of the corporate governance entities (e.g., accounting firms), the principle of Materiality is followed, which is related to all qualitative or quantitative information from a corporation, its securities and the prevailing situation of the corporate group to which it belongs irrespective of the position it has within such a group, to engage in all necessary steps so as to inform all relevant agents of the real financial, administrative, economic and legal situation of the company.

For instance, pursuant to Article 28, paragraph III, section b), of the Stock Markets Law, the Board of Directors must sanction the information provided, considered as a previous opinion of the Audit/Corporate Practices Committee, as for each transaction considered as relevant, with related persons of the issuer or entities controlled by it. No approval will be necessary whenever (i) those transactions are not relevant, (ii) they are operations of the on-going business and paid at market value, and (iii) they are celebrated with employees in similar conditions as any other customer or as a result of labor benefits.

6. Recent Developments in Corporate Governance

This section discusses the developments and salient issues in corporate governance in the Mexican economy during the past three years.

6.1 Corporate Governance Developments

Following the approval of the new Stock Markets Law in 2006, Mexico has undergone profound reform of its corporate governance practices.

Several important changes have taken place since that time. However, the most salient changes include the following examples:

As for listed and non-listed companies, being either family-owned or foreign-owned, the need to have a formal board with some external and independent members is currently enforced. As for the composition of the board, there is now the obligation to have an Audit Committee.

“Pressure” has also been applied for applying high-tech controls like the implementation of modern internal control practices supported by modern and sophisticated information technology systems.

In relation to shareholders rights, it is voluntary for them to formally adopt either the best practices of corporate governance demanded for publicly held companies or to continue operating as before, with a “Commissary” and with no board committees but while adopting a conversion plan and with the ultimate aim of having independent board members.

Under the new legal regime for non-listed companies, all investors, controlling and non-controlling, acquire rights and obligations which allow them to have much more control and transparency than before, while allowing for a better alignment of interests among shareholders. It also creates incentives for founders and or controlling groups to attract external private equity, and for external investors to establish rules to secure their equity. These rules can be agreed and could include issues such as mergers or acquisitions, compensation or to reorient the social responsibilities of the company.

6.2 Enforcement of Corporate Governance Rules

The National Banking and Securities Commission is empowered to impose sanctions to public companies that do not comply with the corresponding legal framework. For example, there was the case of a public company that was involved in transactions with derivatives instruments that lost significant amounts of its financial resources. Although it is not illegal to undertake operations with this kind of instruments, the company in question was fined for not publicly informing investors and markets in general that some of its liquid assets were involved into high-risk speculative operations. Those operations should have been informed by said company, according to our legal framework, as a “relevant fact”.

This company clearly overlooked, among other things, the corporate governance principle of sufficiency and accuracy of information.

6.3 Current Issues and Challenges for Corporate Governance

6.3.1 Priorities

1. The creation of a director training institution. A missing ingredient in Mexico’s corporate governance reform is a director training organization (e.g., an Institute of Directors). The government (including CNBV) and the private sector have a strong interest in increasing director professionalism. International best practice suggests that the new organization can both serve as a training organization (on a fee basis) and a corporate governance advocacy organization, providing input for future corporate governance reforms. Such an institution could communicate the variety of new rules to board members and build a culture of strong and independent boards of directors.

2. Enforcement. The implementation and enforcement of the new corporate governance rules remain global challenges. Mexico will continue to strengthen its capacity to monitor disclosure and to enforce the corporate governance provisions of securities law. Staff should be trained to gain awareness of corporate governance issues and possible abuses. New emphasis should be placed on the disclosure of ownership, and related-party transactions. CNBV has to strengthen in practice, the technical autonomy and powers of sanctioning should be further enhanced.

Mexico still has a single-tier board structure. The updated Mexican Code of Best Practices in Corporate Governance, released in November 2006, emphasizes the functions of the board and includes a recommendation for company boards’ to issue codes of ethics and social responsibility. Although the 2006 LMV reorganizes and clarifies the duties and liabilities of the board of directors and relevant officers, the newly created committees now need to conform at least one committee which acts as an audit and corporate practices committee in a practical manner. That is the committees need to consist entirely of independent directors (with the exception of controlled companies, which may have a corporate practices committee comprised of a majority of independent directors). In this regard, the new Stock Markets Law states that failure to fulfill Duty of Care includes unjustified non-attendance to board meetings and failure to provide information relevant to decision making. However, empowering the CNBV to sanction and imprison someone engaged in the failure to comply with the duty of loyalty, which is penalized with jail time of three to 12 years if directors knowingly benefit one shareholder to the detriment of others, still needs to be addressed.

This still needs to be made applicable, in reality, for cases of conflicts of interest, or misuse of other confidential and/or relevant information.

6.3.2 Financial Crisis

During the recent global financial crisis, some aspects of corporate governance evidenced fragility. Perhaps, definition of value creation should not solely be linked to the volatility in the

price of shares but to a measure (yet unknown) of continuity of the efforts and social purpose of the company more relevant to mid- and long-term objectives.

In this respect, a formal company architecture could be redefined in terms of even more independent members of the board. The above mentioned new structure should include a more formal approach to internal committees and auxiliary bodies, as well as new company laws. These two paths should enable more committees in the compensation, risk management policy, auditing, societary practices, internal ruling, etc.

The independence of directors may not be enough. The crisis showed us that proved experience in the specific industry or sector, as well as strong analytical capacity shall always be welcome.

Last but not least, perhaps a new policy redefining the trade-off between the property and the management of companies could also be useful. For instance, in some economies, a model of members of the board composed of shareholders, versus the “classical” model of the board of executives, self-sufficient and not owners of the company, could be redesigned so as to allow for a more equal management system always in consideration of the rights of minority shareholders.

Key Corporate Governance Rules and Practices in Mexico

Element	Yes	No	Source(s) of Rule	Comments
RIGHTS OF SHAREHOLDERS				
1. Do shareholders add items to the agenda for shareholders' meetings?	X		SL	
2. Do shareholders ask questions of directors at shareholders' meetings and do they receive answers?	X		SL	
3. Must company transactions with its insiders be on a non-preferential basis?	X		SL	
4. Is a super majority vote required for major company acts affecting shareholder rights?		X	SL	
COMPOSITION AND ROLE OF BOARDS OF DIRECTORS				
5. Must boards have independent directors? What percentage?	X		SL	25%
6. Do independent directors have significant influence over (a) internal and external audit and (b) executive compensation?	X		SL	
7. Do independent directors decide what information the board receives from management?		X	SL	
8. Are the chairman of the board and chief executive officer different persons in the majority of listed companies?	X		GP	
9. Are all board members elected annually?		X	SL	
10. Does the board oversee enforcement of a company code of conduct?	X		SL	
TRANSPARENCY AND DISCLOSURE OF INFORMATION				
11. Do financial statements comply with International Financial Reporting Standards		X	SL	

Element	Yes	No	Source(s) of Rule	Comments
(IFRS)?				
12. Are the identities of the five largest shareholders disclosed?	X		SL	
13. Is compensation of company executive officers disclosed?		X	GP	
14. Are extraordinary corporate events disclosed?	X		SL	
15. Are risk factors disclosed in securities offering materials?	X		SL	
16. Are transactions of a company with its insiders disclosed?	X		SL; GP	Depending on the nature of the transaction and/or whether or not it takes place as a related-party transaction.

Note: CL – company law; SL – securities law; CGC – corporate governance code; SLR – stock exchange listing requirement, GP – general practice but not obligatory