

# Corporate Governance: Does Mexico Finally Get It?

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The tremor emanating from the perfect storm of Enron, WorldCom, Tyco and others, resulting in the United States' adoption of the Sarbanes-Oxley Act of 2002, was felt throughout the world. In an attempt to inspire investor confidence and to align themselves more closely with the corporate governance guidelines in the United States, countries began to overhaul their corporate governance standards to provide for greater transparency. Consequently, it appeared as if a world-wide standard of corporate governance was emerging. Amidst all this global movement, Mexico by all appearances seemed content to stand pat. The tide may be changing. As foreign investors continue to demand better corporate governance from Mexico and other emerging markets, Mexico is attempting to reform its corporate governance laws to provide for greater transparency regarding Mexican corporations and their operations. The Mexican Senate recently passed a new Securities Market Law by a vote of 77-1, and the expectation is that this law will be approved by the Chamber of Deputies in this year's sessions.

## Mexico's Business Model.

Given the current business model in Mexico, many investors have doubts as to whether a change in the Mexican securities laws will have any real impact on how Mexican corporations are governed. Today, an estimated 95% of Mexican businesses are family owned and operated. Unlike the United States, where institutional investors hold over 50% of all corporate securities, institutional investors do not hold controlling positions in Mexican corporations. Control resides with the families that own the controlling interest in the voting classes of stock. Consequently, in Mexico public and private corporations alike are akin to closely-held corporations in the United States. Because Mexican companies are closely held, few shares are actively traded on the Mexican Stock Exchange, and those that are often have limited voting rights. Additionally, the Mexican Stock Exchange has approximately 149 listed companies, which is far below that of other comparable economies. For example, there are approximately 1,500 companies on the exchange in South Korea.

The closely held nature of many of Mexico's public companies has led to several instances of corporate fraud. Jonathan Davis, President of Mexico's National Banking and Securities Commission, disclosed that 80 of the approximately 150 currently listed companies are being investigated for irregular operations. The most notable investigation involves TV Azteca, a Mexican television network established in 1933 with shares trading on both the New York



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Stock Exchange and the Mexican Stock Exchange. On January 5, 2005, the U.S. Securities and Exchange Commission accused a TV Azteca executive, Salinas Pliego, of having profited \$109 million dollars from a transaction among Unefon SA (TV Azteca's phone unit), Nortel Networks Corp. and Codisco. The SEC's complaint alleges that in 2003, Mr. Pliego purchased, at a discount, debt that Unefon SA owed to Nortel Networks Corp. Three months later, Pliego received full repayment of the debt from Unefon SA which resulted in a profit of \$109 million. TV Azteca failed to disclose this related party transaction, as required by the Securities Act of 1934. The Mexican Banking and Securities Commission also imposed financial penalties equal to approximately U.S. \$2.3 million, a portion of which the Mexican Banking and Securities Commission intends to impose upon TV Azteca. TV Azteca has since (i) established a new audit committee which will consist of three independent directors, (ii) dissolved its Related Party Transactions Committee and (iii) adopted a Code of Ethics covering all directors, officers and employees.

## The Current Regime.

Currently, Mexico's corporate governance standards are based on the *Circular Unica-Anexo J* issued by the *Comisión Nacional Bancaria y de Valores* (the Mexican Banking and Securities Commission) and under the regulations of the *Ley del Mercado de Valores* (Mexican Securities Market Law). Most public companies in Mexico also voluntarily adhere to the *Código de Mejores Prácticas Corporativas* (Mexican Code of Best Corporate Practices), which was developed by a group of leading Mexican business people and is supported by the Mexican Stock Exchange. Circular 11-29, issued under the Mexican Banking and Securities Law in 1999, requires that in a public offering of a Company's securities the issuer must disclose its level of compliance with the Mexico Code of Best Corporate Practices. Listed companies are also required to disclose, on an annual basis, the extent of their adherence to the Code of Best Corporate Practices.

Under the current Mexican Securities Law:

The board must be comprised of

between 5 and 20 members.

Independent directors must comprise at least 25% of the board (companies are not required to make determination as to the independence of its directors).

Companies are not required to have a corporate governance committee, nominating committee or a compensation committee.

The audit committee must provide an opinion regarding any transaction with a related party that is outside of the ordinary course.

No requirement exists to provide proxy materials for meetings of shareholders.

Shareholder approval is not required for the adoption or amendment of an equity compensation plan.

There is no requirement that independent directors meet regularly in executive sessions at which only independent directors are present.

The Code of Best Corporate Practices calls for a minimum number of outside directors, requirements for information disclosure, the strategic function of the board, and the separation of the CEO position from the board chairmanship. The following is a compilation of the more significant Mexican corporate governance standards as proposed under the Code:

The board should be comprised of between 5 and 15 members.

Independent directors shall comprise of at least 20% of the board.

Independent and patrimonial directors (directors with significant stock ownership in the company) should represent 40% of the board.

The annual report must set forth independent directors and patrimonial directors and a brief resume for each.

A company's board of directors must meet four times a year.

Board members must attend at least 70% of the board meetings.

Generally, under the Mexican Securities Market Law, a director is not independent if such director (i) is an employee or officer of the company; (ii) is a shareholder that has influence over the company or (iii) is a person that has a significant direct or indirect relationship with the company.

According to the Code of Best Corporate Practices, inside directors include company executives, shareholders with managerial responsibilities in the company, advisors or consultants to the company, customers, suppliers, creditors, or debtors of the company, representatives of non-profit organizations that receive significant donations from the firm, and blood relatives of any of the above. Especially crucial is that, as it stands, this definition does not include individuals married to members of the controlling family or the ties of *compadrazgo*. *Compadrazgo* refers to the relation between the parents and godparents of a child and is a relationship of great significance in Mexico. Because of their informal nature, it is extremely difficult to ascertain relations of *compadrazgo*. A review of the publicly available information on the 90 largest companies in Mexico revealed that 53% of directors are top executives of a corporation or relatives

of such executives.

## Proposed Stock Market Law.

On March 30, 2005, Mexican President Vicente Fox's administration submitted to the Mexican Senate a comprehensive bill to regulate the stock market. Mexican officials expect that passage of the bill will result in increased transparency in the operations of Mexican corporations and allow medium-sized companies to enter the market. Mexico's Finance Minister, Gil Diaz, has shared that the principle objective of the proposed Stock Market Law is to attract more capital into the country by allowing mid-sized companies access the Mexican Stock Exchange. This shift in reliance on state and family capital to a reliance on foreign and institutional capital will likely serve as the impetus to more significant changes in corporate governance in Mexico.

The law as proposed would allow for a new type of company called a *Sociedad Anonima Promotora de Inversion* (Stock Investment Promotion Company) which will be able to list shares on the Mexican Stock Exchange for a period of three years before fully complying with the current reporting obligations imposed by the Mexican Banking and Securities Commission. Mexican authorities recognize that access to the Mexican Stock Exchange, alone, will not attract foreign and institutional capital and have therefore included several corporate governance measures that must be adhered to by all public companies in Mexico. The following are a few of the corporate governance measures set forth in the proposed law:

Chief Executive Officers will have direct legal responsibility for their companies day-to-day operations and accounting records.

Shareholders owning at least 5% of the company's shares will be able to file civil suits in response to corporate actions that prejudice their interests.

Companies will have to publicly disclose financial information on all subsidiaries.

The Mexican Banking and Securities Commission will disclose investigations into corporate malfeasance prior to its findings of fact.

While the law has certainly taken its cue from Sarbanes-Oxley, it in no way measures up to the corporate governance requirements imposed by Sarbanes-Oxley, and it is clear that corporate governance in Mexico, following approval of the proposed Stock Market Law, will still have a long way to go.

Perhaps the greatest challenge facing improved corporate governance in Mexico is the tension between families that desire to retain control of their companies and their companies' needs for external financing. There is hope, however, that as foreign investors find opportunities to invest in corporations with better corporate governance practices and greater protection for their interests, Mexican companies will come under increasing pressure to continually improve their corporate governance standards and processes to comply fully with the measures advocated in the Code of Best Corporate Practices.

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