Corporate Governance of Non-Listed Companies

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Mexico's Corporate Governance Practices in Non-Listed Companies

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Leaders and Boards - Mexico

- Update of corporate governance practices in non-listed large (the first 100) companies in Mexico.

- Impact of the new Mexican Stock Exchange Law ('Nueva Ley del Mercado de Valores' or 'NLMV') approved in December of 2005, in areas of Corporate Governance for Non-Listed companies.

- Key recommendations for future advancement in Corporate Governance practices for Non-Listed companies in Mexico.

Update:

Mexico has not yet significantly advanced in applying Corporate Governance best practices at non-listed companies, being either family-owned or foreign-owned, except for those changes either recommended or required by the NLMV.

External enforcement from equity investors and from financial institutions has increased for non-public corporations (family-owned) to adopt some corporate governance best practices. In order of preference, the following 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)
- Applying high-tech control actions, like 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.

In the case of multinational corporations which do not trade in the Mexican Stock Exchange, while their parent corporations do in the New York Stock Exchange or other Corporate Governance legislated Stock Exchanges, their local board composition has not changed from what was presented in our previous report (See OECD 2006 publication, "Corporate Governance of Non-Listed Companies in Emerging Markets,"Chapter 14, "Mexico: Corporate Governance Practices," by Sam Podolsky). The need for compliance at their home-based Stock Exchange is mainly reflected in other areas, such as auditing, information technology, internal controls, and risk assessment.

Impact of the new late 2005 Mexican Stock Exchange Law:

On December 28, 2005, the 'New Mexican Stock Exchange Law' (Nueva Ley del Mercado de Valores de México, or NLMV) was approved by the Federal Congress. Even though it appeared to be a legal framework for listed companies in Mexico, this new law is also a legal framework for non-listed companies willing to adopt some of the best practices of corporate governance. This new law is to become effective 6 months after its publication. That means that as of June 28 2006, every corporation that trades in the Mexican Stock Exchange Market, or that is interested in taking advantage of the new law, has to fully comply with its rules.

Why would a new securities law be interested in covering issues related to corporate governance for non-listed corporations? In the case of Mexico, the new law aims to foster the entrance of medium-size companies to the securities market. Among other objectives, it regulates the way a non-listed company can be subject to public outside investments for growth without necessarily being an active trader in the Stock Market, up to the moment when a company decides to begin trading in the open public stock market.

Specifically, this New Mexican Stock Exchange Law (NLMV) creates 3 new kinds of corporations (today's corporations can request converting into any of the three; i.e. they do not have to create a new corporation):

- The 'Sociedad Anónima Promotora de Inversión' or 'SAPI'
- The 'Sociedad Anónima Promotora de Inversión Bursátil' or 'SAPI**B', and**
- The 'Sociedad Anónima Bursátil' or 'SA**B'**

The SAPI means: the 'Limited liability Corporation that promotes private equity'. It is a non-listed company, which, if it does comply with the requirements established by this new law, can be a formal and much more trusted target for additional equity coming from sources independent to their founders and or controlling groups.

The law that governs corporations in general in Mexico is the 'Corporate Mercantile Law' or 'Ley General de Sociedades Mercantiles' ('LGSM') which is more than half a century old, and it does not specifically differentiate those companies interested in reaching the public financial market through equity.

The SAPIB means: the 'Limited Liability Corporation that promotes equity through public trading'. Companies in this category will have evolved beyond the SAPI when they decide to register their stock at the National Securities Registry and trade in the public stock market. When a SAPI becomes a SAPIB, it must commit to comply with all the requirements of the third type of corporation (the SAB) within a period of up to three years. The SAPIB is the bridge from a medium-size corporation privately traded, to a publicly held corporation.

The SAB means: the 'Limited Liability Corporation Publicly Traded'. In reality it is the new form that every company that trades in the Mexican Stock Market must follow. Those that are today being traded are being 'converted' into SABs to be able to continue trading in the Mexican Stock Exchange Market.

Why is this law so important to Corporate Governance in Mexico? Because it makes an obligation to comply with very key issues of corporate governance practices, depending on the type of corporation being created. The new law enforces Corporate Governance for SAPIs even though they are not publicly traded! And it finally makes a legal obligation for publicly held corporations to comply with modern practices of corporate governance (it is not voluntary anymore!). This new move by the Government of Mexico, and acceptance by the private sector, represents a major advance in corporate governance in Mexico.

The benefits that the new law brings to the legal framework and operations of non-listed corporations in Mexico interested in obtaining private equity investment either from individuals, corporations or institutional investors are, among many, the following:

- The obligation to have a formal Board of Directors (for management and not for legal reasons).

- The freedom to choose to have an Audit Committee, as a way of applying Corporate Governance practices at the Board level. instead of the old figure of the 'Comisario' (a non-voting-member of the Board, responsible to the stockholders for his/her opinion on the accuracy of the financial statements of the corporation).
- It is voluntary at the shareholders level to formally adopt either **fully** the best practices of corporate governance demanded for publicly held companies or to continue operating as before, under the old 'LGSM' law with a 'Comisario' and with no Board Committees. Fully means that there would be no difference between publicly held companies and SAPIs, except for the fact that SAPIs are not required at any moment in time to have independent board members.
- In any case, even if they decide not to adopt Corporate Governance practices, the new law ('NLMV') clearly presents new descriptions of Board functions and responsibilities, different from those of the old law. A SAPI most comply with these obligations, independently of their adoption of corporate governance practices. These remarkable and positive steps to protect minority investors include the following:
    - With only 10% stock ownership or representation, a Board member can be nominated.
    - With 15% stock ownership or representation, civil law action can be requested against the Board or any of the members of Management, including against the 'Comisario' (if applicable).
    - With 20% stock ownership or representation, a shareholder can oppose judicially any Board resolution.
    - To repurchase stock and keep it, either at the treasury level, or to resell it. Unusually so, the law allows this act to be decided by the Board and does not have to be approved by the shareholders assembly.
    - Financial statements must be audited by an external professional or firm.
    - The legal authorization to diverge from the old law, in order to have very specific rules with respect to:
        - Establishing restrictions and/or rules for the transmission of ownership of stock, including who can or cannot be a stock-owner.
        - Excluding certain types or kinds of shareholders.
        - Issuing non-voting, or restricted-voting shares.
        - Convening among stockholders not to establish or to own competing corporations.
        - Tender offer rules.
        - And many others, which intend to foster the creation and evolution of non-listed corporations at competitive legal key issues that non-listed corporations in developed countries do have.

        (Note: These rules have to be part of the corporation statutes to be enforceable)

With this new legal alternative to 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 be able to even establish rules to secure their equity.

As mentioned at the beginning of this paper, for the SAPIBs and the SABs, tremendous advances came about from the obligation to fully comply with corporate governance practices, In particular, concepts such as 'duty of diligence', 'duty of loyalty', and 'duty of care' are now part of the Mexican exchange trading law.

It is not the intention of this advance report to cover in detail such major changes, which can also be definitely improved. We should cover such issues through a different and specific report.

Key recommendations for future advancement in Corporate Governance practices for Non-Listed companies in Mexico:

Mexico is placing a very active attention to the support and promotion of what is known as a 'PYME' ('**P**equeña **y** **M**ediana **E**mpresa' = 'Small to Mid Size Company'). PYMEs employ more than 60% of Mexico's active population. 'Nafinsa', a government owned financial institution to promote growth, has within the last 5 years developed new and innovative 'second floor' financial mechanisms to endorse credit of high risk given by the 'first floor' financial system to these corporations.

It is strongly recommended to formally develop a continuous effort to promote the benefits of corporate governance as a managerial tool for improved performance, risk assessment, global competitiveness, and business continuity, through Mexican authorities and financial institutions.

Family businesses are strongly linked to family values and traditions, to family successes or failures, to social recognition, to family wealth creation, and to apparent assurance of future continuity as a family income provider. As time goes by, it is still not recognized that family owned corporations must be institutionalized for continuous growth and value creation. Unfortunately, a recent (2005) study made by the Mexican Institute of Competitiveness ('IMCO') could not yet find a direct and clear correlation between Mexican companies using some kind of formal corporate governance best practices, and performance. Board members and top management have yet to fully adopt the tremendous responsibilities acquired when the best corporate governance practices are well understood and performed at its best.

Apparently, ninety percent or more of family businesses globally have not been able to succeed for more than 3 generations. Succession planning, the importance of a board composed of non family (if possible) independent members, the advantages of assessing and diminishing risk through use of an Audit Committee, transparency at least to all family members, and many more of the traditional best practices should be made known through a global effort, as part of the future successful evolution of family businesses. Mexico could very well take the lead.

The IFC, by applying what they call CG tools (Corporate Governance Tools), by having invested in developing their 'Progression Matrixes', in analyzing and implementing corporate governance best practices in those companies where they either invest or finance, is a magnificent example of the value added by a third interested party. This approach supports an ongoing improvement in governance, and could very well be used or adapted in part formally with Nafinsa and other financial institutions in Mexico.

In conclusion, corporate governance for non-listed companies is to be taught and/or gradually be adapted and adopted, and Mexico should strongly consider assigning this crucial task to a Government institution or to an independent organization funded by the Government and probably by third party institutional investors.

As for trends in transparency and/or disclosure for non-listed companies in Mexico, due to the fact that here is a much more active relationship between the Federal Government and its corporate suppliers, advances have been made. It is transparent to find through Internet the financial statements of those corporations that have been granted a contract or have been named

Government suppliers. It is not a trend, but at least it brings about financial transparency to those who feel like digging in Internet to find out more about certain non-listed corporations. The major cultural change in this instance is that, for the first time, they are obligated to supply their financial information to a third party.

In Conclusion:

Within the last 15 months, Mexico has advanced poorly with respect to applying corporate governance best practices at non-listed corporations, independently of their size. The NLMV law to be enforced by June 28, 2006, could represent a very important beginning in this complex arena.

Government, financial institutions, institutional investors, private and public universities and colleges, and credit rating providers need to be convinced to demand an ongoing improvement in the adaptation and/or implementation of corporate governance practices at non-listed companies, so they can adequately respond to their future succession planning needs, to properly involve other family shareholders who are not active in the family business, to attract and sustain professional managers and to make them much more interested in developing a long term commitment, and to attract private equity investors and financial institutions willing to support their growth at much lower costs and for longer periods of time than if no governance were applied at all.

The OECD can very well continue with a concrete effort towards this end on a global basis.