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Related Party Transactions, Co-Investment Practices, Conflicts of Interest and Minority Protection. Mexican Legal Framework

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I. Introduction.

In the last few years, the Mexican press has reported several transactions involving Mexican listed companies, which have involved the advancement of the interests of the controlling shareholders thereof to the detriment of their minority shareholders. Such transactions have highlighted the need to assess the protections and remedies afforded by Mexican laws to minority shareholders of Mexican listed companies as well as the necessity of amending the current legal framework to improve the position of minority shareholders of Mexican listed companies in such circumstances. Such concerns form a part of the issues that the new Mexican Presidential administration (which took office on December 1, 2000) intends to address by means of an initiative to be submitted to the Mexican Congress for the amendment of Mexican financial legislation[1]

The aforementioned need to assess and adjust the Mexican legal framework has also been prompted by several high profile transactions that have evidenced that the Mexican legal framework in respect of particular topics is not in line with international business and legal trends to which Mexico is increasingly exposed. For instance, the receipt by the board of directors of a Mexican listed company of two competing merger proposals highlighted the fact that the Mexican legal framework could be adjusted to clarify the duties of the boards of directors of Mexican listed companies and to regulate mechanisms to protect the interests of shareholders in such situations (such as, for example, fairness opinions).

The current Mexican legal regime of protection of minority shareholders of Mexican listed companies against the abuse of the controlling majority is not a comprehensive body of law that was created at one time to address the issue and we are not aware of any binding judicial precedent that has aided to the development of legal theories with practical significance. On the contrary, the system is based on the General Law of Commercial Companies (Ley General de Sociedades Mercantiles, the "Law of Corporations") which was enacted in 1943 (which has suffered no significant amendments in connection with the topic of this paper since its enactment) and the Law of the Securities Market (Ley del Mercado de Valores; the "Law of the Securities Market" which essentially addresses insider trading. The most significant steps taken in respect of protection of shareholders of Mexican public companies in this connection is in the area of disclosure, by means

1 Proposal for the "New Public Treasury" (Nueva Hacienda Pública) made by the Mexican Ministry of Finance and Public Credit on March 13, 2001.

of the issuance by the Mexican National Banking and Securities Commission (Comisión Nacional Bancaria y de Valores, the "CNBV") of several circulars relating to the improvement of (i) the quality and timeliness of disclosure in selling materials of securities, (ii) periodic disclosure requirements of listed companies and (iii) disclosure of relevant corporate events. The above has had as a consequence that even though that, on the one hand, from a disclosure perspective, minority shareholders of Mexican listed companies seem to be in a substantially better position, on the other hand, in respect of rights and remedies in the event of abusive behavior by insiders, minority shareholders of Mexican public companies are in a weak position.

A very important element that was introduced to the Mexican market is the Code of Best Corporate Practices (Código de Mejores Prácticas Corporativas; the "Code") which was prepared by the Coordinating Business Council and which was incorporated to Circular 11-29 of the CNBV effective as of January 1, 2000. Even though such Code is not mandatory, the CNBV requires issuers to report their level of adhesion thereto on a periodic basis and it has therefore has gradually become an instrument to publicize principles contained in the Code. Also, it could become a very valuable tool and parameter for probable future amendments to Mexican financial laws in respect of the protection of minority shareholders.

The focus of this paper is the analysis of director's duties and liabilities and on disclosure since current Mexican law does not afford any significant practical protection to minority shareholders of Mexican listed companies by means of veto rights or tender offer rights in the event of major corporate events (except in the case of delisting where there is a statutory obligation of the majority to offer to purchase the shares of the minority in accordance with certain rules). It is true that the approval of certain major corporate events requires a higher quorum than ordinary matters but, in practice, the quorum is not high enough to provide a significant opportunity to minority public shareholders to oppose corporate action that is detrimental to the minority.

The purpose of this paper is the critical description, in an orderly fashion, of the current legal framework that is relevant to the protections and remedies available to minority shareholders of Mexican listed companies in instances of abuse by controlling shareholders and management (such as in the case of related party transactions, co-investments and conflicts of interest). The analysis of such issues has been divided in two general areas: (i) statutory controls to insider power and (ii) disclosure requirements.

The initial analysis of the Mexican legal framework will not be made taking as a topical basis “Related Party Transactions”, “Co-Investment Practices” and “Conflicts of Interest” since they all have as a common denominator the abuse of the controlling shareholder or of management to the detriment of minority shareholders and since such topics are not specifically addressed by Mexican laws, except in the case of conflicts of interest.

II. Mexican statutory controls of abuse by insiders of Mexican listed companies.

In this section, we will describe the different mechanisms afforded by Mexican law to regulate and prevent abuse by members of the board of directors of Mexican commercial companies. The analysis will begin with the Law of Corporations since it is the general law that contains the basic principles applicable to the duties and liability of members of the board of directors of Mexican companies and which is applicable generally both to public and non-public Mexican companies. Thereafter, the more specific statutes will be analyzed together with the principles contained in the Code.

A. Regulation of Directors.

1. General Law of Commercial Companies.

The Law of Corporations was enacted in 1934 and regulates the four principal types of commercial companies that can be incorporated in Mexico.2 The most common type of commercial company used in Mexico is the sociedad anónima with the added feature of variable capital (capital variable). The principal characteristic of sociedades anónimas is the limited liability of the stockholders up to the value of the equity contributions made thereby. Variable capital is a feature that allows flexibility for the increase and decrease of the capital during the life of the company. Also, sociedades anónimas are the only type of commercial companies that are publicly traded in the Mexican market.

In light of the foregoing and of the fact that the Law of Corporations applies both to private and public companies, the analysis of the duties, liability and accountability of directors of Mexican companies will be based principally upon that provided in Section Third of Chapter V of the Law of Corporations which regulates management of sociedades anónimas, as well as upon that provided in the Law of the Securities Market, which as described below, contains very limited provisions dealing with director's liability. Any references to company or companies in this paper shall be understood to mean a reference to a sociedad anónima.

2 Such four types are the sociedad anónima, the sociedad en nombre colectivo, the sociedad en comandita simple and the sociedad de responsabilidad limitada.

The principal rules applicable to directors contemplated by the Law of Corporations are the following:

(a) Directors are appointed by shareholders and they are defined as "temporary and revocable attorneys-in-fact (mandatarios), who can be partners or persons strange to the company"3. The board of directors of a company is the corporate body thereof entrusted with the "administration" of the company and is subject to the corporate body of highest hierarchy under Mexican law, which is the shareholders' meeting (it has the "supreme authority of the company")4. The Law of Corporations establishes that shareholders of non-public companies that own 25% of the outstanding capital stock of a company have the statutory right to designate a director and, in the case of public companies, such right is afforded to shareholders that own 10% of the outstanding capital stock5.

(b) The concept of "administration" is not defined in the Law of Corporations but is understood not as day-to-day management but rather as the supervision of the day-to-day management of a company. The Law of Corporations does not contain a list of the duties and authority of directors and of the board of directors nor does it enunciate a "duty" attributable to board members. In practice, the articles of incorporation and by-laws (estatutos sociales) of Mexican companies contain a provision that establishes that the board of directors will, in effect, have the broadest authority possible. Only in the context of joint venture companies, the specific authority of the board is delineated so that it is clear which decisions require the joint vote of the partners. It should be noted that the CNBV generally does not allow for the estatutos sociales of Mexican listed companies to contain special attendance or voting quorums or other features typical of joint venture companies.

(c) The position of a director is "intuitu personae" which means that it is a personal position and therefore cannot be delegated or entrusted to another person (except for alternate directors who attend meetings in the absence of regular directors). For such reason a director cannot appoint a proxy holder or attorney-in-fact to represent him or her in meetings of the board of directors of a company. In this connection, it is important to note that individual directors do not

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3 Article 142 of the Law of Corporations.
4 Article 178 of the Law of Corporations.
5 Article 144 of the Law of Corporations.

have authority to represent the company. As mentioned above, the board of directors is a corporate body, which usually has broad powers, which it may delegate to individuals.

(d) In respect of the liability of directors, the basic principle is that directors are liable to the company and not to anyone else. Article 157 of the Law of Corporations establishes that "administrators shall have the responsibility inherent to their mandate (mandato) and that derived from the obligations imposed by the law and the estatutos sociales." This provision has not been interpreted by Mexican courts and essentially refers to other legal provisions and to the contents of the estatutos sociales of a particular company. As it is the case with the provision referred to in paragraph (a) above, this provision also uses the term "mandato" which in accordance with Mexican Federal Civil Code (Código Civil Federal; the "Civil Code") is a contract whereby a person that receives the mandate (mandatario) agrees to execute on account of the grantor (mandante) the legal acts entrusted thereto by the latter6 (a mandato is equivalent to a power-of-attorney in other jurisdictions such as the U.S.). Based upon the application of the Mexican legal regime of the mandato to directors of Mexican companies (in their capacity as mandatarios of the company), it is often said that the "standard of care" to which directors of Mexican companies are subject is that they should "act prudently, caring for the business as if it were his own".7

(e) Article 158 of the Law of Corporations establishes the matters in respect of which directors are, as a matter of law, jointly and severally liable to the company (bearing in mind that the estatutos sociales of a company could expand those matters):

(i) The existence of equity contributions of shareholders;

(ii) compliance with the requirements established by law and by the estatutos sociales of the company with respect to the payment of dividends;

(iii) the existence and maintenance of systems of accounting, control, registration, filing and information required by law; and

(iv) exact compliance with resolutions adopted by shareholders' meetings.

6 Article 2546 of the Federal Civil Code.
7 See Article 2563, in fine, of the Civil Code.

Article 160 of the Law of Corporations establishes also that directors are jointly and severally liable to the company with those directors whom they replace in respect of the irregularities committed by them, only if the new director is aware of any such irregularities and does not denounce them to the statutory auditors (comisarios) of the company.

Also, article 159 of the Law of Corporations establishes that a director who, being blameless, expresses his or her opposition when the corresponding matter is deliberated and resolved upon, will not be subject to liability.

(f) In respect of the procedures that are required to be followed to be in a position to claim judicially liability from directors of Mexican companies, the basic principle is that such liability may only be claimed by resolution of the shareholders' meeting (which will designate a person to exercise the respective action in the courts) and that any monies recovered from any such action are for the exclusive benefit of the company. Directors who are accused by resolution of a shareholders' meeting shall immediately cease to perform their duties and they may re-assume their position if a court dismisses any such claim for liability.

As an exception to the above, article 163 of the Law of Corporations allows shareholders that represent at least 33% of the outstanding capital stock of a company to directly exercise actions claiming civil liability of directors but only as long as the following requirements are satisfied: (i) the complaint shall include the total amount of the liabilities in favor of the company and not only the personal interest of the plaintiffs, (ii) the plaintiffs shall have not approved the resolution adopted by the general shareholders' meeting that resolved not to proceed against the directors being sued and (iii) any goods obtained as a result of the claim shall be perceived by the company.

An unbinding judicial decision rendered by a Mexican federal court in 19968 confirmed the general principles mentioned above and elaborated somewhat on the rationale thereof in the following terms:

- "…The reason that the general assembly is the one legitimated to determine the exercise of the action of responsibility lies in the convenience that managers named by the assembly find therein the Judge of their own responsibility. This has as a basis the social nature of the pretension, since its exercise has as a primordial objective to complete or make-whole

8 S.J.F., IV, 9ª, 590 (1996)

the patrimony of the company, that was affected or diminished by the bad, deficient or negligent management of the manager; also, such action is of a social character because the damage does not affect the individual patrimony of the shareholders in a direct and immediate manner, but as a result of the damage caused to the patrimony of the company…"

- "…Therefore it is excluded that the action of responsibility against managers may be followed by the individual partner, which also avoids the exercise of the action for vengeful purposes, since otherwise even the most unquestionable managers could be subject to the perverse interests of each partner in particular".

2. The Law of the Securities Market.

The Law of the Securities Market and the circulars issued by the CNBV thereunder contain very few provisions dealing with the duties, liability and accountability of directors of Mexican companies except for the provisions therewith dealing with insider trading which will be addressed in the chapter hereof regarding conflicts of interest.. Circular 11-29 of the Securities Commission adopted the Code of Best Corporate Practices, which is not mandatory and will also be addressed in a separate chapter due to its importance and the possibility that it will constitute the parameter for future amendments to the Law of the Securities Market.

The principal provisions of the Law of the Securities Market and the circulars issued by the CNBV thereunder relating to directors are the following:

(a) Article 14 bis, section III of the Law of the Securities Market essentially extends to limited voting shares of Mexican companies the statutory right contemplated by the Law of Corporations, consisting in that holders of limited voting shares that represent 10% of the capital stock of the issuer thereof shall have the right to designate at least one director and its respective alternate. Such provision establishes that if such minority does not designate the director it is entitled to, the holders of all the class of limited voting shares shall have the right to designate two directors and their corresponding alternates by means of a special meeting of shareholders of such class of shares.

(b) Circular 11-28 of the CNBV imposes on the president of the board of directors of a listed company the obligation to disclose material information, that may affect the price of such company's stock; failure to so disclose may result in fines and criminal liability. Such circular will be described in detail subsequently.

(c) Circular 11-14 of the CNBV requires the board of directors of Mexican listed companies that are holding companies to approve (with the prior consent of ordinary shareholders' meeting), among other things, (i) the acquisition or sale of shares of companies that have a value that exceeds twenty percent (20%) of the net worth of the Mexican listed holding company, (ii) the sale of a controlling stake in a company engaged in the same activities as the Mexican listed holding company and (iii) the exercise of withdrawal rights in respect of shares of companies with variable capital, if the value of the resulting reimbursement exceeds twenty percent (20%) of the net worth value of the Mexican listed holding company. The board of directors of a listed company does not require the prior approval of shareholders' meeting but is required to approve (y) the acquisition of equity interests in other companies, if such other companies are engaged in the same activities as the company, and (z) the manner in which shares of subsidiaries are to be voted.

(d) In accordance with Article 14 bis of the Law of the Securities Market, the board of directors of a listed company must approve the repurchase of shares of a listed company (for which purpose, other requirements must be satisfied). In accordance with Article 51, Section II, last paragraph, of the Law of the Securities Market, if a Mexican listed company buys its own shares in violation of the rules established by the Law of the Securities Market, the Securities Commission may impose a fine on the directors of any such company that are responsible of such violation for an amount equal to the amount of the corresponding transaction. Such article also provides that fines may be imposed on companies that contravene the Law of the Securities Market, as well as on board members, officers, employees or attorneys-in-fact thereof, which are responsible of any such violation.

(e) Article 52 bis-2, Section I, of the Securities Market Law specifies that directors may be subject to fines and imprisonment if, knowingly, through the disclosure of false information to the public relating to the relevant listed company, in prospectuses or by any other means, such directors obtain an undue profit or avoid a loss, by selling and/or buying securities. Such provision establishes the following:

"Art. 52 bis 2.- The members of the board of directors, directors, officers and employees of issuers of securities, credit instruments or documents referred to in article 3 of this law, shall be sanctioned with imprisonment of six months to five years, and fines from two to three times the benefit obtained or the loss avoided:

I. If, with knowledge, in prospectuses of information to the public or by any other means, through the divulgation of false information related to the issuer company to which they are related, obtain an undue profit or avoid a loss, directly or through another person, through the acquisition and/or sale of the securities, credit instruments or documents referred to in the first paragraph of this article, which are issued by the same company…"

3. Other Statutory Provisions.

(a) Mexican Federal Fiscal Code.

The general principle is that directors have no personal liability to Mexican tax authorities unless they personally participate in a violation of tax laws. As an exception to such principle, Article 26, section III of the Mexican Federal Fiscal Code (Código Fiscal de la Federación), provides that directors may be jointly and severally liable with the company to the tax authorities for the following omissions:

(i) Failure of the company to register as a taxpayer;

(ii) Failure to advise the tax authorities of a change of domicile of the company in certain cases; and

(iv) Failure to keep accounting records or hiding or destruction of accounting records.

(b) Directors of Mexican Broker-Dealers (Casas de Bolsa).

To be a director of a casa de bolsa, among other requirements, such director shall have not been convicted from an intentional crime, that resulted in imprisonment for a period exceeding one (1) year.

The board of directors of a casa de bolsa must approve, on a monthly basis, the financial statements that are submitted to the CNBV, pursuant to Article 26 bis-4 of the Law of the Securities Market. Directors are responsible for financial statements published quarterly by a casa de bolsa.

Circular 10-231 of the CNBV sets forth that, in connection with derivative transactions, the board of directors shall expressly approve: (i)(x) the general goals and procedures for transactions with clients and other casas de bolsa, (y) maximum credit, market and other risk levels and (z) procedures for the approval of new products, and (ii) the establishment of a unit for monitoring risk.

Article 52 bis-1 of the Law of the Securities Market Law sets forth that a member of the Board of Directors of a casa de bolsa may be subject to fines and imprisonment, if such director (i) knowingly omits to record in the casa de bolsa's books and records, transactions undertaken thereby or alters or permits the alteration of records as a means to alter or hide the true and accurate nature of transactions (and, as a result, assets, liabilities, memoranda accounts or results of operations of the casa de bolsa are affected) and (ii) intentionally records or causes the recordation of false statements, in information to be provided to the CNBV.

On March 10, 1997, rules relating to procedures for detecting and disclosing money laundering activities were published by the Ministry of Finance and Public Credit (the "Ministry of Finance"). Thereunder, casas de bolsa are obligated to produce a manual for the detection and disclosure of possible money laundering activities. Rule Twelve thereof specifies that members of the board of directors of a casa de bolsa must maintain confidential any reports provided to authorities, in respect of money laundering activities; directors breaching such provision may be subject to fines.

(c) Directors of Mexican Banks.

To be a director of a Mexican banking institution, among other requirements, the relevant director shall have not been convicted from a crime of a monetary nature.

Under Article 101 of the Law of Credit Institutions and Circular 1181 of the CNBV, the board of directors of a bank must approve, on a monthly basis, the financial statements that are

submitted to the CNBV. Directors are responsible for financial statements published quarterly by a bank.

Article 73 of the Law of Credit Institutions specifies that the majority of the directors elected by the shareholders of a bank, must approve transactions where, among others, the following persons may become indebted to such bank (except for transactions for a *de minimis* amount): (i) individuals or corporations owning one percent (1%) or more of the capital stock of such bank or its financial services holding company, (ii) directors or alternate directors of the bank, (iii) spouses or close relatives of the persons specified in (i) and (ii) above, and (iv) other related parties. Transactions approved by the board of directors pursuant to the aforementioned provision, must be reported to the CNBV.

Article 75 of the Law of Credit Institutions requires that equity investments made by a bank exceeding five percent (5%) and up to fifteen percent (15%) of the capital stock of a corporation, for a period not exceeding three (3) years, be approved by the majority of the directors elected by the shareholders. Investments exceeding those percentages or such period must be approved by the Ministry of Finance.

Although applicable rules do not set forth a specific role that must be played by the Board of Directors of a bank in respect of capital adequacy requirements and reserves, the CNBV has typically required that the relevant figures are reviewed and approved by such board of directors on a quarterly basis.

Circular 2019/95 of Banco de Mexico specifies that banks that shall be authorized to engage in derivative transactions, are required to have their board of directors expressly approve: (i)(x) the general goals and procedures for transactions with clients and other financial institutions, (y) maximum credit, market and other risk levels and (z) procedures for the approval of new products, (ii) the establishment of a unit for monitoring risk, (iii) an ethics manual, that regulates actions of personnel and (iv) periodically, reports disclosing the risks to the bank.

On March 10, 1997, rules relating to procedures for detecting and disclosing money laundering activities were published by the Ministry. Thereunder, banks are obligated to produce a manual for the detection and disclosure of possible money laundering activities. Rule Twelve thereof specifies that members of the board of directors of a bank must maintain confidential any

reports provided to authorities, in respect of money laundering activities; directors breaching such provision may be subject to fines.

(d) Directors of Mexican Financial Groups.

To be a director of a financial services holding company, among others, the requirements set forth above in respect of directors of banks must be satisfied. The Financial Groups Law does not include any provisions worth noting in connection with directors' liability.

3. Code of Best Corporate Practices.

Under the initiative of the Consejo Coordinador Empresarial, A.C., an important Mexican businessmen council, the Code of Best Corporate Practices (Código de Mejores Prácticas Corporativas; the "Code") was recently approved. It specifies various desirable (although not mandatory) corporate practices, applicable to Mexican companies. The Code is now part of Circular 11-29 of the CNBV and has been recommended by the CNBV for companies the shares of which are registered in the National Registry of Securities and Intermediaries maintained by the CNBV. Attached hereto please find, as Exhibit "A", an English translation of the Code.

Even though the Code, as stated before, is not mandatory, it is possible that its provisions will be adopted by an increasing number of companies and that its principles will constitute the basis for future amendments to Mexican securities laws.

We will not restate the principles contained in the Code since the English translation to the entire Code is attached hereto. However, it is important to note that the Code in various parts thereof and in particular Section I.5 establishes very specifically the duties of board members and recommends that board members be adequately briefed of their duties and liabilities.

Another significant point of the Code is the introduction of the concept of "independent" and "patrimonial" directors, which are defined with precision in the Code. In practices, Mexican public companies do include "independent" directors in their Board of Directors but they seldom are truly "independent" as such term is defined in the Code.

Many of the recommendations included in the Code constitute basic principles that are not stated in any of the applicable Mexican laws and which are fundamental to create a culture of accountability and a sense of duty of directors of Mexican public companies vis á vis investors and not only vis á vis controlling shareholders.

B. Conflicts of Interest.

The only provision of the Law of Corporations that addresses conflicts of interest of directors is Article 156 thereof which provides:

> "The administrator that in any operation has an interest opposed to that of the company, shall manifest it to the remaining administrators and shall abstain from any deliberation and resolution. The administrator that contravenes this provision shall be responsible for the damages and losses that are caused to the company."

This provision restates the principle that has been discussed before consisting in that in accordance with Mexican law, directors have what can be described as a duty of loyalty to the company and not to shareholders (since any moneys recovered are for the benefit of the company). For such reason, the author Roberto Mantilla Molina has stated that "the minority therefore becomes a true corporate body, since its action will result in advantages for the collectivity"9

The Law of Corporations does not contain a definition of what constitutes an "interest opposed to that of the corporation" and we are not aware of any binding judicial precedents that shed light in connection with a concept thereof; on the contrary, the approach of Mexican courts seems to have been entirely factual.

Section I.5 of the Code of Best Corporate Practices (a translation into English of which is attached hereto as Exhibit "A"), clarifies the contents of Article 156 of the Law of Corporations since not only an "interest opposed to that of the corporation" is required to be disclosed but "any situation that may derive in a conflict of interest" which would clearly capture potential conflicts of interest.

9 Roberto L. Mantilla Molina, Derecho Mercantil, Editorial Porrúa, 29th Edition (1993) p.429.

Article 30 of the Code of Professional Ethics (Código de Ética Profesional)10 of the Mexican Bar Association (Barra Mexicana, Colegio de Abogados) establishes that a conflict of interest exists when a person has an interest in a transaction or is related to the parties therewith or is subject to influences adverse to the interests of the transaction.

The principal conflict of interest practice that is regulated by the Law of the Securities Market is insider trading. The Law of the Securities Market defines the statutory concept of privileged information and specifies the persons that are deemed to have access to privileged information by reason of their relationship with an issuer.

The Securities Market Law, in its Article 16 bis, defines the concept of "privileged information" as follows:

> "Art. 16 bis.- For purposes of this law, privileged information shall be considered as the knowledge of acts, facts or situations that may have an influence in market prices of securities that are traded in the securities market, while such information has not been made public…".

Such provision also contemplates the prohibition for trading of all persons having access to privileged information in the following terms:

> "…Persons that have privileged information, shall abstain from trading for their own or third parties benefit, with any security the price of which may be influenced by such information, while the information maintains such character".

Article 16 bis 1 of the Law of the Securities Market lists the persons who are deemed to have access to privileged information as a result of the nature of their relationship with issuers of listed securities:

> "Article 16 bis 1.- For purposes of this law, the following shall be deemed to have access to privileged information of the corresponding issuer:

10 Barra Mexicana, Colegio de Abogados, Código de Ética Profesional, México, D.F. (1957), p.8.

I. The members of the board of directors, directors, officers, managers, external auditors, statutory auditors (comisarios) and secretaries of collective corporate bodies of corporations that have securities registered with the National Registry of Securities and Intermediaries;

II. Shareholders of the referenced corporations that control 10% or more of the shares representing their capital stock;

III. Members of the board of directors, directors, officers and managers of corporations that control 10% or more of the capital stock of the corporations referenced in the foregoing section;

IV. Independent service providers of such corporations and their advisors in general, as well as the managers of any corporation or business that has participated, advised or collaborated with an issuer, in any event that may be construed as privileged information;

V. Shareholders controlling 5% or more of the capital stock of credit institutions that maintain their securities registered with the National Registry of Securities and Intermediaries;

VI. Shareholders controlling 5% or more of the capital stock of financial holding companies or of credit institutions, as well as those controlling 10% or more of the capital stock of other financial entities, when all of them are part of the same financial group and at least one of the corporations forming part of the group, is an issuer of securities registered with the National Registry of Securities and Intermediaries, and

VII. Members of the board of directors of the holding companies and the other corporations referred to in the foregoing paragraph.

The individuals referred to in section II. of this Article, shall inform the National Securities Commission in respect of variations in the percentage of their stock participations, involving the acquisition or divestiture of stock representing ten

percent or more of the capital stock of the corresponding corporation, within the ten business days following the date of the appropriate transaction."

The Law of the Securities Market provides that insiders may not, directly or indirectly, acquire securities from the issuer in respect of which they are an insider, during a three-month period following the date on which they effected the last divestiture on any type of securities of the same issuer, and viceversa.

The CNBV is the governmental agency authorized to verify compliance with and enforce insider trading regulation. In the event that a person uses privileged information for any transaction in violation of that provided in Article 16 bis of the Law of the Securities Market, the CNBV may impose a fine in an amount of up to two times the benefit obtained from the particular transaction, plus the amount calculated as a rate on such resulting benefit equal to the average return of the ten most profitable investment funds during the six months prior to the date of the transaction.

In the event of trading during the three-month period referred to in Article 16 bis 2 of the Law of the Securities Market, the CNBV may impose a fine in an amount that may be equal to the benefit obtained. In the event that the transaction did not report a benefit, the fine may be for an amount ranging between 400 to 5,000 times the daily minimum wage for the Federal District in Mexico[11]. The CNBV has discretion to determine the amount of the fine depending upon the seriousness of the violation. If a transaction involves a breach of both Article 16 bis and 16 bis 2 of the Law of the Securities Markets, the applicable fine will be equal to the sum of both fines should they had been applied separately.

In addition to the foregoing, the Law of the Securities Market also contemplates sanctions such as imprisonment for dealing with insider information in certain instances. In this respect, Article 52 bis 2 the Law of the Securities Market provides the following:

"Art. 52 bis 2.- The members of the board of directors, directors, officers and managers of issuers of securities, credit instruments or documents referred to in article

[11] The current minimum daily salary in Mexico is equal to $40.35 (approximately US$4.00).

3 of this law, shall be sanctioned with imprisonment of two to five years, and fines from two to three times the benefit obtained or the loss avoided:

"…II That, through the use of privileged information, as defined in Article 16 bis of this law, regarding the corporation to which they are related, obtain an undue benefit or avoid a loss, directly or through a third person, through the acquisition and/or sale of securities, credit instruments or documents ... issued by the corporation, whenever there is a variation equal or greater than 10% between the purchase or sale prices in the transactions entered into by the persons referred to in the first paragraph hereof, before the privileged information is made public, and the market price of the securities, credit instruments or documents issued by the corporation with which the relationship exists.

...

The above sanctions also apply to persons with managerial functions, employments, commissions or charges in brokerage firms or other entities acting as advisors in transactions regarding the public offering of securities, credit instruments or documents, when they enter into transactions described above within the 30 business days previous to or following the date of the respective public offering".

Any action for criminal liability is required to be initiated by the Ministry of Finance with the prior opinion of the CNBV.

C. Corporate Purpose and *Ultra Vires* Action.

In respect of cases where the controlling shareholder of a Mexican public company forces the investment by the Mexican listed company in a venture which is not within the core business of the Mexican listed company, it is often asked whether the regulation of the corporate purpose provision of the estatutos sociales of Mexican companies and *ultra vires* legal theories may serve to construe a successful argument to challenge any such transaction.

The success of any such action would depend upon the contents of the corporate purpose provision of the estatutos sociales of the particular Mexican listed company; however, the general practice in Mexican companies is that their corporate purpose is drafted very broadly to allow

maximum flexibility and, therefore, *ultra vires* arguments in this context are not relevant as a remedy to minority shareholders.

II. Mexican statutory disclosure requirements.

In the field of disclosure generally, the CNBV has issued various circulars during the last four years with the objective of improving the quality and timeliness of information disclosed to investors (both in the area of prospectus disclosure as well as in the area of disclosure of material corporate events). In light of such efforts by the CNBV, the quality of disclosure in selling materials of Mexican securities in the Mexican market is dramatically better. In the area of disclosure of material corporate events to the market, even though the regulation is in place, our impression is that its enforcement has not been as active as the market would expect. The principal Mexican regulations dealing with disclosure that are relevant to the general topic of co-investments, related party transactions and conflicts of interest are Circulars 11-29 and 11-28 of the CNBV.

1. Prospectus Disclosure.

Circular 11-29 of the CNBV became effective on January 1, 1998 and it is a result of an effort by the CNBV and the Mexican securities industry to provide a comprehensive and predictable guide for the preparation of applications to the CNBV for the offering of equity and debt securities (both in Mexican and non-Mexican markets), as well as a very detailed guide of the information that is required to be disclosed in prospectuses. A fundamental new element that was introduced by such circular is the concept of "responsibility letters" of the underwriters and their counsel, which essentially commit them before the CNBV to respond for the completeness and accuracy of the information contained in prospectuses. This has changed the dynamics of transactions in the Mexican market; for instance, before the issuance of such circular, legal opinions were very rarely requested from Mexican counsel in such transactions.

The Circular specifies, through a list (included in Rule First), the documents that are required to be filed with the CNBV to obtain the registration of equity securities in the Securities Section of the National Registry of Securities and Intermediaries (which is required for their offering in Mexico). Such list constitutes a departure from prior practice because (i) it sets forth, through written provisions, requirements that were only known as a result of experience arising from negotiations and dealings with the CNBV, (ii) it specifies the forms that are to be used in connection with filings with the CNBV and (iii) it grants equal treatment to issuers (since

information required from each issuer is now identical). Although, as a general proposition, the CNBV has the right to request additional information from issuers (Rule Sixth), the guidance provided by the list is quite useful in practice, and reduces the level of uncertainty relating to filings made with the CNBV in connection with public offerings (specially when timing is critical).

Another one of the objectives of the issuance of Circular 11-29 was to try to expedite the process of review of applications by the CNBV by laying the burden of accuracy and review of corporate information and disclosure on management of the issuer, underwriters and their respective Mexican counsel. In this connection, as mentioned above, the circular contemplates the obligation of the majority of board members of issuers, certain officers as well as underwriters and their respective counsel to file a "responsibility letter" whereby each of them assumes liability of the contents of the prospectus and, in different degrees, of the information filed with the CNBV.

As a means to achieve uniformity in the information provided to investors and to provide guidance to issuers, the Circular contains an attachment that describes all of the information that is to be included in a prospectus for the issuance and placement of equity securities. The information that is required to be disclosed in connection with related party transactions is the following:

> "In this connection briefly describe such transactions that shall have been effected as of the beginning of the immediately preceding fiscal year, the amount of which exceeds 250,000 UDIS[12] and involve goods, services or tangible or intangible assets in which the issuer or its subsidiaries shall have participated or are going to participate and in which any of the following persons is involved:
>
> -Any director or officer of the Company.
>
> -Any shareholder that holds 5% or more of the voting shares of the company;
>
> -Any person that is related by blood or affinity up to the first degree, civil or by marriage, to any of the persons mentioned above.

12 UDIS are inflation-indexed units of account.

The information listed above shall not be provided when the prices of the transaction are determined based upon public bids or are established by the government.

On the other hand, mention if any Director has been an officer or is owner of more than 10% of the shares of any company or organization with which transactions shall have been effected for an amount greater than 5% of the consolidated income of the issuer during the last fiscal year. Similarly, mention if any Director, principal officer or any family member thereof, has assumed debt for an amount in excess of 250,000 UDIS with the issuer or its subsidiaries as of the beginning of the immediately preceding fiscal year, specifying the global amount of such debts and whether they were contracted at market rates. The information provided shall include the maximum balance that shall have been presented during the period through which disclosure is being made, the balance as of the most recent date, the nature of the loan and the interest rate thereof.

In case any of the experts or advisors that participate in the transaction is the owner of a significant portion of the shares of the company or its subsidiaries or has a direct or indirect economic interest that depends upon the success of the placement, provide a brief description of the nature and terms of such contingency or interest".

Circular 11-29 also introduces a principle of relevancy (relevancia) which is similar to the U.S. concept of "materiality", which means that each prospectus must disclose all information that may be necessary for investors to form themselves a reasoned opinion in respect of the issuer, its financial condition and its results of operations, as well as the risks related to the securities being offered. This principle represents a significant step forward for Mexico's securities laws.

The Circular further reflects that the CNBV may authorize Mexican companies not to disclose material information, if such information constitutes a competitive advantage to the relevant issuer and its disclosure may affect such issuer's results of operations or financial condition.

The expectation of participating parties (and certainly of the CNBV) as a result of the Circular is three-folded. First, a significant amount of the work related to a request for approval of a public offering of securities will now need to be conducted prior to filing; in other words, the necessary information will need to be complete and the prospectus of "red-herring" quality will need to be assembled at the time of the initial filing. Second, the burden of filing true and accurate information is now on the issuer and its counsel, rather than on the CNBV; the need to file certain information (primarily, the officers' certificate, the underwriter's certificate and the outside counsel's certificate) puts an emphasis on the issuer's obligation not to submit any information until it satisfies the CNBV standards, rather than relying on typical CNBV objections relating to the quality or accuracy of information supplied. Third, the new procedure is likely to reduce the time necessary to review an application (although whether this point will be achieved will derive entirely from the experience of issuers in complying with the Circular and of the CNBV in enforcing the terms of it).

The Circular (Rule Eighth) includes an obligation of confidentiality that applies to all issuers. It states that an issuer may not disclose information in respect of public offerings that it expects to conduct, until the necessary filing shall have been made with the CNBV (other than information necessary to be disclosed to shareholders' meetings and to the board of directors). The violation of this obligation results in a denial of registration of the securities and of the approval necessary to conduct a public offering (Rule Ninth); the Circular, however, does not contemplate how rapidly an additional request for approval of a public offering may be filed, should a violation of the obligation not to disclose information relating to a public offering occur.

2. Disclosure of Material Corporate Events.

Circular 11-28 of the CNBV was issued on November 14, 1997 and it refers to the disclosure of material corporate information (called in the circular "relevant events") to the market. Rule First thereof defines "corporate events" as: "…the acts, facts or occurrences capable of influencing the price of …securities…".

Issuers are required to determine, under their own responsibility, the information about relevant events that they will disclose to the public, as well as the disclosure they elect to defer; provided, however, that they are not allowed to defer disclosure of information when it refers to acts or facts that shall have been consummated or when "unexpected movements" occur in the

market which are related to such information (in these cases, the issuer is required to disclose the information immediately). "Unexpected movement" is defined broadly as any change in the supply or demand of the securities or their price which is not consistent with their historical behavior and which may not be explained with public information.

In case issuers elect to defer disclosure of a relevant event, they are required to take the steps necessary to guarantee that such information is known by the least number of persons possible and to maintain a registry of the names of such persons which shall specify the date and hour of disclosure. The issuer is also required to obtain a confidentiality obligation of such persons.

The president of the board of directors, the director general and first level officers, which are or should be aware of relevant events, are responsible for disclosing such information notwithstanding the fact that the issuer may designate a person entrusted with such disclosure duty to the CNBV and the Mexican Stock Exchange (Bolsa Mexicana de Valores, S.A. de C.V.; the "MSE").

The Circular also authorizes the MSE to request from issuers information to clarify the cause of unexpected movements of securities in the market or to execute a statement certifying that they are not aware of any such cause. The MSE also has authority to order issuers to clarify or rectify information or to ratify or deny information disclosed by third parties if the MSE considers it will influence the market.

The Circular authorizes the CNBV and the MSE (in accordance with its internal regulations) to suspend the listing of securities of an issuer based on the disclosure requirements set forth therein.

The information is required to be disclosed electronically and issuers that have securities listed in non-Mexican markets are required to disclose the CNBV and the MSE the information that they are required to disclose in any such non-Mexican markets in accordance with applicable law.

This Circular has been in place for some time and the Mexican press has reported cases of sales of controlling stakes of Mexican listed companies in which the CNBV has initiated

investigative action against such issuers to determine whether the disclosure requirements contained in this Circular were complied with.

III. Conclusions.

1. The Mexican Law of Corporations does not contemplate a duty of directors of Mexican companies vis a vis shareholders individually since any liability is required to be claimed by the shareholders' meeting and, as an exception, by shareholders that own 33% of the shares representing the capital stock of the company, in the terms described herein.

2. The Law of the Securities Market and the circulars issued by the CNBV thereunder do not contemplate any specific rules regarding directors' liability for listed companies except for the regulation of insider trading and disclosure in the terms described herein.

3. The Code of Best Corporate Practices does contemplate specific duties of directors although the recommendations contained therein are not mandatory.

4. The Law of Corporations contemplates a provision addressing conflicts of interest, which could be amended to capture potential conflicts of interest, in the terms defined in the Code of Best Corporate Practices.

5. In light of the foregoing, it seems warranted for the Mexican government and the Mexican securities industry to assess as a public policy matter an amendment to the regulation of Mexican listed companies to stipulate with clarity the position of minority shareholders vis a vis members of the board of directors and other corporate bodies of Mexican listed companies. Such assessment should be performed taking into consideration various other public policy issues relevant to the Mexican market, such as the fact that Mexican companies are generally controlled by a concentrated group and the efficiency of the Mexican judicial system. The assessment should take into account relevant experience in similar securities markets of other jurisdictions and, in order for it to truly constitute a practical improvement to the position of minority shareholders of Mexican listed companies, should be coupled with an assessment of the entire structure of the Mexican securities market and the Mexican judicial system.

6. Also, an amendment should take into consideration certain institutions and mechanisms that exist but could be strengthened in the context of a comprehensive system of provisions

designed to protect the minority, such, as for instance, the function of statutory auditors (comisarios) and the rules regarding calls to shareholders' meetings.

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