

# Protecting investors from self-dealing

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A fluke of timing helped Mexico overhaul its securities laws. “We finished drafting the bill in March 2004, too late to submit to Congress that term. But instead of shelving it until October, we decided to show it to people in the private sector,” relates a key drafter of the new law. “Their input made all the difference.”

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## Persistent underperformance

In 2004 Mexico’s securities market was a tiny fraction of what would be expected from the size of its economy. The Republic of Korea’s gross national income was similar (\$600–\$700 billion) but it had 10 times more listed firms. China had a securities market with 4 times the capital of Mexico’s. Latin America received 9% of global private equity flows, but Mexico, with more than a third of the region’s income, received only a tenth of that. And more companies were delisting rather than issuing new shares on the Mexican stock exchange. Investors looking for markets with the greatest liquidity, transparency, and shareholder rights were not investing in Mexico.

Why? Antiquated securities laws and tightly controlled companies gave minority investors little assurance that their rights would be protected. In 2004, Mexico had only 150 companies listed on the stock exchange, with 60% of them controlled by a single shareholder. A diagnostic report by the World Bank identified a number of weaknesses in the legal framework, including a lack of definition for directors’ responsibilities toward the company. The law also had no requirement that subsidiaries comply with the corporate governance requirements, so not surprisingly many listed companies were holding companies, with subsidiaries operating outside the full corporate governance regime. It was difficult for minority shareholders—or any outsiders—to verify managers’ financial conduct.

The result: insider deals were frequent, channeling wealth out of the company into the controlling shareholders’ pockets. “There was a saying in Mexico: rich businessmen, poor companies,” says one reformer.

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## An opportunity to reform

The Fox administration’s success in other financial sector reforms buoyed its hopes to improve Mexico’s securities laws. According to one government official, “Earlier financial sector reforms were not very charged politically.” Securities regulations were seen as another step in the administration’s efforts to reform Mexico’s financial markets. Congressional champions of reform were also vocal: one congresswoman challenged the minister of finance to attack vested interests in the securities markets, taunting him with the label “minister of stagnation” if he failed to push securities reform.

The highly publicized Enron and WorldCom financial scandals in the United States gave Mexican policymakers another political opportunity to push through their capital market reforms. Rather than rewrite existing legislation, the Ministry of Finance

decided to draft a completely new act. The goal: greater Mexican competitiveness in the global contest for funds.

“Mexico has a huge need and a big appetite for capital investment,” says one partner at a top Mexican law firm. Mutual funds, pension funds, and foreign capital in search of new destinations for investment had so far avoided Mexico. “There are funds in Mexico to go around. But without protection, people won’t invest locally.”

### A small drafting team

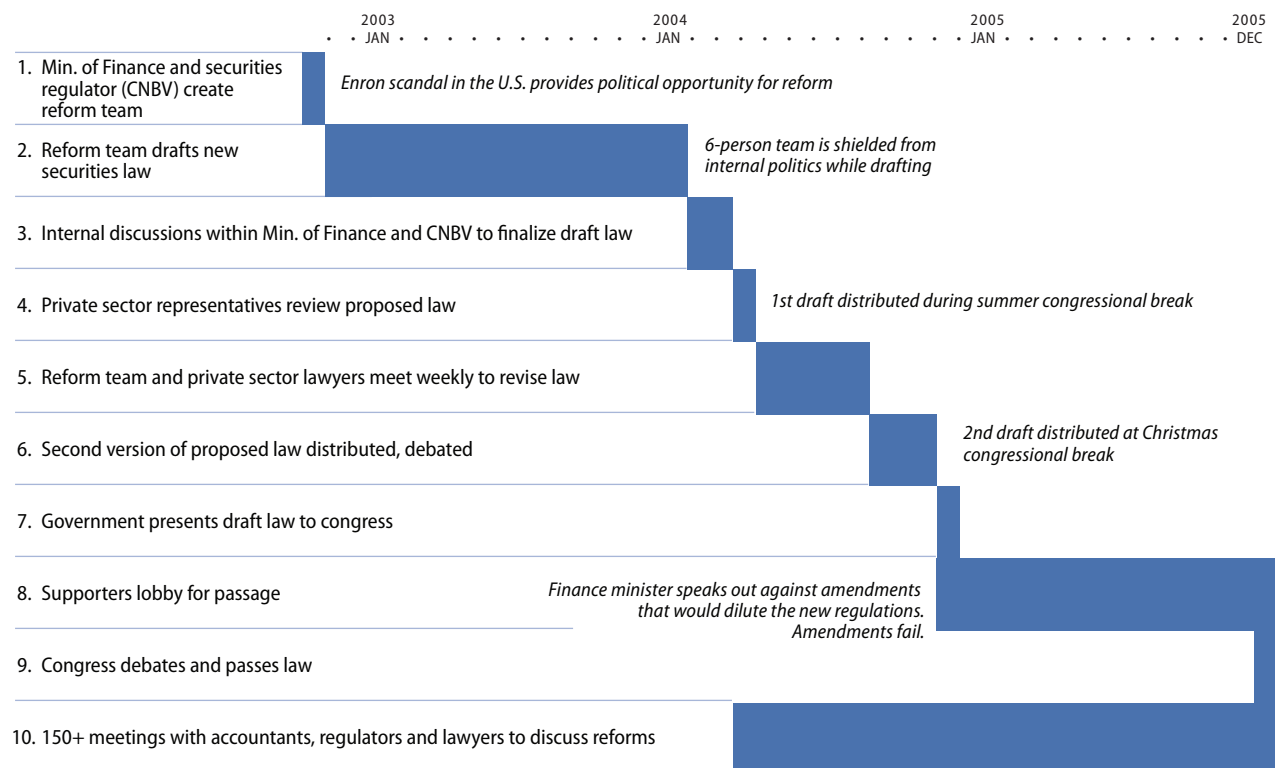
The original drafting team for the new law was small: a senior Ministry of Finance official, a senior official from the Comisión Nacional Bancaria y de Valores (“CNBV,” Mexico’s securities regulator), a lawyer from each office, and 2 outside lawyers. They started with a conceptual base drafted in October 2002 and worked through 2003 writing the new law (figure 5). Only in February 2004 did they complete a full draft for internal review. A month and a half later—a year and a half after beginning—the joint team was ready to present the proposed law to Congress. “We thought we were done, but it was only the beginning,” says one member of the team.

The reform team’s timing was off. In March 2004 Congress had only a few weeks until the end of the session. It was too late to submit such a large and important piece of legislation. But rather than waiting to unveil the bill in Congress and work

FIGURE 5

#### Timeline of investor protections reform in Mexico

Source: Doing Business database.



through any opposition there, reformers took a novel approach: they invited the relevant stakeholders to review a “pre-draft” and participate in shaping it *before* submitting the bill to Congress.

This process took 2 steps. First, reformers met with every group that would be affected by the new legislation (business associations, finance professionals, the Mexican bar, the stock exchange, and listed companies) to present the goals of the reform. These goals were to strengthen the Mexican stock market through 1) new listed firms and 2) higher demand for Mexican firms’ stock. As the government officials explained, the law sought to accomplish this through 3 approaches: 1) streamlined regulations for listing a new company; 2) increased transparency and minority investor rights; and 3) a corporate structure for listed companies that more closely reflected international best practices.

Second, after the presentations the reformers invited a group of prominent private sector lawyers, representative of all the groups, to form a drafting committee. This committee would go through the existing bill—keeping the goals for the legislation in mind—and eliminate any ambiguities, contradictions, and loopholes that might be found in the “pre-draft” text.

Ministry of Finance and CNBV officials met with representatives of top Mexican law firms every Thursday evening between 5pm and 8pm, April to September. “I call them the \$15,000 meetings [the amount the attorneys would typically charge for their time]. In the end, we completely rewrote the law. And the final product met our goals—greater transparency of public company operations and broader protection of minority shareholder rights,” says one official.

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## The political battle

The political battle came next. The new draft was submitted to Congress in October 2004. Although its prospects were uncertain down to the final vote, it ultimately passed in substantively the same form 1 year later.

One of the biggest media conglomerates in Mexico was the most vocal opponent of the bill, protesting the minority shareholder protections and the disclosure provisions. The group also argued that the new law was too sophisticated for Mexico and too closely matched the United States’ Sarbanes-Oxley legislation.

At one point it seemed the reform effort would fail. In November 2005 the Ministry of Finance made an all-out effort to shepherd the draft securities law through Congress. But opponents offered amendments that would affect 4 key provisions of the bill—amendments that would eviscerate the law’s innovative protections. And the opponents were adept at using their access to the Mexican media to squelch support for the bill.

To help make the case for the complete law without amendments to the Congress, Finance Minister Diaz pulled in the World Bank’s *Doing Business* team. Diaz asked

the team to use its “protecting investors” indicators to benchmark the draft securities law proposed by the government against the existing law and against the watered-down alternative.

The results were striking. Under the existing law, Mexico ranked 125 of 145 countries measured by the *Doing Business* investor protection index, with some of the weakest protections in the world for minority shareholders. Among Latin American countries measured, only Honduras and Venezuela had weaker investor protection.

If Mexico passed the law as presented by the Ministry of Finance, Mexico would shoot up the ranking index 92 spots—to 33. “Since we’re the 20th largest economy in the world, we thought we should be ranked around 20 on the *Doing Business* rankings. But even with the improvement, we still hover in the 30s. We still have work to do,” said one Ministry of Finance official. Under the alternative law, Mexico’s rank would fall to 132.

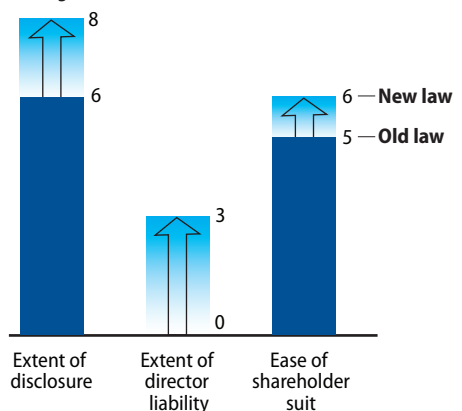
### Disclosure and director liability—two key provisions

The difference hinged on disclosure and director liability provisions. The law proposed by the government strengthened disclosure requirements for directors who face a conflict of interest in their dealings with the firm. It also broadened the company’s responsibility to report any transactions with company insiders. And the law made it easier for shareholders to hold directors accountable for actions harming the company. Mexico’s performance on the *Doing Business* “extent of disclosure index” under the proposed law would increase from 6 to 8 (on a scale of 0 to 10), and its score on the “extent of director liability” would rise from 0 to 3 (figure 6).

FIGURE 6

#### Protecting investors in Mexico—big improvements

Doing business indicator score (0–10)



With the proposed amendments, however, Mexico’s performance on the “extent of disclosure index” would slide backwards significantly. The opponents’ bill removed all requirements for a company to report large transactions with a director or controlling shareholder immediately to the marketplace and in the annual report. It also removed any obligation for the director or controlling shareholder to disclose a conflict of interest to the board.

Minister Diaz presented these results to Congress, along with myriad other reasons to pass the new law untouched. “The simulations stirred enormous interest in Congress and in the media by showing the dramatic differences in Mexico’s business environment if the law were not adopted,” says one of the bill’s proponents.

“If approved as proposed by the government, the new law would enhance investor protection and foster investment in publicly traded and even privately held companies. But if the changes proposed by the outside group were accepted, the opposite would happen.”

The bill passed the lower chamber without the amendments on 6 December 2005 and was confirmed by the Senate a few days later. Heads of manufacturing and investment companies lobbied for its passage, thanks to the tireless work of the reformers to work with local business leaders and their counsel while drafting. The new law (Ley del Mercado de Valores) came into effect 28 June 2006.

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### **What does the new law do? Attack self-dealing**

The Ley del Mercado de Valores:

- Defines clearly the duties of company directors.
- Heightens disclosure requirements for related-party transactions (transactions involving a conflict of interest with a company insider).
- Requires committees of independent board members to review executive compensation and related-party transactions in publicly traded companies.
- Lowers the ownership threshold for minority shareholders to sue for damages.
- Formally establishes the subpoena power of Mexican regulators.
- Increases criminal penalties for corporate crimes.

The law attacked self-dealing. Previous legislation gave board members, directors, and shareholders broad and imprecise responsibility benchmarks. The new legislation presents 2 distinct duties for the board of directors of a publicly held corporation.

First, a duty of care. Board members must fulfill their duties in good faith and place the best interests of the corporation and the entities controlled by it above their own personal interests. They must attend board or committee meetings and disclose all information necessary to make decisions.

Second, a duty of loyalty. This duty forbids directors and individuals with decision-making authority over the corporation from diverting to themselves or to other persons a business opportunity that belongs to the corporation, without a legitimate cause. They cannot favor a shareholder or group of shareholders at the expense of others. Nor can they vote on issues in which they have a conflict of interest, or make inappropriate use of privileged information. Beyond these broad fiduciary obligations, the law provides a nonexhaustive list of activities considered disloyal and behaviors that constitute a lack of diligence.

“Fiduciary duty is the foundation that holds up the building,” remarks one Mexican securities expert. “Before, the law was too broad and imprecise. It said you could

do everything to someone, but in the end you couldn't do anything. It was a bomb without a fuse." The new law blended broad concepts with specific examples of what the lawmakers had in mind. The result, impermeable to loopholes, is enforceable by judges.

The new law also extends corporate governance obligations to subsidiaries. And finally, the law requires listed companies to set up committees of independent directors. These committees review deals involving senior executives, limiting executives' ability to use the company resources to fund lavish lifestyles or enrich themselves at company expense.

Lawyers enthusiastically greeted the greater disclosure for corporate activities and stronger standards for directors' obligations. "It keeps the proper balance between protection of minority shareholders and protection of the company from overly burdensome regulatory compliance," says one practitioner. "The main tension in the law is not a problem of shareholders in a pulverized market. It is more a matter of putting a minority shareholder on the same level as the large shareholders," added another.

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### **Introducing a new corporate form—the SAPI**

The new law didn't only target listed companies. Facing a gap between strong corporate governance provisions for listed companies under the new securities law and weaker regulations for private companies under the company law, drafters sought a middle ground for larger private companies seeking a broader investor base. They found it in a new type of corporate form: one whose adoption is optional, but which offers enhanced corporate governance, minority rights and better access to the stock market as a way to attract minority investors.

That new corporate form is the *Sociedades Anónimas Promotoras de Inversión* (SAPI). SAPIs are stock corporations that offer minority shareholders the right to appoint board members, call for extraordinary shareholders meetings, bring civil actions against board members, and postpone voting with lower ownership threshold levels than in other corporate forms. In exchange for voluntarily adopting these provisions, SAPIs enjoy exemptions from the general corporations law to allow shareholder voting agreements, tag-along and drag-along rights, buy-back mechanisms for the redemption of shares, and restrictions on preemptive and exit rights.

Authorities hope SAPIs will bolster the low numbers of new offerings on the Mexican securities market by creating a breeding ground for listed companies. "Companies that adopt the SAPI regime will signal potential investors that the company is a good recipient of private equity with a credible legal commitment to honor the corporate rights of investors," announces one SAPI promoter. Even without an ultimate listing on the stock market, the regulators aim to increase medium-size companies' access to equity financing through the new structure without overloading them with complicated compliance requirements.

### The initial impact—balance, transparency, openness

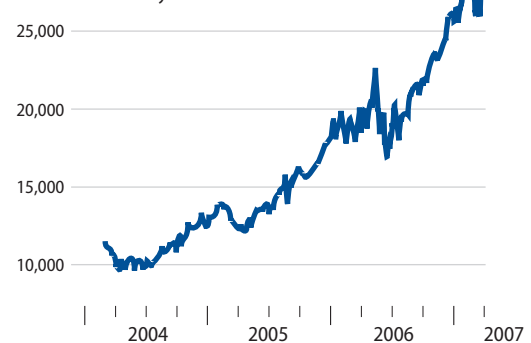
Initial signs indicate that investors are happy with the new securities law. “Before the new law, investors were discouraged by the family domination of Mexican firms,” says one Mexican lawyer who represents Mexican and foreign investors. “Previously, investors and joint venture partners had to battle for the 51% share. Lawyers had to be extremely creative to get protections for their clients. And we were never quite sure that the judges would uphold the protections we worked into the bylaws.” Now local businesses and foreign investors feel the new law has increased balance, transparency, and openness.

This greater confidence is supported by market indicators. The value of shares and other equities on the Mexican stock exchange increased over the previous year by 13.1% in the first quarter of 2006 and 15.1% in the second—the 2 quarters immediately following passage of the new law. The market has continued to perform well over time: the IPC, Mexico’s primary stock market index, shows a steady increase between passage of the new law and March 2007 (figure

FIGURE 7

#### Mexico’s stock performance soars

Índice de Precios y Cotizaciones



7). The Mexican stock market also recorded a historical high in foreign direct investment, at \$128,813 million, within a year of passing the law—a 20.89% increase from the beginning of 2006. And private investment funds in Mexico increased by 84% in 2006 over the year before. The many influences on investment flows make it difficult to attribute these movements directly to the new legislation, but such figures support the general argument that Mexico has become more attractive to investors.

Businesses are taking advantage of the law’s innovations as well. More than 40 SAPIs have been created, voluntarily adopting stricter corporate governance rules to attract more external financing. The National Association of Corporate Lawyers, American Chamber of Commerce, Cámara de Comercio, Barra Mexicana, Mexican Association of Financial Law, Asociación Mexicana de Capital Privado, and the Asociación Mexicana de Instituciones Bursátiles have all held workshops on the benefits of the SAPI for companies and investors alike.



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## Opposition continues

Yet opposition to the new law continues. As soon as it came into force, the media group that was initially the most active critic of the law challenged 54 of its articles. The group's allegations:

- The CNBV's new ability to issue sanctions prior to a legal procedure in front of the court violates the constitutionally protected right to be presumed innocent until proven guilty.
- The law's new duties for directors and auditors violate their constitutional right to work.

On 18 September 2006 a Mexican administrative judge found in favor for 3 of the group's companies, so the 54 articles will not apply to these companies until a final decision on the provisions' constitutionality. The provisions in question, if found unconstitutional, could be revoked for the entire populace. As of March 2007, there had been no final decision on the matter.

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## Talking with stakeholders—priceless

Despite this threat, lasting lessons arise from Mexico's securities law reform. Primary among them is the value of involving stakeholders early on in the process. "Through the drafting committee, business groups were able to make their points about the proposed regulations. And then we, as the regulators, made our points. In the end we came to common ground that served us well during the political fight," explains one reformer. "But you can't elaborate along the way with them," warns another. "That way you lose the pen. You must have the vision, present a complete draft, and take modifications."

Mexico's policymakers have since incorporated these lessons into major legislative efforts. "What we passed was too revolutionary to regulate by imposition," says one drafter. "The open, inclusive process led to a better law." He was clear on its value: "As MasterCard says, priceless."