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## The 2007 Meeting of the Latin American Corporate Governance Roundtable

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### Country Report: Voluntary Corporate Governance Code in Mexico

The OECD asked several consultants, regulators, corporate governance institutes and other relevant stakeholders to elaborate reports regarding the development and implementation of voluntary corporate governance codes in each of their countries/regions. The reports, as well as a synthesis report elaborated by the OECD Secretariat based upon them, is provided to the Roundtable participants as background for the meeting's discussion.

The Mexican report was elaborated by **Felipe Alonso** of the OECD Corporate Affairs Division, drawing substantially upon his interviews with **Roberto Danel**, president of the *Committee of Corporate Best Practices* in charge of the Code's development and revision process. Input from officials from the National Banking and Securities Commission (CNBV) as well as executives from the Mexican Stock Exchange (BMV) also provided background on the Code's current legal and practical standing.

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Further information regarding the code as well as its integral text can be found at:  
[www.cce.org.mx](http://www.cce.org.mx)

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## REPORT ON THE MEXICAN CORPORATE GOVERNANCE CODE

### INTRODUCTION

The present is an explanatory document that tries to give an overall view regarding the origins, development, revision process, promotion, implementation means and results of the Mexican corporate governance code.

More than a practice-by-practice analysis, it tries to explain the general conditions and principal actors involved in the code's realization, as well as the evolution of the corporate context and other relevant events that made evident the need to revise the code. Nevertheless, general subjects included in the first code and those added, updated or improved in its revision are mentioned and broadly detailed.

Official results regarding the level of adherence reported by listed companies to the code's best practices are attached.

### DEVELOPMENT OF THE CODE

After Mexico's adherence to the OECD in 1994, the Mexican Government adopted several reforms to improve its legal and economic framework overall, among them, the initiative to elaborate a national corporate governance code.

Between 1997 and 1998, the National Banking and Securities Commission (CNBV) –the securities regulator- investigated international trends and studies related to the subject. Finally, in 1998, a consensus was reached between the CNBV and the private sector in order to delegate the latter with the responsibility of building such a code. The *Business Coordinating Council* (CCE), the most important business organization in the Country, which gathers several industrial, commercial, financial and other business chambers that represent around 97% of the total formal employers in Mexico, was the organization which finally carried out this responsibility.

A *Committee of Corporate Best Practices* was constituted within the CCE in order to elaborate the Code and include relevant actors in its elaboration process. The members of the Committee were: prominent lawyers, consultants, businessmen and academics, as well as the presidents of the CCE, the Mexican Institute of Public Accountants, the Mexican Bankers Association, the Mexican Finance Executives Institute and the Mexican Stock Exchange.

High-level functionaries from the CNBV, the Ministry of Finance, the Ministry of Economy and the Central Bank were also invited to participate in the process, by reviewing the Code's drafts in its several progress stages and making comments and suggestions therein.

The logic that led to the consensus of the CCE developing the Code, was that the company's owners and management -who in Mexico are usually the same persons- believed they should be the ones creating a set of rules to self-regulate their activities in a voluntary fashion, rather than an authority-issued code which could have given an impression of an early step towards a future obligatory regulation.

The voices of high-profile businessmen who own and manage Mexican transnational companies that at the time were listed in different stock markets worldwide and therefore the subject of high corporate governance standards regimes, were significantly helpful by supporting the adoption of the same standards in Mexico and thereby countering several voices who at a first stage were skeptical about the introduction of the subject in the Country.

## **THE FIRST CODE**

After the Committee's work and consultation period, the **Best Corporate Practices Code** was finally issued in June 1999 and included the following sections in a best-practice recommendation fashion:

1. **Board of Directors:** function, integration, structure, operation issues, director's duties.
2. **Evaluation and Compensation Function:** generic functions, operation issues.
3. **Audit Function:** generic functions, auditors' selection, financial information internal controls, legal provisions fulfillment revision.
4. **Finance and Planning Function:** generic functions, operation issues.
5. **Information Disclosure to Shareholders:** shareholders' meeting information and agenda, information and communication between shareholders and board of directors.

On September 1999, the CNBV issued Circulars 11-11 BIS 8 and 11-23 BIS 3 which constrained listed companies to disclose their adherence level to the Best Corporate Practices Code along with the information they already had to disclose to investors, the CNBV and the Stock Exchange.

## **COMPLY OR EXPLAIN**

In March 2003, the CNBV issued the *Circular Unica de Emisoras* (Issuers Unique Circular), which replaced the above-mentioned circulars and provided specific rules and procedures regarding the Stock Exchange operation. This Circular mandates that listed companies will provide an annual report to the CNBV, including general information on shareholder and management structure as well as financial and stock market information. It also provides, at its **Annex "J"**, that listed companies will report annually their level of adherence to the best practices of the Best Corporate Practices Code. Notwithstanding that the adherence to the Code's best practices is voluntary, companies are constrained to reveal their compliance level and may voluntarily explain why they don't comply with certain best practice or what practice it uses instead, making therefore the code a **"comply or explain"** type (even though the "explain" part is voluntary).

Annex "J" includes open-elaboration questions and "yes" or "no" questionnaires (in which companies may explain why they don't comply with a specific practice or what practice it uses instead,). Annex "J" is composed of the following sections:

- (i) An **Instructions Chapter**.
- (ii) **Sub-annex "J-1"**, includes questions regarding the board of directors' functions and structure, evaluation and compensation functions, audit functions, finance and planning functions and the company's corporate governance practices additional to the one's recommended in the Code (disclosure of the latter is optional).
- (iii) **Sub-annex "J-2"**, includes questions regarding the information that shareholders receive at the shareholder's meetings.
- (iv) **Sub-annex "J-3"**, this sub-annex includes the format of a letter that shall be signed by both the chairman and the secretary of the board of directors, declaring that they have personally reviewed the reports regarding the level of adherence to the Code's best practices of the company and that they agree with its content. This letter is of major importance since even though there's no audit system or supervisory action contemplated to verify the accuracy of the companies' responses, it makes such functionaries responsible for their content. It therefore creates an incentive for making sure that responses are coherent with the real practices, otherwise creating a risk of giving false

information to the authority. Indeed, the company's responses were more straight-forward and accurate since the circular introduced the letter requirement in this sub-annex.

- (v) **Sub-annex "J-4"**, contains the whole Code in order to clarify the context of the questionnaire to the companies.

However, since the entry in force of the new Securities Market Law in June 2006 and the revised version of the Code in November of the same year, the regulator recently decided to abandon the mandatory "comply or explain" system after several years of its implementation, as will be further explained in this report.

## **REVISION PROCESS**

From June 1999, when the Code was first issued, to November 2006, the date on which the revision of the Code was launched, different events evidenced the need to update the Code to take account of the constantly-evolving international standards and the new economic and business atmosphere in the Country and worldwide.

The accumulated experience of seven years of the Code, the issuance of the Latin American White Paper on Corporate Governance and the revised OECD Principles of Corporate Governance in 2003 and 2004 respectively, the New Securities Market Law which entered in force in June 2006 and the necessity to define a common language in terms of corporate governance in the Country were among the main reasons to revise the original version of the code in order to best adapt it to such circumstances.

The Committee of Corporate Best Practices of the CCE was re-integrated with more technically-oriented members in order to revise the Code. The members of the Committee were: prominent lawyers and consultants, members of the Mexican Finance Executives Institute, the Mexican Securities Dealers Association, the Mexican Bankers Association, the Mexican Institute of Public Accountants and the Mexican Stock Exchange.

As in the elaboration of the first Code, high-level functionaries from the CNBV and the Ministry of Finance were invited to participate in the process by sharing information, revising the Code's drafts in its several stages and making comments and suggestions therein.

Contributions from other independent consultants, associations and the World Bank were also received and taken in consideration for the Code's revision.

The Inter-American Development Bank and the Multilateral Investment Fund contributed with funding for the revision process.

For the revision of the Code, the main characteristics of the Mexican companies such as their family origin, values and culture, their shareholder structure and the importance that some shareholders have in their management were taken into consideration.

The Revised Code's best practices have as objective to assist companies in the following aspects: (i) institutionalization processes; (ii) transparency operations; (iii) an adequate information disclosure; (iv) competitiveness in a global world; (v) access to finance sources in favorable conditions; (vi) implementation of stable succession processes and (vii) promote long-term sustainability of the company to the benefit of their shareholders and stakeholders.

Even though the first version of the Code was intended for listed companies, the Revised Code's recommendations are intended and applicable to all kind of companies or associations; either commercial, civil or non-profit, listed or not listed in the stock markets, and also as a reference for banks, institutional investors, pension funds and rating agencies.

## **CURRENT SITUATION**

The new Securities Market Law modified substantially the legal framework of the Mexican market and was considered a big step towards market efficiency, clearer rules, higher corporate governance standards, stronger sanctions and the creation of new kinds of investment-friendly corporation models in order to attract more investors to private companies and create a gradual corporate governance implementation path for companies that want to go public.

Even though the revision process of the voluntary Code raised importantly its corporate governance standards, most of those standards are already mandated by the new Securities Market Law. The private sector, in charge of leading the revision process of the code, considered that the new Law already included new and relevant substantial requirements to which listed companies had to adapt gradually, and therefore didn't consider an even higher scheme of voluntary corporate governance practices.

At the end, with the corporate governance framework for listed companies being raised with the new Law, the decision was to make the Revised Code "universal" in order to focus its efforts in SMEs and non-listed companies.

Since most of the practices of the current Code were already mandated by the new Law, the CNBV decided to abandon the regulatory-mandated "comply or explain" system. The CCE thinks that this is an adequate change since the practices of the former code were already well assimilated by Mexican listed companies and other non-listed who implemented it after seven years of existence, therefore, the current Mexican Code is now located in the totally-voluntary scheme and no longer in a "comply or explain" regulatory-mandated one.

## **THE REVISED CODE**

The **Revised Code** is divided as follows:

### **I. Introduction**

### **II. Corporate Governance**

### **III. Shareholders' Meetings**

III.1 Information and agenda

III.2 information and communication between shareholders and board of directors

### **IV. Board of Directors**

IV.1 Functions

IV.2 Integration

IV.3 Structure

IV.4 Operation

IV.5 Director's duties

### **V. Audit Function**

V.1 Generic functions

V.2 Auditors selection

V.3 Financial information

V.4 Internal control

V.5 Related parties

V.6 legal provisions fulfillment revision.

### **VI. Evaluation and Compensation Function**

VI.1 Generic functions

VI.2 Operative issues

### **VII. Finance and Planning Function**

VII.1 Generic functions

VII.2 Operative issues

The following are among the main improvements and additions of the Revised Code in comparison to the first one:

In order to establish a common language for Mexican companies, chapter II was included to define the **concept of corporate governance** (which some audit and consulting firms confused with internal controls). Corporate governance is initially defined as *"the system under which*

*companies are directed and controlled”* within this system, the guidelines decided by the company's shareholders and the recommendations of best corporate practices shall also be considered.

In this context, the Revised Code states that the role of the board of directors is to define the strategic vision, surveillance of the operation and approval of the company's management performance.

The CEO is considered to be in charge of the company's management, conduct and to implement the business operations under the guidelines approved by the board of directors.

After a quote of a wider definition of corporate governance by the OECD, the Revised Code underlines that the best practices included therein are made to improve the integration and functioning of the board of directors and its intermediary organs.

Finally **ten basic principles** are mentioned in order to reach a good corporate governance system:

1. Equal treatment and the protection of every shareholder's rights.
2. The recognition of the existence of stakeholders interested in the company's development and sustainability.
3. The responsible issuance and revelation of information, so as transparency in management.
4. Being sure that strategic guidance, effective surveillance of management and fiduciary responsibility of the board effectively exists.
5. Identification and control of the risks to which the company may be exposed.
6. Declaration of social responsibility and ethical principles.
7. Prevention of illegal operations and conflict of interest.
8. Revelation of improper acts and whistleblower protection.
9. Fulfillment of legal provisions to which the company is subject.
10. Give certainty and confidence to investors and stake holders regarding the honest and responsible conduct of the company's businesses.

Regarding the **Shareholders Meeting**, Chapter III was added in order to give the supreme governance body in companies its importance. Information disclosure to shareholders is emphasized by suggesting handing over to shareholders information regarding each point of the agenda at least 15 days prior the meeting, including a proposal for the integration of the board of directors with each of the candidates CV, so as a report of relevant activities from the intermediary organs of the board. It also suggests that shareholders shall elaborate a formulary with possible voting scenarios for each point of the agenda in order to best instruct their representatives.

The **Board of Directors** shall define the strategic vision, oversee the operation and approve the management of the company. All directors are responsible for such duties. The following functions of the board were added; (i) oversee the operation of the company and promote the responsible disclosure of information; (ii) establish policies and approve operations with related parties; (iii) promote social responsibility within the company, the declaration of a business ethics code and consider stakeholders in its decisions; (iv) promote the disclosure of improper acts and whistleblower protection; (v) give confidence and certainty to investors and stakeholders regarding the honest and responsible conduct of the company businesses.



Regarding the **composition** of the board, the Revised Code recommends a number between 3 and 15 members. The definition of independent director is provided and the percentage of recommended independent directors went from 20% to 25%. Also, the percentage of recommended non-executive plus independent directors together went from 40% to 60%. The definition of independent director was also included –considering also as independent a shareholder without important influence or command control and who is not involved with the controlling group of the company.

Regarding the board's **structure**, the Revised Code recommends the integration of intermediary organs -such as board committees- to handle specific topics such as audit, evaluation and compensation, and finance and planning. Such committees shall be composed of independent members, but they may first be integrated by an independent majority at an early stage in order that companies adapt better to such changes.

The importance of constantly validating the internal control and financial information disclosure-process is recommended in the section dedicated to the **Audit Function**. The following recommendations were also included therein: (i) analysis and evaluation of related-parties transactions; (ii) verification of the business ethics code and the mechanism to disclose improper acts and whistleblower protection; (iii) to intervene in the analysis of the contingency and information recuperation plans; (iv) financial information presented to the board of directors shall be signed by the CEO and the executive responsible of its elaboration; (v) subject to the shareholder's meeting approval related-parties transactions out of the regular scope of the company representing more than 10% of the consolidated assets of the company.

In the section related to the board's **Evaluation and Compensation Function**, the Revised Code adds the following function to its correspondent committee; (i) recommend the criteria for director's compensation, and (ii) study the proposal to declare the company as a socially-responsible organism, the business ethics code, the improper acts information system and whistleblowers protection. The existence of a formal succession plan for the Chief Executive and senior executives is also recommended.

Regarding the **Finance and Planning Function**, the analysis and evaluation of the risks to which the company may be subject, along with their control, was added as a function of the corresponding board committee.

## **DISCLOSURE AND PROMOTION**

The Revised Code version was issued in a protocol ceremony on November 14, 2006 called by the President of the CCE where he addressed the audience along with the Minister of Finance, the President of the Mexican Association of Securities Dealers and the President of the Stock Exchange as well as read-messages from the OECD's Secretary General and the CNBV's President. Relevant actors from the private and public sector and academics were also invited. A press conference was also organized.

A promotion plan that's already active was designed, involving authorities, CCE's bodies, universities, consulting firms, professional associations, press appearances and articles in specialized newspapers and magazines.

40,000 copies of the code were printed, which were distributed among business and professional organizations, companies, universities and interested parties. A new set of 20,000 copies is estimated to be printed soon.

## **RESULTS AND IMPLEMENTATION**

As a result of the reports regarding the level of adherence to the Code's best practices that companies had to submit each year to the CNBV already described above, the authority has issued a series of statistics regarding the companies' evolution in adopting the Code's best practices. Due to the fact that the revised Code is no longer in the regulatory-mandated "comply or explain" scheme, these results correspond to the adherence-level reporting to the first Code best practices.

The results for each of the responses to the CNBV questionnaire included at the listed-companies' reports of adherence to the former Code are being attached as **annex "1"** hereby.

## **CORPORATE GOVERNANCE AND THE MARKET CHALLENGE**

We can conclude that while the revision of the Code and the new Securities Market Law are an important step forward to promote and implement better corporate governance practices within Mexican companies, there's still a lot to be done by the private, public and non-profit sector in order to trigger a deep corporate governance culture within the business community. This could translate into a healthier, more dynamic and expanding stock market that could be a major source of finance for Mexican companies and foster the country's economic growth overall.

The main index of the Mexican Stock Exchange experienced its best year ever in 2006 with an overall accumulated performance increase of 48.56% (in local currency). Nevertheless, the objective to expand it and enlarge the number of participants therein -in relation to the size of the country's economy- is generally-agreed.

A comparison with Brazil, the other regional economic giant, reinforces this point. While Brazil has a slightly larger economy in terms of GDP (around 7% larger in 2005)<sup>1</sup>, its Stock Exchange (Bovespa) had by the end of 2006 about USD\$710 billion of market capitalization, 347 domestic listed companies and 26 IPOs in the year. The BMV had, in the same period, a market capitalization of about USD\$348 billion, about 132 local companies trading shares and only 4 IPOs.<sup>2</sup>

The latter puts in evidence the great growth potential of the Mexican market relative to the size and growth of the country's economy, as well as the major challenges for the business culture overall and the stock-market. De-concentration of the companies' ownership and of the market overall seems to be the biggest issue.

In conclusion, deep assimilation of corporate governance practices is a "must" for the Mexican listed and non-listed companies' scope since it's a globally-proven step in order to attract major investments and have better and cheaper access to capital. It also prepares companies for more developed stock-market characteristics such as de-concentrated ownership, and minority shareholder activism and protection arising from larger investment flows.

If the country is to catch up with the performance and growth of the most thriving emerging economies, its companies must assimilate international best practices, be more open to stock dispersion, and to "external" or minority interference in the company managerial decisions in order to attract more capital from local and international investors. Developed markets have done it; emerging market leaders are doing it; the Mexican market and companies should head the same way.

## **LINKS OF INTEREST**

Consejo Coordinador Empresarial [www.cce.org.mx](http://www.cce.org.mx)  
Comisión Nacional Bancaria y de Valores [www.cnbv.gob.mx](http://www.cnbv.gob.mx)  
Bolsa Mexicana de Valores [www.bmv.com.mx](http://www.bmv.com.mx)  
Centro de Excelencia en Gobierno Corporativo [www.uas.mx/cegc](http://www.uas.mx/cegc)

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1. IMF data extracted from the World Federation of Exchanges

2. Federación Iberoamericana de Bolsas, Monthly Information, December 2006 ([www.fiabnet.org](http://www.fiabnet.org)).