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CORPORATE GOVERNANCE: AN INTERNATIONAL AND MEXICAN PERSPECTIVE

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The purpose of this discussion is to set out some of the salient characteristics of Latin America's securities markets, and from this perspective present a case for why continued viability of these markets is largely dependent on radical changes in the approach, which, up until now, companies, exchanges, and investors have taken to corporate governance¹. At first, it may not appear to present an encouraging picture. But it is hoped that by identifying some of the key causes of the markets' current problems, we can see our way to some solutions.

State of the Markets

It is difficult at this point in time to present an optimistic assessment of Latin securities markets, particularly the equity markets. During the last semi-annual meeting of the Council of Securities Regulators of the Americas² in Caracas, one presenter stated that all of the traditional exchanges are facing possible extinction. Most in attendance (including regulators and participants from all of the largest markets – Brazil, Mexico, Argentina and Chile) nodded their heads in agreement. This is not the place to present a detailed analysis of the current woes of the markets. But to summarize, the obvious symptoms of decline include:

- Reduced domestic trading volumes and a shift to trading in American Depositary Receipts (ADRs)³ traded in New York;
- Languishing foreign portfolio inflows;
- Fewer new offerings in domestic markets or via Depositary Receipts

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1. The term corporate governance can be defined broadly or narrowly. For a broad definition, see Sir Adrian Cadbury, September 20th 1999. Preface to the World Bank publication, "Corporate Governance: A Framework for Implementation". Since this discussion is primarily concerned with the relationship between corporate governance and capital market development, a narrow definition seems appropriate. Here the term refers to the set of rules, practices, and institutions of internal company governance (e.g. the shareholders meeting, the Board of Directors) and market discipline of company controllers (disclosure, tender offer rules, etc.) that directly affect the powers and treatment of outside sources of finance (investors).

2. The Council of Securities Regulators of the Americas (COSRA) is the Western Hemisphere association of securities commissions and is affiliated with the International Organization of Securities Commissions (IOSCO) <<http://www.iosco.org>>.

3. An instrument traded on a U.S. securities exchange or over the counter that is issued by a U.S. bank and represents a specified number of shares in a foreign corporation. ADRs are bought and sold in the American markets just like regular shares. An ADR is issued by a U.S. bank and consists of a bundle of shares of a foreign corporation that are being held in custody overseas.

- Exit from the domestic capital markets of Latin American blue chips, often as a consequence of absorption by an overseas parent;
- De-listings and going private transactions; and
- Stagnating or declining market capitalization.

In Brazil, the region's largest economy with the largest market capitalization, ADR trading of domestic companies began to exceed trading on the São Paulo Stock Exchange in March and April of 2000⁴. In 1999, the number of listed companies contracted, with the de-listing of companies on both ends of the spectrum – family-controlled companies on the one hand, and large subsidiaries of multinational companies (particularly in telecommunications and electricity) on the other.

The Argentine public equities market has all but disappeared - its market capitalization at the end of 1999 was only 8% of GDP⁵. Trading volume is also down, to about US\$20-30 million from US\$50 million a few years ago. This too is partly the result of de-listing, most notably the take-over of YPF, formerly the most traded Argentine stock, by Spain's Repsol⁶.

Chile, despite its large domestic savings, has also witnessed an equity supply problem. De-listings have occurred not only in utilities, but also in financial services as well. Controlling shareholders are taking larger shares of companies, reducing the public float – the case of Endesa-España's purchase of a controlling position in Enersis⁷ is the most dramatic case.

While de-listings and market capitalization contraction has been less pronounced so far in Mexico, that country is not likely to be immune from these trends. Most trading in Mexican equities has long taken place in New York in the form of ADRs. Mexican market participants are aware of the dynamic that has been evident in Brazil, Argentina and Chile – and they see the signs in their own market of fewer listings, few new offerings and declining investor interest. The Mexican small-capital market experiment, the MEMMEX⁸, failed to flourish. Further consolidation of the financial sector, bankruptcies, and the consolidation of Mexican industry are likely to result in further shrinkage of the supply of domestic equity securities.

Some Reasons Behind the Stagnation and Contraction

At first, the rapid contraction and resulting stagnation in the markets is surprising, given other developments in the Latin economies. True, these past five years have been bumpy – with the Tequila, Asian and Brazilian crises all taking their toll. However, this period has been impressive in terms of foreign capital flows in the form of direct investment. 1999 was a record year for foreign direct investment in

4. Lucia Rebouças, *Negócio com ADR brasileiro já supera Bovespa*, GAZETA MERCANTIL (São Paulo), May 4, 2000, at B-1.

5. *Death of the Stock Market*, EUROMONEY, March 2000, at 64.

6. Repsol YPF is an oil, chemical and gas company, carrying out activities in exploration and production, refining, distribution and marketing, chemicals and natural gas and electricity. In 1999, Repsol, Spain's largest petroleum company conducted successful tender offer for YPF, Argentina's dominant petroleum company, and converted it into a subsidiary.

7. Endesa-España is Spain's largest electric utility, producing about half of all electric power in Spain. In 1999-2000, it amassed a controlling interest in Enersis, Chile's 's largest electric utility.

8. The Mexican Mid-cap Market (MEMMEX) was launched by the Mexican Stock Exchange in 1997, but was closed by 1999.

Brazil (where it reached US\$ 31 billion)⁹, as well as for Argentina, Mexico, Chile and Peru. And in countries like Argentina, Mexico and Peru, the mandatory private pension system is beginning to kick in – which might be expected to provide the demand needed to increase domestic equity and debt market activity. But instead the securities markets have languished.

The reasons for the failure of domestic securities markets to grow have both an encouraging and a discouraging side to them. On the positive side, many of Latin America's best companies have become attractive purchases for multinational companies looking to expand. The take-overs of YPF by Repsol in Argentina and of Enersis by Endesa-España are just two high-profile cases. The region's best companies are also finding cheaper costs of capital by financing through international markets, either via direct debt offers or through parent companies based abroad then downstream the funding to the subsidiary. Also, global economic consolidation and integration (including NAFTA¹⁰ and MERCOSUR¹¹) means that it is reasonable to expect fewer and fewer of the region's large companies to remain independent and domestically focused.

Sadly, however, it is not just their growing access to foreign capital and foreign markets, and their attractiveness to foreign purchasers, that has caused many Latin companies to withdraw from domestic markets. Crowding out by high domestic interest rates remains a major problem for Brazil, and to a lesser extent for the other major markets. High domestic interest rates, reflecting the government's need to finance fiscal deficits, but also incorporating investor perception of macroeconomic and policy risk, dampens both the supply and demand side of the securities markets. Despite this, what we have seen in the past couple of years in Brazil and elsewhere is that as domestic interest rates come down, there has been little corresponding increase in equity market activity. Why?

A key factor is that investors, both domestic and foreign, have become discouraged by poor corporate governance practices, mistreatment of minority shareholders and weak investor protection under the local legal/regulatory regimes. A number of well-publicized cases of disadvantageous treatment of minority shareholders in take-overs and de-listings served to underline, for the investor community the risks of investing in Latin companies, even when such companies are competitive and growing. The potential for shareholder abuse, both in the case of one-time events like take-overs, and through less than arms-length transactions with controlling shareholders (e.g., the case of Mexico's TV Azteca¹²) has resulted

9. Matt Moffett, *Cash Flows in to Latin America*, THE WALL STREET JOURNAL EUROPE, February 2, 2000, at 62.

10. NAFTA –North American Free Trade Agreement, drafted Aug.12, 1992, revised Sept.6, 1992, U.S.-Can.-Mex., 32 I.L.M. 605 (entered into force Jan. 1, 1994).

11. The Common Market of the Southern Cone is a customs union established by the Treaty of Asuncion, March 26, 1991. It comprises four members (Brazil, Argentina, Paraguay and Uruguay) and two Associate Members (Bolivia and Chile) representing over 220 million people. MERCOSUR is the third-largest trading bloc in the world after the EU and NAFTA. 30 I.L.M. 1041 (1991), *See also* < <http://www.mac.doc.gov/ola/mercosur/mgi/inbrief.htm>>.

12. TV AZTECA S.A. de C.V. is the second largest producer of Spanish programming in the world, and one of two broadcast television companies in Mexico, operating two national television networks, through more than 250 owned-and-operated stations located throughout Mexico. In 2000, the company, under the control of Mr. Ricardo Salinas Pliego, provided an important part of the financing of a cellular telephone franchise also controlled

in huge premiums being offered for controlling blocks of shares. This sends a signal to portfolio investors that if you don't have control, you won't get a fair deal. Minority investors may not see dividends reflecting the real profitability of the firm while they hold the shares, and they won't participate in the upside when the controllers sell out. This is not a recipe for confidence.

The problem for domestic market development is compounded when one considers that as the number of listings declines, the native infrastructure of market analysts and securities dealers also begins to disappear, making it progressively more difficult for new issuers to get access through these channels. The fewer blue chips there are, the fewer analysts there are likely to be to look at new companies.

Central Role of Corporate Governance

In some sense, a good part of the old approach to promoting securities markets development in Latin America (as well as elsewhere in the emerging markets) could be described as "If you build it, they will come." That is, if a country's public authorities and private sector establish the legal framework for issuing, selling and trading securities; and modern trading systems, secure clearance and settlement are in place, and as long as there is a relatively stable macroeconomy, the market will grow and thrive. Issuers will be willing and able to issue, investors will buy, and brokers will trade.

All this was true for a time in Mexico and the rest of the region. Why? Because of pent-up supply and demand. The core issuers - the region's blue chips, and its newly privatized utilities - were ready to float a portion (though rarely if ever a potentially controlling portion) of their shares. And there were domestic and foreign investors that either wanted to, or had to, take positions in the local economy. Country funds, including some in which IFC¹³ helped to sponsor, provided international investors with a way to take diversified country exposure. There was substantial appetite for this, as international investors saw investment in a diversified portfolio of major blue chips as a way of capitalizing on the expected growth potential of Mexico and the rest of the region in the aftermath of the 1980s debt crisis.

Of course, not all investors were completely blind to the shortcomings of transparency and governance of Latin America's largely family-owned public companies in the early 1990s when the markets were taking off. They understood that buying a small percentage of the stock of a Mexican company was not the same as buying a similar position in an U.S. or UK blue chip. Local accounting standards differed from those prevailing in OECD countries. The role and responsibility of boards of directors were less defined, and the remedies against self-serving managers (who were usually also the controlling shareholders) were much weaker.

by Mr. Salinas Pliego. See also Andrea Mandel-Campbell, *Mexican Entrepreneur in Peace Offering to Minorities*, FINANCIAL TIMES, October 12, 1999, at 38.

13. The International Finance Corporation, part of the World Bank Group, promotes private sector investment in developing countries, which will reduce poverty and improve people's lives. IFC is the largest multilateral source of loan and equity financing for private sector projects in the developing world. IFC finances and provides advice for private sector ventures and projects in developing countries in partnership with private investors and, through its advisory work, helps governments create conditions that stimulate the flow of both domestic and foreign private savings and investment. IFC Mission Statement. <<http://www.ifc.org/about/facts/mission/mission.html>>.

But most investors, even the most savvy, were complacent, and felt they could afford to be. They knew that disclosure, professional oversight, and legal enforcement were not up to ideal standards, but they also knew, or thought they knew, that there were natural limits to how badly minority shareholders could be treated by the big companies. The nature of the business of most Latin issuers – predominantly utilities and established industries – imposed practical limits on the opportunities for management misrepresentation and tunneling of profits. In addition, there was market discipline over companies that wanted to raise more money in the securities markets in future years.

What investigators learned is that the practical limits on shareholder mistreatment were weaker than they thought, and likely to become weaker still. One reason is that today's companies are harder to understand. The businesses of the companies that are likely to want to come to domestic capital markets is dramatically distinct from the old blue chips that went public in the 1980s and 1990s. In the late 1980s, investors could buy stock of an electricity generating company and predict that if GDP grew at a 5% annual rate, electricity consumption would grow and revenues would rise. The company's plants would be renovated through introduction of new technologies and become more efficient, allowing the company's assets and earnings to increase commensurately. (This author recalls his days representing a Mexican brewer. The prospectuses were all about the relationship between beer consumption, demographics and GDP.) However, when investors look at Latin America's rising companies today, with new technologies and in less-established industries – the kind of dynamic enterprises that Mexico needs to develop and modernize – they can't rely on valuation principles such as beer consumption to GDP. Each new company is more than ever a unique mix of skills, technologies and potential markets. Investors, or at least the private securities markets infrastructure of analysts, financial journalists, and asset managers, need to understand in greater detail each company's financial workings and business strategy in order to assess its prospects. They need to understand its management and how flexible it is. Finally, they need to have confidence that they understand the company's numbers, its strategy, and especially its internal checks and balances and oversight of management. And of course, they need to have confidence in the legal regulatory framework that assures that the company will respect the equity contract embedding in its shares.

Conclusion

It is fair then to ask, what can those of us (like IFC) with an interest in seeing deeper and broader capital markets in Mexico and the rest of the region look forward to? What is the task ahead? There are at least two central themes that we need to build on. First, Latin America's securities market needs to be re-invented. They are not at a normal stage in a gradual evolution. The traditional exchanges and the infrastructure that supports them are at a point where they become a new species, or else go the way of the dinosaur. Second, the new market or markets that emerge can only be built on the basis of clear property rights in sound, transparent public companies. This means, first and foremost, good corporate governance and the equitable treatment of shareholders and other outside sources of capital.

What solutions should those, like IFC, who see securities markets as an important part of a healthy financial sector, and as an essential element of private sector-led growth, be promoting? It's probably too early to tell in exquisite detail, but some guiding principles can help us get moving in the right direction:

- First, policy makers must keep their eyes on the prize. Their goal is to build an infrastructure that maximizes access to affordable capital by good companies. The goal is not to save the local stock exchanges. It is tempting to be sentimental about institutions that have survived since the 19th century. But they survived because they served the needs of the day, and if they can't or won't adapt to the new reality, they belong in a museum.
- Second, the public and private sector should focus on the binding constraints. Particularly in Mexico, the binding constraints today are not in the costs or risks of the trading systems. They are the corporate governance practices of the issuers, and the infrastructure that is needed to assure the quality of information, dissemination, analysis of information on companies, and enforcement of claims. If the rights represented by the securities traded in the market remain ill defined and difficult to enforce, the best trading systems in the world can't make them a good investment.
- Third, every country is different, with indigenous business customs and practices. But capital markets will become even more international. This means, like it or not, that compliance with international standards - be they in accounting and audit, internal controls or corporate governance - must be the objective of policy makers, market participants and companies. And if one looks at the standards that we are talking about today, like IAS (international accounting standards), IOSCO's disclosure standards for cross-border securities offerings¹⁴, or the OECD's Principles of Corporate Governance¹⁵, it is evident that each country can internalize them without abandoning the useful elements of its indigenous business culture. The fact that the new Mexican Code of Best Corporate Practices¹⁶ is fully consistent with the OECD Principles is ample evidence of this.
- Finally, we must all be practical and realistic, not doctrinaire and theoretical in approach. This means building markets and infrastructure that suit the kinds of issuers and investors we have today and can reasonably expect in the near- to mid-term. It is nice to think twenty or thirty years down the road, but

14. International Organization of Securities Commissions (IOSCO) is designed to promote high standards of regulation in order to maintain just, efficient and sound markets; to exchange information on their respective experiences in order to promote the development of domestic markets; to unite their efforts to establish standards and an effective surveillance of international securities transactions; and to provide mutual assistance to promote the integrity of the markets by a rigorous application of the standards and by effective enforcement against offenses. <<http://www.iosco.org>>.

15. The Principles are intended to assist member and non-member governments in their efforts to evaluate and improve the legal, institutional and regulatory framework for corporate governance in their countries, and to provide guidance and suggestions for stock exchanges, investors, corporations, and other parties that have a role in the process of developing good corporate governance. The Principles focus on publicly traded companies. However, to the extent they are deemed applicable, they might also be a useful tool to improve corporate governance in non-traded companies, for example, privately held and state-owned enterprises. The Principles represent a common basis that OECD Member countries consider essential for the development of good governance practice. They are intended to be concise, understandable and accessible to the international community. They are not intended to substitute for private sector initiatives to develop more detailed "best practice" in governance. The Principles are available through the website of the Global Corporate Governance Forum <<http://www.gcgf.org>>.

16. The Mexican Code of Best Corporate Practices was published by the Business Coordinating Council (Consejo Coordinador Empresarial) in 2000. <<http://www.cce.org>>.

in this age of rapid globalization and technological advance, building for the future may best be accomplished by securing the short term and remaining flexible.

What are, or will be, some of the signs that the importance of improving governance has been internalized? Here, recent developments do give some reason for optimism. Encouraging signs that companies, market participants, the public, and governments are moving in the right direction include:

- **Public awareness / Change in corporate culture.** One good thing about scandals is they shake people out of complacency. The wave of corporate governance-related scandals in the region since 1997 has moved corporate governance up the agenda, and placed it on the business pages and sometimes on the front pages of the national and international papers. Some offending companies have responded, by adopting codes of best practice, improving their practices, and publicizing their willingness to change.
- **Recognition that new companies need better, not worse transparency and governance.** This is the idea behind Brazil's Novo Mercado¹⁷. Issuers listing on the Novo Mercado must meet one of two enhanced disclosure standards and internal governance standards. Under the stricter standards, a listed company must agree to submit to arbitration of disputes with shareholders.
- **Improvement of standards, coordination of efforts.** By the end of next year all of the major markets of the region, and some of the smaller, will likely have voluntary national codes of corporate governance in place. Mexico already does. Through the Council of Securities Regulators of the Americas and the OECD/World Bank Latin America Corporate Governance Roundtable¹⁸, both the public and private sectors are working together both within and without the region to coordinate their reform efforts and agree on regional priorities. These efforts will need to intensify as the markets transform and become more integrated.
- **Deepening of private informational infrastructure.** Here there are some encouraging efforts, on the part of local as well as international information service providers (like Standard & Poor's) to develop rating like products that assess and report the quality of internal governance and transparency of issuers.
- **Legal Reforms.** First Chile, and now Brazil and Argentina have undertaken long-overdue reforms of their company and securities legislation to reinforce shareholder rights, better define the role of directors, and require greater transparency and comparability of financial and other company information. Mexico must not be far behind.
- **Enforcement.** While enforcement remains a weak link, the high profile that securities regulators have taken in recent cases of shareholder abuse bodes well. But their resources are modest. It is to be hoped that the role that the securities regulators have played in mitigating some of the worst abuses will encourage legislatures to increase their legal authority and resources. The

17. In late 2000, the São Paulo Stock Exchange established new listing segments for companies with better corporate governance practices. Companies that meet the highest standards may be listed on the "Novo Mercado." Geoff Dyer, *Brazil's Pitch for Market Credibility*, FINANCIAL TIMES, February 27, 2001, at 12.

18. The Latin American Roundtable aims to facilitate public and private sector policy-dialogue. It provides a forum for the exchange of experiences between senior policy-makers, regulators and market participants with first hand experience of present developments and ongoing work. <<http://www.oecd.org/daf/corporate-affairs/governance/roundtables/in-latin-america/>>.

Novo Mercado's experiment with arbitration is also a good sign. But, of course, these can never be complete substitutes for competent courts to which shareholders can have recourse when all else fails.

So we can end on an encouraging note, in the realization that all these efforts need additional support, from both the public and private sectors. As it was and continues to be in the OECD countries, improving corporate governance in Latin America will require determination on the part of companies, investors, market participants, professionals and government. Without these efforts, the securities markets cannot hope to prosper.