8. CORPORATE GOVERNANCE IN MEXICO

Karen Watkins-Fassler

8.1. Overview of the Legal Framework of Corporate Governance in Mexico

In Latin America, legal protection is weaker than in Europe and the USA, and capital markets are less developed (Chong and López-de-Silanes, 2007; Djankov et al., 2008). However, these issues have advanced significantly in recent years, especially in the four largest economies in Latin America (Diamandis and Drakos, 2011). In many cases, emerging economies have sought to adopt the legal systems of developed countries, particularly the Anglo-Saxon system, either through internally-driven reforms or in response to international demands, and Latin American countries have voluntarily adhered to corporate governance practices and policies to partially overcome the legal gaps identified (Briano-Turrent and Rodríguez-Ariza, 2016; Garay and González, 2008).

In the Latin American region, Mexico has been one of the most active countries regarding Corporate Governance matters. This is to some extent because in this part of the world Mexico is one of the few OECD member countries, and the first to join this organization during 1994. The OECD Principles of Corporate Governance were first released in 1999; during the same year, Mexico established the Code of Best Corporate Practices (with modifications during 2006 and a revision in 2010). Many of the recommendations identified in this code were included in the Mexican Securities Market Law, which was implemented in 2001 (revised during 2006 and 2014). This law aims to protect minority shareholders from expropriation by majority shareholders. It incorporates practices such as 1. At least 25% of the board members have to be independent. 2. The existence of corporate practices committees leaded by independent directors. 3. More rights for minority shareholders, such as a lower required shareholding percentage in order to promote directors, ask for extraordinary assemblies, and sue executives or directors.

There are other laws that regulate firms that are not quoted in the Mexican Stock Exchange, such as the Credit Institutions Law and the General Law of Commercial Companies. Both suggest the establishment of boards of directors, with at least 25% of independent members. Nevertheless, there is still a lot to do in terms of the implementation of the laws and regulations. Mexico has been criticized by the lax enforcement of the law and consecutively weak investor protection. Although Mexico has recently adopted important structural reforms aimed at increasing business competitiveness, confidence in its formal institutions has deteriorated in recent years and levels of corruption have increased considerably (Centro de Excelencia en Gobierno Corporativo, 2008; World Economic Forum, 2015). In sum, companies in Mexico are situated in an environment of formal institutional weakness.

8.2 Ownership Structures of Companies in Mexico

Mexican companies are characterized by high ownership concentration (particularly among families), pyramid structures (i.e., groups of family businesses) and the issuance of shares without voting rights (Castañeda, 2000; San Martín-Reyna and Durán-Encalada, 2012; Santiago and Brown, 2009; Chong et al., 2009; Espinoza and Espinoza, 2012). The average ownership concentration for listed companies is 54%. Although it is well known that small and medium-sized enterprises (which account for 95% of all firms in Mexico) are mostly family businesses, a less known fact is that the majority of the firms listed on the Mexican Stock Exchange are family owned as well (Watkins-Fassler et.al, 2016). As stated by Faccio and Lang (2002), and Claessens et al. (2000), ownership concentration and family control is a solution to agent-principal conflicts in settings with low investor protection.

The predominance of family businesses in the Mexican Stock Exchange is evidenced in table 8.1. It includes balanced panel data for 89 non-financial companies listed during 2001-2015. Companies are grouped as family and non-family owned according to two definitions: 1.When a single person or family owns 30% or more of ordinary shares. This classification is in line with the European Union definition (2009) which considers a family business when a family possesses at least 25% of voting rights. 2. When a single person or family owns 51% or more of ordinary shares. Due to Mexican firms´ high ownership concentration, this superior level of shareholding in the definition of family firm is convenient, as proposed by San Martín-Reyna and Durán-Encalada (2012), and Watkins-Fassler (2017b). The table considers as well families´ influence in the administration of the companies, through a family-member CEO.

Table 8.1 Predominance of Family Businesses in the Mexican Stock Exchange

Year	*Family Ownership[1]*	*Family Ownership[2]*	*CEO Family*
2001	0.77	0.77	0.31
2002	0.81	0.75	0.47
2003	0.77	0.62	0.40
2004	0.81	0.65	0.49
2005	0.81	0.65	0.46
2006	0.79	0.61	0.49
2007	0.82	0.58	0.47
2008	0.81	0.61	0.44
2009	0.77	0.60	0.45
2010	0.75	0.55	0.41
2011	0.71	0.55	0.43
2012	0.71	0.55	0.49
2013	0.74	0.54	0.45
2014	0.74	0.53	0.48
2015	0.75	0.48	0.45
Total	0.77	0.58	0.45

Notes: Average annual values do not differ from the rest, at 10% significance level. 1/ Family Ownership: A single person or family owns 30% or more of ordinary shares (family control). 2/ Family Ownership: A single person or family owns 51% or more of ordinary shares (family control). CEO Family: CEOs are members of the families that own the companies (family management). Data for 89 non-financial companies listed in the Mexican Stock Market during 2001-2015.

Source: Own elaboration

It is observed that the companies under study display high ownership concentration (in family hands), stable throughout time, even when considering the crisis period (2008-2009). On average, 77% of firms are family controlled, according to the less strict definition employed of family business (30% or more shareholding). When considering 51% or more of ordinary shares in family hands, on average family firms correspond to 58% of the sample. In addition, approximately 45% of family companies are managed by family members, percentage that does not vary significantly throughout time. Often companies´ ownership tends to re-structure during financial crises, although apparently this is not the case for Mexico. During these episodes, mergers and acquisitions take place, which should incite a reduction in family ownership concentration. According to authors such as Bena and Li (2014), these events do not favor concentrated proprietorship, as firms´ possibilities to obtain loans are limited. Nevertheless, Mexican firms´ proprietorship is quite stable in time.

8.3 Market for Corporate Controls (M&A)

M&A events typically take place after performance variations, so they are related many times to CEO turnovers (see Conyon and Florou, 2002; Fee and Hadlock, 2004). In the same direction, when a company is acquired by a different controller, very often a new CEO is hired. Due to the predominance of family businesses in Mexico, control changes are not a common practice.

Table 8.2 shows the complete list of CEO turnovers for companies quoted in the Mexican Stock Market during 2002-2015 (Watkins-Fassler, 2017b). From the table it is possible to conclude that in Mexico control changes are quite rare.

Table 8.2 CEO Turnovers in Mexico

Firm	***Year***	***Firm***	***Year***	***Firm***	***Year***	***Firm***	***Year***	***Firm***	***Year***	***Firm***	***Year***	***Firm***	***Year***	***Firm***	***Year***
AHMSA	2004	AZTECA	2004	CMR	2004	GCARSO	2013	GRUMA	2007	ICH	2006	MEDICA	2013	SARE	2011
ALFA	2009	AZTECA	2015	CMR	2009	GCC	2015	GRUMA	2010	IDEAL	2009	MEDICA	2015	SARE	2012
ALSEA	2007	BACHOCO	2010	CNCI	2005	GEO	2015	GRUMA	2011	KIMBER	2007	MEXCHEM	2010	SARE	2015
ALSEA	2009	***BEVIDES***	***2002***	COLLADO	2013	GEUPEC	2009	GRUMA	2012	KUO	2014	MEXCHEM	2012	TELMEX	2006
ALSEA	2010	BEVIDES	2003	CONVER	2004	GEUPEC	2010	HILASAL	2007	KUO	2015	OMA	2009	TMM	2007
ALSEA	2015	BEVIDES	2007	CONVER	2007	GEUPEC	2011	HOGAR	2004	LAB	2015	OMA	2011	***TMM***	***2009***
ASUR	2002	BEVIDES	2011	CONVER	2012	GISSA	2006	HOGAR	2005	MASECA	2005	PASA	2010	VITRO	2008
ASUR	2006	CABLE	2002	CYDSASA	2004	GISSA	2008	***HOGAR***	***2007***	MASECA	2006	PEÑOLES	2008	VITRO	2013
ASUR	2011	CABLE	2012	ELEKTRA	2007	GISSA	2014	HOGAR	2008	MASECA	2013	POCHTEC	2007	WALMEX	2004
ASUR	2013	CABLE	2013	ELEKTRA	2012	***GMARTI***	***2007***	HOGAR	2010	MAXCOM	2008	POSADAS	2006	WALMEX	2009
AUTLAN	2005	CEMEX	2014	ELEKTRA	2015	GMD	2005	ICA	2006	MAXCOM	2009	POSADAS	2011	WALMEX	2014
AUTLAN	2012	CICSA	2007	FEMSA	2014	***GMODELO***	***2013***	ICA	2012	MAXCOM	2011	PYP	2009	WALMEX	2015
AUTLAN	2013	CIE	2008	GAP	2007	GPH	2015	ICA	2015	MAXCOM	2013	SAB	2008		
AXTEL	***2015***	CMOCTEZ	2009	GAP	2010	GRUMA	2005	ICH	2004	MEDICA	2010	SARE	2006		

Note: Turnovers that coincide with a change in ownership are shown in bold and italics.
Source: Own elaboration.

In fact, from a total of 110 CEO turnovers, only 6 (5%) coincided with a change in ownership: BEVIDES 2002 (who was experiencing negative ROA from 2001 till 2002, and from 2003 on this was no longer the case), GMARTI 2007 (ROA was positive during all quoted years; the firms´ main shareholder and the Board of Directors accepted a tender offer), HOGAR 2007 (ROA was negative from 2005 till 2011), TMM 2009 (afterwards there was a positive performance effect), GMODELO 2013 (it was sold to Anheuser-Busch International Holdings), and AXTEL 2015 (it was suffering loses in 2014 and merged with ALESTRA). It is interesting to notice that there has never been a hostile takeover in the Mexican Stock Market, in part due to the high levels of family ownership concentration.

8.4 Board of Directors Practices

In environments of formal institutional weakness, as is the case in Mexico, listed family companies that professionalize their management by hiring a non-family CEO (thus alleviating the principal-principal problem), tend to retain control of the firm by appointing a family member as Chair of the Board of Directors (COB) (thus alleviating the agent-principal problem-Stewart and Hitt, 2012; Lien and Li, 2014). When considering 51% or more of ordinary shares in family hands for the definition of family business, during the period 2001-2015 there are 52 non-financial family companies listed on the Mexican Stock Market. From this balanced panel it is observed that on average CEOs are members of the owner families in only 45% of cases, in contrast to 90% of the COBs. In addition, duality (when the CEO and COB is the same person) occurs in approximately 28% of the cases.

Moreover, the choice of managers and directors in family firms is often strongly influenced by personal friendship or family ties (Songini et al., 2013). Specifically, external directors generally have close connections to family members (Ward and Handy, 1988; Corbetta and Tomaselli, 1996). Although companies comply with independency requirements (the Mexican stock exchange regulations request at least 25% of board members to be independent-in practice this percentage is on average 45%), independent directors might not be really independent (García-Ramos and García-Olalla, 2011), which limits their effectiveness and possibility to counter-balance families´ control. The definition used for an independent board member in Mexico takes into account family ties and direct relationships within the company (shareholders, employees, providers, creditors, clients, etc.); it does not account for other types of relations, such as friendship.

Mexican family business groups are characterized by the presence of a well-established social structure among participating firms. Hence, interlocking directorates tend to be more frequent and powerful, as suggested by Dyck and Zingales (2004), Berglof and Claessens (2006), and Uddin and Choudhury (2008). An interlock is formed when an individual initially affiliated with one firm (in the role of CEO or COB, for instance) also joins the board of another firm (Mizruchi, 1996). About 50% of the COBs of the 52 listed Mexican family firms participated in such business networks, simultaneously holding up to six positions on different boards. Regarding CEO interlocks, these are observed in 24%

of the study population, where CEOs were found to hold positions in up to three boards in any given year.

8.5 Directors' Remuneration Practices

In Mexico, it is not mandatory to disclose individual managers´ and directors´ remuneration, only aggregate amounts. Neither are companies required to reveal the pay gap between CEOs and other executives or directors. According to Business Insider (2015), the ratio of CEO pay to average worker in Mexico is 47:1, one of the biggest for an OECD country. In addition, existing data provides information on the execution of executive stock options (a financial incentive contingent to results), not the value itself. Therefore, studies on directors´ remuneration usually require the application of surveys. The First Survey on Corporate Governance in Mexico (2011-by PWC) shows that 50% of the 130 companies surveyed pay their directors less than US$900 a month. In addition, 50% of the firms do not have compensation plans congruent to executives´ performance. In Mexico, most of managers´ and directors´ remuneration is flat, accounting for 70-80% of total financial incentives. There are not many changes observed with the Second and Third Surveys on Corporate Governance in Mexico (2013, 2015-PWC).

In a study on monetary incentives and firm performance for Mexican listed companies, Watkins-Fassler (2017a) finds that mean values for the execution of executive stock options do not fluctuate significantly in time. However, in less than half of the cases CEOs exercised this right. In addition, CEOs´ remuneration shows a clear ascending tendency throughout time. In Mexican companies this phenomenon started in 2003, and although profits declined significantly during the worse crisis year (2009), on average chief executive officers did not share the losses. Nevertheless, there seems to be comparatively more wage volatility during 2009, which highlights the greater business instability arising during the crisis period.

8.6 Shareholder's Rights Protection

The effectiveness of shareholders´ protection mechanisms in Mexico differs from developed countries, mainly when considering Anglo-Saxon nations: a) there is a greater probability that boards of directors in Mexico are under the influence of controlling shareholders, who might not perform their legitimate fiduciary duty to safeguard minority shareholders´ and other stakeholders´ interests; b) the ownership structure is concentrated in the hands of the controlling family or families, who tend to appoint family members as board chairs and CEOs; and c) formal institutional protection is often corrupted, or not enforced (Santiago and Brown, 2009).

The Doing Business 2017 report ranks Mexico as country 53 (out of 190) in the indicator for Protecting Minority Investors. This index covers several governance safeguards with respect to disclosure, director liabilities, and simplicity to bring a lawsuit, shareholder rights, corporate transparency, and protection against expropriation from

majority shareholders. All Anglo-Saxon countries- except for Australia- perform better than Mexico in this indicator, as shown in table 8.3.

Table 8.3 Protecting Minority Investors

Anglo-Saxon Countries	*Rank*
New Zealand	1
UK	6
Canada	7
Ireland	13
USA	41
Australia	63

Source: Doing Business 2017 Report

As a means to protect minority shareholders from expropriation by majority shareholders, the Mexican Securities Market Law states that at least 25% of the members of listed companies´ board of directors have to be independent. The presence of independent board members (those not related with the company itself) reduces agency costs between managers and shareholders (Coles et al., 2008), and between majority and minority shareholders (Santiago and Brown, 2009). Independent board members attract more investment into the companies; they favor business accountability and due to reputational concerns, they are more willing to look after profit maximization strategies and more eager to fire a CEO when the firm is not performing well.

However, the usefulness of an independent board member depends on several individual and environmental factors. The main personal attributes deal with his (her) experience, capabilities, professional prestige, ethics, assertiveness, and actualization. With respect to issues in the business environment, independent directors´ efficacy rests on their real degree of independency and majority shareholders´ willingness to share corporate information with them and take into account their positions (Castañeda, 2005; Silva-Méndez and Alonso-Gómez, 2013).

The study by Silva-Méndez and Alonso-Gómez (2013) questions the success of independent directors in Mexican firms, according to the evidence obtained from 10 in-depth interviews. The same interrogation arises when considering the 52 non-financial family companies listed on the Mexican Stock Market during the period 2001-2015. Board´s independency favours firm performance (measured by return on assets-ROA) when the CEO is not a family member. However, when the CEO belongs to the family that owns the firm, board´s independency negatively affects ROA. Family-member CEOs have more power, which increases the odds of centralized decision-making. In such cases, it is more difficult for the board of directors to oppose CEO´s guidelines, especially for those directors that are not part of the controlling family.

8.7 Shareholder Activism

The Mexican law does not provide any special rights for institutional investors or particular shareholder groups. Minority investors are better protected in listed

companies, having the right to appoint a board member, ask for shareholders´ assemblies, and postpone for three days a vote with 10% shareholding. In order to legally oppose to controllers´ decisions, minority shareholders must consolidate 20% shareholding. In addition, for initiating a lawsuit against directors, 5% voting rights is required. Nevertheless, in practice, it is difficult to rely on the Mexican court system (OECD, 2008).

Institutional investors in Mexico correspond to foreign and local pension funds and mutual funds. They tend to acquire minority stakes in the stock market, mostly fixed income instruments. Therefore, they are more interested in credit ratings than in corporate governance issues and consequently act as passive stakeholders. Their lack of involvement is also due to the high ownership concentration and family nature observed in most listed Mexican firms (Arcudia-Hernández, 2012).

8.8 Corporate Governance and Firm Performance

La Porta et al. (1999) suggested that high concentration of ownership impedes the development of capital markets, thus limiting access to financial resources and investment. This, in turn, brings about high financing costs, higher levels of corporate risk and poorer business performance. The inverse relation between ownership concentration and business results has also been observed by Baek et al. (2004) and Maury (2006), who reported that majority shareholders (especially in family-owned companies) tend to expropriate minority shareholders, with acts that are detrimental to business interests. In times of financial crisis, this type of expropriation is particularly common, and so its harmful effects on corporate results and on the economy, in general, are even greater. On the other hand, Bunkanwanicha et al. (2008) and Boubakri et al. (2005) point out that a high concentration of ownership can reduce the agency problem and promote business performance, because majority owners are motivated to closely monitor business outcomes, in order to maximize the value of the firm. A high ownership concentration (particularly among family members) favours the establishment of long-term relationships in companies, with a corresponding positive impact on investment and performance, even in times of financial crisis. Finally, some studies have observed no relationship at all between ownership concentration and business performance (Demsetz and Villalonga, 2001), while others have reported it to be non-linear (McConnell and Servaes, 1990).

A recent study by Watkins-Fassler (2017b) indicates that Mexican listed family controlled firms outperform non-family companies. This intimate entrepreneurial environment benefits corporate results, as it promotes long-term relationships and responsible management (Henssen et al., 2014; Fernando et al., 2014). In Latin American and other emerging markets, where external Corporate Governance mechanisms - such as the implementation of laws and regulations - do not function as efficiently as in developed economies (Boubakri et al., 2005; Chong and Lopez-de-Silanes, 2007), firms rely more on internal governance schemes - such as family proprietorship - for stakeholder protection and consequently investor confidence (La Porta et al., 1999; Steier, 2009). Families´ reputation is a key element for companies´ long-term success, which provides a

counterbalance against expropriation of minority shareholders and creditors (Bunkanwanicha et al., 2008; Estrin and Prevezer, 2011).

In addition, Watkins-Fassler (2017b) finds that during the most recent financial crisis (2008-2009), CEOs who are members of the controlling families had a significant favorable impact on Mexican firm performance. Family CEOs can reduce conflicts between managers and shareholders (Jensen and Meckling, 1976; Peng and Jiang, 2010), which is beneficial for the firms. A family-member CEO is more committed to the company, and usually has more experience and information on the business (Bertrand and Schoar, 2006). Through a family-member CEO, it is easier to align objectives and reduce opportunistic behaviors, resulting in efficient resource and risk management (Galve, 2002). This is especially relevant during crisis times, when asymmetric information and business risk increases. Also, family CEOs can access resources and reduce information constraints through their networks and interlocking directorate practices, which are above all beneficial when dealing with turbulent periods of time (Sitthipongpanich and Polsiri, 2015; Watkins-Fassler et al., 2017c).

8.9 Corporate Social Responsibility

Corporate Social Responsibility (CSR) is leaded by CEMEFI, the Mexican Philanthropic Center. CEMEFI was founded in 1998; during 2001, it created the Socially Responsible Business Distinction, to honor Mexican and other Latin American firms for their CSR best practices. During 2017, 1354 Mexican companies received this award (most being big businesses), which corresponds only to 0.19% of all officially registered firms (696333 in total). In addition to this distinction, there are several other local efforts to recognize CSR activities, such as Great Place to Work and Great Businesses lists. In the public arena, the Federal Attorney of Environmental Protection (PROFECA) certifies sustainable firms, if requested. During 2017 there were around 2100 socially responsible companies recognized through this certification.

During 2011, the Mexican Stock Market introduced a green index. It groups sustainable companies, committed with the environment and with their stakeholders. Initially 23 companies integrated this index; in 2017, this number increased to 30 firms, which represents about 22 percent of Mexican publicly traded corporates.

With respect to international standards, very few Mexican companies report according to GRI´s framework. During 2017, only 19 Mexican organizations integrated GRI´s Sustainability Disclosure Database. All of them operated in the Latin American and Caribbean region, and most were US and European affiliates or subsidiaries.

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