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Recent Developments in Mexican Securities Offerings

*Rafael Robles Miaja*¹

Increasingly over the last five years, Mexico (together with other Latin American countries) has seen a revolution in securities financing techniques and a liberalization of Mexican law aimed at increasing the "internationalization" of the markets. Although the recent financial crisis in Mexico may make a discussion of developments in international securities offerings appear untimely, Mexico is still one of the most important economies among the "emerging markets", is the thirteenth largest economy in the world, and is the neighbor and still one of the most important trading partners of the United States.

I. The Economic Crisis

Due to the pressures resulting from an unsustainable current account deficit, and as a direct response to an estimated \$5 to \$6 billion loss in reserves since mid-November 1994,² on December 20, 1994, the Mexican government announced a devaluation of the new peso, then trading at a rate of 3.45 pesos to the U.S. dollar. The "managed" devaluation announced by the government to confront this situation quickly got out of hand, and the government was forced to announce a "free float" of the peso. By January 30, 1995 the rate had fallen to 6.33 pesos to the U.S. dollar, although the peso has since recovered to a range of approximately 5.25 to 5.75 pesos to the U.S. dollar (an overall fall of 30.35%) following the hastily arranged US\$50 billion package of loans and guarantees announced by the Clinton Administration on February 1, 1995.³

The Mexican stock market "IPC" index fell sharply as a result of the crisis of confidence associated with the devaluation. On January 5, 1995 the index level was 2,273, and on February 2, 1995 the index closed at 1,943; a fall of 14.5%⁴ It is not expected that the market will recover quickly this year as investors are concerned with the impact on the domestic economy and on corporate profits and solvency. Securities offerings have, therefore, stalled, and no major offerings are expected through the remainder of 1995.

1. Partner, Franck, Galicia, Duclaud y Robles, S.C., Mexico City.
 2. The reserve loss also reflects growing investor concern over the uncertainty in the Chiapas region where the up-to-now peaceful encounters with the rebels have the potential to turn violent.
 3. The package includes: \$20 billion from the U.S. (\$11 billion more than the prior authorized amount of \$9 billion); \$17.57 billion from the International Monetary Fund; \$10 billion from the Bank for International Settlements; and \$3 billion expected from commercial banks. Furthermore, the maturities of the U.S. loans have been extended from 3-6 months to 3-10 years, a fact that will reduce pressures in the short term. *Chase Manhattan Bank, Emerging Markets Group, Mex. Fin. Weekly Report, Feb. 3, 1995.*
 4. Taking into account that during 1994 the growth of the index was negative.
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The values of Mexican government and corporate bonds have also fallen, proving very volatile and subject to swings in international confidence towards Mexico. Yields on *Tesobono* instruments (U.S. dollar denominated Mexican trading bills) have risen from 12% in December 1994, to 22% in January 1995, and to 17% on February 6, 1995.

It is widely believed that the recent guarantee package will provide sufficient support so as to prevent the Mexican government from defaulting on its international debt obligations, and that, as a result, investors will take advantage of the expected recovery in international confidence. This recovery should continue to benefit the exchange rate, which is widely believed will settle into a trading range of 4.70-5.00 pesos to the U.S. dollar, and benefit the value of Mexican government debt.

The devaluation and crisis of confidence have hit the Mexican corporate sector very hard, as:

- (i) a large proportion of corporate debt is U.S. dollar denominated (making the peso equivalent of their capital repayments larger);
- (ii) domestic interest rates are likely to stay high (as the government seeks to subdue the inflationary pressures which helped to cause the devaluation initially); and
- (iii) imports of raw materials and intermediate and finished goods, which are priced in U.S. dollars, have become more expensive.

These influences, and the uncertainty which the market may attach to the credit-worthiness of corporate bonds, will restrict price increases in these instruments. It is believed that the most aggressive investors will identify situations where creditworthiness is likely to improve or situations where an excessively pessimistic credit rating has been applied to a particular corporate bond. Such bonds will then be purchased in advance of any general market re-rating. As a consequence, substantial value could arise from early purchases of such bonds, although the high risk of corporate default will mean that such a strategy will rely on the information networks and analytical skills of the investors.

In addition, some financial groups are struggling to raise funds to repay loans advanced to acquire banks from the government as part of the privatization of that sector, or to purchase from the government their remaining interest in certain banks, which interests the Finance Minister has indicated will be sold at the time most convenient for the government.

II. Simultaneous Public Offerings

Prior to the onset of the crisis, many changes had been made in the Mexican offering process in order for Mexican issuers to be able to have access to the international securities markets. Simultaneous public offerings of securities in the U.S. and Mexican markets have been greatly improved by cooperation between the Securities and Exchange Commission (SEC) and Mexican National Banking and Securities Commission (*Comisión Nacional Bancaria y de Valores*, or CNV) in modifying certain practices and coordinating the most relevant stages of the offering process. Changes have taken place, mainly on the Mexican side, in recognition of the need to conform market practices in Mexico with those that are common in other international markets.

The SEC and the CNV signed a Memorandum of Understanding dated October 18, 1990 providing for mutual assistance in enforcement and in regulatory matters, including

assistance in the exchange of information in their respective files.⁵ Due to the resulting cooperation and communication between the two governmental agencies, the trading of Mexican securities in both markets is now possible.

On February 15, 1991, the Mexican Stock Exchange was designated an off-shore securities market, within the meaning of Rule 902(a) of Regulation S under the Securities Act of 1933.⁶

Further, on August 6, 1991 the Division of Market Regulation of the SEC advised the CNV that eleven Mexican securities qualified for "ready market" status. Today such status applies to eighteen Mexican securities. As a result, U.S. registered broker-dealers may now treat those securities, for purposes of computing their required net capital, as "actively traded securities" traded on major U.S. exchanges. Prior to such ruling, broker-dealers holding securities listed in the Mexican Exchange were required to maintain 100% capital from market value for the corresponding portfolio.⁷ The "ready market" designation creates an incentive for U.S. broker-dealers to take a position in those securities that have such status.

To implement and synchronize a simultaneous offering process in the U.S. and Mexico, both the SEC and CNV, in coordination with the issuer and managing underwriters, must adhere to three basic principles: 1) same quality of information, distributed at the same time; 2) same price, determined simultaneously, and 3) trading of actual securities at the same time in both markets.

5. *SEC, Mexico Sign MOU Regarding Enforcement Cooperation*, 22 Sec. Reg. & L. Rep. 1518 (BNA) (Oct. 26, 1990). The memorandum of understanding contains provisions regarding consultations, technical assistance, and mutual assistance for the exchange of information. *Id.* For example, the SEC and CNV agreed to "consult periodically" regarding matters of mutual interest, such as capital development; business practices; clearance, settlement, and other market systems; coordination of market oversight; and administration of U.S. and Mexican securities laws. *Id.* In addition, the SEC agreed to provide the CNV with technical assistance in developing, administering and operating Mexican securities markets. *Id.* The parties further agreed to provide "the fullest measure of mutual assistance." *Id.*
6. *Staff Designates Mexican Offshore Securities Market Per Rule 902*, 23 Sec. Reg. & L. Rep. 306 (BNA) (Feb. 22, 1991). The Mexican Stock Exchange (MSE) said that it requested the designation "to permit the resale of securities listed on the MSE in transactions effected in, on or through the facilities of the MSE in reliance on the safe harbor from the registration requirements of the Securities Act provided by Rule 904 of Regulation S." *Id.* The Rule 904 safe harbor applies to offers or sales of securities effected by any person other than an issuer, a distributor, an affiliate of an issuer or distributor, or any person acting on behalf of such a person. *Id.* An offer or sale of securities that satisfies the conditions of Rule 904 is deemed to occur outside the United States and, therefore, is deemed not to be subject to the registration requirements of the Securities Act. *Id.* Rule 904 requires that the offer or sale be made in an "offshore transaction" within the meaning of Rule 902 (i). *Id.* Rule 902 (a) identifies seven attributes that are considered in determining whether to designate a non-U.S. securities market as a designated offshore securities market. *Id.* According to the MSE, it has each of these attributes. *Id.*
7. The amount of the deduction depends on a number of variables, but it may be equal to 30% of the market value or as low as 15% for large broker-dealers, for purposes of Rule 15c3-1. 17 C.F.R. § 240.15c3-1 (1995).

A. THE PRE-OFFERING PERIOD

In practice, the pre-offering period commences when the issuer first determines to make a public offering of securities and continues until the initial registration application is filed with the CNV. At no time during this period are written or oral public offerings of securities allowed. Issuers must maintain strict confidentiality regarding the terms of the public offerings that they wish to carry out so long as the corresponding application has not been formally filed with the CNV. This requirement applies to the disclosure of information in both Mexico and, in the event of a simultaneous offering, abroad.

During the pre-offering period, the registration application and the prospectus are prepared. Mexican securities that are to be publicly offered in foreign countries must be registered in the Special Section of the National Registry of Securities and Intermediaries (NRSI). The registration application or statement in Mexico is not supported by a special form as in the U.S. (e.g., Form S-1), but rather by questionnaires, documents, and financial information required by the CNV. A draft of the prospectus is required by the CNV at the time of registration. In practice, the managing underwriter sometimes provides the members of the syndicate with relevant information regarding the issuer.

Verification of information provided by the issuer is a common practice on the part of the managing underwriters in Mexico, and issuers of registered securities may be fined when they furnish false or misleading information on their financial situation or on the securities issued by them.

B. THE OFFERING PERIOD

Mexican regulations establish no formal offering period. In domestic offerings, however, it commences the moment the registration application and the prospectus are submitted to the CNV and continues until the authorization is granted by its governing board (*Junta de Gobierno*), followed by the publication of the notice of the offering. In simultaneous public offerings, the offering period must start the same day in every market.

Current Mexican practice has been modified to allow underwriters to make public offers of securities during this period, once the draft of the prospectus is expressly approved as "preliminary". In contrast to former practices, the preliminary prospectus in Mexico is now used to promote the issuance to potential investors, reflecting both a modification of conventional practices as well as CNV requirements aimed at conforming to U.S. practice. Communications by the Mexican underwriters with prospective investors are constrained to the preliminary prospectus, which includes the "red herring" legend.⁸

In the course of the review process in the U.S., comments to the preliminary prospectus are given to the issuer and the managing underwriters by the SEC's staff. During this process, coordination between the CNV and the SEC insures that, where applicable, the same modifications are made to both the U.S. and Mexican versions of the preliminary prospectus. Both the U. S. and the Mexican version of the preliminary prospectus must be distributed at the same time.

8. A legend in red ink stating that the prospectus is preliminary, that it shall not constitute an offer to sell, that registration of the securities has not been approved by CNV and that a formal offer to sell can only be made subsequent to official registration of such securities, in conformity with federal securities regulations in the U.S.
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During the offering period, the issuer and the managing underwriters in both countries begin to market the securities but are not allowed to sell them. For simultaneous offerings in the U.S. and Mexico, the CNV requires the issuer and underwriter to provide Mexican investors with a prospectus in Spanish that is similar to the one used in the U.S. Some of the data included in the U.S. prospectus, resulting from differences in accounting principles, is not included in the Mexican version.

The timing of authorizations granted by both the CNV and the SEC (i.e., when the registration statement is declared effective) is agreed upon in advance, at the end of the offering period, by all parties involved. Such information is communicated to both commissions in order to commence the sales period simultaneously in both markets.

C. THE SALES PERIOD

Registration in Mexico may become effective by only two methods: a) traditional, or b) shelf registration. In either case, once registration is declared effective, the securities may be sold immediately upon pricing. Under either of the registration methods, simultaneous timing for the pricing in both the U.S. and Mexican markets is agreed upon in advance by the issuer and the managing underwriters, and the offering price is the same (taking into consideration exchange differences).

In purely domestic offerings, the sales period lasts two or three days, beginning with the publishing of the notice of the public offer. At the end of the trading session on the last day of the Mexican sales period, there is a matching of the buy and sell orders on the floor of the stock-exchange by the managing underwriter, and the trading of securities starts in the secondary market the following business day. With respect to simultaneous public offerings, in order to match the closing date in the U.S. with that of the actual trading of the securities in the Mexican market, the sales period in Mexico has been expanded to five business days. Accordingly, trading of shares in the secondary market will now take place in Mexico after five days. The CNV has, however, authorized the trade on the first day of the sales period.

III. Recent Developments

Measures taken by the CNV in conforming Mexican and U.S. market practices, coordinating with U.S. regulatory authorities, as well as certain legal changes, have been instrumental in the successful placement of Mexican securities abroad. Even the time of opening and closing of trading in the Mexican Bolsa has been adjusted to gain transparency and consistency with the trading of Mexican securities abroad. Now, equity trading takes place in the Mexican Stock Exchange between 8:30 a.m. and 2:00 p.m. each weekday (other than authorized holidays), and it is frequently modified to coincide with New York, for reasons such as time changes.

A. INVESTMENT IN TESOBONOS⁹

Tesobonos could be considered as the most important element influencing the current Mexican financial crisis. When investors perceived an increase in the currency fluctuation

9. Exchange Rate Linked Mexican Sovereign Debt Securities.

risk, the demand for such securities increased, as investors attempted to protect their investments from abrupt changes in the exchange rate. This pressure had the effect of switching the internal debt denominated in pesos to a debt denominated in U.S. dollars, and with the aforementioned devaluation, Mexican public debt was increased dramatically.

Outside of Mexico, no public foreign exchange market for new pesos exists where investors may cover the risks of devaluation of the new peso against the dollar. Moreover, the foreign exchange market in Mexico only offers contracts for the coverage of the exchange rate risk of the new peso against the dollar, and such contracts are limited one year terms and require amounts payable resulting from exchange rate variations to be settled between participants in new pesos.

Only once during the last 40 years¹⁰ has the Mexican government imposed strict exchange control policies which limited the right to exchange Pesos for foreign currency.

The risks involved in an investment in Tesobonos can be summarized as follows: (i) exchange risk due to the fact that the exchange rate could ultimately be determined by the Mexican government; (ii) convertibility risk, because legal restrictions may be imposed; (iii) transfer risk, because restrictions on transferability may be imposed; and (iv) the general sovereign risk of the Mexican government.

B. SECOND TIER MARKET

In order to permit less-liquid issues and issuers with a lower capitalization to participate in a public securities market, the CNV recently published general rules to implement an intermediate securities market, in addition to the current market, which will also be operated by the Mexican Stock Exchange. In essence, the general rules divide the Securities Registry of the registry of the CNV into two subsections, Subsection "A" and Subsection "B". Registration of securities in Subsection "A" enables such securities to be eligible for certain transactions for which only securities classified as "high-liquidity" issues by the Mexican Stock Exchange are eligible (i.e. issuance of warrants).

In general, in order to become registered and maintain such registration in Subsection "A" of the registry of the CNV, an issuer is required to meet more stringent qualitative and quantitative requirements than for Subsection "B". In order to become registered in Subsection "A", for example, an issuer is generally required to have (i) at least three years of operating history; (ii) shareholders' equity of at least 100 million new pesos; (iii) profits for the last three years of operation, taken as a whole; (iv) a public float of at least 15 percent of its capital stock, on a fully diluted basis; and (v) as a result of the offering, there must be at least 200 shareholders, with diversified individual participation with respect to the total amount of the offering.

To maintain their registration in Subsection "A", issuers are required to have (i) shareholders' equity of at least 50 million new pesos; (ii) a public float of at least 12 percent of its capital stock, on a fully diluted basis; and (iii) at least 100 shareholders, whose individual participation is diversified with respect to the total capitalization of the issuer in accordance with the current market price for the securities. Such amounts are updated on a yearly basis to reflect changes in the Mexican National Consumer Price Index.

The requirements for Subsection "B" are of the same nature, but the quantitative requirements are lower. The Mexican Stock Exchange will carry out an annual review of

10. During the four-month period from September 1, 1982 to December 20, 1992.

each issuer to determine if it continues to meet the requirements for registration in Subsection "A". The registration of the securities will be reclassified as Subsection "B" if the issuer does not meet the requirements for Subsection "A". In the event that the issuer does not meet the requirements to maintain the registration of its securities in Subsection "B", such registration, and the listing thereof on the Mexican Stock Exchange, may be canceled by the CNV.

C. INTERNATIONAL QUOTATION SYSTEM

On July 24, 1993, amendments to the Mexican Securities Market Law became effective, which included the creation of an international quotation system. As a result, for the first time in recent Mexican history, it will be possible to effect a public offering and to intervene in the Mexican market with securities issued abroad.

The following distinction was established by the law:

1. In the case of the *intermediation* of securities without effecting a public offering in Mexico, quotation in the International Quotation System is permitted, subject to the following: (i) the securities may not be registered in the Securities Section of the registry of the CNV;¹¹ and (ii) the issuers or the market of origin of the securities must receive the recognition of the CNV.
2. In the case of a *public offering*, registration in the Securities Section of the registry of the CNV is permitted, but the Mexican Central Bank and the Ministry of Finance and Public Credit may establish the timing and conditions for such registration, taking into consideration National Development Planning objectives and those guidelines of the monetary, credit and exchange policy considered to be fundamental.

D. MANDATORY TENDER OFFERS FOR CONTROL GROUPS

On April 13, 1993, the CNV issued Rule 11-22 which, among other things, established a mandatory obligation on the part of the control shareholders to carry out a tender offer before the delisting of the company's shares on the Mexican Stock Exchange and the registry of the CNV. This can be a potential liability for controlling shareholders, mainly because the rule establishes certain parameters for the price of the tender offer which may not be less than the higher of: (i) the average closing price during the prior thirty days on which the shares were traded; or (ii) at least 90% of book value.

E. TRANSACTIONS WITH DERIVATIVES IN THE LOCAL MARKET

As a result of local risks and the internationalization of the Mexican economy, a risky environment was created in Mexico which forced Mexican companies and intermediaries to look for more efficient hedging alternatives. New mechanisms for exchange hedging have been sought, because they allow business concerns to minimize the effects of the volatility of the exchange markets.

Aware of this situation, on October 11, 1994 the Central Bank of Mexico, allowed Mexican banks access to an interest rate hedging market, through swaps of interest rates and forwards. The prevailing view, however, is that a Mexican bank may not enter directly

11. Which would allow to effect a public offering.

into any kind of derivatives transaction in the local market (specifically those of a speculative nature). It is also expected that the authorities will issue new rules to impose capitalization requirements for such transactions.

The Mexican Securities Commission issued Rule 10-157 which permits the issuance of listed warrants by Mexican banks, stock brokerage houses and even companies, although to date, Mexican companies, have not issued warrants in the local market. Mexican issuers are also starting to use novel type of securities that combine features of equity and debt instruments, like the one created by Nacional Financiera, S.N.C. to sell off the last package of shares of Teléfonos de Mexico, S.A. de C.V. owned by the government.¹²

F. ISSUANCE OF LIMITED VOTING STOCK

Limited voting stock and non-voting common stock are currently a "hot" issue in Mexico. The authorities, on the one hand, take one of two views of such stock. First, as a means to permit the flow of foreign investment, the Ministry of Commerce and Industrial Development permits, and even promotes, the issuance and sale of such shares as a means for Mexican nationals to maintain control of companies, while capitalizing them through new investment. Such a view has also been taken by the Ministry of Finance and Public Credit in connection with financial intermediaries. Second, as listed securities, such shares have been restricted and limited to certain conditions by the Mexican Securities Commission. Only a limited percentage of capital stock can be represented by such special shares, and exchange offers are limited.

On the other hand, Mexican companies and shareholders are pressing to get more freedom to list such special shares, since they are accepted by investors (both domestic and foreign) and allow liquidity without loss of control.

The CNV has also established a policy that prohibits an issuer that already has publicly-traded common stock from engaging in a corporate action or issuance that disparately reduces or restricts shareholder voting rights. This criteria, not developed in Mexico, is derived from the so-called "one share, one vote" rule, Rule 19c4, issued by the SEC, and by which certain standards are imposed for listing by National Securities Exchanges and Associations. This rule is, however, only applicable to U.S. domestic issuers, and generally prohibits any corporate action which has the effect of nullifying, restricting or disparately reducing the per share voting rights of holders of an outstanding class or classes of common stock of an issuer.¹³

That rule was invalidated by the U.S. Court of Appeals in the case of *The Business Roundtable V. SEC*, 905 F.2d 406 (D.C. Cir. 1990). The New York Stock Exchange, Inc., however, proposed a rule change on June 1, 1994 to adopt a new voting rights policy in order to not disparately reduce or restrict, through any corporate action or policy, the voting rights of existing shareholders of publicly traded companies. Examples of such corporate action

12. PRIDES (Provisionally Redeemable Income Debt Exchangeable for Stock), on May 11, 1994.

13. The most commented issue was Rule 19c-4 (c), which presumes that any issuance of securities through an exchange offer by the issuer for shares of an outstanding class of the common stock of the issuer, in which the securities issued have voting rights greater than or less than the per share voting rights of an outstanding class of the common stock of the issuer, is considered to restrict the per share voting rights of an outstanding class or classes of common stock.

include the adoption of time phased voting plans, the adoption of capped voting rights plans, the issuance of super voting stock, or the issuance of stock through an exchange offer with voting rights less than the per share voting rights of existing common stock.

G. PARTICIPATION OF FOREIGN INTERMEDIARIES

As a result of the North America Free Trade Agreement (the NAFTA), Mexico opened its financial system to U.S. and Canadian financial intermediaries. Intermediaries with U.S. or Canadian based branches or subsidiaries are also eligible for the national treatment granted by the NAFTA.

On January 16, 1995 President Ernesto Zedillo Ponce de León forwarded a Decree to the Mexican Congress for consideration to amend several statutes related to such financial intermediaries. The Decree, which was published in the *Diario Oficial de la Federación*, entered into force on February 16, 1995, with the exception of the last paragraph of article 73 of the Law of Credit Institutions, which entered into force on July 1, 1995.

The reforms evidenced by the Decree are far reaching with respect to foreign participation in the Mexican financial services sector. On the one hand, the maximum participation by foreigners in the voting stock of Mexican financial group holding companies, multiple banking institutions and securities firms has been increased from 30% to 49%; while on the other, Mexican investment in the voting stock of holding company affiliates and affiliate banks is now permitted by as much as 49%, provided that a foreign financial institution or holding company affiliate, as the case may be, owns at least 51% of such stock.

In addition, the maximum allowed individual shareholder participation has been increased from 10% to 20%; and participation in Series "L" shares of non-voting stock has been increased from 30% to 40% of the ordinary portion of the capital stock.

Finally, the Decree contains provisions aimed at increasing the protection of the public interest by allowing the intervention of governing bodies in the case of unsafe and unsound practices, and further restricting loans by banks to insiders and investments by banks in their affiliates.

H. PACKAGING OF SECURITIES

In order to avoid segmentation of the quotation price on securities due to the need for different classes of shares for control purposes, Mexican companies have recently begun to "bundle" or tie together different classes of securities in one single unit. Historically, this has not been a very common practice. In the future, however, we expect to see more of these types of units in that they increase the ability of all the shareholders to sell their stock in the market regardless of the class of security traded.

The procedures to unify securities vary, but the types can be summarized, as follows:

1. *CPOs*: CPOs are participation certificates issued by a Mexican bank acting as trustee under a Trust Indenture, which holds the securities. CPOs evidence financial and other rights on the underlying shares.
2. *Transitory Units*: A condition to certain public offerings has been the purchase of two or more classes of securities by each individual purchaser. After the offering period the shares trade separately.

3. *Permanent Units*: Permanent units are different classes of shares which are evidenced by a single certificate. The only security which is tradeable on the Exchange is the unit and not the individual shares.¹⁴

IV. Prospects

The importance of international securities markets has not diminished for Mexican issuers, notwithstanding the significant drop of the Mexican Stock Exchange during the last months. Foreign investors are cautiously waiting signs of better conditions and a possible recovery of the equities market before adding Mexican paper to their portfolios again. In addition, there continues to be a need for additional capital in Mexican companies, specifically in those with large expansion projects and debt restructuring plans. As a result, we expect that Mexican issuers will be resorting, in the short term, to the placement of high-yield debt instruments in international markets.

The financial crisis of the last months has also encouraged the issuance of warrants and the creativity of companies and underwriters in developing and promoting new investment instruments.

The opening up of the Mexican economy still offers many opportunities, such as competition of long distance telephone services, the privatization of railroads, gas storage and distribution, electric power generation, satellite telecommunications systems, and airports and port facilities. Although the development and process of opening an economy is normally accompanied by painful consequences and are not exempt from tumbles, the long term view of the Mexican securities market remains both challenging and promising. From the legal perspective, there still exist issues connected with international offerings that must be resolved, including differences in accounting principles, differences in regulatory approaches and different approaches to secondary trading.

14. For example, the recent international offering of units of *Internacional de Cerámica, S.A. de C.V.* (NYSE symbol "ICM"), which was a package of Limited Voting Units each consisting of one Series D Share and one Series L Share.