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North American
Free Trade & Investment Report

WorldTrade Executive, Inc.

Biweekly report on legal & financial issues affecting direct investment and cross-border trade in Mexico, the U.S., and Canada

Mexico: Energy Reform

The Pemex Law and Related Measures – What Energy Reform Means for Mexico

By Larry B. Pascal (Haynes and Boone, LLP) and
Marcelo Paramo (ERC Abogados)

Background on Oil and Gas Sector

The Mexican Constitution reserves to the State the exploration and production of all hydrocarbons located in Mexico. Nationalized in 1938 by President Lazaro Cardenas, the oil industry has become a source of national pride and a symbol of the wealth and patrimony of the Mexican people. It is considered a "strategic activity" by the Mexican Constitution, and to that effect is strictly reserved to the State. Private participation in the sector is very limited. Specifically, the State has the

*See **Mexico**, page 4*

Canada: Mergers

Failing Firm Analysis in Canadian Merger Review

By Richard Elliott and Jim Dinning
(Davies Ward Phillips & Vineberg LLP)

With the recent global economic downturn, mergers across many industries have been promoted to meet a variety of public interest objectives. A common thread underlying many of these mergers is that at least one of the parties' business is failing. Merger review under Canadian competition law, as in many other antitrust jurisdictions, has long recognized that whether a party to a merger is a "failing firm" is a relevant consideration in the merger analysis. Business failure may in itself constitute a complete justification for allowing a seemingly problematic merger to proceed. This article outlines the Canadian approach to failing firm analysis and briefly considers whether it is adequate to respond to the challenges of the current economic environment.

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HIGHLIGHTS

Vol. 19, No. 14
July 31, 2009

Canadian competition law has long recognized that whether a party to a merger is a "failing firm" is a relevant consideration in the merger analysis. *NAFTIR* outlines the Canadian approach to failing firm analysis.
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NAFTIR takes a look at the Pemex Law and what energy reform means for Mexico.
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North American Free Trade & Investment Report is published biweekly (once in August and December) by WorldTrade Executive, a part of Thomson Reuters, P.O. Box 761, Concord, MA 01742 USA. Tel: (978) 287-0301; Fax: (978) 287-0302; E-Mail: info@wtexec.com; Website: http://wtexecutive.com. Subscription rate is $794 per year U.S./$844 per year non-U.S.
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MEXICO/CANADA

Snapshots

New Pension Fund Rules Allow Managers More Freedom to Pick Stocks

Mexican pension funds have been able to sell less-liquid stocks that were seen as overpriced after regulators gave managers more freedom to pick stocks.

Prior to the development, Mexican funds had to hold stocks in a basket that mimicked the composition of the IPC within a percentage point of deviation.

But Mexico's pension fund regulator Consar said it had increased the acceptable deviation from the official IPC weightings to four percentage points.

"This will give you a lot more flexibility to be overweight or underweight in particular stocks," said Rogelio Gallegos, who manages 3.2 billion pesos ($250 million) in stock investments at Actinver in Mexico City.

Funds managers responded to the new rules by shedding some of the least-liquid stocks on the IPC. Previously, fund managers who wanted to increase their holdings in local stocks had to indiscriminately pick up all the major stocks on the IPC.

"Obviously, people felt that had driven up the valuations of some of the stocks too much," Gallegos said. *—Reuters*

Canada Inflation Rate Hits 56-Year-Low

Canada's annual inflation rate hit a 56-year-low in July, when prices fell by 0.9 percent from a year earlier on sharply lower energy prices, Statistics Canada said.

Analysts had on average expected an annual decline of 0.8 percent. July's figure -- the lowest since the 1.4 percent drop recorded in July 1953 -- is far weaker than the Bank of Canada's target range of around 2 percent annual inflation.

Statscan said the July figure reflected a 23.4 percent fall in energy prices from July 2008 to July 2009. The annual inflation rate excluding energy rose 1.8 percent in the 12 months to July 2009.

The core annual inflation rate -- closely watched by the Bank of Canada -- dropped to 1.8 percent from 1.9 percent in June. The rate excludes the costs of volatile components such as fruit, vegetables, natural gas, fuel oil and gasoline.

Inflation in July fell by 0.3 percent from June while the core rate remained unchanged over the same period. *—Reuters*

Latin American Law & Business Report

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Mexico, from page 1

exclusive right to (a) explore, exploit, refine, and process crude oil and natural gas, (b) produce basic petrochemicals and liquid petroleum gas (LPG), and (c) carry out first-hand sales of such hydrocarbon products.

The Mexican government performs oil and gas related activities through its national oil company, Petroleos Mexicanos (PEMEX), and its four vertically integrated subsidiaries: *Pemex Exploración y Producción, Pemex-Refinación, Pemex Gas y Petroquímica Básica,* and *Pemex Petroquímica*. Basically, private parties may participate in this sector only as contractors, through construction, procurement, or services contracts with PEMEX or any of its subsidiaries. PEMEX may enter into contracts with private parties, but by statute all contracts must be paid in cash. Private parties are prohibited from receiving an ownership interest in the production or results from the operation.

Decline of Cantarell Oil Field

However, the long-term viability of this constitutional framework, and in particular the ban on risk contracts, has been called into question by the dramatic decline of the Cantarell oil field, Mexico's most productive and one of the world's largest producing oil fields.[1] Located in the shallow waters of the Bay of Campeche, production at Cantarell started in 1979, but output began to decline by the mid 1980s. Daily production was 2.3 million bbl/day in 2004, which represented 63% of Mexico's crude oil production.[2] Most analysts believe that the production decline in Cantarell is irreversible.

The decline of the Cantarell oil field also has serious implications for the Mexican federal budget. The Mexican Government has historically relied heavily on PEMEX for general revenue needs, and to this effect the government receives approximately 60% of Pemex's gross revenue, and in recent years this has amounted to 110% of the company's net income.[3] Despite being a monopoly, Pemex has consistently recorded losses in recent years, even when international oil prices were high. Consequently, PEMEX depends on governmental appropriations and borrowings for new investment. This lack of capital has prevented it from investing in new technologies that could help it carry out deep water projects, which offer the best opportunity for large undiscovered finds.

In fact, these failures are arguably affecting Mexico at the present time. Mexico's prized investment level credit rating may be vulnerable, as rating agencies assess the country's vulnerability to lower oil prices and declining production.[4] For example, PEMEX contributed 37% of government revenue in 2008 and the 60% reduction in oil prices from a July 2008 record helped contribute to Mexico's budget deficit of 149 billion pesos (US$ 11.3 billion) in the twelve months through March 2009, compared to a 3.3 billion peso surplus for the prior twelve month period.

Adoption of Recent Pemex Law

General Principles of the Reform

In response to these and other factors, the Mexican government reformed PEMEX's legal framework by amending laws and regulations that govern PEMEX's activities. As part of this reform, in November 2008, Mexico adopted the PEMEX Law, which created a new legal framework for its national oil company. The main goal of the reform is to transform PEMEX from a bureaucratic company, constrained and limited by excessive governmental regulations, to a more agile state-owned company that has the necessary flexibility to operate and compete in the international oil and gas market. On the other hand, this reform does not change the constitutional principles that reserve oil production to the Mexican government, and hence many independent observers remain skeptical as to whether this measure will accomplish these lofty goals.

The reform introduces four legal and structural changes: (a) special public administration regime, (b) corporate governance reforms, (c) operational autonomy, and (d) special contracting reforms. These concepts are discussed further below.

(a) Special Public Administration Regime. The PEMEX Law seeks to transform PEMEX into a state-owned company with sufficient flexibility to operate in a competitive market, in part by authorizing it to adopt its own regulations to operate (subject only to some broad restrictions discussed below), without violating fundamental constitutional principles. As such, PEMEX will operate pursuant to its own internal regulations (to be adopted), as opposed to those that apply to general quasi-governmental entities. Nevertheless, where PEMEX's new regulations are silent, regulations that apply to general quasi-governmental entities will continue to apply.

(b) Corporate Governance Reforms. Pursuant to the PEMEX Law, the company's board of directors is composed of fifteen (15) members[5] consisting of six (6) representatives of the Mexican State appointed by the President,[6] five (5) representatives appointed by the PEMEX union,[7] and four (4) professional directors appointed by the President and ratified by the Senate.[8] PEMEX's General Counsel will serve as the Board's Secretary.

The goal of the new structure is to create a less politicized decision-making process. With the addition of the four professional board members, the goal of the PEMEX Law is that PEMEX make important decisions from a more technical perspective.

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The PEMEX Law seeks to strengthen PEMEX's internal governance in two significant aspects:

(i) Authority of the Board of Directors. In the interest of achieving greater autonomy, under the reforms, the PEMEX board of directors will now have greater authority over PEMEX's management. In particular, PEMEX will adopt its own annual budget, instead of having to depend on obtaining authorizations from the Ministry of Finance and Public Credit (Secretaria de Hacienda y Credito Publico or "SHCP"). Furthermore, the board of directors now has an array of significant powers to carry out PEMEX's operations, and several committees presided by professional directors will assist the board to this effect.[9]

(ii) Adoption of Best Corporate Practices. Although this concept is not a novel one, it has not been fully implemented in Mexican quasi-governmental entities such as PEMEX. The PEMEX Law seeks to enhance Board oversight and control, which constitute a significant change from the manner in which PEMEX and its subsidiary entities previously operated, particularly with respect to the decision-making process and the relationship with management.

(c) Operational Autonomy. Third, the PEMEX Law seeks to advance operational autonomy (and by implication enhanced efficiency), particularly in the financing and budgeting areas. The public policy consideration was that PEMEX needed more decision-making flexibility, particularly in strategic areas, such as financing and budgeting, in order to move away from its historic dependence on the Mexican Treasury.

In particular, with respect to financial issues, certain significant rules that re-define PEMEX's ability to obtain credit have been adopted:

(i) Own Financial Program. PEMEX has been given authority to prepare its own financial program, consistent with the General Law of Public Debt (Ley General de Dueda Pública) and subject to the annual limits established by the Mexican Congress. Regarding budgetary issues, the PEMEX Law grants more authority to the PEMEX board to develop and approve its own budget. On one hand, under certain conditions, the approval previously required by the Mexican Treasury under the Federal Law of Budget and Financial Responsibility (Ley Federal de Presupuesto y Responsabilidad Hacendaria) is no longer required.[10] On the other hand, as discussed below, the PEMEX Law grants PEMEX more flexibility in contracting with its Mexican suppliers and contractors.

(ii) More Authority to Obtain Financing from External Sources. PEMEX has been given the authority to obtain financing from external sources, such as the capital markets, without the need for approval by the Mexican Treasury, provided that no rights over Mexican hydrocarbons are granted to creditors. However, significantly, PEMEX will not be permitted to use financing that relies on the full faith and credit of the Mexican Government.

(iii) Citizen Bonds. PEMEX is authorized to issue "citizen bonds," which although not expected to be a major source of capital due to the relatively small size of the Mexican capital markets, may create a closer link between the Mexican public and PEMEX's operations. Interestingly, these bonds will grant their holders a return linked to the entity's financial performance.

(d) Special Contracting Regime. Finally, the PEMEX Law grants Pemex (but not other para-statals) a new regime for the procurement of goods and services. For activities that are not deemed part of the oil industry reserved to the State, the general regime for acquisitions and works of the public sector remains the same. With this new special contracting regime, subject to the previously mentioned restrictions, PEMEX may establish the bid terms, criteria, and contract models which best meet the needs of the particular services or works that govern the international market in this industry.

To this effect, as part of the implementation of this change, the Public Works Law ("Ley de Obras Públicas y Servicios Relacionados con las Mismas") and the Procurement Law ("Ley de Adquisiciones, Arrendamientos y Servicios del Sector Público") have been amended to exclude from such laws, public works and procurement contracts entered into by PEMEX in connection with the oil and gas industry.

In addition, PEMEX's board of directors now has the authority to issue administrative regulations to govern procurement and public works related to contracts within the range of activities of the oil industry reserved to the State, which will be published in the Federal Official Gazette. These regulations must comply with the general procurement contracting principles of article 134 of the Mexican Constitution, which basically mandate that government contracts will be awarded through public bidding procedures or, with limited exceptions, through restricted bidding procedures, or direct awards. In any event, in all contracts executed by PEMEX, public officers have the responsibility to assure that PEMEX is getting the best available conditions regarding price, quality, financing, opportunity, and other relevant terms and conditions.

PEMEX and its subsidiaries, in performing the activities reserved to the State, may enter into contracts, subject to certain conditions provided in the PEMEX Law, which shall assure the State's sovereignty over hydrocarbons,

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such as: (i) No rights shall be granted over hydrocarbon reserves, therefore suppliers or contractors may not book the reserves on their financial statements; (ii) Payment shall always be made in cash, and no percentage in the production, sales, or profits may be agreed upon as a payment method; and (iii) No production sharing contracts or any other type of association compromising the reserves will be allowed.

However, it is important to point out that the new PEMEX Law allows for PEMEX to include in its procurement and construction contracts clauses for additional compensation to the contractor in instances where the contractor performs efficiently and provides economic and technical benefits to PEMEX. In any event, this additional compensation must be paid in cash and specifically be provided for in the respective contract at the time of execution.

Other Relevant Aspects of the Reform

As part of the reform of November 2008, Mexico also amended several other laws with the goal of developing the energy sector, without changing the constitutional principles that reserve energy resources to the Federal Government.

National Hydrocarbon Commission

The Law of the National Hydrocarbon Commission provides for the creation of the National Hydrocarbon Commission (*Comisión Nacional de Hidrocarburos*) as an entity (*órgano desconcentrado*) of the Ministry of Energy. Its purpose is to regulate and supervise exploration and production of hydrocarbons in Mexico, and the processing, transportation, and storage of these products.

In complying with this purpose, this Commission shall act pursuant to the National Energy Strategy and carry out its mandate, making sure that PEMEX and its subsidiaries carry out exploration and production activities using the most suitable technology, according to economic and productive principles, environmental protection, and sustainability of natural resources. The Commission's most important authorities include:

(a) Provide the technical elements for the design and definition of the country's hydrocarbon policy, as well as for the preparation of sector plans with respect to hydrocarbon exploration and production, according to the policy adopted by the Ministry of Energy;

(b) Collaborate with the Ministry of Energy in the determination of the policy for the restoration of hydrocarbon reserves;

(c) Establish technical standards for exploration and production of hydrocarbons, within its scope of authority, and verify the compliance thereof;

(d) Perform technical studies prior to the assignment of exploration fields to PEMEX by the Energy Ministry; and

(e) Maintain an oil registry that contains records of adopted resolutions, areas assigned to PEMEX, oil reserve zones, etc.

The Commission will be composed of five commissioners appointed by the President for a five-year term, renewable on one occasion for a term of the same length. The law provides that the Commission will be duly established within 90 days of November 28, 2008, and is to be fully operational no later than 180 business days from November 28, 2008. This Commission was officially installed on May 20, 2009 with the announcement by Georgina Kessel, Minister of Energy, of the five commissioners that were appointed by President Felipe Calderón.[11] The Commission will adopt its internal regulations in order to formally commence in August 2009.

Energy Ministry's New Authority

As part of the above-mentioned amendments, article 33 of the Federal Public Administration Organization Law (*Ley Orgánica de la Administración Pública Federal*) was also amended to grant additional authority to the Ministry of Energy, necessary under the newly enacted laws and reforms for:

a. The carrying out of the country's energy policy, as well as the oversight of compliance, with emphasis on energy security, diversification, and environmental protection;

b. The development of mid-term and long-term energy plans; preparation of social and economic guidelines for the state-owned companies of the energy sector, focusing on aspects related to energy sovereignty and security, improvement of energy productivity, restoration of hydrocarbon reserves, progressive reduction of environmental impacts in energy production and consumption, greater development of renewable energies, satisfaction of basic energy needs of the population, energy savings, greater efficiency in production and consumption, strengthening governmental entities in the energy sector, support to national technological research and development; and

c. Forming the National Energy Council and issuance of its rules of operation,[12] promotion of energy savings, and issuance of norms for modernization, efficiency and development of the sector, regulation and promotion of the development and use of alternative energy sources and promote the corresponding incentives.

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New Authority for the Energy Regulatory Commission

Amendments to the Law of the Energy Regulating Commission (*Ley de la Comisión Reguladora de Energía*) have also granted the Energy Regulatory Commission (*Comisión Reguladora de Energía,* "CRE") more decision-making autonomy to complement the operational and technical autonomy that it previously had prior to the reform. In addition to its obligation to promote the efficient development of the regulated activities regarding gas and electricity, the CRE also now has the authority to regulate the first-hand sale of fuel oil and basic petrochemicals. The regulation of transportation, storage and distribution of oil-refined products and biological fuels, when such activities are carried out through pipelines, was also added.

Law for the Use of Renewable Energy and Financing the Energy Transition

The Law for the Use of Renewable Energy and the Financing of the Energy Transition (*Ley para el Aprovechamiento de Energías Renovables y el Financiamiento de la Transición Energética*) was adopted to regulate the use of renewable energy and clean technologies for the generation of electricity for uses other than rendering of the "public service" of electric power, as well as to set forth the national strategy and instruments for the financing of energy transition.

The Energy Ministry is to adopt a strategy focused on the primary use of renewable energies to generate electric power. The term "energy transformation" implies the promotion by the State of energy efficiency and sustainability, as well as the reduction of the use of hydrocarbons as a primary energy source. According to this law, renewable energies include wind, solar, water movement, oceanic energy (tidal power, tide-thermal power, waves, etc.), heat from geothermic fields, bioenergetics, and any other forms of energies determined by the Energy Ministry.

In addition, the CRE has the authority under this law to issue the norms, standards, guidelines, methodologies, and other administrative provisions governing electricity generation from renewable energies, according to the energy policy set forth by the Ministry of Economy. The criteria to determine payment for bio-fuels utilized in the generation of electricity is to be coordinated by the CRE with the Mexican Treasury. Among the CRE's duties in this aspect, there is the authority to issue methodologies to determine the provision of the generation capacity of renewable energies to the National Electric System.

Law to Promote Sustainable Use of Energy

The purpose of the "Law to Promote Sustainable Use of Energy" (*Ley para Promover el Aprovechamiento Sustentable de Energía*) is to achieve sustainable development of the energy industry, through its optimal use in all its processes and activities, from exploitation to consumption. The President is to establish the strategies, objectives, and measures, of energy conservation under a special program by the name of National Program for the Sustainable Use of Energy.

The National Commission for the Efficient Use of Energy (*Comisión Nacional para el Uso Eficiente de la Energía*), which replaces the National Commission for Energy Savings (*Comisión Nacional para el Ahorro de Energía*), is an organization within the Ministry of Energy with technical and operational autonomy, granted the mandate to promote energy efficiency.

The Consulting Council for the Sustainable Use of Energy (*Consejo Consultivo para el Aprovechamiento Sustentable de la Energia*) is an advisory body of the Commission, with the purpose to evaluate the compliance of objectives, strategies and actions set forth in the Program. This council is formed by the Minister of Energy and six academic researchers.

Gas Associated with Mineral Carbon Deposits

Gas Associated with Mineral Coal Deposits, also called in Mexico *gas grisú*, is primarily composed of methane. The regulation of this gas is within the authority of the Ministry of Energy and the Ministry of Economy, through the Regulatory Law of Article 27 of the Mexican Constitution Regarding Oil and the Mining Law (*Ley Minera*). Its use is restricted to internal use by the holder of the mining concession, or sale to PEMEX. However, the sale to third parties by the concession holder is not allowed.

In December 2008, the implementing regulations for *gas grisú* were published. To this effect, the Ministry of Energy has been granted authority to issue permits and guidelines for the consumption of the gas by the mining concession holder or for its supply to PEMEX.

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1 See "Mexico Cantarell oil field output falls again in May," citing a Mexican Energy Ministry report indicating that oil production for the field fell in May 2008 for the eighth month in a row to 1.038 million barrels per day, its lowest level in twelve years," Reuters.com, June 26, 2008.

2 See "Energy Cooperation in the Western Hemisphere," edited by Sidney Weintraub, p. 115 (2007).

3 Weintraub, p. 107.

4 See "Mexico Faces Downgrade after 'Very Complacent' Decade," Valerie Rota and Carlos Manuel Rodriguez, May 12, 2009, Bloomberg.com.

5 Previously, the board was composed of six representatives designated by the President and five representatives designated by the union, a nod to the grand coalition put together by the PRI, Mexico's ruling party for approximately 70 years.
6 Currently, the directors appointed by the Mexican State are Georgina Kessel, who serves as president of the Board (Ministry of Energy), Agustin Carstens (Treasury Ministry), Gerardo Ruiz Mateos (Economy Ministry), Patricia Flores (Director of the President's Office), Ernesto Cordero (Ministry of Social Advancement), and Salvador Vega (Ministry of the Public Comptroller).
7 The board representatives designated by the Pemex union are Ricardo Aldama, Fernando Pacheco, Jorge Wade, Hector Manuel Sosa, and Pedro Garcia.
8 In March 2009, the four professional Board members were announced and subsequently approved by the Congress. These individuals, serving staggered terms, are: (a) José Fortunato Álvarez (6-year term)(he has previously served as the head of the PEMEX's Internal Control Office, as a congressman, and held several positions in Baja California's Government; (b) Hector Moreira Rodriguez (5-year term) (he has previously served as the Vice-Dean of the Investigations and Technology Departments of the *Tecnológico de Monterrey*, Vice-Secretary of Hydrocarbons for the Ministry of Energy, and Chief of Vicente Fox's office of Strategic Planning; (c) Rogelio Gasca Neri (4-year term)(he formerly worked as a politician and businessman, including as Minister of Budget for ex-President Carlos Salinas' government, president of the Federal Electricity Commission, and most recently, as president of the holding company that controlled Aeromexico and Mexicana (Mexico's largest airlines); and (d) Fluvio Ruiz Alarcón (3-year term)(he is a member of the Citizen Energy Observation and Study Commission, and acted as advisor for the PRD on energy matters as part of the negotiations for the new PEMEX's legal framework.
9 Article 19 of the PEMEX Law provides a long list of duties and authority granted to the board of directors, including: issue guidelines to regulate the relationship between PEMEX and its subsidiaries, manage PEMEX's according to best industry practices, and issue internal regulations for contracting procurement and construction contracts.
10 Article 49 (III) of the PEMEX Law provides that the board of directors may authorize to increase budgeted expenditures, if PEMEX's own profit exceeds projected income, without the need to obtain other governmental authorizations.
11 The five new commissioners are (i) Juan Carlos Zepeda Molina (President), (ii) Edgar René Rangel Germán, (iii) Javier Humberto Estrada Estrada, (iv) Guillermo Cruz Dominguez Vargas, and (v) Alfredo Eduardo Guzmán Baldizán.
12 The National Energy Council is composed of the head of each governmental entity of the energy sector (i.e. PEMEX, CFE, CRE, National Water Commission, etc.). The purpose of the Council is to assist the Energy Ministry in establishing national energy policy.

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CANADA

Executive Compensation

"Say on Pay" Comes to Canada: The Canadian Campaign to Give Shareholders a Say on Executive Compensation

By Tiffany K. Koch and David A. Judson
(Miller Thomson LLP)

"Say on pay" has received increased attention in Canada this year due to investor concerns with executive compensation in markets characterized by poor financial results and declining share prices. "Say on pay" is a term used to describe annual non-binding shareholder advisory votes on the executive compensation policies of public companies. The voting results do not determine whether a compensation committee's report will be approved, but rather serve as an indicator as to the level of shareholder support for a public company's executive compensation and compensation policies.

Currently, there is no Canadian legislation or securities commission instruments that require or regulate say on pay. Legislation has been adopted in the United Kingdom and Australia providing for non-binding advisory votes and legislation for *binding* annual shareholder votes on executive pay is currently in effect in the Netherlands, Sweden, Norway, Spain and France. In the U.S., financial

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institutions that received funds under the Troubled Asset Recovery Program (TARP) (approximately 400) are required to conduct an annual, non-binding shareholder vote on executive compensation for all proxy statements filed after February 17, 2009.

This year, shareholder proposals for advisory votes were approved by a majority of shareholders of four of Canada's banks – Royal Bank, CIBC, Bank of Montreal and Bank of Nova Scotia. National Bank of Canada and The Toronto-Dominion Bank voluntarily agreed to advisory votes on executive compensation prior to proposals being voted on at their next annual general meetings in 2010. In addition to the banks, a handful of other reporting issuers in Canada announced that they will have say on pay votes at their next annual meetings. Earlier this year, the Canadian Coalition for Good Governance, an organization representing the interests of institutional investors, recommended that all boards of public companies adopt a say on pay vote as a best practice.

Miller Thomson Analysis

To date, no say on pay vote has actually occurred in Canada. The first of these votes will take place in 2010. It is difficult to predict what, if any, real impact say on pay voting will have on the compensation policies and practices of Canadian public companies. Experience from other jurisdictions suggests that the vast majority of executive compensation reports are approved. Accordingly, it may well be the case that say on pay advisory votes will prove to have negligible impact on the compensation policies and practices of Canadian public companies.

What Should CanadianCompanies be Doing Now?

In considering whether to adopt a say on pay vote, Canadian public companies should assess the following:

1. If a shareholder proposal has been submitted, its likely level of support.
2. Prevailing practices of other issuers in the same or a comparable sector.
3. The views of significant shareholders.
4. The over-all purpose for implementing a say on pay vote.
5. The particular matters that would be the subject of a say on pay vote.

6 The expected impact of such a vote on shareholder relations.

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Product Safety

Canada's Proposed Consumer Product Safety Act: Bill C-6

By Jennifer Bishop and Roxanne Chow
(Miller Thomson LLP)

On January 29, 2009, the Canadian federal government reintroduced Bill C-6, the proposed *Canada Consumer Product Safety Act* (the "Act"). If passed, the Act will bring under Health Canada's supervision a number of consumer products that had not previously been regulated, and will affect all consumer products except for certain products regulated under other statutes, such as foods, drugs and cosmetics. Although Bill C-6 has not yet been passed into law, it is useful to take a preliminary look at its provisions in preparation for the new changes.

The Act will address regulation of manufacturing, importation, packaging, storage, advertising, labelling, sale and testing of consumer products. In addition, the new legislation will broaden the scope of powers granted to Health Canada inspectors to order recalls and remedial measures if inspectors have "reasonable grounds" to believe that a product is a danger to human health or safety. More specifically, the Act contains the following provisions:

Recalls

Section 20 of the Act grants to inspectors the power to conduct spot inspections and the power to order a recall or other remedial measures where the inspector believes on reasonable grounds that a consumer product is a danger to human health or safety. This is a broad grant of power to the inspectors as what constitutes "reasonable grounds" is not defined within the Act.

Prohibitions

Section 7 of the Act states that no manufacturer or importer shall manufacture, import, advertise or sell a consumer product that (a) is a danger to human health or safety; (b) is the subject of a recall order or voluntary recall in Canada because the product is a danger to human health or safety; or (c) is subject to an inspector's order that has not been complied with. The legislation defines "danger to human health or safety" as any existing or potential unreasonable hazard that is posed by the consumer product during its normal or foreseeable use that may reasonably be expected to cause death, injury or have an adverse effect on that individual's health. This is a broad definition that also includes any chronic adverse effect on human health. However, there is no definition for the term "unreasonable hazard".

Reporting Obligations

Section 13 of the Act mandates that a manufacturer, importer or seller must report an incident that could reasonably be expected to have serious adverse health effects or result in serious injury. An incident includes any recall order made by a regulator in another jurisdiction, and any occurrence or product defect in Canada or in another country that resulted or may reasonably have been expected to result in an individual's death, serious adverse health effect or serious injury. The manufacturer, importer or seller must notify Health Canada within two days of becoming aware of the incident or recall, and provide a more detailed report within ten days of becoming aware of the incident or recall.

Disclosures by Health Canada

Section 17 of the Act permits Health Canada to disclose confidential business information related to a consumer product to a person or government working in the area of protection of human health and safety or the environment where there is a serious and imminent danger to human health or safety if the disclosure is essential to address the danger. This disclosure can take place without the prior consent of or notification to the person to whom the information relates, although notification of this disclosure shall subsequently be made to that person by the following business day. The time lapse between disclosure and notification may unduly expose certain pieces of proprietary information belonging to manufacturers, distributors and retailers.

Penalties

Section 38 of the Act imposes a fine of up to $5,000,000 on individuals who fail to comply with the Act, or imprisonment for a term not longer than two years, or both. In addition, the fine for an offence will accrue on a daily basis where an offence is continued for more than one day Section 39 of the Act puts liability expressly on directors and officers who directed, authorized or assented to the commission of the offence. Section 47 of the Act sets the amount of a maximum administrative penalty of up to $25,000 for violations of the Act.

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Failing Firm Analysis under the Competition Act

The substantive test for merger review under the *Competition Act* (the "Act") is whether the merger is likely to prevent or lessen competition substantially. The Act enumerates a list of factors that may be relevant in carrying out that competition assessment. Among these factors is "whether the business, or part of the business, of a party to the merger or proposed merger has failed or is likely to fail" (paragraph 93(b)).

There has been no consideration of paragraph 93(b) by the courts or Competition Tribunal. Given this, the Competition Bureau's (the "Bureau") 2004 *Merger Enforcement Guidelines* (the "MEGs") take on added importance in understanding how the Bureau is likely to treat claims of business failure in merger review.

There are two broad issues in the MEGs' failing firm framework: (i) whether there is likely business failure and exit of assets from the relevant market; and (ii) whether there is any alternative to the merger that would likely lead to a materially higher level of competition. Where there is likely failure and exit of assets with no competitively preferable alternative, the merger can be permitted on the rationale that the loss of competition is not attributable to the merger – i.e., the merger is not preventing or lessening competition substantially. According to the MEGs, the Bureau considers a firm to be failing if: (1) it is insolvent

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or is likely to become insolvent; (2) it has initiated or is likely to initiate voluntary bankruptcy proceedings; or (3) it has been or is likely to be petitioned into bankruptcy or receivership. The Bureau typically requires audited or independently prepared financial information from the firm (such as projected cash flows, credit information) to support claims that the firm is failing or is likely to fail.

The Bureau also looks at three factors in assessing whether there are alternatives to the merger that would be likely to result in a materially greater level of competition: (1) is there a "competitively preferable" third party that is willing to pay a price for the failing firm greater than the net proceeds that would be received in a liquidation; (2) will the retrenchment or restructuring of the failing firm (e.g., restructuring with more focused or narrower operations) lead to a materially greater level of competition than if the proposed merger proceeds; and (3) will liquidation of the failing firm lead to a materially greater level of competition than if the proposed merger proceeds?

The Bureau must be satisfied that a thorough search for a competitively preferable purchaser has been conducted. If not, the Bureau will require an independent third party (such as an investment dealer, trustee, or broker) to conduct such a search.

Failing Firm Cases

The Bureau has publicly discussed failing firm analysis in only a very limited number of merger cases.

Prior to the release of the first version of the Bureau's MEGs in 1991, the Bureau applied a failing firm analysis in two mergers: the acquisition of the assets of Noranda Metal by Wolverine Tube (at the time Canada's only two manufacturers of seamless copper tubing) and the acquisition by PWA Corporation, the parent of Canadian Airlines, of Wardair, another scheduled domestic airline. In both cases, the analysis applied was broadly consistent with what would later be seen in the MEGs.

The Bureau's highest profile use of the failing firm analysis came in late 1999 when it permitted the acquisition of Canadian Airlines by Air Canada, notwithstanding that Air Canada would emerge as a single dominant Canadian airline. The Bureau's rationale for this decision was that Canadian Airlines was facing imminent failure and there was no competitively preferable alternative to the merger with Air Canada.

It should be noted that Air Canada's acquisition of Canadian Airlines was ultimately approved by the Minister of Transport under (subsequently enacted) provisions of the *Canada Transportation Act*, not by the Bureau under the Act. Thus, notwithstanding that Air Canada's acquisition of Canadian Airlines satisfied the Bureau's failing firm test under competition principles, the transaction was allowed in any event under the broader public interest standard employed by the Minister of Transport.

The Bureau has not allowed any other mergers to proceed on failing firm grounds since its Air Canada decision in 1999 (at least not publicly). That is not to say that the financial state of companies or industries has not been a relevant consideration in merger review. For example, in declining to challenge the merger of two cell phone providers in 2005, the Bureau referred to the target's poor financial position, including its recent filing under the *Company Creditor's Arrangement Act*, in concluding that the merger was unlikely to remove a significant "maverick" from the industry. Also, in the Bureau's 2007 decision to not oppose the Abitibi/Bowater merger, the Bureau noted that the newsprint industry is experiencing declining demand.

Do Non-Competition Considerations Matter in the Failing Firm Analysis?

The MEGs state that the impact that a firm's exit can have in terms of matters other than competition are generally beyond the scope of the assessment contemplated by paragraph 93(b). The wording "generally beyond the scope" arguably leaves the door open to non-competition considerations; however, in practice, the Bureau has stuck to doing what it does best: competition analysis. That is not surprising, given the economic orientation of the MEGs and the fact that even without paragraph 93(b) the substantive test under the merger provisions relates to the impact on competition (i.e., a substantial lessening or prevention of competition).

Although the Bureau (unlike some other competition authorities) pays little regard to non-competition considerations, such as job loss, in carrying out its merger assessments, it would be an oversimplification to suggest that broader public interest considerations have not been relevant to how merger review has evolved at the Bureau. Notably, in the one merger where the potential tension between competition and broader public interest concerns mattered most (Air Canada-Canadian Airlines), the Minister of Transport was sufficiently concerned that the Bureau's approach to failing firm analysis would not adequately consider broader public interest considerations, that the Act and the *Canada Transportation Act* were amended to allow the Minister to override the competition analysis to effect broader public interest goals.

Will the Bureau be More Tolerant of Failing Firm Mergers?

Melanie Aitken, the new Commissioner of Competition, has signalled that the Bureau will stick to its standard competition principles in evaluating mergers in the current environment, noting that the Act applies equally in times of prosperity as it does in times of economic hardship. Thus, it is likely that the Bureau's requirements for justifying a merger on failing firm grounds will remain essentially intact.

Jurisdictions outside Canada have taken different approaches to the same question. For example, the head of the UK's Office of Fair Trading recently warned against the wholesale abandonment of competition principles in dealing with the economic downturn but also acknowledged the need for pragmatism. Some American politicians (such as Speaker of the House of Representatives, Nancy Pelosi) and antitrust experts have called for a more flexible approach to failing firm claims in the current economic climate. On the other hand, Europe's Commissioner for Competition, Neelie Kroes, has stated that the Commission is committed to applying existing rules in the economic downturn, while acknowledging the need to act quickly in response to emergency rescue measures.

One new issue that the Bureau may have to grapple with is how its recently enacted authority to issue a "supplementary information request" (similar to the U.S. HSR second request process) in a merger review will impact failing firm analysis. Responding to a supplementary information request may take too long where a party is truly failing. Recall that the entire review of Air Canada's acquisition of Canadian Airlines occurred in a little over one month.

The Bureau should consider more expeditious options than a second request (which would typically seek extensive market information) to verify the likelihood of failure and lack of competitively preferable alternatives. For example, the Bureau could allow the transaction to close into a hold separate arrangement, thereby permitting immediate funding of the failing firm operations while preserving the ability to continue the substantive merger review post-closing.

Conclusion

The Canadian experience to date with failing firm analysis in merger review has been limited. The few cases where the Bureau has expressly addressed failing firm arguments have largely followed the criteria set out in the MEGs.

While one should not expect any significant relaxation of the Bureau's requirements for establishing a failing firm argument, the prevailing economic climate may increase the number of transactions that satisfy those requirements. In addition, while substantive changes in the Bureau's approach are unlikely, it is hoped that there may nonetheless be opportunities for greater procedural flexibility, such as allowing transactions to close into hold separate arrangements where appropriate, that can help address the challenges of reviewing mergers involving failing firms in Canada.

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