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September 28, 2021

Chris Kirkpatrick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street NW
Washington, DC 20581

Re: Substituted Compliance Application for Mexico Swap Dealers from CEA Sections 4s(e)–(f) and Rules 23.101 and 23.105(d)–(e)

Dear Mr. Kirkpatrick:

On behalf of Morgan Stanley México, Casa de Bolsa, S.A. de C.V., Goldman Sachs México, Casa de Bolsa, S.A. de C.V., and Casa de Bolsa Finamex, S.A.B. de C.V., we are submitting this application to request that the Commodity Futures Trading Commission (“Commission”) make a determination with respect to the capital, financial reporting and related requirements of Mexico specified herein (“Mexico’s Capital & Reporting Framework”) and that compliance with Mexico’s Capital & Reporting Framework by a nonbank swap dealer (“SD”) licensed as a broker-dealer (*casa de bolsa*) in Mexico (a “Mexican SD”) may satisfy the capital and financial reporting requirements applicable to a nonbank SD under Section 4s(e)–(f) of the Commodity Exchange Act (the “CEA”) and Rules 23.101 and 23.105(d)–(e) thereunder (the “Commission Capital & Reporting Requirements”).¹ As we describe in more detail below, Mexico’s Capital & Reporting Framework is designed with the purpose of ensuring the safety and soundness of Mexican SDs, in a manner comparable to the Commission Capital & Reporting Requirements.

I. Introduction

In making a substituted compliance determination pursuant to Rule 23.106 in regards to the Commission Capital & Reporting Requirements, the Commission will consider

¹ As used herein, a “nonbank” SD refers to an SD that does not have a Prudential Regulator as defined in Section 1a(39) of the CEA.

whether the capital and financial reporting requirements of the foreign regulatory system “are comparable to the Commission’s corresponding capital adequacy and financial . . . reporting requirements.”² The Commission has explained that its “approach to substituted compliance is a principles-based, holistic approach that focuses on whether the foreign regulations are designed with the objective of ensuring overall safety and soundness” in a manner that is comparable with the Commission’s capital and financial reporting requirements, rather than a “line-by-line assessment or comparison” of the foreign jurisdiction’s and the Commission’s regulatory requirements.³

Rule 23.106 requires an applicant for substituted compliance to provide:

- “A description of the objectives of the relevant foreign jurisdiction’s capital adequacy and financial reporting requirements”;
- “A description (including specific legal and regulatory provisions) of how the relevant foreign jurisdiction’s capital adequacy and financial reporting requirements address the elements of the [Commission Capital & Reporting Requirements] . . . including, at a minimum, the methodologies for establishing and calculating capital adequacy requirements and whether such methodologies comport with any international standards, including Basel-based capital requirements”; and
- “A description of the ability of the relevant foreign regulatory authority to . . . supervise and enforce compliance with the relevant foreign jurisdiction’s capital adequacy and financial reporting requirements.”⁴

In accordance with the requirements set forth in Rule 23.106, this application is organized as follows: In Section II, we provide an overview addressing general comparability of Mexico’s Capital & Reporting Framework and the Commission Capital & Reporting Requirements, including any general differences between the two sets of requirements and the consistency of the sets’ objectives. In Section III, we address the specific information that Rule 23.106 requires.

For the reasons set forth below, Mexico’s Capital & Reporting Framework is designed with the purpose to ensure the safety and soundness of Mexican SDs, in a manner comparable to the Commission Capital & Reporting Requirements.

II. Overview

Under the Commission Capital & Reporting Requirements, a standalone, nonbank SD may elect the “Bank-Based Approach” or the “Net Liquid Assets Approach” for establishing its minimum capital requirements and computing its regulatory capital under Section 4s(e) of the

² 17 C.F.R. § 23.106(a)(3).

³ Capital Requirements of Swap Dealers and Major Swap Participants, 85 Fed. Reg. 57462, 57521 (Sept. 15, 2020) (“CFTC Capital Final Rule Release”).

⁴ 17 C.F.R. § 23.106(a)(2).

CEA and Rule 23.101 thereunder (the “Commission Capital Requirements”).⁵ The Commission sought to provide this flexibility to SDs in order to allow an SD to choose the capital approach that best fits its business model and to mitigate competitive disparities that might otherwise arise were each SD required to follow the same capital approach.⁶

Bank-Based Approach. The “Bank-Based Approach” is based on the capital requirements established by the Board of Governors of the Federal Reserve System (“FRB”) for bank holding companies, which are codified in the FRB’s Part 217 regulations.⁷ Under the Bank-Based Approach, an SD must maintain:

- Common equity tier one capital (“Common Equity Tier 1”) of at least \$20 million;
- Common Equity Tier 1 equal to at least 6.5 percent of the SD’s risk-weighted assets (“RWAs”);
- Common Equity Tier 1, additional tier one capital (“Additional Tier 1”), and tier 2 capital (“Tier 2” and collectively, “total capital”) equal to at least 8 percent of the SD’s RWAs; or
- Total capital equal to 8 percent of the SD’s uncleared swap margin.

An SD that follows the Bank-Based Approach will calculate its Common Equity Tier 1, Additional Tier 1, Tier 2 and RWAs in accordance with the FRB’s Part 217 requirements. An SD’s “uncleared swap margin” is the aggregate amount of initial margin (“IM”) that the SD would be required to collect pursuant to the Commission’s uncleared swap margin rules from each counterparty for each outstanding uncleared swap position (including exempt and excluded swaps), calculated on a counterparty-by-counterparty basis.

Net Liquid Assets Approach. The “Net Liquid Assets Approach” is based on the capital requirements adopted by the United States Securities and Exchange Commission (“SEC”) for a security-based swap dealer that does not have a Prudential Regulator. These requirements, which are codified in SEC Rule 18a-1 (“Rule 18a-1”), mirror the net liquid assets approach that Rule 15c3-1 of the Securities Exchange Act of 1934 applies to securities broker-dealers, requiring a nonbank SD to compute its “net capital” requirement by determining its net worth according to U.S. generally accepted accounting principles (“GAAP”) and then subtracting certain illiquid assets, adding certain subordinated liabilities and making specified additional adjustments. These additional adjustments include certain standardized or model-based market and credit risk deductions, as well as penalty charges for operational risks. An SD that elects the Net Liquid Assets Approach must maintain net capital at the greater of \$20 million or 2 percent of its uncleared

⁵ Rule 23.101(a)(2) permits a standalone SD that is “predominantly engaged in non-financial activities” to elect a third approach to comply with the Commission’s capital requirements based on the tangible net worth of the SD. Because no currently registered Mexican SD would be eligible for this approach, we do not address it.

⁶ See CFTC Capital Final Rule Release, 85 Fed. Reg. at 57480.

⁷ See 17 C.F.R. § 23.101(a)(1)(i); 12 C.F.R. Part 217.

swap margin amount. An SD permitted to use models to compute market or credit risk deductions is also required to maintain tentative net capital, as defined in SEC Rule 18a-1, of \$100 million.

The Commission Financial Reporting Requirements. Pursuant to Rule 23.105(d), a nonbank SD must file with the Commission and a registered futures association of which it is a member monthly unaudited financial reports as of the close of business each month. Rule 23.105(e) requires a nonbank SD to file with the Commission and a registered futures association of which it is a member annual audited financial reports no later than 60 days after the close of the nonbank SD's fiscal year-end. These reports must include statements of financial condition, income/loss, changes in liabilities subordinated to the claims of general creditors, changes in ownership equity and compliance with and calculation of the required capital. In addition, the annual audited financial report must include a reconciliation of any material differences between the year-end unaudited financial report and the audited financial report.

Mexico's Capital & Reporting Framework. The Securities Market Law (*Ley del Mercado de Valores*, the "Law"⁸) and the General Provisions Applicable to Broker-Dealers (*Disposiciones de Carácter General Aplicables a las Casas de Bolsa*, the "General Provisions")⁹ issued by the Mexican Banking and Securities Commission (*Comisión Nacional Bancaria y de Valores*, the "Mexican Commission")¹⁰ contain the capital adequacy and reporting requirements that apply to broker-dealers,¹¹ such as Mexican SDs. The Law and the General Provisions impose mandatory capital and liquidity requirements that address quantifiable discretionary (credit, liquidity and market), quantifiable non-discretionary (legal, operational and technological) and non-quantifiable risks.

Mexico's Capital Framework. The capital and related requirements of Mexico ("Mexico's Capital Framework") require Mexican SDs to maintain (a) a minimum amount of paid-in capital stock and (b) equity and loss-absorbing liabilities to address the market, credit, and

⁸ Published in the Federal Official Gazette (*Diario Oficial de la Federación*) on December 30, 2005, as amended.

⁹ Published in the Federal Official Gazette on September 6, 2004, as amended.

¹⁰ The Mexican Commission is a governmental agency that is part of the Ministry of Finance, having independent technical and executive powers. The Mexican Commission is in charge of the supervision and regulation of financial entities, such as Mexican SDs, with the purpose of ensuring their stability and sound performance, as well as maintaining a safe and sound financial system. The scope of the Mexican Commission's authority includes inspection, supervision, prevention and correction powers. The primary financial entities regulated by the Mexican Commission are commercial banks, national development banks, regulated multiple purpose financial institutions and broker dealers, such as Mexican SDs. The Mexican Commission is also in charge of granting and revoking broker-dealer licenses in Mexico.

¹¹ Pursuant to the provisions set forth in Article 113 of the Law, broker-dealers, such as Mexican SDs, among other entities, are the only financial institutions that may perform securities intermediation transactions. Under Article 2 of the Law, securities intermediation is defined as the customary and professional performance of any of the following activities in Mexico: (a) actions for the purpose of facilitating the contact between the supply and demand of securities, (b) the execution of transactions with securities for the account of third parties as commission agent, attorney-in-fact or in any other capacity, participating in the relevant legal transactions either personally or on behalf of third parties, and (c) the negotiation of securities on an intermediary's own account with the general public or with other intermediaries acting on their own account or on behalf of third parties. The organization and operation of broker-dealers, such as Mexican SDs, is governed by the Law and the General Provisions.

operational risks arising from the Mexican SD's overall operations or transactions. More specifically, under Mexico's Capital Framework, a Mexican SD must maintain:

- Common Equity Tier 1 equal to at least 4.5 percent of the SD's RWAs;
- Tier 1 capital (i.e., Common Equity Tier 1 plus Additional Tier 1) equal to at least 6 percent of the SD's RWAs;
- Total capital equal to at least 8 percent of the SD's RWAs; and
- A capital conservation of buffer of 2.5 percent of the SD's RWAs that must be met with Common Equity Tier 1 capital.¹²

Thus, a Mexican SD is effectively required to maintain total capital equal to no less than 10.5 percent of its RWAs and Common Equity Tier 1 capital equal to no less than 7 percent of its RWAs.

With respect to liquidity requirements, the General Provisions set forth that a Mexican SD must invest at least 20 percent of its total capital in any of the following: (a) bank deposits; (b) highly liquid debt securities registered in Mexico; (c) shares of debt investment funds; (d) reserve funds created to maintain funds available to cover contingencies, as set forth by the applicable regulation issued by self-regulatory organizations (*organismos autorregulatorios*), such as the securities central clearinghouse (*Contraparte Central de Valores de México, S.A. de C.V.*) and the central derivatives clearinghouse (*Asigna, Compensación y Liquidación F/30430*),¹³ as well as the Mexican Association of Securities Intermediaries (*Asociación Mexicana de Intermediarios Bursátiles, A.C. or AMIB*); and (e) high and low marketability shares to which a market value discount of 20 percent and 25 percent, respectively, is applied.¹⁴ In addition, a Mexican SD must have procedures in place to monitor its liquidity and ensure it has sufficient liquid assets to meet anticipated needs.

Mexico's Financial Reporting Framework. The financial reporting and related requirements of Mexico ("Mexico's Financial Reporting Framework") require a Mexican SD to submit, among other regulatory reports, (a) quarterly consolidated financial statements and (b) audited consolidated annual financial statements. Such audited financial statements must include notes and the audit report made by the independent external auditor. Additionally, a Mexican SD must submit to the Mexican Commission a report regarding the business progress, as

¹² Articles 172 and 173 of the Law and Article 162 of the General Provisions. Notably, Mexico's Capital Framework employs different terminology to refer to the components of total capital. For example, total capital is called "net capital," Common Equity Tier 1 is called "fundamental capital," and the 8 percent requirement is described as a "capitalization index" requirement. For ease of reference and to avoid confusion with terminology used in the context of the Net Liquid Assets Approach, we use the same terminology that is used in the Basel Committee framework and the Bank-Based Approach.

¹³ Article 288 of the Law recognizes the stock exchanges and the securities central clearinghouse as self-regulatory organizations and indicates that other entities that comply with certain requirements (such as *Asigna* and the *AMIB*) may be recognized as self-regulatory organizations.

¹⁴ Article 146 of the General Provisions.

well as the report of the statutory examiner of the commissioner, within one hundred twenty calendar days following each fiscal year end.¹⁵ The reports shall be approved by the Mexican SD's board of directors and prepared in accordance with the Accounting Criteria for Broker-Dealers issued by the Mexican Commission.¹⁶

Mexico's Financial Reporting Framework also requires a Mexican SD to submit to the Mexican Commission within the 20 (twenty) days following the end of each month, the following financial information: (i) minimum catalog (i.e., a report of all of the items that make up the balance sheet and income statement), (ii) accounts receivable, (iii) balance sheet and income statement reclassifications, (iv) financial statements with the balance sheet and income statement of the Mexican SD, (v) qualitative information regarding the number of employees and the number of client's accounts, and (vi) accounts payable.¹⁷ In these reports, a Mexican SD must present its total capital, including shareholder's equity, capital reserves and contributed capital.¹⁸

Furthermore, Mexico's Financial Reporting Framework requires regular disclosure, not only to the Mexican Commission, but also to the general public, of a Mexican SD's capital requirements and capital position. Mexican SDs have to make these disclosures available on a publically accessible website.

General Comparability. Like the Commission Capital & Reporting Requirements, Mexico's Capital & Reporting Framework is designed to ensure the safety, soundness and financial strength of nonbank SDs.

Capital Requirements. In accordance with the capital framework issued by the Basel Committee on Banking Supervision ("BCBS"), the Bank-Based Approach and Mexico's Capital Framework both require a nonbank SD to maintain a quantity of high quality capital that is sufficient, based on the SD's activities, to absorb potential losses the SD may incur. Both the Net Liquid Assets Approach and Mexico's Capital Framework require that a nonbank SD maintains sufficiently liquid and high quality assets to meet its obligations to customers, counterparties and other creditors if the firm were to experience financial distress.

Market and Credit Risk Charges. Both the Commission Capital Requirements and Mexico's Capital Framework require firms to hold capital against both the market risk and the credit risk of their off- and on-balance sheet positions, including standardized approaches for market and credit risk charges and deductions, depending on the asset or exposure. Both rule sets also impose operational risk capital requirements.

Minimum Required Capital. The minimum capital levels required by Mexico's Capital Framework are robust and comparable to the minimum levels required by the Commission Capital Requirements. In particular, taking into account applicable capital buffer requirements, a Mexican SD must hold Common Equity Tier 1 equal to at least 7 percent and

¹⁵ Article 203 and Exhibit 9 of the General Provisions.

¹⁶ Article 175 and Exhibit 5 of the General Provisions.

¹⁷ Article 201 and Exhibit 9 of the General Provisions.

¹⁸ Exhibit 9 of the General Provisions.

total capital equal to at least 10.5 percent of its RWAs. These requirements are comparable to, and indeed larger than, the 6.5 percent Common Equity Tier 1 and 8 percent total capital required under the Bank-Based Approach. Moreover, Mexico's Capital Framework requires that an SD calculate RWAs and capital in a manner that is similar to that required under the FRB's Part 217 regulations.

Also, the minimum capital levels required by Mexico's Capital Framework may be compared in some respects to the 8 percent of the uncleared swap margin requirement under the Bank-Based Approach. As the Commission has noted, the uncleared swap margin requirement "provides a floor based on a measure of the risk of the positions, the volume of the positions, the number of counterparties and the complexity of the operations of the" SD.¹⁹ The Commission further explained that the requirement covers "potential operational risk, legal risk, and liquidity risk."²⁰ As noted above, Mexico's Capital Framework requires that an SD calculate RWAs in a manner that is similar to the FRB's Part 217 regulations, which incorporate risk exposure amounts composed of market, credit and equity exposures, and operational risk. Mexican SDs are also subject to liquidity requirements that are designed to ensure that an SD has sufficient liquid assets to meet its ongoing obligations. Furthermore, Mexican SDs are subject to leverage limitations that, similar to the uncleared swap margin requirement, are based principally on volume and counterparties without regard to risk-weighting. Lastly, Mexican SDs must conduct regular stress tests to ensure that they have sufficient resources to withstand adverse economic scenarios. As a result, although Mexico's Capital Framework does not have a direct analogue to the 8 percent uncleared swap margin requirement, it has various other measures that achieve the same regulatory objective of ensuring that an SD maintains an amount of capital that is sufficient to cover the full range of risks a Mexican SD may face.

Considering that all Mexican SDs would be eligible to elect the Bank-Based Approach, we think that the foregoing comparison to that approach should suffice to establish the comparability of Mexico's Capital Framework to the Commission Capital Requirements. But in addition, for the reasons discussed above, the minimum capital levels required by Mexico's Capital Framework may be compared in some respects to the sum of the 2 percent uncleared swap margin amount requirement and market and credit risk charges applicable under the Net Liquid Assets Approach.

Liquidity Requirements. Mexico's Capital Framework also imposes liquidity requirements on Mexican SDs. The approach under Mexico's Capital Framework differs from the Net Liquid Assets Approach, which, in lieu of a specific liquidity requirements, requires nonbank SDs to deduct from their net capital 100 percent of the carrying value for unsecured receivables (except that an SD with credit risk model approval may instead apply a credit risk weighted charge for receivables to certain derivatives counterparties) and other assets that cannot readily be converted into cash, as well as securities that have no ready market.²¹ Conversely, Mexico's Capital Framework requires that a Mexican SD invest 20% of its regulatory capital in highly liquid assets, with haircuts for assets that present higher risk. Although this approach

¹⁹ CFTC Capital Final Rule Release, 85. Fed. Reg. at 57485.

²⁰ *Id.*

²¹ 17 C.F.R. § 23.101(a)(ii)(A); 17 C.F.R. § 240.18a-1(a)(1)(iv).

differs from the Net Liquid Assets Approach, they share a common objective of ensuring that the SD has sufficient liquidity to satisfy customer obligations. Moreover, a Mexican SD will not be subject to liquidation as a commodity broker under the U.S. Bankruptcy Code, and property of U.S. swaps customers of Mexican SDs should be at minimal risk, since Mexico is on track to adopt margin regulations, including IM segregation requirements, consistent with the framework adopted by the BCBS and the International Organisation of Securities Commissions (the “WGMR Framework”). In addition, Mexican SDs are subject to the Commission’s margin requirements for uncleared swaps, including entity-wide application of such requirements for Mexican SDs that are foreign consolidated subsidiaries of U.S. parent companies.²²

Financial Reporting Requirements. The Commission’s financial reporting requirements under Section 4s(f) of the CEA and Rule 23.105(d)–(e) thereunder (the “Commission Financial Reporting Requirements”) and Mexico’s Financial Reporting Framework provide the relevant regulatory authorities with comprehensive financial information about an SD on a monthly basis. In addition, both frameworks require annual audited financial reports to provide greater detail regarding the firm’s financial condition and ensure the accuracy of the relevant reports. Moreover, both frameworks provide regular disclosure of an SD’s capital position. Accordingly, although certain specific requirements of the Commission Financial Reporting Requirements differ from those under Mexico’s Financial Framework, both provide regulators with a comprehensive view of the financial condition of the relevant SD in order to promote safety and soundness and transparency.

III. Comparability Analysis

A. Comparability of Mexico’s Capital Framework and the Commission Capital Requirements

1. Comparability of Objectives

The Commission Capital Requirements and Mexico’s Capital Framework have the same regulatory objectives. Both are aimed at ensuring the safety and soundness of SDs in order to protect counterparties and customers and the derivatives and financial markets more generally. The Bank-Based Approach, consistent with the BCBS capital framework, achieves this goal by requiring a nonbank SD to maintain a sufficient cushion against losses. The Net Liquid Assets Approach, meanwhile, furthers safety and soundness by requiring an SD to maintain enough liquid assets to satisfy customer and counterparty claims in the event of a distress scenario.

Mexico’s Capital Framework seeks to achieve both of the objectives of the Bank-Based Approach and the Net Liquid Assets Approach. Consistent with the Bank-Based Approach, Mexico’s Capital Framework has the purpose of ensuring that a Mexican SD has sufficient equity and subordinated liabilities in order to withstand unexpected losses. And, consistent with the Net Liquid Assets Approach, Mexico’s Capital Framework seeks to ensure that a Mexican SD has sufficient liquidity in order to meet its obligations in a distress scenario. Pursuant to Article 173 of the Law, the capital requirements established by the Mexican

²² 17 C.F.R. § 23.160(b)(2).

Commission seek to preserve the financial stability and solvency of broker-dealers, as well as protecting the interests of the public investors.

2. **Comparability of Methodologies and Outcomes**

i. Measurement of Assets and Total Risk Exposure

Mexican SDs are subject to bank-like capital requirements that, consistent with the BCBS framework, require a firm to hold sufficient amounts of regulatory capital, composed of Common Equity Tier 1, Additional Tier 1 and Tier 2 capital instruments. The amount of regulatory capital required to be held is determined by calculating the firm's total risk exposure, including operational, market and credit risk. The method of calculating such exposure is based on the BCBS framework. More specifically, for market and credit risk, a Mexican SD is generally required to apply a standardized approach set forth in the General Provisions.²³ To calculate exposure to operational risks, a Mexican SD is required to use a basic method as set forth in the General Provisions, an alternative basic method based on the guidelines issued by the Mexican Commission or other method authorized by the Mexican Commission.²⁴

The approach under Mexico's Capital Framework is comparable to the Bank-Based Approach, which similarly subjects a nonbank SD to bank-like capital requirements that require the SD to hold sufficient regulatory capital, composed of Common Equity Tier 1, Additional Tier 1, and Tier 2 capital instruments, based on the risk of its activities and positions. Moreover, under both the Bank-Based Approach and Mexico's capital framework, the calculation of market and credit risk that a firm must use to determine its regulatory capital is based on the BCBS capital framework.

a. Derivative Instruments and Marketable Securities

Under Mexico's Capital Framework, as under the Commission Capital Requirements, derivative instruments and marketable securities are subject to charges for market and credit risk. As under the Bank-Based Approach and the BCBS capital framework more generally, these charges are added to the SD's risk exposure calculation. Although the Net Liquid Assets Approach incorporates market and credit risk by providing for deductions from net capital,

²³ Article 150 Bis of the General Provisions. Although Mexico's Capital Framework permits a Mexican SD to apply for approval to calculate market risk using internal models that comply with guidelines issued by the Mexican Commission, no Mexican SD is currently so approved or has an application outstanding.

²⁴ Article 161 Bis of the General Provisions.

the ultimate objective, which is to require greater capital to account for market and credit risk, is the same as under the Bank-Based Approach and the BCBS capital framework.

The comparability between the risk-weighted approach under Mexico's Capital Framework and the Commission Capital Requirements can be illustrated by comparing their respective approaches to market and credit risk.

1. Market Risk

In terms of market risk, the Bank-Based Approach requires an SD to calculate additions to its RWAs for derivatives positions and marketable securities using either the Commission's standardized haircuts, multiplied by 12.5, or if approved to use models, market-risk models. The Net Liquid Assets Approach similarly requires a nonbank SD to take certain net capital deductions for its derivatives positions and marketable securities using either standardized haircuts or, if approved to use internal models, market risk models. Mexico's Capital Framework takes a similar approach to calculating market risk. Under the framework, a Mexican SD is required to take a deduction from capital in relation to market risk based on standardized charges published by the Mexican Commission.²⁵ These charges are based on the same principles and methodology as the BCBS market risk framework and include deductions for interest rate, foreign exchange ("FX") and equity price risks.²⁶

Similar to the Commission Capital Requirements, Mexico's Capital Framework generally applies a look-through approach to derivatives transactions, requiring a Mexican SD to apply deductions to a derivative exposure based on the underlier of the transaction.²⁷ However, the charges under Mexico's Capital Framework function somewhat differently from those applicable under the Commission Capital Requirements. Instead of imposing a different charge for each specific type of product, Mexico's Capital Framework applies cumulative charges to individual positions depending on the risks such positions present. For example, under Mexico's Capital Framework, a Mexican SD that holds a floating interest rate debt security denominated in Mexican pesos with a remaining term of 2,558 to 3,653 days is required to take a deduction from capital equal to 13.92 percent of the par value of the security. If the security is a fixed rate security, the charge would be increased by 0.75 percent to reflect the interest rate risk associated with the security, and if the security is denominated in a different currency, the charge would be increased by another 7.38 percent to reflect the FX risk associated with the position. The particular market risk charge that a Mexican SD is required to apply to a given position may accordingly differ from that which would be applicable under the Commission Capital Requirements, with some positions attracting higher charges under Mexico's Capital Framework and others attracting higher charges under the Commission Capital Framework. However, the ultimate objective of Mexico's Capital Framework is to require a Mexican SD to maintain additional capital to reflect the particular market risks to which it is exposed.

²⁵ Article 150 Bis of the General Provisions.

²⁶ Mexico's Capital Framework does not have market risk charges specific to commodity price risk since Mexican SDs are not permitted to engage in physical commodity transactions.

²⁷ Mexico's Capital Framework does not have market risk charges applicable to credit default swaps because Mexican SDs are not permitted by the Mexican Commission to enter into such swaps.

2. *Credit Risk*

In terms of credit risk, the Bank-Based Approach provides for the credit risk of a nonbank SD's positions to be incorporated into the calculation of its RWAs. Under the Bank-Based Approach, a nonbank SD that is not approved to use internal models to calculate credit risk will compute its RWA in accordance with Subpart D of the FRB's Part 217 regulations, which sets forth a standardized methodology for calculating the risk weights applicable to a bank holding company's assets. A nonbank SD approved to use internal models will calculate its RWA in accordance with Subpart E of the FRB's Part 217 regulations, which sets forth a models-based methodology for calculating risk weights applicable to a bank holding company's assets. The Net Liquid Assets Approach, in turn, requires a nonbank SD to take a net capital deduction for unsecured current exposure and uncollected IM, but a firm with model approval may instead multiply that deduction by 8 percent and further by a credit risk weight.

Under both the Bank-Based Approach and the Net Liquid Assets Approach, an SD calculating the credit risk of uncleared derivatives transactions with a single counterparty may recognize the effects of a netting agreement, so long as the firm concludes that the agreement satisfies certain enforceability requirements.²⁸

Pursuant to Mexico's Capital Framework, a Mexican SD calculates its credit risk exposure by taking the accounting value of each of its on- and off-balance sheet positions and exposures, determining a conversion value to credit risk under Article 160 of the General Regulations, and then applying specific risk weights under Article 161 of the General Regulations based on the type of issuer or counterparty (as applicable) and the asset's credit quality. A Mexican SD must make these calculations using a standardized approach, as Mexico's Capital Framework does not authorize the use of internal models for the measurement of credit risk. However, similar to the Bank-Based Approach, the standardized risk weights under Article 161 of the General Regulations are based on the BCBS capital framework.

Moreover, the mandatory use of the standardized approach under Mexico's Capital Framework will in many instances yield higher RWA calculations than would result were Mexican SDs permitted to calculate credit risk using internal models under either the Net Liquid Assets Approach or the Bank-Based Approach. In addition, the rule set forth in Article 160 of the General Regulations requires, in the case of swaps, a "trade by trade" determination of RWAs as opposed to a "counterparty" approach (i.e., all long positions are counted regardless of whether such positions are netted within a counterparty portfolio). As a result, Mexican SDs will in many instances be required to calculate a higher measure of credit risk exposure in respect of derivatives transactions for capital purposes than what would be required by the Bank-Based Approach or the Net Liquid Assets Approach.

3. *Additional Measures and Supervision*

In addition to the requirements set forth above, Article 136 of the General Provisions requires Mexican SDs to prepare a consolidated credit report considering transactions under which it is exposed to a default by the counterparty, as well as derivative financial

²⁸ See generally 17 C.F.R. § 240.18a-1(e)(2)(iii)(D); 12 C.F.R. § 217.34(b)(2).

instruments. This analysis should be compared with the applicable limits of risk exposure. In this respect, the analysis shall:

- Measure and evaluate risk and concentration;
- Design credit risk control procedures for investments in debt instruments, forward transactions, as well as for derivative financial instruments;
- Estimate risk exposure with financial instruments, including derivatives, both current and future, meaning the replacement value of the position and the changes in that value over the remaining life of the position, respectively;
- Calculate the probability of default of the counterparty;
- Analyze the recovery value, as well as the mitigation mechanisms and estimate the expected loss in the operation; and
- Calculate potential losses under different scenarios, including extreme scenarios.

With respect to market risk, Mexican SDs shall at least:²⁹

- Analyze, evaluate and monitor all positions subject to market risk using for such purposes value at risk models that allow measurement of the potential loss on such positions associated with price movements, interest rates or exchange rates, with a probability level and over a specified period;
- Ensure consistency between risk management's valuation models of positions in financial instruments, including derivatives, used by the various business units;
- Evaluate the concentration of its positions subject to market risk;
- Compare the estimated market risk exposures with the actual results observed;
- Consider the historical information of the risk factors necessary for the calculation of the market risk; and
- Calculate potential losses under different scenarios, including extreme scenarios.

²⁹ Article 138 of the General Provisions.

A Mexican SD shall annually evaluate and inform the Mexican Commission if its capital would be sufficient to cover possible losses arising from the risks in different scenarios, including those with adverse economic conditions.³⁰

b. Other Types of Assets and Exposures

Under the Net Liquid Assets Approach, proprietary assets and exposures aside from derivatives and marketable securities are generally subject to a 100 percent deduction to net capital in order to address liquidity risk. Conversely, Mexico's Capital Framework and the Bank-Based Approach subject each asset to the risk weight approach described above.

As noted above, considering that all Mexican SDs would be eligible to elect the Bank-Based Approach, we think that a comparison to that approach should suffice to establish the comparability of Mexico's Capital Framework to the Commission Capital Requirements. But, to the extent that a comparison to the Net Liquid Assets Approach is relevant, Mexico's Capital Framework addresses liquidity risk by imposing separate liquidity requirements on broker-dealers. Specifically, under Article 146 of the General Provisions, a Mexican SD must maintain at least 20 percent of its total capital invested in any of the following: (a) bank deposits; (b) highly liquid debt securities registered in Mexico; (c) shares of debt investment funds; (d) reserve funds created to maintain funds available to cover contingencies, as set forth by the applicable regulation issued by self-regulating organisms; and (e) high and low marketability shares to which a market value discount of 20 percent and a 25 percent discount, respectively, is applied. In addition, a Mexican SD must measure and evaluate the risk caused by differences between cash flows projected on different dates, considering for such purpose its assets and liabilities, denominated in local currency, foreign currency and investment units, and evaluate the diversification of its financing sources.³¹

Although these measures are different from the Net Liquid Assets Approach, they seek to achieve substantially similar objectives, namely to ensure that the SD has sufficient liquid assets to satisfy claims as they become due. The liquidity requirements under Mexico's Capital Framework should also be considered in light of the differences between Mexican SDs and other firms. Mexican SDs would not be subject to the commodity broker liquidation provisions of the U.S. Bankruptcy Code, the Securities Investor Protection Act or an analogous regime that involves prompt liquidation preceding the distribution of assets to customers. Accordingly, there is less value in applying a net liquid assets requirement that is designed to facilitate a rapid liquidation. Rather, liquidity requirements are necessary to ensure that a Mexican SD can continue performing in the context of a market with distressed liquidity.

Further, Mexico's imminent implementation of margin requirements for non-centrally cleared OTC derivatives will serve many of the same benefits as standalone liquidity requirements. Specifically, VM and IM margin exchange obligations will ensure that Mexican SDs and their counterparties have sufficient liquid assets available to them to protect against losses on such derivatives. And IM segregation requirements will help to ensure that a Mexican SD's

³⁰ Article 173 Bis of the Law.

³¹ Article 137 of the General Provisions.

default does not result in a loss of customer property. Moreover, Mexican SDs are subject to the Commission's margin requirements for uncleared swaps, including entity-wide application of such requirements for Mexican SDs that are foreign consolidated subsidiaries of U.S. parent companies.³² In light of these requirements, the additional benefit of standalone liquidity mandates will be substantially smaller.

ii. Qualifying Components of Capital

The Net Liquid Assets Approach permits a nonbank SD to include both equity capital and satisfactory subordinated debt as net capital by permitting the SD to exclude subordinated liabilities from the net worth calculation, with satisfactory subordinated debt allowed to comprise up to 70 percent of the sum of the SD's subordinated debt and equity.³³

Under the Bank-Based Approach, an SD must maintain the following components of regulatory capital:³⁴

- Common Equity Tier 1, which is generally limited to retained earnings and common equity; and
- Additional Tier 1 and Tier 2 capital, which include certain preferred stock and subordinated debt instruments.³⁵

Similar to the Bank-Based Approach, Mexico's Capital Framework imposes different ratios for the various capital components of regulatory capital. These components align with the components of regulatory capital required under the Bank-Based Approach, as they include:³⁶

- Common Equity Tier 1 (*capital fundamental*), which is generally limited to retained earnings and common equity;
- Additional Tier 1 capital (*capital básico no fundamental*), which includes other capital instruments and certain long-term convertible debt instruments; and
- Tier 2 (*capital complementario*), which includes certain subordinated debt instruments.³⁷

³² 17 C.F.R. § 23.160(b)(2).

³³ 17 C.F.R. § 240.18a-1(c)(1), (g).

³⁴ See 17 C.F.R. § 23.101(a)(1)(i); 12 C.F.R. §§ 217.20(b) (Common Equity Tier 1), 217.20(c) (Additional Tier 1), 217.20(d) (Tier 2).

³⁵ See generally 12 C.F.R. § 217.20. An SD that follows the Bank-Based Approach can only include subordinated debt in its regulatory capital if such subordinated debt would be eligible to be treated as net capital under the Net Liquid Assets Approach. 17 C.F.R. § 23.101(a)(1)(i)(B).

³⁶ Article 162 of the General Provisions.

³⁷ Article 162 Bis and 162 Bis 1 of the General Provisions.

iii. Required Minimum Amounts of Capital

As noted above, the Bank-Based Approach requires nonbank SDs to maintain:

- Common Equity Tier 1 of at least \$20 million;
- Common Equity Tier 1 equal to at least 6.5 percent of the SD's RWAs;
- Total capital equal to at least 8 percent of the nonbank SD's RWAs; and
- Total capital equal to 8 percent of its uncleared swap margin.³⁸

The Net Liquid Assets Approach requires a nonbank SD without model approval to maintain net capital, subject to the adjustments described above, at the higher of \$20 million or 2 percent of its uncleared swap margin amount.³⁹ Under the Net Liquid Assets Approach, a nonbank SD with model approval is also required to maintain tentative net capital, which is the net capital *before* taking certain market and credit risk deductions, of at least \$100 million.⁴⁰

Mexico's Capital Framework takes a somewhat analogous approach to the Bank-Based Approach, setting out minimum capital ratios for each component of capital. Specifically, Mexican SDs must maintain sufficient levels of Common Equity Tier 1, Tier 1 (Common Equity Tier 1 and Additional Tier 1) capital and Tier 2 capital to satisfy the following capital ratios, expressed as a percentage of the firm's total RWA:

- Common Equity Tier 1 equal to at least 4.5 percent of the SD's RWAs;
- Tier 1 capital equal to at least 6 percent of the SD's RWAs;
- Total capital equal to at least 8 percent of the SD's RWAs; and
- A capital conservation of buffer of 2.5 percent that must be met with Common Equity Tier 1 capital.

Accordingly, similarly to the Bank-Based Approach, the Mexico's capital ratios are calibrated as a percentage of the firm's total risk exposure. In addition, the ratios under the Mexican Capital Framework are broadly similar to those required under the Bank-Based Approach.

Consistent with both the Bank-Based Approach and the Net Liquid Assets Approach, Mexico's Capital Framework also requires Mexican SDs to comply with minimum paid-in capital requirements depending on the services or activities to be performed. The minimum paid-in capital requirement is indexed to Inflation Indexed Units ("UDIs"), so a different minimum capital is required each year depending on the UDI equivalence. In the context of Mexican SDs,

³⁸ 17 C.F.R. § 23.101(a)(1)(i).

³⁹ 17 C.F.R. § 23.101(a)(1)(ii)

⁴⁰ *Id.*

which perform the broadest array of activities, the requirement would be 12,500,000 UDIs, which for 2020 would equal approximately MXN\$79,987,725.00 or USD\$3,980,677.07.⁴¹ In addition, the Mexican Central Bank imposes a number of rules that limit a Mexican SD's leverage.⁴² In a similar spirit to the uncleared swap margin requirement, these rules are based principally on volume and counterparties without regard to risk-weighting.

Additionally, pursuant to Article 169 of the General Provisions, the Mexican Commission may require a Mexican SD to satisfy additional capital requirements, considering the composition of its capital, the composition of its assets, the efficiency of its internal control systems, compliance with its remuneration system and, in general, its exposure and risk management. As an additional measure to ensure Mexican SDs maintain sufficient capital, the Mexican Commission publishes on a quarterly basis on its website the classification of broker-dealers according to categories, based on their respective capital ratios.⁴³

Lastly, in order to ensure they retain sufficient capital, broker-dealers are required to conduct annual stress tests. These assessments are designed to determine whether a Mexican SD's capital would be sufficient to cover losses under the supervisory scenarios identified by the Mexican Commission, whether the Mexican SD will remain in its capital category and whether the Mexican SD will comply with the minimum capital requirements. To this end, Mexican SDs must submit annually to the Mexican Commission a report containing the results of such assessments, which must contain, for each supervisory scenario, various estimates for at least the 12 quarters as of December of the year prior to the year to which the assessments correspond, including estimated balance sheet statements, income statements, operating volumes, capital ratios, RWAs and, if applicable, deviations from the risk exposure limits established by the firm and from other regulatory limits. If, based on these stress tests, a broker dealer's capital ratios are not sufficient, the broker dealer must file a preventive action plan.⁴⁴

B. Comparability of Mexico's Financial Reporting Framework and the Commission Financial Reporting Requirements

1. Comparability of Objectives

Mexico's Financial Reporting Framework and the Commission Financial Reporting Requirements are intended to enable the relevant regulatory authorities to assess the financial condition and safety and soundness of firms subject to their respective regulation. Specifically, as discussed below, both regimes require an SD to report its financial position and capital levels. These disclosures serve to provide regulatory authorities with a comprehensive view of the financial health and activities of the financial entity.

⁴¹ Considering an exchange rate per US dollar of MXN\$20.0940 as published by the Mexican Central Bank in the Federal Official Gazette (Diario Oficial de la Federación) on May 12, 2021.

⁴² Section C.B1 of Circular 115/2002, issued by the Mexican Central Bank on November 11, 2002, as amended from time to time.

⁴³ Article 204 Bis 1 of the General Provisions.

⁴⁴ Articles 214, 215 and 216 of the General Provisions.

2. Comparability of Methodologies and Outcomes

The Commission Financial Reporting Requirements require that a nonbank SD file with the Commission and with a registered futures association of which it is a member monthly, unaudited financial reports as of the close of business of each month and annual, audited financial reports as of the close of its fiscal year.⁴⁵ The monthly financial reports must be filed no later than 17 business days after the date for which the report is made, and the annual financial reports must be filed no later than 60 days after the close of the nonbank SD's fiscal year.⁴⁶ The annual financial report must be audited and accompanied by an opinion of an independent certified public accountant or independent licensed accountant in good standing.⁴⁷

A nonbank SD must prepare its monthly and annual financial reports in the English language, denominated in U.S. dollars and in accordance with U.S. GAAP.⁴⁸ If the nonbank SD is not otherwise required to prepare financial statements in accordance with U.S. GAAP, it may prepare its monthly and annual financial reports in accordance with the International Financial Reporting Standards. The financial reports must include the following statements:

- Financial condition;
- Income/loss;
- Changes in liabilities subordinated to the claims of general creditors;
- Changes in ownership equity; and
- Compliance with and calculation of the nonbank SD's applicable regulatory capital requirements under Rule 23.101.⁴⁹

In addition to the above elements, the annual financial report must also contain:

- A statement of cash flows;
- Appropriate footnote disclosures; and
- A reconciliation of any material differences from the SD's unaudited financial report prepared as of its year-end date and its annual financial report.

Mexico's Financial Reporting Framework imposes similar requirements on a Mexican SD. Article 203 of the General Provisions requires a Mexican SD to provide (i) within the month immediately following the month of the Mexican SD's closing date, the Mexican SD's

⁴⁵ 17 C.F.R. §§ 23.105(d), (e).

⁴⁶ 17 C.F.R. §§ 23.105(d)(1), (e)(1).

⁴⁷ 17 C.F.R. § 23.105(e)(2).

⁴⁸ 17 C.F.R. §§ 23.105(d)(2), (e)(3).

⁴⁹ 17 C.F.R. §§ 23.105(d)(2), (e)(4).

basic consolidated financial statements for March, June and September of each year; and (ii) within the 90 (ninety) calendar days following the end of each fiscal year, the Mexican SD's basic audited consolidated annual financial statements for such year, including its notes and the audit report made by the independent external auditor. Additionally, a Mexican SD is required to submit to the Mexican Commission a report regarding the business progress, as well as the report of the statutory auditor, within one hundred and twenty calendar days following each fiscal year end.

A Mexican SD must prepare its financial reports denominated in millions of Mexican pesos and in accordance with Accounting Criteria for Broker-Dealers referred to in Exhibit 5 of the General Provisions. In addition, each report must be approved by the Mexican SD's board of directors and Internal Audit Committee and signed by at least the chief executive officer, the chief accountant and the internal auditor, or their equivalent.⁵⁰ Pursuant to these requirements, the basic consolidated financial statements of a Mexican SD must include:

- A balance sheet statement;
- An income/loss statement;
- A statement of changes in equity;
- A statement of cash flows;
- Appropriate footnote disclosures relating to, among other topics, nominal amounts of derivative contracts by type of instrument and by underlying valuation results and the results obtained in the assessment of the adequacy of its regulatory capital in relation to credit, market and operational risk requirements.⁵¹

In addition to the above, Mexican SDs must provide to the Mexican Commission:⁵²

- monthly: information regarding the minimum catalog, accounts receivable, reclassifications in the balance sheet and income statement, as well as balance sheet and income statements, within the 20 (twenty days) following the end of the respective month; and
- quarterly: information regarding deferred income taxes, consolidation with respect to balance sheet and income statements, stockholders equity statement and cash flow statements, within the 20 (twenty days) following its respective date.

Mexican SDs licensed to perform derivative transactions are required to file with the Mexican Central Bank, during May of every year, a written communication issued by their

⁵⁰ Articles 175, 176 and 179 of the General Provisions.

⁵¹ Article 180 of the General Provisions.

⁵² Article 202 and Exhibit 9 of the General Provisions.

Internal Audit Committee evidencing the compliance in the performance of their derivative transactions of each and all the applicable legal provisions and, when required by the Mexican Central Bank, such SDs shall provide to the Mexican Central Bank with all the information related to the derivative transactions performed by them.⁵³

Likewise, Mexican SDs licensed to perform derivative transactions are required to file with the Mexican Central Bank on a daily basis a report containing all the derivative transactions performed by the corresponding Mexican SD.

Additionally, a Mexican SD is required to provide to the general public, on a publically accessible website, along with its financial statements, information related to its regulatory capital structure, including its main components, its capital adequacy level and the amount of the assets subject to risk. A Mexican SD must also disclose its risk level,⁵⁴ according to the credit rating issued by two credit rating agencies authorized by the Mexican Commission, including for such purposes both ratings in the notes to their financial statements.⁵⁵

As a result of these requirements, a Mexican SD must provide substantially the same information as that required by the Commission Financial Reporting Requirements, as well as other detailed information that is not required by the Commission Financial Reporting Requirements.

C. Enforcement and Supervision of Mexico's Capital & Reporting Framework

The Mexican Commission has ample supervisory, inspection and surveillance powers,⁵⁶ which include the power to require a broker-dealer to provide all necessary information and documentation in order to verify its compliance with the Law and the General Provisions, to adopt any necessary measures to correct the irregular activities and to conduct all necessary in site inspections.⁵⁷ In the exercise of its powers, the Mexican Commission may impose the following:

⁵³ Provision 3.1.3 of the Rule 4/2012 issued by the Mexican Central Bank.

⁵⁴ Pursuant to article 144 of the General Provisions, broker-dealers shall make available to investors, through notes on their annual financial statements and their websites, the information relating to the policies, methodologies, levels of risk assumed and other relevant measures adopted for the management of each type of risk, including qualitative and quantitative information in connection with such risks.

⁵⁵ Article 169 Bis of the General Provisions.

⁵⁶ Article 350 of the Law, and Articles 5 and 19 of the Mexican Commission Law, the Supervision Regulations of the Mexican Commission.

⁵⁷ Pursuant to Article 358 of the Law, the Mexican Commission is entitled to provide to foreign financial authorities with all kind of information that they deem appropriate, within the scope of their competence, such as documents, records, declarations and other evidence that such authorities have in their possession by virtue of having obtained it in the exercise of their powers; provided that that authorities must have executed an agreement for the exchange of information, including the principle of reciprocity.

- Fine of 30,000 to 100,000 Units of Measurement and Update⁵⁸ (*Unidad de Medida y Actualización, UMA*) (approximately MXN\$2,606,400.00 to MXN\$8,688,000.00 or USD\$129,710.36 to USD\$432,367.87),⁵⁹ if the broker-dealer fails to maintain sufficient regulatory capital in relation to the risks in its operations.⁶⁰
- Fine of 10,000 to 100,000 Units of Measurement and Update (approximately MXN\$2,606,400.00 to MXN\$8,688,000.00 or USD\$129,710.36 to USD\$432,367.87), if the broker-dealer fails to comply with the information or documentation requirements made by the Mexican Commission or fails to provide its periodic information.⁶¹

In addition to the above, if the Mexican SD fails to comply with the applicable regulatory capital ratios, including the 2.5% Common Equity Tier 1 capital buffer, the Mexican Commission may order, among other measures, the following corrective measures:⁶²

- A prohibition on entering into transactions whose execution would cause the total capital ratio to be less than 8 percent RWAs;
- A requirement that the Mexican SD submit for the approval of the Mexican Commission a recovery capital plan, previously approved by the board of directors, which must contain at least the sources of the resources to increase the capital and/or reduce the assets subject to risk; the period in which the Mexican SD will reach the level of the regulatory capital required; a calendar with the objectives that would be achieved in each period; and a detailed list of the information that the Mexican SD must provide periodically to the Mexican Commission to enable the latter to monitor compliance of such plan;
- A suspension of the payment of dividends, as well as any mechanism or acts involving a transfer of patrimonial benefits;
- A suspension of the programs of acquisition of shares of the capital stock of the Mexican SD;
- A suspension of payments of compensation, extraordinary bonuses, or other remuneration in addition to the salary of the chief executive officer (“CEO”)

⁵⁸ Considering the UMA price of MXN\$86.88 per UMA during 2020, as published by the Mexican Institute for Statistics, Geography and Information Technology (*Instituto Nacional de Estadística, Geografía e Informática, INEGI*) in its website.

⁵⁹ Considering an exchange rate per US dollar of MXN\$20.0940, as published by the Mexican Central Bank in the Federal Official Gazette (*Diario Oficial de la Federación*) on May 12, 2021.

⁶⁰ Article 392 paragraph III, subparagraph v) of the Law.

⁶¹ Article 392 paragraph I, subparagraph a) of the Law.

⁶² Articles 204 Bis 7 to 204 Bis 21 of the General Provisions.

and officials of the two hierarchical levels below the CEO, as well as a requirement to refrain from granting new compensation in the future for the CEO and officials;

- An engagement with external auditors or other specialized third parties to carry out special audits on specific issues; and
- A limitation the execution of new transactions that may cause an increase in RWAs and/or cause greater impairment in the SD's regulatory capital ratios.

Furthermore, the Mexican Commission may revoke a Mexican SD's license to operate as a broker-dealer, if the Mexican SD fails to comply with the above corrective measures or if it reports losses that reduce its capital to a level below the minimum required.⁶³

IV. Conclusion

Taken together, Mexico's Capital & Reporting Framework reflects similar regulatory concerns and leads to comparable regulatory outcomes as the Commission Capital & Reporting Requirements. Rather than require Mexican SDs to comply with two different approaches to capital and liquidity, the Commission should grant this application for the Mexican SDs to satisfy their requirements under the Commission Capital & Reporting Requirements by continuing to comply with Mexico's Capital & Reporting Framework.

Very truly yours,



Colin D. Lloyd
Partner, Cleary Gottlieb Steen & Hamilton LLP

⁶³ Article 153 of the Law.