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MEXICO: MUTUAL FUND REGULATION

by

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FOREWORD

Paucity of savings has been recognized as an important constraint limiting the growth, and employment opportunities of most Latin American economies. While shortcomings in macroeconomic management are a principal cause, the underdevelopment of financial markets, products, and intermediaries can also raise intermediation costs and deprive savers of appropriate vehicles for savings.

Mutual funds constitute an important savings product and class of financial intermediary. Mutual funds provide small savers opportunities for risk diversification, professional investment management, and access to wholesale transaction costs. They significantly expand the investment opportunities available to small investors who are otherwise restricted to bank products or undiversified stock investments. They can simultaneously offer investors liquidity and foster long term regular saving habit.

While mutual funds are an enormous industry in developed countries, particularly in the U.S.A., they are still an emerging industry in most of Latin America. Only Brazil, Mexico, and Chile have significant mutual fund activity within their borders. The purpose of this series of papers is to make available better information about mutual fund regulation and operations in several Latin American countries, with a view to facilitate a comparison and improvement in their regulation and management.

This paper is part of a series of eight papers. The series is edited by Hemant Shah, Laura Mecagni, and Mike Lubrano, all from Latin America and the Caribbean Region of the World Bank. Papers are written by legal and mutual fund industry experts from Argentina (Steven Darch, Bernardo E. Duggan, Leonardo F. Fernández, and Andrew Powell), Brazil (Fernando J. Prado Ferreira), Chile (Santiago Edwards M., Alberto Eguiuren), Colombia (Rodrigo Puyo Vasco), Mexico (Teófilo G. Berdeja Prieto and Agustin Berdeja Prieto), and Peru (Fernando Bellido). Their time and contributions, and the cooperation of their respective institutions, are deeply appreciated.

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ABSTRACT

This paper is published as part of a series of papers on mutual fund regulation in six Latin American countries: Argentina, Brazil, Chile, Colombia, Mexico, and Peru. This paper covers the regulations and structure of the mutual fund industry in Mexico. The paper is divided into three main sections. The first section briefly describes the regulations and regulatory bodies governing mutual funds. The second section describes in detail the legal structure of the industry including forms of mutual funds, sponsors and advisors, trusts, boards of directors, custodians, shareholders' rights, transfer agents, and underwriters. The final section focuses on the regulation of the industry including investment policies, fees, investor protection, taxation, distribution, pricing, and marketing.
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1. CITATION OF GOVERNING LEGISLATION, REGULATIONS, AUTHORITIES AND REGISTRATION REQUIREMENT AND PROCESS

The main laws and regulations which directly regulate mutual funds (sociedades de inversión) in Mexico are the Investment Companies Act of 1985 (hereinafter referred to as ICA), the Securities Exchange Act of 1975 (hereinafter referred to as SEA) and the body of general rulings issued by the National Banking and Securities Commission.

The main regulatory body of mutual funds in Mexico is the National Banking and Securities Commission (hereinafter also referred to as the Commission). The Commission is the result of a recent merger between the National Banking Commission and the National Securities Commission aimed at achieving consolidation and simplification of agency jurisdiction over financial institutions. Other important government agencies with jurisdiction over the financial system are the Ministry of Finance and Public Credit, Banco de Mexico and the National Bonding and Insurance Commission.

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The authors gratefully acknowledge the valuable comments of the officials and staff of the National Banking and Securities Commission. The opinions expressed herein, however, are solely those of the authors. This paper is current as of December 31, 1995.


2/ Ley del Mercado de Valores, D.O., January 2, 1975.

The incorporation of a mutual fund requires the authorization of the Commission. Mutual funds must be registered with the National Securities and Brokers Registry (Registro Nacional de Valores e Intermediarios; hereinafter also referred to as the Registry) which is maintained by the Commission. This registration subjects mutual funds to a reporting system which requires them to furnish periodically certain data and documents to the Registry. Mutual funds listed with the Mexican Stock Exchange are required to furnish such data and documents to the Exchange as well, which in turn makes them available to the public.\(^4\)

Mutual funds are subject to close regulation by the Commission, which has issued a special body of general rulings called circulares governing their operations. Such regulations establish special rules of operation, accounting requirements, reporting and disclosure systems, and restrictions to be observed by mutual funds and mutual fund operating companies in dealings between them, as well as with their shareholders and the public.

Mutual funds may or may not list their shares with the Mexican Stock Exchange (see section 2 (a) (ii) below). In practice, most "debt instruments" and "common" investment companies have their shares listed with the Exchange, while only a few "capital" investment companies have their shares listed with the Exchange.

2. LEGAL STRUCTURE OF THE INDUSTRY

(a) Legal Form of the Fund

(i) Managed, Unmanaged, Others

Mutual funds are required to be managed by a mutual fund operating company, brokerage firm or bank. Mutual fund operating companies are established to sponsor, advise and distribute mutual funds as well as to repurchase their shares. Such services may also be rendered directly by a brokerage firm or bank acting in lieu of an operating company.\(^5\) So far in Mexico, most mutual funds are advised by banks and brokerage firms acting directly or through mutual fund operating companies incorporated by same. As at December 31, 1995, there were 44 mutual fund operating companies incorporated in Mexico. Of those companies, 26 were truly independent mutual fund operating companies, i.e., not controlled by a securities firm or a bank, 23 of which managed "capital" investment companies and only three managed "common" and "debt instruments" investment companies (Source: Commission). So far, banks and brokerage firms have shown the greatest interest in sponsoring mutual funds and have been able to satisfy the capital and operational requirements to incorporate them.

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\(^4\) The main self-regulatory organization in the Mexican securities market is the Mexican Stock Exchange (Bolsa Mexicana de Valores, S.A. de C.V.; hereinafter also referred to as the Exchange). The Exchange is a private institution owned by its members, which are those brokerage firms licensed to operate in Mexico. Specialists are also required to be members of the Exchange. The Exchange conducts its activities under a concession from the Ministry of Finance and Public Credit and is, at present, Mexico's only stock exchange.

\(^5\) ICA, art. 28.
(ii) Open-end, Closed-end

There are three basic types of mutual funds in Mexico.

"Common" investment companies (sociedades de inversión comunes) invest in a mixed portfolio of equities and debt instruments and must have a minimum capital of $143,000 dollars.\(^6\)

"Debt instruments" investment companies (sociedades de inversión en instrumentos de deuda) invest, as their name indicates, in debt instruments. Their required minimum capital is $143,000 dollars.\(^7\)

"Capital" investment companies (sociedades de inversión de capitales) known in practice also as "venture capital funds", seek maximum capital gains by investing in stock of new industries and must have a minimum capital of $15,000 dollars.\(^8\)

The Commission may authorize different types of funds within the basic categories mentioned before.

"Common" investment companies and "debt instruments" investment companies may be open-end or closed-end. "Capital" investment companies may only be closed-end; these companies, when listed on the Exchange, are entitled but not obliged to repurchase their shares.\(^9\)

Under applicable regulations, both open-end and closed-end funds may be listed and traded on the Stock Exchange. In practice, closed-end funds (the majority of which are "capital" investment companies) have seldom listed their shares on the Stock Exchange. After the initial offering (or subsequent offering by the issuer), closed-end shares are available mainly in the secondary market where they trade at a market price based on factors such as supply and demand. In practice, open-end funds list their shares on the Stock Exchange mainly for purposes of providing information to the Exchange that once disseminated may attract investors. Open-end funds are required by ICA to sell and redeem their shares at a price based on the funds' net asset value computed pursuant to the appraisal procedure discussed in section 3 (g) below. Open-end shares are not actually traded on the Exchange at market price.

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\(^6\) Id., art. 17; Circular 12-22 issued on October 18, 1993, rule 26. Although these requirements are established in Mexican pesos, for simplicity sake we have included the dollar equivalent of such amounts based upon the exchange rate of $7 Mexican pesos per $1 U.S. dollar.

\(^7\) ICA, art. 19; see also Circular 12-22, supra note 6.

\(^8\) ICA, art. 22; Circular 12-9 issued on May 20, 1986, rule 1.

\(^9\) ICA, art. 9-X.
We understand that in some countries, including the United States, certain open-end funds are required to stand ready on any day the fund is open for business to redeem any or all shares outstanding. That was the case at the initial stages of mutual fund regulation in Mexico. However, under current regulations, open-end mutual funds are not required to redeem daily. The redemption rights and timing of redemption (i.e., daily, weekly, etc.) must be set forth by the fund and included in its prospectus.

(iii) Structure of the Fund

Mutual funds must be organized as stock corporations of variable capital, which allows greater flexibility for increases or reductions in capital stock. Shares do not have the right to withdraw their capital below the fixed capital portion established by the Commission. As a general rule, no one person, regardless of nationality, may own more than ten percent of the shares of a mutual fund. However, higher percentages may be temporarily held by incorporators of mutual funds, by the mutual fund operating companies, by shareholders of capital investment companies and by certain trust and pension funds.11

As a general rule, foreign investors may own up to 49% of the fixed capital of a mutual fund. They may also own up to 100% of the variable capital of a mutual fund.12

Under NAFTA, U.S. and Canadian financial institutions may establish wholly-owned subsidiaries that are mutual fund operating companies and mutual funds in Mexico. Such subsidiaries may engage in the same type of activities their U.S. or Canadian parent company conducts directly or indirectly in its home country. 13

99% of the capital stock of the affiliate

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10 Id., art. 9-VI; Ley General de Sociedades Mercantiles, D.O., August 4, 1934, arts. 213 and 216. The most commonly used corporate form in Mexico today is the stock corporation called sociedad anónima. A sociedad anónima may be organized as a fixed capital corporation or a variable capital corporation. A fixed capital corporation, as its name indicates, has a fixed capital stated in its by-laws. In order to increase or reduce its capital, it is necessary to amend its by-laws by a vote of a special shareholders' meeting of the corporation; the minutes of the special shareholders' meeting must be notarized and registered with the Public Registry of Commerce of the domicile of the corporation. The variable capital corporation allows a greater degree of flexibility in the increase or reduction of its corporate capital. This particular corporate form is frequently used because it does not require the formal and costly steps that need to be taken in order to effect and register an increase in the capital stock of fixed capital corporations. In sum, the variable capital corporation has a fixed capital and a variable capital. The variable capital is typically much higher than the fixed capital and its increases or reductions may be effected by resolution of an ordinary shareholders' meeting of the corporation, which may be convened and held with less corporate formalities than a special shareholders' meeting. Increases and reductions of the variable capital do not require an amendment of the by-laws of the corporation. The minutes of an ordinary shareholders' meeting adopting such resolution do not need to be notarized or registered with the Public Registry of Commerce. The fixed capital portion is seldom increased or reduced. An increase or reduction of the fixed capital portion must be formalized following the same steps described for increases or reductions of the capital stock of fixed capital corporations.

11 1CA, art. 10.

12 Ley de Inversión Extranjera, D.O., December 27, 1993, arts. 4 and 7-IV (i).

13 North American Free Trade Agreement, December 17, 1992, United States - Canada - Mexico, Chapter 14, art. 1408-2 and Annex VII, Schedule of Mexico, § B-12 and 14, D.O. December 20, 1993; ICA, arts. 34-Bis, 34-
must be owned by the U.S. or Canadian parent company.\textsuperscript{14} U.S. and Canadian firms are not subject to the limitations on aggregate capital or individual capital imposed under NAFTA in connection with banks, brokerage firms and insurance companies.\textsuperscript{15}

(b) Legal Form of the Fund Sponsor and Advisor

(i) Who Can Sponsor and Manage

Funds may be sponsored by banks, securities firms and other individuals or corporations, except for those having foreign government participation.\textsuperscript{16}

Pension funds may become in the future an important sponsor of mutual funds. Regulations governing the mandatory Savings for Retirement Program adopted by Mexico in 1992 contemplated the possibility to invest pension contributions through mutual funds. Mexican banks were entrusted to manage pension contributions between 1992 and 1996.\textsuperscript{17}

Pension contributions are to be invested through specialized mutual funds commencing January, 1997. On May 21, 1996, the Savings for Retirement Systems Act (hereinafter referred to as the Pension Funds Act) was signed into law by President Zedillo. The Pension Fund Act was controversial during the months before its enactment. Some of its provision are likely to require congressional action within the near future.

The Pension Fund Act provides that specialized mutual funds (sociedades de inversión especializadas de fondos para el retiro also known as Siefores) are to be incorporated pursuant to an authorization of the Pension Funds Regulatory Commission, and will be required to operate under rules to be issued by such Commission. These funds are to be managed by a special type of operating company (administradoras de fondos para el retiro also known as Afores) that will also be incorporated pursuant to an authorization of, and pursuant to rules issued by, such Commission. Both the funds and the operating companies must be organized as stock corporations of variable capital. Shareholders do not have the right to withdraw their capital below the fixed capital portion established by the Commission. As a general rule, no one person, regardless of nationality, may own more than ten percent of the shares of an operating company. However, higher percentages may be authorized by the Commission.

\textsuperscript{14} ICA, art. 34-Bis-6.

\textsuperscript{15} Id., arts. 34-Bis-1, 34-Bis-4 and 34-Bis 6.

\textsuperscript{16} Id., art. 9-III.

\textsuperscript{17} Ley para la Coordinación de los Sistemas de Ahorro para el Retiro, D.O., July 22, 1994, art. 3-VII, VIII and IX; Ley del Seguro Social, D.O., March 12, 1973, art. 183-M; Ley del Instituto de Seguridad y Servicios Sociales de los Traba-jadores del Estado, D.O., December 27, 1983, art. 90-Bis-M.
As a general rule, foreign investors may own up to 49% of the capital stock of an operating company. 99% of the fixed capital portion of a fund must be owned by the operating company that is managing it. While the bill submitted to Congress contemplated the possibility to establish wholly-owned subsidiaries of U.S. and Canadian financial institutions that were to be operating companies and mutual funds, such provision was taken out from the final text of the Act. Much of the legislative debate on the Act centered on its potential inconsistency with Mexican obligations under NAFTA and the Mexican Constitution. This is an area that will require congressional action in the near future to obtain the necessary consistency with obligations derived therefrom.

The board of directors of both, operating companies and mutual funds, must have no less than five members. No less than two of such directors must be independent directors. This is a positive development that should be incorporated in the regulatory framework of mutual funds in Mexico. The Pension Funds Act establishes minimum portfolio diversification guidelines to be further defined by the Commission. These funds may not invest in non-Mexican securities. This restriction is inconsistent with a sound diversification policy for portfolio investments of these funds. It is very important to allow investment of a percentage of assets of these funds in non-Mexican securities, so as to hedge their portfolio against sudden fluctuations of the Mexican securities market and the exchange rate. One hopes that this issue will be addressed in the near future by Mexican Congress so as to better protect in the long term the savings of the Mexican workers which are the ultimate beneficiaries of the system. The Pension Funds Act establishes rules seeking to attain investor protection, as well as disclosure and reporting requirements. A worker may decide to invest his pension funds through the specialized mutual fund of his choice.\textsuperscript{18}

The organizational and operational requirements of the specialized mutual funds are operating companies that will invest pension contributions are to be included in a set of regulations being prepared by the Pension Funds Regulatory Commission.

These funds may become an important catalyst for capital formation in Mexico, provided certain fundamental conditions are established and met. Capitalization and operational requirements should be properly defined. The regulations to be adopted should encourage equity investment and long-term holdings as opposed to excessive debt investments and short-term trading activities. Of paramount importance, the specialized operating companies should show the willingness and discipline to pursue the opportunities opened to them with a constructive and self-regulatory attitude.

(ii) Corporate, Partnership, etc.

Mutual fund operating companies, banks and securities firms are required to be organized as stock corporations. Banks must have fixed capital stock and cannot incorporate as a stock corporation of variable capital. The Commission requires that mutual fund operating companies

\textsuperscript{18} Ley de los Sistemas de Ahorro para el Retiro, D.O., May 23, 1996.
and securities firms be organized as stock corporations of variable capital; shareholders do not have the right to withdraw their capital below the fixed capital portion.\(^{19}\)

(c) **Contractual Form of Trust and Legal Relation to Trustees**

As a general rule, Mexican mutual funds must be incorporated as stock corporations of variable capital.\(^{20}\) A trust may be a vehicle for foreign investors to participate in a Mexican mutual fund, but not the legal structure to incorporate the fund.

(d) **Board of Directors**

(i) Number, Qualifications, Restrictions

The board of directors of a mutual fund must have not less than five members. A majority of same may be appointed by holders of fixed capital of the mutual fund (see section 2 (f) below). Directors must be reputable people with knowledge of securities markets. The Commission may veto the appointment of a director that does not meet such qualifications.\(^{21}\)

(ii) Requirement of Independent Directors

Applicable regulations do not require at present to have independent directors in the board of mutual funds. The trend is, however, for major mutual funds to have independent directors.

(e) **Custodians**

(i) Qualifications, Resolution of Conflict of Interest

Shares issued by mutual funds are generally kept in custody by the mutual fund operating company, who must keep same deposited with a depository company.\(^ {22}\)

Portfolio securities of mutual funds must be kept in deposit with a depository company.\(^ {23}\)

Securities depositories function as clearinghouses and depositories for securities traded in Mexico, eliminating the need for the physical transfer of securities. Initially, SEA contemplated

\(^ {19}\) ICA, art. 29-III; Ley de Instituciones de Crédito, D.O., July 18, 1990, art. 9; SEA, art. 17-1.

\(^ {20}\) See supra note 10 and accompanying text.

\(^ {21}\) ICA, arts. 9-VIII, 5-II and 39-VI.

\(^ {22}\) Id., art. 31.

\(^ {23}\) Id., art. 12.
the existence of only one such depository, called the Instituto para el Depósito de Valores (Indeval). SEA contemplates the creation of other such institutions, but only Indeval, reprivatized and renamed S.D. Indeval, S.A. de C.V., exists at present.²⁴/ 

Indeval receives securities for deposit from brokerage firms, banks, mutual fund operating companies, other participants in the Mexican securities market and foreign financial institutions. It clears transfers and other transactions with respect to deposited securities.

There is a centralized system for the custody of securities, and the rules for operation of such system are subject to review and approval by the Commission. Probably as a result of that, no detailed rules for conflicts of interest have been required to be issued yet.²⁵/

(ii) Limitations on Fees

Indeval as custodian may charge fees approved by the Commission for (a) deposit and withdrawal, (b) custody and (c) transfer of securities deposited with same. Such fees are typically deducted by the mutual fund operating company from the fund assets and paid to Indeval.

Current fees for deposit are $.15 dollars for each certificate in case of individual certificates or $7.14 dollars in case of a global certificate evidencing all securities. Fees for withdrawal of securities from Indeval are $1.43 dollars for each individual certificate or $71.42 dollars for a global certificate.

Custody fees are based upon a sliding scale and may range up to .00075 percent of a depositor's average assets per month if the depositor is a shareholder of Indeval, and up to .00192 percent if the depositor is not a shareholder of Indeval.

Transfer fees are $.86 dollars per transfer if the transfer is executed through the computer linkage system of Indeval (sistema interactivo de depósito de valores), and $4.29 dollars if the transfer is executed through other means.²⁶/

(f) Shareholder Rights: Electing Directors, Approving Fees, Investment Policies

Holders of fixed capital of a mutual fund have the right to elect a majority of the mutual fund's board of directors and all members of the mutual fund's investments committee. The investments committee decides which securities will be purchased and which will be sold.²²/

²⁵/ SEA, arts. 22-V (b), 22-Bis-III (b) and 60.
²⁶/ Source: S.D. Indeval, S.A. de C.V. See supra note 6.
²²/ ICA, art. 9-VIII.
Holders of variable capital of a mutual fund have the right to elect a minority of the fund's board but cannot elect members of the investments committee. The variable capital of a mutual fund is normally structured to foster the capitalization of the mutual fund by attracting investors interested in the yield on its investment and willing to accept limited voting rights in the governance of the mutual fund. Shareholder rights regarding investment policies are discussed in section 3 (a) (iv) below.

(g) Transfer Agents

Mutual funds are required to employ a depository company to prepare and maintain records relating to the accounts of its shareholders (see section 2 (e) (i) above).

(h) Underwriters, Distribution Networks; Restrictions to Avoid Conflict of Interest

While the fixed capital of a mutual fund must be fully subscribed at the time of incorporation, the variable capital may be placed directly or through underwriters. The initial distribution plan of a mutual fund must be approved in advance by the Commission.  

Brokerage firms may act as underwriters for the purpose of assisting mutual funds in the public placement of their shares. In such capacity, brokerage firms may invest a portion of their assets in shares of the mutual fund for a placement period of three months, which may be extended with the prior authorization of the Commission.

Restrictions to avoid conflict of interests of underwriters are established on a case-by-case basis by the Commission when approving the distribution plan of a mutual fund.

General restrictions to be observed in all distribution plans include a prohibition that the chief executive officer and the officer in charge of handling investments for the account of a brokerage firm that will act as underwriter, form part of the investments committee of a mutual fund. The investments committee must keep records of all its meetings for review by the Commission. The prohibition of insider trading and the general anti-fraud provisions of the Civil Code and the Criminal Code seek to guard against self-dealing by insiders.

3. SUBSTANTIVE REGULATION OF THE INDUSTRY

(a) Investment Policies

(i) Eligible Securities, in Particular, Can Fund Invest in Derivatives,

28 Id., arts. 9-1 and 39-II.

29 Id., art. 39-II; SEA, art. 22-V (a); Circular 10-163 issued on December 11, 1992, rule 4.

30 ICA art. 9-VIII; Circular 12-22, supra note 6, rule 25-3.
Private Placements, Unlisted Securities, Foreign Securities, Illiquid Securities, etc.

As a general rule, Mexican mutual funds are required to invest in Mexican securities registered with the National Securities and Brokers Registry. Such securities need not be listed on the Mexican Stock Exchange.31/ Pursuant to recent legislative changes to be discussed below, Mexican mutual funds may now invest in non-Mexican securities listed in the international quotation system of the Mexican Stock Exchange (the "International System"), which is expected to become operational in the near future. Plans for implementation of the International System contemplate that these securities will be traded in Mexican pesos.32/

Mutual funds, with the exception of capital investment companies, may not invest in securities which are not registered with the Registry or derivatives.

Investment in illiquid securities is permitted, although certain types of investment companies must maintain a percentage of their assets in "liquid" securities (see Section 3 (a) (ii) below). For the time being, "liquid" securities are considered by the Commission to be short-term, highly-traded securities. The Commission plans to issue rules to further define "liquid" securities in the future.

The regulatory scheme of SEA seeks to assure a minimum of protection and adequate disclosure for the benefit of investors in the securities market by requiring that every public offering be approved by the Commission and registered with the Registry. This registration subjects issuers to a reporting system which requires them to furnish periodically certain data and documents to both the Registry and the Exchange, which in turn make them available to the public.33/

Eligibility of a non-Mexican security for investment by mutual funds in the International System of the Exchange requires compliance with one of the following requirements: (a) designation by the Commission of the foreign market where the security is principally listed as a "recognized market", or (b) the granting by the Commission of the status of "recognized issuer" to the issuer of the security involved.

A foreign market may be designated a "recognized market" if it meets the following criteria:

(i) the market is regulated by an authority, prohibits insider trading and limits

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31/ ICA, art. 11.


33/ For an analysis of the regulatory framework of public offerings in Mexico, see Teófilo G. Berdeja Prieto, International Securities Regulation, Mexico Chapter (Dobbs Ferry, N.Y., 1992).
transactions where there is a conflict of interests;

(ii) the market is subject to adequate rules regarding market information and timely disclosure of same;

(iii) the market requires issuers to prepare financial information following international standards and to have such information audited by external auditors; and

(iv) the market maintains a centralized system of market information to allow enforcement of applicable regulations.\textsuperscript{34}

The granting of the status of "recognized issuer" by the Commission is subject to similar criteria, as well as to the following additional requirements:

(i) with respect to issuers of debt, such issues must be reviewed and rated by an authorized rating company;

(ii) the issuer or the Mexican brokerage firm applying for "recognized issuer" status, must commit to furnish to the Mexican Stock Exchange financial and legal information of the issuer with the same frequency required by the exchange of the home country of the issuer and the principal exchange on which the securities involved are listed, as applicable.\textsuperscript{35}

A listing in the International System of the Mexican Stock Exchange requires that the Exchange file an application for the designation of a market as a "recognized market" or for the granting of status as "recognized issuer" by the Commission. The procedure to obtain the status of a "recognized issuer" must be initiated by the Exchange upon petition of an interested brokerage firm. This procedure has been designed, primarily, to be utilized with respect to sound issuers of securities listed in markets that do not qualify at present as "recognized markets".

The Commission has already granted the status of "recognized market" to equity sections of exchanges of countries that form part of the Technical Committee of the International Organization of Securities Commissions, and that are considered a "principal market" by the regulatory authorities of its home countries.

The International System was expected to be fully operational in December of 1994. However, the transition in the Federal Administration that began on December 1, 1994 and economic problems faced by Mexico in 1995, delayed the implementation of the International System and other projects relating to the securities market. While several important steps for its implementation have been taken, it is difficult to ascertain at present when will the International System become operational. An important element to start operations will be the effectiveness of

\textsuperscript{34} Circular 10-176, supra note 32, rule 6.

\textsuperscript{35} Id., rule 8.
the action to be taken by Mexican brokerage firms in order to obtain the final regulatory approvals required to start operations.

Recent legislative changes also permit Mexican mutual funds to invest in non-Mexican securities that are not listed in the International System, under rules to be issued by the Commission.\(^{36}\)

Although the Commission has not issued such rules yet, a draft general ruling has been prepared by the staff of the Commission for such purpose.

The Mexican Association of Securities Brokers has proposed a set of rules aimed at governing such investments to the Commission. The Commission will consider such proposal when preparing the final text of the general ruling.

(ii) Minimum Portfolio Diversification Guidelines

ICA contemplates three basic types of investment companies: (i) common, (ii) debt instruments, and (iii) capital. ICA establishes diversification guidelines for portfolio investments of such companies.\(^{37}\)

Applicable rulings provide that there may be two additional categories of investment companies: (i) diversified investment companies, required to invest in accordance with portfolio diversification guidelines of the Commission established for the three basic types of companies mentioned above, and (ii) specialized investment companies, which may invest in accordance with their own investment policies.

A. Common Investment Companies

The Commission has determined that diversified common investment companies must maintain a minimum amount equal to 30 percent of their equity in equity securities eligible under rules issued by the Commission. This type of investment company may invest up to 70 percent of its equity in securities issued by the Federal Government. Pursuant to diversification requirements, common investment companies may invest neither more than 15 percent of their equity in securities of a single issuer or in warrants, nor own more that 30 percent of the equity or debt instruments issues of a single corporation. Common investment companies may not invest more than 20 percent of their equity in securities issued by corporations belonging to the same business group.\(^{38}\) They may not invest in securities issued by subsidiaries of the financial group to which its operating company belongs, if such is the case, except for those securities issued or backed by Mexican banks.

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\(^{36}\) See ICA Amendments of 1992, supra note 32, art. 11.

\(^{37}\) ICA, arts. 18, 20 and 23.

\(^{38}\) Circular 12-22, supra note 6, rule 3-A. Corporations belonging to the same "business group" are the parent company, subsidiaries and affiliates of same.
B. Debt Instruments Investment Companies

The Commission has determined that diversified debt instruments investment companies offering repurchase of shares to their shareholders within an eight-day term must maintain a minimum amount equal to 40 percent of their equity in liquid securities. This type of investment company may invest up to 100 percent of its equity in securities issued by the Federal Government or issued or backed by Mexican banks. Pursuant to diversification requirements, debt instruments investment companies may invest neither more than 15 percent of their equity in securities of a single issuer nor own more that 30 percent of the securities of a single corporation. Debt instruments investment companies may not invest more than 20 percent of their equity in securities issued by corporations belonging to the same business group. This type of investment company may not invest any amount in equity securities.\(^{39}\) They may not invest in securities issued by subsidiaries of the financial group to which its operating company belongs, if such is the case, except for those securities issued or backed by Mexican banks.

Common and debt instruments investment companies of the specialized type must maintain no less than 60 percent of their equity in securities of the type described in its prospectus to the public. These companies may not invest more than 20 percent of their equity in securities issued by corporations belonging to the same business group. They may not invest either in securities issued by subsidiaries of the financial group to which its operating company belongs, if applicable, except for those securities issued or backed by Mexican banks.\(^{30}\)

The Commission may authorize common and debt instruments investment companies to invest in warrants.\(^{41}\)

C. Capital Investment Companies

In order to qualify as a recipient of funds from a capital investment company, an issuer must have entered into a contract with the investment company whereby such issuer, called promoted corporation by ICA, promises to abide by certain rules prescribed by ICA and submits to surveillance and inspection by the Commission. Such contract must establish a ceiling with respect to the percentage of equity of the promoted corporation that may be acquired by the investment company; pursuant to a 1990 amendment to ICA, capital investment companies may acquire more than 49 percent of the stock of promoted corporations.\(^{42}\)

ICA establishes that, as a general rule, capital investment companies may invest only in

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\(^{39}\) Id., rule 3-B.

\(^{40}\) Id., rule 4.

\(^{41}\) Id., rule 6.

shares and debentures of promoted corporations and that any remaining funds may be invested temporarily in securities approved by the Commission for investment by such companies. Diversification requirements establish that an investment company of this type may not invest more than 25 percent of its equity in debentures issued by promoted corporations; the rules establish further that it may neither invest more than 10 percent of its equity in the stock of corporations formerly promoted by it nor own more than 10 percent of the stock of such corporations.\(^{43}\) These requirements are being reassessed by the Commission.

(iii) Consistency Between Description and Portfolio Objectives

Common investment companies may be described as balanced funds which generally have a three-part investment objective: (i) to conserve investors' initial principal, (ii) to distribute current income, and (iii) to promote long-term growth of both principal and income. Balanced funds have a portfolio mix of both equities and debt instruments.

Debt instruments investment companies may be described as income-bond funds, which seek a high level of current income by investing at all times in a mix of corporate and government bonds.

Capital investment companies may be categorized as aggressive growth funds or venture capital funds which seek maximum capital gains as their investment objective. Current income is not a significant factor. Some companies in this category may invest in stocks of businesses that are somewhat out of the mainstream, such as new or temporarily out-of-favor industries, or fledgling or struggling companies.\(^{43}\)

(iv) Requirement to Seek Shareholder Approval for Portfolio Management or Investment Policy Changes

Investment policy changes require shareholder approval. Portfolio management changes that do not alter investment policies may be approved by the investments committee and do not require shareholder approval.

The Commission may authorize changes in investment policies as long as at least six months have elapsed since the incorporation of the mutual fund or the last modification of its investment policy.

A change in the investment policies requires resolution by a special stockholders meeting. Dissenting stockholders are entitled to have their shares repurchased at the appraisal value within ten business days from the date they are notified of such changes. A publication in a newspaper must be made and notice to the shareholders must be given 20 days prior to such change.

\(^{43}\) ICA, art. 23; Circular 12-8 issued on September 13, 1985, rule 1.

becoming effective.  

(v) Leverage and Borrowings

ICA provides that mutual funds may borrow money from commercial banks, non-bank financial intermediaries and foreign financial institutions for the purpose of financing transactions for their own account within rules to be issued by Banco de Mexico.  

In practice, borrowing by mutual funds is unusual.

(b) Ceilings on Fees Chargeable to Clients

Fees for the services of mutual fund operating companies are charged within ceilings authorized by the Commission. In recent years, the mutual fund industry has developed a variety of fee structures within such ceilings to respond to varying investor preferences.

Under Commission rules, management monthly fees may not exceed .4167 percent of the fund's average net assets during the previous month.

In addition, a commission or sales charge may be attached to purchases or sales of mutual fund shares. Such sales charge may range up to 1.7 percent, although sales charges may not be attached to purchases or sales of shares of debt instruments investment companies.

Finally, a commission or sales charge may be attached to purchases or sales of mutual fund portfolio shares, when these shares are purchased or sold by the mutual fund operating company upon instructions of the mutual fund. Such sales charge may range up to .5 percent.

Custody fees are discussed in section 2 (e) (ii) above.

(c) Investor Protection

(i) Restrictions on Front-running, Self-dealing and Insider Trading

Applicable regulations contain restrictions on front running, self-dealing and insider trading. This is an area of special concentration by the staff of the Commission and new regulations have been continuously adopted over the past few years.

Front running by brokerage firms, i.e. the purchase of shares by managers prior to purchases by the fund, is expressly prohibited under general rulings of the Commission. The Commission requires that brokerage firms observe strict automated systems for execution of

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55/ Circular 12-22, supra note 6, rule 8.

56/ ICA, art. 14-IX.

57/ Circular 10-149, issued on October 30, 1991, rule 4-1, II and III.
orders. The Commission determines controls and records that brokerage firms must maintain in conducting their trading activities. Each brokerage firm must keep a centralized and automated control in which all orders received are registered to assure that such orders be processed on a first-in first-out basis. A brokerage firm may take its own positions only after its client orders have been executed at the same or a better price than that at which the brokerage firm takes its own positions. The rules also set forth procedures to be followed in case of inability to fully execute a client's orders.\textsuperscript{48v}

So far, restrictions on front running apply only to brokerage firms. This is probably due to the fact that they may act as managers of investment companies, as well as to the fact that all trades with listed securities are required to be executed through such firms. However, it seems desirable to review and expand these rules to specifically cover the full scope of the activity of brokerage firms as managers. It is important also to include within such rules the activity of banks who may also act in lieu of operating companies, as well as independent operating companies (i.e., not owned by a bank or a brokerage firm).

Self-dealing by brokerage firms is prohibited under general rulings of the Commission. As a general rule, brokerage firms may not enter into transactions for their own account with portfolio securities of mutual funds managed by them or by affiliates of the financial group to which they belong. Brokerage firms may, however, sell and repurchase shares issued by the mutual fund they manage.\textsuperscript{49v} For the reasons mentioned before, it would also seem desirable to expand these provisions to specifically cover the activities of banks as managers of mutual funds, as well as those of independent operating companies.

Article 16 Bis of SEA prohibits a person with knowledge of privileged or inside information from trading in securities the price of which may be influenced by such information, until such information is disclosed to the public. If an insider trades before the information is so disclosed, the injured party may request a court to hold him to the transaction ordering him to pay damages.\textsuperscript{50v}

An action under Article 16 Bis differs from the civil law deceit action in that the affected buyer need not show any causal connection between the possession of inside information and his injury; indeed, he need not even show that he has been injured, nor is the intent of the seller relevant.\textsuperscript{51v} What needs to be shown is that the insider traded with the knowledge of privileged

\textsuperscript{48v} Circular 10-163, supra note 29.

\textsuperscript{49v} Id., rule 11.

\textsuperscript{50v} For an analysis of the law on insider trading in Mexico, see Berdeja Prieto, supra note 33, p. 62.

\textsuperscript{51v} The Mexican Civil Code contains a concept, deceit (\textit{dolo}), which may provide the basis for nullifying a securities transaction, even though such concept was not developed with the idiosyncrasies of securities trading in mind. Deceit is defined by the Mexican Civil Code as \textit{any suggestion or device used to mislead one of the contracting parties or to maintain him in a mistake}. Deceit vitiates the consent of a contracting party. Since free consent is a basic requirement for a valid contract, deceit provides a basis for nullifying a transaction. The declaration of nullity of a contract by a court has the effect of rescinding or abrogating the contract from its
information. In this sense, there is a simplification of the elements of such an action.

Despite such simplification, an action under the present form of Article 16 Bis presents certain problems that require further review and clarification to improve its effectiveness. The interpretation of the Commission so far has been that an insider should refrain from trading on the basis of material information prior to its disclosure to the public by the issuer. According to such interpretation, the duty of disclosure is imposed upon the issuer rather than upon the insider. If an issuer never discloses allegedly inside information, the injured party may have considerable difficulty in establishing a cause of action against the violator. It would not be sufficient to prove that certain information was material. It would be necessary to establish, in addition, when certain information became known to an issuer, and that the issuer should have disclosed such information to the public.

1990 amendments to SEA opened the path for a different interpretation on this point by the Commission.\(^52\) We believe that the elements of an action under Article 16 Bis would be simplified if disclosure could be effected in addition to the issuer, by someone other than the issuer, for example a bona fide seller of the security in question to his purchaser. By confirming that material information could also be disclosed by other persons, Article 16 Bis would be made fairer and easier to apply. However, the interpretation of the 1990 amendments to SEA on this point awaits clarification by the Commission or interpretation by competent courts.\(^53\)

In those cases in which an issuer discloses material information to the public after an insider has traded on the basis of same, the plaintiff may have a valid cause of action against


\(^{53}\) We understand that under U.S. case law interpreting the very general prohibition in rule 10 b-5 of the Securities Exchange Act, the elements of an insider trading violation are that: (i) the trader is in possession of information that is material; (ii) the information is non-public; and (iii) the trader is either an insider (for example, a director or officer, or an investment banker or lawyer for the issuer), or a "tippee" who knows or should know that the tipper, in transmitting the material non-public information, is breaching a fiduciary relationship; or is someone who steals or misappropriates from another person information that is material and non-public (or is a knowing tippee from a misappropriator). The case law has also developed the idea that someone in one of these categories who is in possession of material non-public information must either disclose the information, or abstain from trading -- the so-called "disclose or abstain" rule. The case law does not prevent disclosure from being made by someone other than the issuer. For example, a bona fide seller of the security in question could make disclosure to his purchaser. There may, of course, be other restrictions on disclosure, such as obligations under confidentiality agreements. Moreover, someone in possession of material non-public information may be reluctant to disclose the information if disclosure would strain relations with the issuer, or if disclosure might somehow implicate the person disclosing information in vouching for the accuracy of the information (although it appears possible to guard against this latter risk). For a review of disclosure requirements under United States law, see Meredith M. Brown, *Summary of Disclosure Requirements Under United States Securities Law* (1995) (unpublished study in Debevoise & Plimpton Library).
such insider.

The remedy available under Article 16 Bis is payment of damages by the defendant for an amount up to twice the amount of profits derived from the transaction. In addition, violators may be fined by the Commission for up to twice the amount of profits derived from the transaction, plus surcharges.

Only the injured party is entitled to sue under Article 16 Bis. No derivative action is available to the shareholders of the issuer. The statute of limitations is six months from the date the transaction took place. Such statute is probably longer in most circumstances than that of the civil law deceit action, which expires 60 days after an affected party learns that it has been deceived.54/

(ii) Minimum Reserves Required in the Management Company

Applicable regulations establish capitalization requirements for mutual fund operating companies.

Independent mutual fund operating companies (i.e., not owned by a bank or securities firm) established to manage common investment companies and debt instruments investment companies must have a minimum capital of $1.7 million dollars.55/ The required capital for those intended to manage capital investment companies is $21,000 dollars.56/

Mutual fund operating companies owned by holding companies of financial groups, banks or brokerage firms have different capitalization requirements. Those operating companies established to manage common and debt instruments investment companies are required to have a minimum capital of $143,000 dollars. Those established to manage capital investment companies have the same capitalization requirement of $21,000 dollars established with respect to independent operating companies.57/

Under current regulations, the capitalization requirements established for independent mutual fund operating companies are higher than those set for mutual fund operating companies owned by holding companies of financial groups, banks or brokerage firms. The National Banking and Securities Commission explains such difference on the grounds that capitalization requirements established for banks and securities firms are rather substantial so as to provide a likelihood of financial responsibility in the management of a mutual fund controlled by such entities. Accordingly, the capitalization of an independent mutual fund operating company must

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54/ Civil Code, art. 2236.
57/ Id.
be higher than that required from an operating company controlled by a bank or a brokerage firm, so as to provide a similar degree of financial responsibility on the manager's side.

This rationale should be reviewed, though, since the assets of a bank or brokerage firm do not back the obligations of a mutual fund sponsored by such institutions. Adequate regulation and a clear relation between performance and accountability of fund managers would seem the best methods to address the Commission's valid concern. One hopes that capitalization requirements for independent mutual fund operating companies will be reduced in the future, and adequate regulation will be maintained so as to enable the incorporation of a higher number of independent managers and foster competition and innovation for the benefit of the investing public.

(iii) Mechanisms to Prevent Abuse of Securities Held in Fund

Mutual funds and mutual fund operating companies are subject to close regulation by the Commission, which currently has 56 members of its staff assigned to supervise the activities of mutual funds. General rulings of the Commission establish special accounting requirements, reporting and disclosure systems, and restrictions to be observed by mutual funds and mutual fund operating companies in dealings between them as well as when dealing with their shareholders.

The operating company and the mutual fund must enter into a contract for the rendering of administrative services and a contract for the distribution of shares that must comply with rules issued by the Commission.  

Mutual funds must make their investments in compliance with diversification guidelines issued by the Commission (see section 3 (a) (ii) above). Investment policy changes require shareholder approval. Investment decisions must be made by the investments committee of the mutual fund. Minutes of each meeting must be prepared and delivered periodically to the Commission.  

Execution of orders by brokerage firms is regulated by the Commission.  

Disclosure and reporting requirements applicable to mutual funds will be discussed in section 3 (c) (v) below.

Finally, Mexican law establishes certain civil and criminal liabilities in connection with

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59/ See supra note 45 and accompanying text.
60/ See supra note 28 and accompanying text.
61/ See supra note 48 and accompanying text.
securities transactions that may apply to transactions involving securities held by mutual funds. Prior to 1983, the only remedies available were those existing under the civil law in respect of deceit and under the criminal law in respect of fraud and embezzlement. In that year, Congress amended SEA to create a special securities fraud concept which prohibits trading on the basis of privileged information (see section 3 (c) (i) above).

Mutual fund operating companies and mutual funds are subject to surveillance and inspection powers of the Commission, which include cancellation of their authorization to operate if they fail to comply with applicable provisions.62/

(iv) Regulation of Advertisements

Mutual fund operating companies and investment companies are, in general, prohibited from publishing, circulating or distributing any advertisement that recommends a certain specific participant or security over another specific participant or security, or that utilizes an offensive term, or that claims a chart or other device can in and of itself determine that a participant or security is "sound" or "solid" with the exclusion of others, or that contains untrue statements of material facts or is otherwise misleading. Copies of advertisements must be furnished to the Commission within three business days of its publication.63/ As a general matter, however, the staff of the Commission does not review or approve specific advertisements.

(v) Frequency and Content of Prospectus, Disclosure and Periodic Reporting Requirements

A. Prospectus

A mutual fund must furnish each shareholder and prospective shareholder with a written prospectus. The prospectus must include information about the mutual fund and its sponsor, the rules for repurchase of shares and the ceilings on holdings applicable to each shareholder, the investment policies and portfolio management rules, the main risks associated with investment in the mutual fund, the rules for appraisal of shares of the fund, the amount of the fees, the scope of the services to be provided by the mutual fund operating company and the right of a shareholder to have its shares repurchased in case of changes in the investment policies or rules for repurchase of shares.64/

B. Disclosure Requirements

The operating company of each common and debt instruments investment company must monthly, without charge, deliver to each of the shareholders of the fund a statement containing

62/ ICA, art. 34.
64/ ICA, art. 6; Circular 12-22, supra note 6, rule 22.
(i) a detail of the transactions between the fund and the shareholder during the period and the fees charged for such transactions, (ii) the holdings of such shareholder at the end of the month and at the end of the previous month, and (iii) the current portfolio statement of the fund.

Each common and debt instruments investment company must publish in a national newspaper, within the first five business days of each month, its monthly portfolio statement.\(^{63}\)

Each fund must publish in a national newspaper, within 30 days following the end of each quarter, its quarterly financial statements. Capital investment companies which have not made a public offering of their shares are exempted from this requirement.

In addition, each fund must publish in a national newspaper, within 90 days following the year end, its annual financial statements.\(^{66}\)

C. Reporting Requirements

Every common and debt instruments investment company is required to file the following reports with the Commission on forms issued by the Commission:

(i) daily appraisal of its portfolio;

(ii) monthly financial statements within five business days of the end of the month;

(iii) a monthly summary of minutes of meetings of the investments committee, within five business days of the end of the month;

(iv) a monthly summary of appraisal values of shares issued by the fund, as well as a monthly summary of transactions with respect to shares issued by the fund, within five business days of the end of each month; and

(v) copy of the publication of annual financial statements of the fund, no later than 90 days after the end of the year.\(^{67}\)

Each capital investment company is required to file with the Commission (i) a quarterly appraisal of its portfolio, (ii) quarterly financial statements, and (iii) a copy of the publication of the annual financial statements of the fund, no later than 90 days after the end of the year.

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\(^{63}\) Circular 12-22, supra note 6, rules 19 and 20.

\(^{66}\) ICA art. 38; Circular 12-22, supra note 6, rules 23 and 25-7.

\(^{67}\) Circular 12-22, supra note 6, rule 25.
(d) Taxation of Mutual Fund Interest, Dividend and Capital Gains

The activities of a mutual fund give rise to tax obligations. These obligations concern three types of taxes: the income tax (*impuesto sobre la renta*), known as ISR, the value added tax (*impuesto al valor agregado*), known as IVA, and the asset tax (*impuesto al activo*), known as IMPAC. The taxation varies for each type of mutual fund.

(i) Debt Instruments Investment Companies and Common Investment Companies

A. Taxation of Debt Instruments Investment Companies and Common Investment Companies

Neither debt instruments investment companies nor common investment companies are taxpayers for purposes of the *LISR*. They are, nevertheless, obligated to comply with a limited number of tax obligations.

As regards the IMPAC, debt instruments investment companies and common investment companies are entirely exempt from this tax because they are not considered to be taxpayers under the *LISR*.

Debt instruments investment companies and common investment companies must pay IVA as any other taxpayer. The sale of shares in any of these companies is exempt from IVA. And so is the distribution of dividends.

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69/ *LISR*, art. 68. As an exception, they will pay taxes for income obtained from (i) the sale of assets, (ii) interest from investments, and (iii) awards. *Id.*, arts. 69, 95, 125 and 129. Normally, taxes payable by debt instruments investment companies and common investment companies for income of this nature must be withheld. As an exception, income derived from awards for money market funds where only legal entities can invest will not be subject to withholding. *Id.*, art. 74, 6th para.

70/ *Id.*, art. 72.

71/ *LIMPAC*, art. 6-1.

72/ *LIVA*, art. 1.

73/ *Id.*, art. 9-VII.

74/ *Id.*, art. 9-VII; *LIVA Regulations*, art. 22.
B. Taxation of Mexican Legal Entities

The taxation of Mexican legal entities who sell their shareholdings in a common investment company is identical to the taxation of the sale of shares in a capital investment company, as explained in section 3 (d) (ii) B below. In order to determine the profit obtained by a legal entity for the sale of its shares in a common investment company, the legal entity selling the shares must deduct the average tax cost per share from the income derived therefrom. When the average tax cost is greater than the selling price, the legal entity has the right to take a deduction for the loss.

Seldom do debt instruments investment companies or common investment companies distribute dividends in Mexico. Almost invariably, shareholders of these companies get the return on their investment by selling their shares therein. The sale is practically guaranteed as these companies are typically open-end funds.

Were dividends distributed by a common investment company, the legal entity receiving them would be treated as described in section 3 (d) (ii) B below regarding dividends distributed by capital investment companies. Common investment companies must also apply 34% to the amount resulting from multiplying the actual amount of the dividends by a factor of 1.515. Mexico has eliminated the double-taxation system on dividends. Dividends are subject to the income tax only when earned at the corporate level. Dividends paid by Mexican corporations out of earnings that have been subject to corporate income tax are exempt from further taxation. Likewise, dividends paid out of the "net-tax profit account" are tax-exempt, as are dividends received from other legal entities when paid by these types of funds.

The daily increase in the value of shares of debt instruments investment companies is to be accounted for as interest. Income derived from the sale of such shares shall be determined on the basis of their price on the date of the sale by the legal entity who owns them. The price

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25/ For these purposes the gain, if any, is considered to be a capital gain, as opposed to an interest gain. Therefore, these gains are to be accounted for, from a tax point of view, only upon the sale of the shares. LISR, arts. 7-A and 19.

26/ Id., art. 25-XVIII; LISR Regulations, art. 31. For these purposes, the yield of the shares is treated as interest. LISR, art. 7-A.

27/ ICA, art. 9-X.

28/ LISR, art. 10-A.

29/ Id., art. 10-A, 3rd para. The "net tax profit account" seeks to promote re-investment of a company's profits.

30/ Common investment companies must maintain a "net dividends account", and dividends distributed by common investment companies out of this account will not be accumulated by the recipient thereof. Id., art. 71.

31/ Id., art. 7-A, 6th para.
shall be adjusted to consider the impact of inflation thereon.\textsuperscript{82/}

Debt instruments investment companies do not customarily distribute dividends in Mexico. The LISR has no specific provision applicable to the distribution of dividends. Note, however, that both legal entities and individuals must accumulate those amounts received as "distributable balance" (remanente distribuible) from a debt instruments investment company.\textsuperscript{83/}

C. Taxation of Mexican Individuals

Generally, income derived from the sale of shares of debt instruments investment companies by individuals, is tax-exempt.\textsuperscript{84/} And losses incurred as a result of the sale of such shares are not tax-deductible.\textsuperscript{85/}

Dividends paid to individuals by debt instruments investment companies or common investment companies, whether in cash or in kind, must be treated as "distributable balance."\textsuperscript{86/} Accordingly, such dividends receive a treatment similar to the distribution of dividends to Mexican legal entities, as described in section 3 (d) (i) B above. An important difference, however, is that individuals will not accumulate dividends distributed in kind when the value thereof does not exceed the limit set forth by the LISR.\textsuperscript{82/}

D. Taxation of Foreign Residents

As a general rule, foreign residents, whether individuals or legal entities, must pay taxes for the sale of their shares in a debt instruments investment company or a common investment company. As an exception, gains obtained by foreign residents for the sale of such shares shall be tax-exempt if effected through a stock exchange or an "active securities market."\textsuperscript{88/}

\textsuperscript{82/} Id., art. 7-B-IV: a).

\textsuperscript{83/} Id., arts. 68, 72-III, IV, and 133-X. See also arts. 70 (which defines "distributable balance") and 135, 3rd. para. thereof (establishing a 20\% withholding rate for such payments).

\textsuperscript{84/} Id., art. 71-A. The only exception is the sale of such shares from an individual retirement account. Id., art. 165. See also art. 77-XVI thereof (confirming that sales effected through a stock exchange or an "active securities market", are tax-exempt).

\textsuperscript{85/} Id., art. 137-XII.

\textsuperscript{86/} Id., art. 68.

\textsuperscript{87/} Id., art. 77-XXIV: b).

\textsuperscript{88/} Id., art. 151, 6th para. The Ministry of Finance and Public Credit, Secretaría de Hacienda y Crédito Público, hereinafter the SHCP, has defined active securities markets to be those which (i) have a stock exchange authorized to operate in their home country, and (ii) have entered into "broad information exchange" agreements with Mexico. See Miscellaneous Resolution, Resolución que establece para 1995 reglas de carácter general aplicables a los impuestos y derechos federales, excepto a los relacionados con el comercio exterior, D.O. March 31, 1995, No., 187, (hereinafter referred to as the Miscellaneous Resolution). Treaties to avoid double taxation
Dividends distributed to foreign residents are considered as "distributable balance", and as such are subject to withholding. The withholding rate is 35%.

(ii) Capital Investment Companies

A. Taxation of Capital Investment Companies

Capital investment companies are considered to be legal entities (personas morales) by the LISR, and as taxpayers (contribuyentes), they must comply with the general tax obligations provided for legal entities in the LISR. Nevertheless, they receive a specific tax treatment in certain respects.

For example, the LISR grants capital investment companies the right to accumulate gains for interest, inflation, and the sale of shares, until such gains are actually distributed to the shareholders of the fund. The benefit of this tax deferral also applies to gains obtained by the capital investment company from the sale of shares of portfolio companies. (The general principle is that all gains for interest, inflation, and the sale of shares must be accumulated in the fiscal year when they are obtained.) There is no requirement that a minimum percentage of dividends be distributed by capital investment companies each year.

Also, a capital investment company is allowed to consolidate for tax purposes as a holding company even if it holds less than 50% of the shares of its controlled companies, provided it holds "effective control" of its controlled companies and provided these are not consolidating as part of another group.

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 qualify for these purposes. See Annex 26 of the Miscellaneous Resolution, D.O. April 7, 1995. In the last five years Mexico has executed treaties, to avoid double taxation with the U.S., Canada, France, Italy, Sweden, Spain, the U.K., the Benelux Countries, Germany, Norway and Switzerland.

89/ LISR, art. 68.
90/ Id., art. 144, 4th para.
91/ Id., art. 153, 2nd para.
92/ Id., arts. 5 and 52-A.
93/ Id., art. 52-A.
94/ Id., arts. 7-A, 7-B and 19.
95/ Id., art. 57-A, 5th para. The general principle is that a holding company must hold more than 50% of the voting shares of its controlled companies to be able to consolidate for tax purposes. Note, however, that the SHCP's specific authorization is required for any corporation, including capital investment companies, to consolidate. Id., art. 57-B-IV. And note, also, that an authorization to consolidate becomes effective only on the fiscal year following that of its issuance. Id., art. 57-1.
Capital investment companies are subject to the LIMPAC. However, these funds receive a favorable treatment in that most of their assets are shares of their portfolio companies and such shares are not to be considered as assets for purposes of the LIMPAC.

Capital investment companies must pay IVA pursuant to article 1 of the LIVA. As all other taxpayers, they must pay IVA for the selling of goods, the rendering of services, the leasing of assets, and the import of goods or services.

Both the sale of shares in, and the distribution of dividends by, a capital investment company, are exempt from the IVA. This makes the acquisition of shares of capital investment companies attractive as buyers of such shares are not obligated to add IVA as a transaction cost.

Finally, the main activity of a capital investment company, i.e. holding shares of other companies, does not give rise to IVA.

B. Taxation of Mexican Legal Entities

Both legal entities and individuals can profit from the sale of their shareholdings in a capital investment company, or from the distribution of dividends by the latter.

The general income tax corporate rate in Mexico is 34% of the so-called "fiscal result." With some exceptions, all income obtained by Mexican legal entities must be accumulated. Profits obtained from the sale of shares must be accumulated too. In order to determine the profit for the sale of its shares in a capital investment company, the legal entity selling the shares must deduct the average fiscal cost per share from the income derived

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96/ LIMPAC, arts. 1 and 6-1.

97/ Id., art. 4-II. As an exception, shareholdings in debt instruments investment companies must be considered as financial assets. Id.

98/ The general rate of this tax is 15%, but it can also be 0%, 6% or 10%, depending on the kind of transaction. LIVA, arts. 1, 2, 2-A and 2-B.

99/ Id., art. 9-VII; LIVA regulations, art. 22. Note that the purchase of shares is generally exempt from IVA. Id.

100/ This conclusion is valid in that tax obligations cannot be created by analogy under Mexican principles of Constitutional law. In order for a tax obligation to be created it must be expressly contemplated in a statute. And the holding of shares is not per se a taxable activity under the LIVA. See art. 5 of the Fiscal Code of the Federation, Código Fiscal de la Federación, D.O., December 31, 1981, hereinafter referred to as the Fiscal Code.

101/ LISR, art. 10. The "fiscal result" is obtained by deducting from the tax profit (which is equal to income accumulated less all authorized deductions), all carry on tax losses.

102/ Id., art. 15.
therefrom. The formula to calculate the profit takes into consideration inflationary accounting and other factors.\textsuperscript{103/}

In distributing dividends, capital investment companies must pay the general corporate income tax rate. The application of the 34% rate, however, must be made upon the amount resulting from multiplying the actual amount of the dividends by a factor of 1.515.\textsuperscript{104/}

As an exception, dividends paid out of the "net-tax profit account" (\textit{cuenta de utilidad fiscal neta}) will not give rise to the payment described above.\textsuperscript{105/}

The payment of dividends by a capital investment company to another legal entity is not to be accumulated as income for tax purposes by the recipient.\textsuperscript{106/}

C. Taxation of Mexican Individuals

Profits from the sale of shareholdings in a capital investment company are considered to be taxable income for individuals.\textsuperscript{107/} It is noteworthy, however, that they are tax-exempt if the sale is effected through a stock exchange or an "active securities market".\textsuperscript{108/} Losses arising from the sale of shares in a capital investment company are not tax-deductible.\textsuperscript{109/}

Dividends paid by a capital investment company to individuals are considered to be "taxable income".\textsuperscript{110/} Individuals are not obligated, but have the right to, accumulate dividends received from this type of fund during the fiscal year.\textsuperscript{111/}

Also, it is noteworthy that dividends paid by capital investment companies to individuals

\textsuperscript{103/} \textit{Id.}, arts. 7, 7-A and 19.

\textsuperscript{104/} \textit{Id.}, art. 10-A.

\textsuperscript{105/} \textit{Id.}, arts. 10-A, 121, 3rd para., and 124.

\textsuperscript{106/} \textit{Id.}, art. 15, 4th para. Conversely, the amount of the dividends paid by a capital investment company to another legal entity must be accumulated for the limited purpose of calculating the basis for the payment of profit sharing to the recipient's employees. \textit{Id.}, art. 14-I: a).

\textsuperscript{107/} \textit{Id.}, art. 95, 4th para.

\textsuperscript{108/} \textit{Id.}, art. 77-XVI.

\textsuperscript{109/} \textit{Id.}, art. 137-XII.

\textsuperscript{110/} \textit{Id.}, art. 120-I.

\textsuperscript{111/} \textit{Id.}, art. 122, 1st para. Individuals who decide to accumulate must multiply the actual amount of the dividends received by a factor of 1.515 and apply 34% thereon. The resulting amount will be credited against the individual's annual accumulated income. \textit{Id.}, art. 122, 2nd para.
are not considered to be "interest" for purposes of article 125 of the *LISR*. As a result, individuals who receive dividends will not be withheld taxes for such payments.  

D. Taxation of Foreign Residents

As a general rule, foreign residents, whether individuals or legal entities, must pay 20% of the amount received for the sale of their shares in a capital investment company.  

But the treatment can be more favorable when the seller has a representative for tax purposes in Mexico. 30% of the profit obtained in the sale. In both cases, the purchaser of the shares, if a Mexican resident or a foreign resident with a permanent establishment in Mexico, must make the withholding.

As an exception, profits from the sale of shareholdings in a capital investment company are tax exempt if effected through a stock exchange or an "active securities market". 

The *LISR* provides the same treatment for the distribution of dividends to foreign residents, regardless of whether these are legal entities or individuals. In distributing dividends, capital investment companies must withhold taxes in the terms of article 10-A of the *LISR*, applying the formula described in section 3 (d) (ii) B above.

(e) Requirements to Distribute Income of Mutual Fund

The value of shares issued by mutual funds and, in some cases, of securities owned by them must be determined according to an appraisal procedure established by ICA (see section 3 (g) below). The appraisal must be used by the mutual fund as the basis for determining the price of the initial offering or any repurchase of its shares, and, in certain cases, of the price for sale of shares in its portfolio to the public.

Each mutual fund may determine the basis for distribution of its income. Most Mexican

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112 The withholding rate for "interest" payments is 20% over the first 10 percentage points, there is no right of deduction whatsoever, and the payment via withholding is final. *Id.*, arts. 126 and 127-1.

113 *Id.*, art. 151.

114 *Id.*, art. 160.

115 *Id.*, art. 151, 4th para.

116 *Id.*, art. 151, 3rd para. Note, however, that a more favorable treatment could be available under a treaty to avoid double taxation. *Id.*, art. 4-A.

117 *Id.*, art. 151, 6th para.

118 *Id.*, art. 152, 1st para. See also article 120 thereof.

119 *ICA*, art. 13.
mutual funds are open-end funds.\textsuperscript{120}  

There are two basic ways in which mutual funds may distribute income to shareholders. One, through dividends earned from the fund's investments. Two, if the securities held in the fund's portfolio increase in value, but the fund holds on to those securities instead of selling them, this increases the value of the fund's total portfolio and thus the fund's price per share at which a shareholder may redeem its shares. The basis to distribute income require shareholder approval.\textsuperscript{121}  

(f) Securities Market Regulation  

(i) Issuance of Prospectus  

A prospectus must be delivered by the fund prior to entering into any transaction for subscription of purchase of shares with a prospective shareholder. The prospective shareholder must sign a receipt acknowledging delivery of the prospectus. Amendments to the prospectus must be delivered to each shareholder prior to becoming effective. As mentioned before, a change in investment policies or repurchase regime entitles a dissenting shareholder to withdraw from the corporation.\textsuperscript{122}  

(ii) Soliciting, Marketing  

The marketing plan of a mutual fund requires the prior authorization of the Commission.\textsuperscript{123}  As a general rule, the distribution of a mutual fund is carried out by the mutual fund operating company. Most often, the operating company distributes the fund shares to individual investors through the branch offices of the bank or brokerage firm that sponsors the operating company. If such bank or brokerage firm is part of a financial group, distribution can be carried out by the branch offices of affiliate companies of the financial group.  

However, the Commission may authorize that distribution be effected by other entities.\textsuperscript{124}  In such case, the mutual fund operating company may establish sales agreements with securities-ties firms or other types of firms, provided the employees of such firms are qualified to effect the distribution.

\textsuperscript{120}  See supra note 9 and accompanying text.  

\textsuperscript{121}  See supra note 45 and accompanying text.  

\textsuperscript{122}  See supra note 64 and accompanying text.  

\textsuperscript{123}  ICA, art. 29-II.  

\textsuperscript{124}  Circular 12-19, supra note 58, rule 13.
(iii) Reporting Requirements

The reporting requirements applicable to mutual funds are described in section 3 (c) (v) above.

(g) Price Quotations and Method of Calculations

The shares of mutual funds must be appraised either by an appraisal committee approved by the Commission (Comité de Valuación; hereinafter referred to as the Valuation Committee), an appraisal company authorized by the Commission, or a commercial bank. If, however, the mutual fund is affiliated with a financial group, the commercial bank making the appraisal may not form part of such financial group. Shares of capital investment companies may only be appraised by the Valuation Committee. Indeval is authorized to act as appraiser under ICA, although in practice, it has not performed such service so far. Shares of common and debt instruments investment companies must be appraised on a daily basis. Shares of capital investment companies are required to be appraised on a quarterly basis, unless a significant event which affects the price of its shares occurs earlier.

The valuation of shares of mutual funds requires a complex analysis. To illustrate this complexity one must mention that more than 10 years elapsed before the Commission published a comprehensive General Ruling which, among other important objectives, seeks transparency in the valuation process.125/

The valuation process involves not only mathematical calculations, but also the use of sophisticated computer software and hardware. Not all operating companies have resources sufficient to value the portfolio of the mutual funds they manage with the same degree of desired accuracy. General criteria are yet to be adopted so that every market participant will abide by the same technical valuation standards.

Section Eleventh of General Ruling 12-22 contemplates the future publication of "guidelines and norms". To this effect, an inter-agency group including officials of the Commission, Banco de Mexico and the National Insurance and Bonding Commission, has been working for almost 2 years in an attempt to create such guidelines and norms.

The inter-agency group has used an interdisciplinary approach. It has made progress, but it will be quite some time before the group is actually able to issue the guidelines and norms referred to in section Eleventh of General Ruling 12-22.

The foregoing notwithstanding, seldom have investors in Mexico raised claims for improper valuation. Furthermore, the market works remarkably well as the daily valuations published by the fund managers are strictly observed when paying investors.

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125/ Circular 12-22, supra note 6.
(i) **Valuation of Shares in a Capital Investment Company**

The valuation of shares in a capital investment company requires different skills than the valuation of shares in debt instruments investment companies or common investment companies. This can be attributed to the fact that the portfolio of capital investment companies is often comprised of fewer companies and seldom traded on the Stock Exchange.

The valuation of the shares of an investment company must be made by the Valuation Committee. In the case of a capital investment company, generally both the book value and any value appreciation must be taken into account by the Valuation Committee to assess the shares of a promoted corporation (*compañía promovida*). As regards bonds (*obligaciones*) issued by promoted corporations, the acquisition cost plus capital and interest payments shall be taken into account on the valuation date.

Shares of promoted corporations that are listed in the Registry shall be valued following the criteria applicable to the valuation of shares of common investment companies. Finally, valuation of investments by capital investment companies in shares other than those included in section First of General Ruling 12-8 must be made following the criteria applicable to the valuation of shares of debt instruments investment companies.

It is noteworthy that promoted corporations themselves are obligated to furnish periodically to the Commission certain information, and that an "economic feasibility" study must be undertaken by the capital investment company before an investment decision is made. Also, capital investment companies must observe the catalog attached as Annex 2 to General Ruling 12-8 in presenting their accounting, and the format attached as Annex 3 regarding accounts grouping for purposes of their financial statements.

(ii) **Valuation of Common Investment Company and Debt Instrument Investment Company Shares**

The valuation of common investment company and debt instruments company shares,

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127/ *Id.*, rule 2-1. This is also applicable to shares of promoted corporations that are not listed in the Registry.

128/ *Id.*, rule 2-2. The valuation can also result in a decrease of the price of the shares if and when the promoted corporation is in arrears as regards payment of the issue.

129/ *Id.*, rule 2-3.

130/ *Id.*, rule 2-4.

131/ *Id.*, rules 5 and 6.

132/ *Id.*, rule 7.
both for individuals and for legal entities, must be made as set forth in General Rulings 12-16 and 12-22. General Ruling 12-16, which applies to the valuation of shares held by these types of funds, was derogated by General Ruling 12-22, but its Section Eighth continues to be in force temporarily, until such time as the "guidelines and norms" referred to in section 3 (g) (i) herein above are issued. Otherwise, General Ruling 12-22 has the same scope as General Ruling 12-16.

A. Valuation of Debt Instruments Investment Company Shares

Section Eighth of General Ruling 12-16 establishes that securities with a defined maturity shall be valued on the basis of the average price actually transacted in the Mexican Stock Exchange on the date of the valuation or the acquisition, whichever occurs later. As regards instruments that were not traded on the valuation date, the price shall be obtained by applying to the last "known price", to be calculated as described before, the last average discount rate for the issue. The result will be the yield. The yield for the balance of the term shall be obtained by applying a mathematical formula which is stated in detail in General Ruling 12-16.

The base price of the shares is always the price that is published by the Mexican Stock Exchange in the securities bulletin, as quoted for transactions between brokerage firms and their customers. The market value of money market instruments must be updated to reflect the balance of the term of the corresponding issue.

As regards instruments whose yield is adjusted periodically or whose interest rate is not published in the securities bulletin, the base price shall be the last price for an actual transaction in the Exchange involving the corresponding issue. The Commission remains empowered to amend the foregoing prior publication of the new technical formulae.

B. Valuation of Common Investment Company Shares

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133/ *Circular* 12-16, issued on October 2, 1990.
134/ *Circular* 12-22, supra note 6, rule 1 Transitory.
135/ *Circular* 12-16, supra note 133, rule 8-A) 1.
136/ *Id.,* rule 8-A) 2.
137/ *Id.,* rule 8-A) 2.2.
138/ *Id.,* rule 8-A) 3.
139/ *Id.,* rule 8-A) 4.
140/ *Id.,* rule 8-A) 5.
Common investment company shares shall be valued following the last price quoted in the Mexican Stock Exchange, as actually transacted on the valuation date.\textsuperscript{142} If no transaction is effected on the valuation date, then the price for the last transaction actually effected, regardless of the date, shall be the base price.\textsuperscript{143}

C. Criteria of a General Application

Sections Tenth through Fifteenth of General Ruling 12-22 include a set of criteria which apply equally to the valuation of shares in debt instruments investment companies and common investment companies. We are summarizing the most important of such criteria:

(i) to obtain the price per share, the shares of the paid in capital of the mutual fund shall be divided by the factor resulting from subtracting the mutual fund liabilities from its assets;\textsuperscript{144}

(ii) all transactions involving shares of such funds must be effected through, or at least recorded in, the Mexican Stock Exchange, no later than the business day following the transaction date;\textsuperscript{145}

(iii) instruments of issuers who are in partial or total default regarding the corresponding issue must be assigned a value of 0, unless guaranteed by a mortgage in which case they shall be assigned a value of 50% of their last (full) value;\textsuperscript{146}

(iv) members of the Valuation Committee are not permitted to act as members of the Valuation Committee of other banks or securities rating agencies;\textsuperscript{147}

(v) the price of the fund shares must be determined following the provisions of article 13 of the Investment Companies Act;\textsuperscript{148}

\textsuperscript{142} Id., rule 8-B).

\textsuperscript{143} Id.

\textsuperscript{144} Circular 12-22, supra note 6, rule 10.

\textsuperscript{145} Id., rule 11-1.

\textsuperscript{146} Id., rule 11-2. Any subsequent recovery of the investment shall be reflected directly in the income statement of the issuer. Upon the expiration of the term of the issue, whether as originally agreed or as extended by the security holders, the assigned value shall be 0 if the issuer continues to be in default.

\textsuperscript{147} Id., rule 12.

\textsuperscript{148} Id., rule 12; ICA, art. 13. This provision of the ICA is key to the valuation process. It contains comprehensive rules regarding the performance of the Valuation Committee and other parties who are involved in the valuation process in general.
(vi) the Valuation Committee must determine the price of the fund shares and shall make such price publicly available no later than 5 p.m. every business day, and funds are required to maintain a daily record including at least the number of transactions involving their shares, the price per share per transaction, and the aggregate amount thereon.\(^{149/}\)

(vii) the valuation price must be published every business day in a newspaper of a national reach, along with the differential with the previous business day's valuation price; and, \(^{150/}\)

(viii) whenever the Mexican Stock Exchange price index decreases 3% or more in a single day, the price of any series of shares not traded during that day shall be adjusted to reflect such price index decrease.\(^{151/}\)

Mutual funds are authorized to purchase their own shares. In so doing they must abide by strict guidelines.\(^{152/}\) These guidelines seek to bring transparency and to avoid unfair dealings in the process.

Finally, General Ruling 12-22 includes as annexes formats which must be observed regarding presentation of accounts grouping and financial statements.\(^{153/}\) And it also includes accounting rules which apply specifically to certain types of transactions, such as repurchase transactions (reportos), those involving warrants, and those involving the payment of dividends in shares to common investment companies.\(^{154/}\)

(h) Marketing of Domestic Funds Abroad and Overseas Funds Domestically

Domestic funds may be marketed abroad in compliance with requirements of countries where distribution is effected. Major Mexican securities firms are distributing Mexican mutual funds through their foreign subsidiaries as well as through foreign firms, although the actual trade is executed in Mexico.

Overseas funds may not be offered to the public in Mexico. There are two possible routes for sales of overseas funds in Mexico. One route is to sell the overseas fund through private sales. A farther reaching route is to incorporate a Mexican mutual fund to be sold in

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\(^{149/}\) Circular 12-22, supra note 6, rule 13.

\(^{150/}\) Id., rule 14.

\(^{151/}\) Id., rule 15.

\(^{152/}\) Id., rules 16 and 17.

\(^{153/}\) Id., rule 23. Likewise, rule 25 implements, often in the form of an Annex to General Ruling 12-22, various provisions of the ICA concerning information disclosure by mutual funds.

\(^{154/}\) Circular 12-22, supra note 6, rule 24.
Mexico (see section 2 (a) (iii) above). It is contemplated that Mexican mutual funds will be able to invest in non-Mexican Securities within the near future, pursuant to rules being implemented by the Commission (see section 3 (a) (i) above).

The breadth of such changes is cogent evidence of a basic shift in perception which places as an important priority the need to allow Mexican investors to invest in foreign corporations in Mexico, rather than offshore, as they have often done until now.

Mexican mutual funds have proven to be an effective vehicle for capital formation in the country. The efforts to strengthen and internationalize them are not only desirable, but necessary for a full utilization of its potential as a catalyst for capital formation in the country and as a means to foster the emergence in Mexico of an international securities market able to vigorously compete with the other great capital markets of the world.
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