BEFORE THE
INTERNATIONAL CENTRE FOR SETTLEMENT OF INVESTMENT DISPUTES
UNDER THE RULES GOVERNING THE ADDITIONAL FACILITY
FOR THE ADMINISTRATION OF PROCEEDINGS
AND UNDER THE NORTH AMERICAN FREE TRADE AGREEMENT

Fireman's Fund Insurance Company,
Claimant,
v.
The United Mexican States,
Respondent.

Case No. ARB(AF)/02/01

CLAIMANT'S REJOINDER ON THE PRELIMINARY QUESTION

February 4, 2003

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ATTACHMENT

Exhibit – Supplemental Opinion of Fernando Borja Mujica

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I. Introduction — Respondent's Submission

1. Respondent, the United Mexican States ("Mexico"), on January 29, 2003 filed a submission from the Secretaría de Hacienda y Crédito Público (the "Ministry of Finance" or the "Finance Ministry") of Mexico in support of Respondent's challenge to the jurisdiction of the Tribunal in this proceeding to hear certain of the claims advanced by Claimant, Fireman's Fund Insurance Company ("Fireman's Fund"). That submission is signed by the Director General of the Finance Ministry's General Directorate of Banks and Savings in his official capacity.

2. In the submission, the Government of Mexico, represented by the Finance Ministry, sets forth legal arguments in support of its jurisdictional objections. It does not set forth the views of an independent expert; it is an additional pleading that sets forth the Party's own arguments. As such, the views advanced should be given no more weight than any other legal argument advanced by the Respondent, such as in Respondent's Memorial of October 21, 2002. The submission is, in essence, a reply to the legal arguments made in Claimant's December 20, 2002 Memorial, which in turn was a response to Respondent's October 21, 2002 Memorial setting

forth its jurisdictional objections. As such, Claimant will refer to that document as the Reply of Respondent (or "Reply").

3. Pursuant to modalities agreed by the parties in a January 30, 2003 teleconference with the President of the Tribunal, Claimant hereby submits the following Rejoinder to Respondent's Reply of January 29, 2003. As also agreed, Claimant additionally plans to elicit testimony from Claimant's witnesses responsive to Respondent's Reply at this week's hearing before the Tribunal on February 6-7, 2003.[1]

4. Respondent's statements in the Reply are not dispositive of the legal questions before the Tribunal. While the Finance Ministry is indeed the responsible authority in financial services matters in Mexico, it is not and cannot be the case that, as Respondent appears to suggest, the Tribunal has no role to play once the Ministry has proffered its interpretation of the Mexican financial laws.[2] The Ministry's views on the legal question of whether a holding company is "authorized to do business and regulated or supervised as a financial institution" under Mexican law cannot be, *ipse dixit*, dispositive of the Tribunal's jurisdiction. It is for the Tribunal, in the exercise of its *kompetenz kompetenz*, to determine, in light of the evidence and arguments presented by *both* parties, whether Fireman's Fund invested in an enterprise "authorized to do business and regulated and supervised as a financial institution under [Mexican law]." As will

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[1] *See* Letter from Mr. Onwuamaegbu of January 30, 2003; Letter from Claimants of January 31, 2003; Letter from Mr. Flores of January 31, 2003. Following discussions with the parties regarding such mitigating modalities, the Tribunal accepted Respondent's submission on January 31, 2003, notwithstanding its inconsistency with the Tribunal's January 23, 2003 rejection of Respondent's request for additional briefing in advance of the Hearing.

[2] *See* Reply of Respondent at p. 23-24 ("[L]a Secretaría de Hacienda tiene la facultad de interpretar para efectos administrativos la [Ley para Regular las Agrupaciones Financieras]" and "En virtud de lo anterior, seta Secretaría al ejercer sus facultades de interpretación en materia de servicios financieros, señala que las sociedades controladoras de grupos financieros encuadran en la definición de institución financiera del TLCAN mencionada y por lo tanto les es aplicable lo relativo al Capítulo XIV 'Servicios Financieros' del TLCAN.")

be outlined in greater detail below, Respondent's legal analysis remains unpersuasive, and the jurisdictional objections accordingly should be rejected.

II. Fireman's Fund Did Not Invest in a Financial Institution Within the Meaning of NAFTA Article 1416

5. The parties are in agreement that the dispositive question affecting the Tribunal's jurisdiction over certain claims in this dispute is whether or not Fireman's Fund's investment in debentures issued by Grupo Financiero BanCrecer S.A. de C.V. ("Grupo Financiero") was an investment in a Mexican financial institution, as defined in NAFTA Article 1416. If not, Respondent's jurisdictional objections fail, and all of Claimant's claims—including its claim for a violation of Mexico's national treatment obligations—are properly before the Tribunal.

6. The parties agree, then, that the legal analysis must begin with Article 1416, the pertinent part of which provides:

> [F]inancial institution means any financial intermediary or other enterprise that is authorized to do business and regulated or supervised as a financial institution under the law of the Party in whose territory it is located.

The parties disagree, however, with respect to the interpretation of certain aspects of Article 1416's definition, and its application in light of Mexican law.

A. Fireman's Fund Invested in an "Enterprise"

7. Respondent takes pains in its Reply to establish that Grupo Financiero is an "enterprise" within the definition of NAFTA Article 201: namely, "an entity constituted or organized under applicable law, whether or not for profit, and whether privately owned or governmentally owned, including any corporation, trust, partnership, sole partnership, joint venture or other

associations."[3] Claimant has never disputed, however, that Grupo Financiero was an incorporated legal entity, and thus, an "enterprise."[4] It is the remaining elements defining "financial institution" that, in Claimant's view, are not satisfied.

B. Grupo Financiero Was Not "Authorized To Do Business...as a Financial Institution"

8. Similarly, Respondent goes into some detail to establish that Grupo Financiero was "authorized to do business." More specifically, Mexico works to reach the conclusion that "holding companies [*sociedades controladoras*] are authorized by the Finance Ministry to carry out business in Mexico."[5] Here again, Claimant does not dispute that Grupo Financiero was authorized to do business in Mexico. That conclusion, however, is *not* the dispositive point with respect to this element of the Article 1416 definition.

9. Respondent misreads and misstates Article 1416. The NAFTA definition does not merely require that the enterprise be "authorized to do business" under Mexican law. The enterprise must be "authorized to do business...as a financial institution." That is, the definition's limiting condition "as a financial institution" qualifies not only the "regulated or supervised" element (as Mexico acknowledges), but also the "authorized to do business" element of the definition.

10. This reading is necessary in order to give meaning to the second element of the definition. If all that were required was, as Mexico suggests, that the enterprise be "authorized to

[3] *See* Reply of Respondent at pp. 2-3.

[4] As is explained below, however, the same is not true of the "agrupación financiera" of which Grupo Financiero (together with its financial institution subsidiaries) was a part.

[5] *See* Reply of Respondent at p. 5.

do business," without more, then that authorization would add nothing in defining "financial institution." By definition, the "enterprise" element already incorporates, in virtually all cases, an authorization to do business of some kind. Moreover, Respondent's reading of the "authorization" element would render it entirely unrelated to the entity's status as a financial institution. In effect, under Respondent's reading, only the third ("regulated and supervised") element of Article 1416's definition is meaningful or bears any relation to financial services or financial institutions. It would be strange indeed for the parties to have created a definition of financial institutions, two of the three elements of which ("an <u>enterprise</u> that is <u>authorized to do business</u>...") bear no relation at all to the features of financial institutions.

11. Respondent's own explanation of the authorized businesses of Grupo Financiero makes clear that it was *not* authorized to do business *as a financial institution.* As Respondent notes in its Reply, "the purpose of holding companies is to acquire and administer shares issued by the members of the corresponding group."[6] Respondent also notes that holding companies are authorized to issue their own debentures, and to enter into a special-purpose guarantee agreement and very limited short term borrowing.[7] That, however, is *all* that they are authorized to do.

12. Specifically, holding companies are not authorized to do the business of financial institutions—they are not authorized, for example, to provide financial services, to engage in financial intermediation, or to interact with the public. Indeed, by law they are forbidden from doing so. Article 16 of the Financial Holding Company Act (*Ley para Regular las Agrupaciones Financieras*, hereinafter "FHCA") is explicit: "En ningún caso la controladora podrá celebrar operaciones que sean propias de las entidades financieras integrantes del grupo," that is, in no

[6] *See* Reply of Respondent at p. 4.

[7] *Id* at pp. 4-5.

case may the holding company perform the operations typical of the financial institutions that are members of the group. As also spelled out in Claimant's Memorial,[8] the holding companies' authorizations to do business are limited to functioning as passive vehicles for the ownership of financial institutions—in no way, however, are they authorized to do business *as financial institutions*.

C. Grupo Financiero Was Not "Regulated or Supervised as a Financial Institution"

13. Respondent dedicates the bulk of its Reply to supporting the proposition that holding companies are "regulated or supervised as financial institutions" under Mexican law. The essence of Respondent's argument, however, may once again be reduced to the proposition that because the holding companies are *regulated by the Mexican financial authorities* they must necessarily be *regulated as financial institutions*. Respondent thus describes at length authorities such as the Finance Ministry and the National Banking and Securities Commission ("Commission"), and itemizes the regulations and supervisory regimes that they administer. Respondent even describes the regulatory functions of the Central Bank, without once mentioning the holding companies in that description, or any way in which such holding companies might be affected by the Bank's regulatory authority.[9]

14. What none of that discussion establishes, however, is the key fact that Mexico must prove: that these authorities regulate or supervise the holding companies *as financial institutions*. Such a functional assessment of *what* holding companies do and *how* those activities are regulated or supervised—not the mere identity of their regulators, or a listing of applicable

[8] *See* Claimant's Memorial at para. 66.

[9] *See* Reply of Respondent at pp. 11-12.

statutes and regulations—is what determines whether the NAFTA Article 1416 definition of a financial institution is satisfied.

15. Without doubt, there are quite a few Mexican regulations that apply to holding companies. As noted in Claimant's Memorial, however, those regulations are limited to governing the corporate structure and accounting practices of holding companies.[10] This is wholly consistent with the limited functions of holding companies in the Mexican financial system as mere vehicles for the common ownership of multiple financial institutions. Their role is entirely passive; even the identity of the government agency responsible for the regulation and supervision of a given holding company is a function of the types of financial institutions it holds.[11]

16. In contrast, financial institutions are at the center of the Mexican financial system. They engage in the provision of financial services and financial intermediation and interact with the public. Financial institutions engage in, for example, the taking of deposits, lending, insurance, mortgaging, credit card services, foreign exchange operations, factoring, bonding, time deposits, securities transactions, and investment services. Thus, they are involved in financial activities that entail commercial risk, and that render their stability and solvency important to the well-being of the Mexican financial system. The necessary corollary of these touchstone functions is that financial institutions face extensive prudential regulation and supervision of their financial services operations and their solvency. The regulation and supervision of financial institutions thus includes, for example, minimum capital requirements, capital adequacy requirements,

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[10] *See* Claimant's Memorial at paras. 71, 76-77.

[11] *See, e.g.,* FHCA Art. 30 (R0442); Reply of Respondent at pp. 6-7, 9. This bottom-up allocation of regulatory responsibilities—regulating a holding company, not in its own right, but as a function of the nature of its subsidiaries—helps dispel any notion that the holding companies are structurally equivalent to financial institutions

requirements for deposit reserves and loan loss reserves, limitations on credit concentration, limitations on related party transactions, requirements for risk-weighted asset valuations, mandatory credit evaluations for debtors, foreign exchange restrictions, and money laundering regulations, all backed up by special criminal sanctions set forth in the governing financial laws. Such regulation and close monitoring of a financial institution's soundness is the hallmark of regulation and supervision of an entity *as* a financial institution. Critically, *no* such regulation or supervision is imposed on the holding companies that own financial institutions. Respondent has not, and cannot, establish that such a regulatory regime for holding companies exists. That, in the Claimant's view, is dispositive of the preliminary question.

17. Respondent's Reply avoids this fact – that, above all, holding companies are not regulated and supervised "as financial institutions" because there is simply no regulatory concern for the financial soundness of entities that do not engage in financial services—and describes instead *other* regulations and supervisory procedures that are applicable to holding companies. Nevertheless, Claimant believes that it may be helpful to the Tribunal to address some of the other regulatory and supervisory provisions invoked by Respondent, and to explain that these measures do not mean that holding companies are regulated and supervised as financial institutions.

1. Corporate Structure

18. Respondent points in the Reply to the financial authorities' involvement in overseeing the corporate structure of holding companies, as evidence of their purported regulation as financial institutions.[12] As noted above, holding companies are first and foremost vehicles for the

under Mexican law.

[12] *See, e.g.*, Reply of Respondent at pp. 7-8.

common corporate ownership of multiple financial institutions of different types. Inasmuch as the key function of holding companies is to own financial institutions, it thus comes as no surprise that—as noted in Claimant's Memorial[13] as well—the financial authorities exercise authority over the incorporation of holding companies and the acquisition and removal of financial institutions from their holdings. That structural oversight, however, is not comparable to the comprehensive oversight of operations, transactions, and soundness applicable to the financial institutions themselves.

2. Transparency Requirements

19. Respondent notes that the holding companies are required to publish audited financial statements, as are each of the individual financial institutions owned by a holding company.[14] Of course, the same is true of every company in Mexico whose shares are publicly traded in the market.[15] Thus, such a reporting requirement is hardly a hallmark or indicium of the regulation of financial institutions. Likewise, the requirement to disclose corporate and financial information to the Commission[16] is by no means singular.

3. Accounting Regulations

20. Like the regulation and supervision of a holding company's corporate structure, the regulation and supervision of its accounting practices are to be expected. As Respondent notes,[17] the Mexican authorities promulgate rules governing accounting practices that are applicable to the holding companies, and may review their books. Accounting specifications, however, do not

[13] *See* Claimant's Memorial at para. 71.

[14] *See* Reply of Respondent at p. 10.

[15] *See* Supplemental Opinion of Fernando Borja Mujica ("Borja Supplemental Opinion") at para. 13 (C0684).

[16] *See* Reply of Respondent at p. 15.

[17] *Id.* at p. 10.

make a financial institution; rather, it is rules about what must be accounted for—namely, capital reserves, asset ratios, and the like—that do so. Claimant also notes that Respondent's suggestion, that in some fashion Commission accounting rules may serve to "avoid the transfer of risks" from the financial institutions in a group to the holding company, is not persuasive.[18] Nowhere does Respondent explain how a bookkeeping rule is functionally equivalent to a capital requirement or other regulation that directly reduces credit, market, liquidity, operational or legal risks.

4. "Guarantee" Agreement

21. Respondent places considerable emphasis on the so-called "guarantee agreement," or *convenio*, into which holding companies are required to enter with each of their financial institution subsidiaries. Under the convenio, the holding company is (at least theoretically) liable for the debts and losses of the financial institutions it owns. Respondent argues that this nominally "unlimited" liability means that holding companies do play a role in the stability and soundness of their subsidiary financial institutions (from which the Tribunal is apparently meant to infer that holding companies are regulated as financial institutions themselves). This argument is deficient in two ways.

22. First, it is important to appreciate that while a holding company is required by the regulatory authorities to sign a convenio, those same regulatory authorities do nothing to ensure that the guarantee is economically meaningful. Holding companies are not subject to any regulation or supervision of the levels of their assets or holdings; there are no regulations that

[18] *Id.* at p. 11. Moreover, Respondent's statement is also factually contradicted by its own description of the holding company guarantee agreement ("*convenio*") discussed *infra*. According to Respondent, holding companies are required to enter into a convenio precisely in order (at least in theory) to transfer some risks from financial institutions to their holding companies. Respondent's suggestion that at the same time the government is working to foreclose that very transmission of risk is implausible.

require, and no effort on the part of the regulators to ensure, that the holding company maintains sufficient assets or capital reserves to satisfy the debts or losses of its subsidiaries. In effect, the convenio is an empty commitment; there is no assurance whatsoever that the holding company will have assets adequate to make good on its promises. Even more practically, it is notable that Sr. Borja states that he is not aware of even a single instance since holding companies and their convenios came into being in 1990, in which a convenio was exercised on behalf of a failing financial institution—even during the worst of the Mexican financial crisis of the mid-1990s.[19] By way of example, there was never any effort to bring the Grupo Financiero convenio into play on behalf of BanCrecer at any time during the events at issue in this case. Functionally and in practice, then, the holding company convenio is a regulation without consequence for the holding companies or for the financial system.

23. Second, contrary to Respondent's suggestions,[20] a holding company poses no risks to the financial institutions it owns or to the financial system that would invite prudential regulation, whether or not there is a convenio in place. If a convenio ever were to be invoked on behalf of a failing financial institution, at most the holding company could be obliged to liquidate its own assets—that is, to sell its ownership interests in its other financial institution subsidiaries. A holding company may not in any event reach the assets of its subsidiary financial institutions. As a result, each financial institution's soundness is unaffected by the financial woes of their sibling financial institutions; at most, they would find themselves with new shareholders. The holding company does not, therefore, permit or facilitate any transmission of economic risk from one financial institution to another, whether or not it is required to enter into a convenio.

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[19] *See* Borja Supplemental Opinion at para. 16 (CB685).

[20] *See* Reply of Respondent at p. 9.

24. Thus, the convenio requirement does not indicate any regulation of holding companies as financial institutions. Regulation of that kind would involve substantive requirements ensuring the adequacy and practical application of the convenio, not merely its formal existence.

5. Intervention

25. Respondent notes that the Mexican financial authorities' supervisory powers include certain nominal powers of "intervention"—that is, authority to step in and assume control (or at least receivership) of a troubled entity—under Articles 30-A and 30-B of the FHCA.[21] What Respondent omits, however, is context for that power, which was only added to the Act in 1995. As is the case with many other regulations of *controladoras*, it is not a regulatory or supervisory authority established for the sake of overseeing holding companies themselves. Instead, it is supplementary to the government's oversight of financial institutions. Thus, while the Commission may in theory intervene a holding company, in practice, no intervention has ever taken place solely with respect to a holding company itself.[22] This is hardly surprising, in light of the extremely limited range of activities in which holding companies are permitted to engage (none of which involve financial services)—there simply do not arise many, if any, circumstances in which a holding company could become financially troubled other than as a consequence of the financial condition of its subsidiaries. Rather, the intervention power is exercised as a supplemental means of regulating the financial institutions that the holding company owns. Primarily for purposes of administrative convenience in supervising the financial institutions in a financial group, the Commission may opt to intervene a holding company if one of its financial institution subsidiaries is also the subject of intervention. As

[21] *See* Reply of Respondent at pp.15-16; FHCA Articles 30-A & 30-B (R0443).

[22] *See* Borja Supplemental Opinion at para. 14 (C0684).

such, the theoretical possibility of intervention does not constitute regulation of a holding company as a financial institution.

26. In sum, Respondent's efforts to itemize regulations or supervision of holding companies "by the same entities" that regulate and supervise financial institutions[23] fail to make the case that the holding companies are regulated and supervised *as financial institutions*. As explained above, the ancillary regulatory and supervisory powers that do exist with respect to holding companies are of marginal importance. More important, Claimant reiterates that the essential features of financial institution regulation—oversight of the financial soundness of an entity, and of its operations in providing financial services to the public—are altogether missing from Respondent's litany. As a result, Respondent does not and cannot establish that holding companies are "regulated or supervised as financial institutions" under Mexican law for purposes of NAFTA Article 1416.

D. Grupo Financiero Was Not Authorized To Do Business and Regulated or Supervised as a Financial Institution by Virtue of Its Role in an "Agrupación Financiera"

27. Apparently aware of the unpersuasiveness of its arguments with respect to holding companies themselves, Respondent also advances an alternative argument, to the effect that it is not the holding company, but rather the financial group as a whole, that provides financial services. Respondent suggests that the holding companies thus "indirectly" provide financial services—apparently with the result, in Respondent's view, that the holding companies should be deemed financial institutions even if they do not satisfy that definition independently.

[23] *See, e.g.*, Reply of Respondent at p.16.

28. The first flaw in this imaginative approach is that it takes no account of the law. Holding companies are, in law and in fact, distinct from the financial institutions they own. They have an independent legal existence, and are in no way interchangeable—as evidenced by the very different functions that they are authorized to carry out. Furthermore, as Respondent itself acknowledges,[24] Mexican law expressly and purposefully separates them: by law, holding companies may not engage in the financial services activities of the financial institutions that they own, and may not act on behalf of or exercise management over those institutions.[25] Financial institutions, in turn, may not operate through their holding companies.[26]

29. The second flaw is that Respondent's theory proves too much. Respondent suggests that because the holding companies own at least a majority stake in their financial institutions, they in effect control directly their administration, business strategies, guidelines, and financial services operations. This is not so as a matter of Mexican corporate law—majority ownership only confers on the shareholder control over the appointment of directors, who owe personal fiduciary duties to the subsidiary, not the parent.[27] But its greater flaw is that it would apply to any majority ownership position held by any kind of entity in any kind of company. By Respondent's logic, any majority owner of a financial institution should itself be deemed a financial institution, because it is acting indirectly through that subsidiary—a manufacturing enterprise, or even an individual investor, that acquires 51% of the shares of a financial institution is instantly transformed into a financial institution. That cannot be.

[24] *See* Reply of Respondent at p. 21 (citing FHCA Art. 16).

[25] *See* FHCA Art. 16 (R0432); Regulations, Title III, § 18 (C0267).

[26] *See* FHCA Art. 8 (R0429).

[27] *See* General Law of Commercial Companies (*Ley General de Sociedades Mercantiles*), Arts. 142, 147, 156.

30. Respondent's theory has a third flaw: even setting aside the fact that Fireman's Fund invested in the holding company and not the "financial group," such a "group" does not qualify as a financial institution under the NAFTA definition in Article 1416. Most clearly, it fails the first element of the definition: an "agrupación financiera" under the FHCA is not an "enterprise." The FHCA contemplates that certain legal entities (namely, a holding company and at least two or three financial institution subsidiaries) will come together under a common brand name—but that authorized "group" is not a legal person enjoying separate legal personality. FHCA financial groups are not legal entities or juridical persons; they have no independent corporate existence, no legal representatives, and no powers to act or do business. Nor do any precepts of authorization, regulation or supervision apply to the "group" as such. Thus such a group is not a financial institution within the meaning of NAFTA Article 1416.

III. Conclusion

31. For the foregoing reasons, Fireman's Fund respectfully renews its request that the Tribunal reject the jurisdictional objections advanced by the Government of Mexico and proceed to consider the case on its merits.

Respectfully submitted,

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