

Fintech in Mexico: Market Participants and the Regulatory Response

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Abstract: Following the 2008 financial crisis, companies formed financial alternatives to traditional banking to meet consumers' needs. Such alternatives benefitted from the advent of new means of recruiting and interacting with clients, remunerating and investing. Mexico has a track record of facilitating flourishing start-ups in the financial technology (fintech) sector. This article presents the context in which Mexico developed regulations for its fintech industry and provides an overview of key regulations and models of operating fintech institutions under Mexican law.

Context of Fintech in Mexico

The emergence and expansion of Unregulated Multiple Purpose Financial Companies (Sofom) and Popular Financial Companies (Sofipos), a model under which some of the financial technology companies in Mexico began to operate, made the country one of the largest hubs for startups in Latin America, although the services were not strictly regulated or supervised.

The main problems were the lack of regulation in matters of crowdfunding, deposits and payments, and currency

exchange, which had never been considered under the Securities Market Law or the Credit Institutions Law. The overall lack of regulation generated either significant legal uncertainty for the operation of fintech start-ups in Mexico or insufficient legislation to cover the operations carried out by the sector.

On March 9, 2018, Mexico enacted the Financial Technology Institutions Law (the "Law") to categorize and regulate banking sector agents, entrepreneurs and private capital owners.

The Fintech Regulatory Framework

The Law is critical to understanding the interactions of market participants, associations, regulators and financial institutions because new forms of financial services provided by the fintech industry, such as crowdfunding and electronic payments, are now subject to a new regulatory scheme. The Law regulates three parties involved in the industry: the banking sector, entrepreneurs and private capital, and seeks to stimulate broad-based market participation; promote financial stability in domestic and regional markets; prevent fraud, money laundering operations through

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mobile payments and cryptocurrencies; and generally protect consumers and maintain competition.

The Law regulates two types of Financial Technology Institutions (ITF): (i) crowdfunding institutions, and (ii) electronic-payment fund institutions. It also regulates virtual assets—securities not backed by a banking institution. The differentiation of regulated activities leaves out important areas, such as credit risk, insurance activities (insurtech), among others. The net result is a largely asymmetrical regulation of the sector.

The first type of regulated ITF, crowdfunding, is defined by the Law as activities intended to establish connections amongst members of the general public, with the purpose of providing funding through operations carried out through computer applications, interface platforms, webpages or any other forms of electronic or digital communication.

However, crowdfunding activities are divided into five categories, which the Law only regulates three of: (i) crowdfunding debt, in which funding is granted to applicants through various investors; (ii) crowdfunding capital, in which investors acquire a specific interest in the applicant entity; and (iii) crowdfunding co-ownership or royalties, in which an investor acquires a percentage of the revenue, profits, royalties or losses on an applicant's projects, as part of a joint venture or agreement. The remaining two types of crowdfunding (donation-based and reward-based) are not regulated, as they do not require an authorization for carrying out essential activities.

Crowdfunding institutions must perform the obligations established by the Law, as they apply to their operations. For example, all transactions must be done in pesos, US dollars or cryptocurrencies if an authorization from the Bank of Mexico (BM) is granted; must be subject to a money laundering prevention framework; and cannot issue statements of guaranteed return on investments.

One common service provided by electronic payment institutions is the opening of accounts for customers, where the customers are able to make deposits in local or foreign currency, move certain virtual assets, issue electronic payment transfers and transfer funds, whether in national or foreign currency or virtual assets, if authorized by the BM. However, no interest, income or any other monetary benefit is paid on the accumulated balance for these

transactions, and no loans can be granted by these payment institutions.

Both types of ITFs require the use of an operating authorization and funds used by clients in operations with the ITF and are not guaranteed by the federal or state government.

Virtual Assets

The Law defines virtual assets as an electronic representation of currency used by the general public as payment for all types of transactions that are only conducted electronically.¹ In practice, some users use them for a different purposes, such as storing currency. Although the exchange of virtual assets generates interest on accounts of public demand, they are neither issued nor endorsed by the BM or any financial institution.

On March 8, 2019, *CIRCULAR 4/2019*, issued by the BM was published. The Law tasked the BM to determine the means of implementation for *CIRCULAR 4/2019*: (i) determine which virtual assets and characteristics are allowed to operate; (ii) set the type of operations and restrictions for transactions; (iii) establish deadlines, terms and conditions in cases where the virtual assets involved are converted into other sort of virtual assets or their characteristics are modified; (iv) ascertain the information regarding virtual assets transactions that are required to submit to BM in order to obtain its authorization to operate with virtual assets; and (v) define the characteristic of the authorization required to execute the transactions with virtual assets.

If you are interested in setting up an account, make sure to do the following: (i) identify the different cryptocurrencies offered in the market and verify the number of users that support the chosen cryptocurrency, the greater the number the better; (ii) confirm that the official site of the offered cryptocurrency is duly authorized for exchanges; and (iii) make sure to have a wallet provider to store the acquired cryptocurrencies which has high standards for safety.

Consumer Protection

Not only does the Law clearly seek to protect ITFs from money laundering or terrorist financing, it also aims to protect against consumer fraud and the

unlawful use of personal data by requiring applicants and investors to identify themselves and by regulating the money transfers by consumers. However, this protection has not been enough, since the law dictates that the consumer must bear the entire risk. In addition, market participants need to be fully aware of the financial risks involved, and fintech providers may have internal controls and risk management that need to be carried out in strict connection with the Law and its secondary provisions (i.e. minimum and maximum limits of capital stock permitted by their clients and the amount clients may use, the minimum and maximum limits of cash and money transfers in Mexico and abroad, among others).

Also, fintech providers will use Application Programming Interface (API) to exchange market participants' private information with financial institutions and other competitors. Companies and market participants need to be aware that their data can only be transferred by means of the APIs if the fintech providers or financial institutions had received written consent of their customers to do so. Additionally, customers may confirm with the fintech provider if they are complying with the legal obligation to adopt systems to prevent money laundering and terrorism financing and know-your-customer policies for personal data processing before onboarding.

Authorization Procedure

Operating an ITF requires authorization from the *Comisión Nacional Bancaria y de Valores (CNBV)*, which is discretionarily granted by the Inter-institutional Committee. The approval to operate an ITF requires approval from the Inter-institutional Committee composed by: a favorable vote from officials representing the Ministry of Finance and Public Credit, the BM and the CNBV. An additional approval from the BM is required for those ITFs seeking operations involving virtual assets or foreign currency.

Any legal entity applying for ITF authorization must be previously incorporated as a Business Corporation (S.A. de C.V.), and its bylaws must include (i) a corporate purpose strictly related to the operations it will engage in; (ii) an address in Mexico; and (iii) the minimum capital necessary to operate. To receive authorization from the CNBV, the application must indicate or include several documents, such as its

bylaws, business plan, board of directors, company officers and a financial feasibility study.

Operating an ITF

ITFs handle their clients' funds and limit how much they may use. Any funds received by a client must be from or deposited into accounts opened with a financial institution. In exceptional cases, the CNBV may authorize cash or electronic deposits or transfers from accounts opened abroad. Likewise, funds received from clients must be identifiable and separated from the ITF's own funds. ITFs are therefore required to provide clients with account statements, and financial statements issued by the ITF must be audited by an independent external auditor.

The CNBV oversees ITFs and ensures their compliance with procedures and guidelines on (i) preventing and detecting any acts, omissions or operations related to terrorist financing and money laundering; (ii) preparing reports on any risk-based actions, operations or services conducted with clients; on a client's due diligence or knowledge policy and the client's degree of risk; (iii) maintaining appropriate internal structures and standardized computer software interfaces and data exchanges. Similarly, the BM oversees compliance with its regulations on virtual assets, foreign currency transfers, credit bureaus, clearinghouses and transactional reports the ITF is required to submit.

The Regulatory Sandbox

Authorization under a sandbox model (*modelo novedoso*) is required by companies interested in testing innovative technologies or non-existent or regulated financial services reserved to financial entities. If issued, authorization is specific to these services, limited to two years for commercial companies and one year for financial entities, and its terms and conditions are established therein; and in the event of a conflict between the authorized company or entity and its client, the National Commission for the Protection and Defense of Users of Financial Services (*Comisión Nacional para la Protección y Defensa de los Usuarios de Servicios Financieros* or the *CONDUSEF* in Spanish) will oversee any dispute resolution.

All companies are required to report the number of

clients with whom they have transacted, the type of transactions and the risks that may have arisen and which clients are exposed.

Administrative and Criminal Penalties

Any violation to the Law or to the conditions outlined in the ITF authorization or the sandbox model is subject to administrative or criminal penalties.

The scope of these penalties touch financial institutions, ITFs and sandbox companies, and—along with board members—CEOs, executives, officials, employees and other staff may be penalized.

Fines vary in amount, depending on the degree of the violation, which are limited to 1,000 to 150,000 Units of Measurement and Update (“UMA” for its acronym in Spanish). Criminal penalties are levied in proportion to the offense committed, and the most severe penalty is seven to fifteen years’ prison for conducting any unauthorized transactions.

Inherent Risks and Deficiencies in the Law

Despite evidence indicating that the Law strives to prevent unlawful market operations and to protect consumers, a number of risks have still not been mitigated. The most prominent risk is money laundering. Even though the Law already establishes certain controls on information exchanges to prevent unlawful activities, it does not yet include any measures on fraud or computer crimes, taxing crowdfunding activities or consumer protection. These are areas where close observers in Mexico can anticipate a new round of regulations.

Conclusion

The Law seeks to establish general principles, while secondary provisions look to regulate the practical considerations involved in operating ITFs. Despite significant attempts to establish a regulatory framework, the current Law leaves out several important areas covered in secondary provisions.

Finally, there are some important takeaways from the current state of the Law: (i) clearer guidance from the authorities is still needed in order to provide stability

and certainty in the market and to allow innovation and full competition to market participants; (ii) broader regulatory authority from the supervisory bodies should be granted to allow and calibrate more market-efficient responses; and (iii) a stricter and more robust legal framework should be formulated to aid expansion of small to medium-sized fintech providers. It is possible that the lack of compliance with all secondary regulation will drive the search for mechanisms to mitigate non-compliance.

Endnotes

¹ Article 30 of the the Financial Technology Institutions Law.

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