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FinTech in Mexico: Innovation versus regulation

Eduardo Flores Herrera, Partner at Creel, García-Cuéllar, Aiza y Enriquez, S.C., discusses in detail Mexico's draft FinTech Law and the delicate balance that will have to be struck to ensure that the FinTech market is allowed to thrive, whilst being adequately regulated.



In recent years, Mexico has become one of the prominent countries in Latin America in regards to the innovation of financial services and penetration of so-called 'FinTech' companies. The steady growth of Mexico's middle class and the clear, consistent and market friendly monetary policies being adopted have attracted the attention of local and foreign entrepreneurs, which have ventured into the FinTech space.

In broad terms, FinTech companies fill a gap overlooked by the regulated financial system: easy access to cross-border and local payments of almost any amount, financing of all sorts of entrepreneurs and, sometimes, non-bankable projects, and freely transferable assets that allow for the settlement of any kind of transaction, amongst others.
While some of the activities that FinTech companies are engaged in seem to fit within Mexico's capital markets - such markets being viewed by the majority of the population as an unreachable mechanism with which to access financing or invest their savings (at least in emerging markets, generally) - FinTech has succeeded in getting the attention of retail clients and those with low use of financial products.

This phenomenon has caused the rapid growth of financial services provided by entities which basically operate in a grey area between regulated and non-regulated activities. This tendency is not exclusive to Mexico and has led the Mexican authorities to take a closer look at FinTech companies in order to work on appropriate regulation. However, unlike most financial regulation which aims to promote the stability of banks, broker dealers and other financial institutions, one of the key components of FinTech is that it is ever-changing and continually looks to innovate. This is a nightmare for legislators and regulators: laws, regulations and models of supervision are always one step behind the industry they are trying to regulate and supervise. In order to better understand the need for FinTech regulation in Mexico, it is necessary to first analyse its current state.

Current status

There are currently many different types of FinTech companies operating in Mexico, from crowdfunding (equity, debt, donations, profit sharing and prize based), to payment transmitters, virtual asset exchanges, and fully electronic broker dealers (casa de bolsa). However, each type of FinTech entity has its own regulatory hurdles and challenges.

Crowdfunding, equity and debt-based companies have to be mindful of the Mexican Securities Market Law (particularly the rules on public offerings) and the Mexican Banking Law (particularly



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the rules on deposit taking activities). As with crowdfunding, payment companies and virtual asset exchanges have been operating in Mexico in a grey area trying to fit their activities within the scope of Mexican law, without operating regulated activities, such as public offering or deposit taking. In some cases, certain entities have used aggressive interpretations of applicable law that have not been signed off by financial authorities and they have therefore been forced to close their operations.

The Draft FinTech Law

In view of the foregoing, the adoption of a FinTech Law is imperative. The Mexican authorities have been working on the draft for over a year, which has involved interaction with market participants, associations, other regulators and other entities (i.e., financial institutions).

While in general terms, adopting a FinTech Law in Mexico would create certainty for FinTech companies, users and investors, there are terms within the draft that have caused concern among current and potential players. Some of the key issues are set out below:

Types of FinTech entities

The draft Fintech Law recognises and regulates two types of financial technology institutions (instituciones de teconlogía financiera or 'ITFs'): crowdfunding institutions (instituciones de financiamiento colectivo) and electronic funds payment institutions (instituciones de fondos de pago electrónico).

Article 15 of the draft FinTech Law provides that crowdfunding institutions are those institutions that are engaged in bringing together individuals or corporations from the general public in order to obtain or grant financing through electronic applications, interfaces, websites or any other electronic or digital means of communication.

The draft recognises three types of crowdfunding: debt, equity and profit sharing. Therefore, donation and gift-based crowdfunding activities would not fall within the scope of the Law and could be performed without a licence in Mexico.

Article 22 of the draft FinTech Law provides that electronic payment funds institutions are those engaged in creating, managing, settling and transmitting electronic payment funds through electronic applications, interfaces, websites or any other electronic or digital means of communication, by

1. opening and maintaining electronic payment funds' accounts for each client;
2. transferring electronic payment funds among their clients through deposits and withdrawals from such accounts;
3. transferring certain amounts of Mexican pesos, foreign currency or virtual assets between their client's accounts or those of another electronic funds payment institution, financial entities or foreign institutions that perform similar activities;
4. delivering the monetary or virtual asset equivalent of the electronic payment funds deposited in a client's account; and
5. updating the registry of its clients' accounts and amending it to reflect every deposit, transfer or withdrawal involving the said accounts.

However, in order to fully understand the scope of the activities that can be performed by electronic funds payment institutions, it is imperative to understand the concept of 'electronic payment funds.'

Article 23 of the draft defines the concept as funds recorded in an electronic registry of transactional accounts kept by an electronic payment funds institution that (a) refer to a Mexican peso or foreign currency amount, or to a certain number of virtual assets; (b) represent a payment obligation of the issuer; (c) are issued upon receipt of a monetary or virtual asset amount, with the purpose of transferring or withdrawing such funds; and (d) are accepted by a third party as a form of receiving a monetary or virtual asset amount. As noted above, the draft FinTech Law places electronic payment institutions and virtual asset exchanges under the same category as electronic payment funds institutions.

Authorisation and licence to operate

In order to perform any of the activities described above, a licence must be obtained from the National Banking and Securities Commission (Comisión Nacional Bancaria y de Valores or 'CNBV'), prior to favourable review by the Interdisciplinary Committee[1]. In addition to such authorisation, electronic payment funds institutions that intend to trade in foreign currency or virtual assets also require authorisation from the Central Bank of Mexico (Banco de México or 'Banxico').

The draft FinTech Law sets forth in general terms the information that ITFs will have to file in order to obtain the relevant licence, including legal information (by-laws, rights to the webpage's domain, etc), policies and principles to mitigate operational risk, minimum capital requirements, shareholders and directors information, risk disclosure policies, and conflict of interest mitigation, etc. However, the details of the information to be filed will be set forth in secondary regulation issued by the CNBV.

It is yet to be seen which criteria the CNBV will use when drafting the secondary regulation. If it chooses to treat ITFs similarly to financial institutions, it could create a process so cumbersome that it would prevent certain startups from entering the market; on the other hand setting requirements that are too lax could jeopardise the stability of the sector.

Virtual assets

Article 30 of the draft FinTech Law defines 'virtual assets' as value represented in an electronic form used by the public as a form of payment for


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all types of legal act that can only be transferred by electronic means. ITFs will only be able to trade with the virtual assets that are authorised by Banxico through secondary regulation, which will consider the general use of such virtual assets as a means of payment and a representation of value, the treatment that other jurisdictions grant to such virtual assets, and the conventions, mechanisms, rules and protocols used to generate, identify, fraction and control the replication of such virtual assets.

There is still uncertainty about the way Banxico will draft the relevant secondary regulation. Banxico could set a list of virtual assets that can be traded or used in Mexico, or it could provide a set of rules that any virtual asset would have to meet to be traded or used in Mexico. If Banxico uses the list approach, it could affect the possibility of carrying out initial coin offerings in Mexico.

Shares in ITFs

Pursuant to Article 41 of the draft FinTech Law, the acquisition or granting of shares as collateral in ITFs is subject to the prior authorisation of the CNBV. While the requirements to obtain such authorisation will be set in secondary regulation, if the approach of the CNBV is to require information about potential shareholders in ITFs with a scope similar to that required of financial institutions, it could affect capital-raising processes for ITFs, especially smaller institutions.

AML

Pursuant to Article 58 of the draft FinTech Law, ITFs will have to implement policies and systems to prevent money laundering and terrorism financing ('AML'), and shall inform the Ministry of Finance and Public Credit, through the CNBV, about any potential breach to AML provisions. While the draft includes provisions similar to those applicable to financial institutions, many of the details about know-your-costumer ('KYC') and AML requirements will be set forth in secondary regulation. Providing a legal obligation for ITFs to adopt AML and KYC policies and procedures is an important step to providing certainty in the FinTech ecosystem in Mexico, since it will ensure that all of the innovation is being used for its main purpose (financial inclusion, easy access to financial services, etc.) and not for illegal activity.

However, the CNBV has to be mindful of the way ITFs work and their capabilities in order to make sure that it does not create a barrier to entry for new ITFs due to burdensome requirements that are not compatible with FinTech activities.

Supervision

The draft FinTech Law provides that ITFs will be subject to the supervision of the CNBV and, for electronic payment funds institutions that trade with foreign currency and/or virtual assets, Banxico.

During the process of drafting the FinTech Law, financial authorities in Mexico have gained a vast amount of knowledge about FinTech activities and institutions in Mexico and abroad; however, all participants have to be mindful of the learning curve that supervisors will have to go through to best supervise ITFs.

Regulatory sandbox

The draft FinTech Law includes a 'regulatory sandbox' mechanism aimed at promoting the creation of innovative business models to provide financial services. Under this provision, companies will have the opportunity to embark on a transitional period to trial technologies to provide financial services without the need for a full licence. While the trial has to be limited to a certain number of clients and for a limited amount of time, this provision could boost financial inclusion and innovation in Mexico.

The grandfathering provision

The draft FinTech Law includes a transitory provision that allows companies that are performing activities reserved to ITFs at the time of enactment of the Law to continue their activities without a licence or registration for a period of up to one year after the CNBV has issued the secondary regulation related, among other topics, to the requirements to obtain an ITF licence. This means that once the FinTech Law is enacted, FinTech companies currently in operation will have 18 months to obtain the relevant licence.

Closing remarks

While the provisions discussed in this article are not the only aspects of the draft FinTech Law that have caused discussion in the FinTech and startup ecosystem in Mexico (there is, for example, a lot of discussion about the potential fines that could be imposed on ITFs, the tax implications of such operations, etc.), there are some important takeaways from the current state of FinTech in Mexico:

- One, financial authorities in Mexico are taking a proactive approach to regulating FinTech and trying to provide stability and certainty in the market;
- Two, in the event that the FinTech Law is enacted by the Mexican Congress in its current form, there is still a lot of work for the authorities and market participants to do to arrive at a set of regulations that allows for innovation and competition;
- Three, granting broad regulatory authority for FinTech to the CNBV and Banxico allows for continuous calibration of the regulation in a timely manner; and
- Four, even with all of the flaws and uncertainties surrounding the draft, adopting a law specific to FinTech is a much better scenario than continuing with the current *status quo* where entities are operating in a legal grey area or in some cases such activities are contrary to the law.

1. The Interdisciplinary Committee is a collegiate body of the CNBV to be created by the FinTech Law, comprised of six proprietary members: two from the CNBV, two from Banxico and two from the Ministry of Finance and Public Credit.