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Investment Funds

Mexico

Nader, Hayaux y Goebel, S.C.

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Law and Practice

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Nader, Hayaux y Goebel, S.C. is a market leader in mergers and acquisitions, banking and finance, securities and capital markets, structured finance, telecom, tax, insurance and reinsurance, project finance, real estate, energy and infrastructure, restructurings and workouts, real estate, government procurement and antitrust. Nader, Hayaux y Goebel, S.C. (NHG) is formed by 17 partners and more than

30 associates, and represents one of the largest groups of corporate finance experts in the Mexican market. NHG is the only Mexican law firm with an office in London, with a strong focus on developing and pursuing business opportunities between Mexico, the UK and other European countries. The firm also enjoys excellent working relationships with law firms in all major cities around the world.

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1. Fund Formation

1.1 Formation of Investment Funds

Local managers generally use Mexican jurisdiction for the formation of investment funds, although Ontario and Quebec limited partnerships are also used, depending on the type of investors targeted and the type of investment fund. Some international fund managers have also used Mexican jurisdiction to raise their local funds.

The most commonly structured funds are private funds, listed funds and retail funds.

Private funds and listed funds are generally structured as Mexican trusts, either the private equity investment trust or Fideicomiso de Inversión de Capital Privado (FICAP), which has certain tax benefits aimed at incentivising private equity investors, or the Mexican passive income, tax transparent trust.

Listed funds are structured as FICAPs or passive income Mexican trusts that publicly issue and list:

- equity development notes (*certificados bursátiles fiduciarios de desarrollo*, or CKDs), which funds are invested in Mexican projects;

- real estate development certificates (*certificados bursátiles fiduciarios inmobiliarios*, or FIBRAs), which funds are used to invest in income-generating real estate portfolios (similar to the US REIT);
- investment project certificates (*certificados bursátiles fiduciarios de proyectos de inversión*, or CERPIs), which funds are invested in projects in Mexico or abroad; or
- energy and infrastructure investment certificates (FIBRA-E, also known as the ‘Mexican MLP’), which funds are used to invest in long-term Mexican qualified energy, electricity and infrastructure projects.

Retail funds (*fondos de inversión*) are statutorily regulated in Mexico and must be structured as public corporations that publicly issue and list shares, which proceeds are used to invest in a previously determined portfolio of trading securities.

1.2 Raising Capital from Investors

Mexican jurisdiction is generally used for the raising of capital from investors within Mexico.

1.3 Common Process for Setting Up Investment Funds

Private Funds

As these funds are generally structured as Mexican trusts, the process starts with the investment memo or PPM and the drafting of the trust agreement. These funds are always man-

aged by a manager or general partner (GP) and the scope of this management is generally documented through a service agreement between the trustee of the trust and the GP. The trust agreement is always negotiated with the trustee and, depending on the type of fund being raised, with key investors.

Listed Funds

Listed funds require the trustee of these funds to make a filing for the authorisation of the notes they issue to be offered publicly before the National Banking and Securities Commission of Mexico (CNBV) and before the relevant Mexican stock exchange regarding the listing process. The issuance process of this type of listed fund generally takes between six and twelve months and the notes are generally placed with institutional investors (mainly Mexican pension funds). As with the private funds, these listed funds are mainly documented by a trust agreement, a management or services agreement and a prospectus. Depending on the type of fund, co-investment agreements between the GP and the issuing trust are common to document the co-investment commitment of the GP.

Retail Funds

The setting-up process involves incorporating the vehicle and the IPO process before the CNVB and before the relevant Mexican stock exchange regarding the listing process. These funds are managed by a fund operator which requires a licence from the CNBV.

1.4 Regulation of Fund Structures

Private funds are not specifically regulated in Mexico but are commonly managed by a GP. As to listed and retail funds, regulation requires these funds to have a manager or GP.

1.5 Limited Liability

Investors investing through Mexican trusts do not have statutory limited liability. These investors in general are protected from negligence and fraud from the trustee or the manager through indemnity clauses. Legal opinions are not typically given in this respect.

1.6 Common Tax Regimes

Most funds are structured as trusts that comply with the relevant requirements to be treated as transparent for Mexican tax purposes, which allows investors to openly identify the income generated through the trust (dividends, capital gains, interest payments, etc) as if they had obtained this income from investing directly in a Mexican target entity. In addition to this, FICAPs are allowed to delay taxation until the FICAP actually makes a distribution to its beneficiaries.

On the other hand, retail funds are considered tax exempt under the Mexican tax laws and the income generated through them is attributed to the investors, who are subject to tax on this income (although the retail funds may be

required to withhold taxes, that can then be used by investors as a credit against their own annual income tax liability). Thus, the regime applicable to retail funds also achieves some sort of tax transparency.

1.7 Investment Sponsors

Mexican funds are mostly used as vehicles for Mexican investors.

1.8 Disclosure Requirements

Private funds are not specifically regulated in Mexico and there are no disclosure requirements to investors in Mexico, although PPMs are customary. As to listed and retail funds, Mexican regulations require disclosure levels to investors comparable to those of public companies and therefore a prospectus approved by the CNBV needs to be published before the public offer of the securities issued by these funds.

1.9 Legal Forms

The typical legal form of the private and listed funds is the Mexican trust. The Mexican trust does not have legal personality as it is a contract. The retail fund takes the form of a Mexican corporation (*sociedad anónima*) that issues shares.

1.10 Regulatory Status

Private funds are unregulated in Mexico. Mexican trustees (mainly Mexican banks), however, are subject to strict supervision and regulation regarding their trust settlement and administration.

Listed and retail funds are subject to securities regulation in their capacity of note issuers. Regulation and supervision mentioned regarding Mexican trustees in the preceding paragraph would also apply in this case. Retail fund managers are also subject to regulation and supervision as licensed entities.

1.11 Legal, Regulatory or Tax Legislative Changes

There is nothing formally in process.

2. Fund Investment

2.1 Types of Investors

As to private funds, the predominant investors would be high net worth individuals, family offices or other international funds or asset managers.

Regarding listed funds, the main investors are the Mexican Pension Funds or AFORES.

Retail funds are open to any type of investor.

2.2 Legal, Regulatory and Investment Structures

Investors would generally look for a tax-efficient structure, which in Mexico commonly means using a tax transparent

vehicle, so they will normally choose a Mexican trust that qualifies as transparent for tax purposes (either a FICAP trust or a passive income trust).

2.3 Legal, Regulatory or Tax Themes/Issues

The investment structure of the fund is generally an important issue for Mexican tax-exempt investors, as investments made through corporate vehicles are not tax efficient for this type of investor, since any taxes paid will generally not be recoverable by these investors. Likewise, non-Mexican investors also tend to favour tax-transparent fund structures that will typically allow them to apply any tax treaty benefits that may be available to them.

2.4 Restrictions on Investors

Most recent listed funds are restricted to qualified and institutional investors. Some private funds structured to issue securities through private placements are also restricted to qualified and institutional investors.

2.5 Marketing Restrictions

This firm generally advises private funds to avoid public solicitation (marketing to undetermined persons) of investors even if they are not issuing securities and to abide by the safe harbour rules for private placements.

As to listed and retail funds, marketing regulation is the one applicable to any public issuers in the Mexican market, which in general provides for the market to have all available information at the same time and forbidding the solicitation using information which is not already publicly available to everyone.

3. Regulatory Environment

3.1 Regulatory Regime

Managers of private and listed funds in Mexico are not regulated entities and do not require any type of authorisation or licence.

As mentioned, the managers of retail funds in Mexico are required to set up an SPV and to get a licence for this SPV, which will be subject to regulation and supervision of the CNBV. As to managers that wish to create an investment fund that will invest in listed securities (eg, a hedge fund), a registration process as an investment adviser before the CNBV would be required.

Authorisation to act as a retail fund operator is burdensome and requires considerable investment in systems and human resources that comply with the requirements set forth by the CNBV. The registration process of financial advisers is not as cumbersome and can be obtained in a short period of time.

3.2 Territorial Reach of Regulators

When applicable, the territorial reach of the Mexican regulator is just Mexico's territory. If required under Mexican law to have a licence, a foreign manager would need to apply for its Mexican licence.

3.3 Regulatory Approval

Marketing of investment funds does not require regulatory approval.

3.4 Investor-Protection Rules

Listed funds are restricted to qualified and institutional investors when they issue securities through 'restricted offers' (which is generally the case for most recent funds). Some private funds structured to issue securities through private placements are also restricted to qualified and institutional investors so that the private placement can qualify under the Mexican safe harbour rules.

3.5 Approach of the Regulator

The department of the CNBV in charge of the approval of the issuances of listed funds is in general very co-operative and business driven, it is always open to discuss regulatory and filing process matters, as well as new structures. The CNBV is in general a very professional organisation.

4. Fund Finance

4.1 Access to Fund Finance

As private funds are not regulated, they can access financing at the fund level without any regulatory restriction. Listed and retail funds are also allowed to access financing with some regulatory restrictions.

4.2 Borrowing Restrictions/Requirements

Private funds do not have any restrictions or requirements in connection to borrowing. Practical issues may arise regarding the possibility of granting collateral to the lender, depending on the investment structure of the fund.

Listed funds are in general allowed to obtain financing provided they abide by regulation, requiring them to have a minimal asset to loan ratio depending on the type of fund.

From a tax perspective, it should be considered that Mexican tax laws include thin capitalisation rules which may limit the deduction of interest payable to non-resident investors.

4.3 Securing Finance

When their financing is secured, funds normally secure their financing with real assets (mortgages or pledges) or with cash flows (via a security trust) of the fund or of the vehicles in which they have invested.

4.4 Common Issues in Relation to Fund Finance

Funds structured as trusts generally require 'corporate authorisations' (authorisations of governing bodies of the trust). These authorisations may become complex for listed funds if a bondholder meeting is required for their approval, as the call for this meeting takes, in general, a couple of weeks.

5. Tax Environment

5.1 Tax Framework

As previously referred, funds created subject to Mexican jurisdiction are typically structured so that they can be treated as tax transparent. Thus, the income is directly attributable to investors and will be subject to the individual tax regime applicable to each of them. In the case of listed funds or retail funds, the financial institutions involved in the structure may be required to withhold taxes which will be considered paid on behalf of the investors (and Mexican residents will then be entitled to credit these payments when determining their annual income tax liability).

Non-resident investors are typically subject to withholding taxes at rates that will vary depending on the nature of the income realised through the fund, as well as their country of residency for tax purposes. Withholding tax rates under Mexican legislation range between 4.9% and 35%, but they will generally be reduced under an applicable tax treaty.

Retail funds are exempt from tax under Mexican tax laws, but they will be required to withhold taxes on the income that is attributable to the investors (and thus they basically achieve a transparency regime).

Mexican tax rules do not establish a specific regime for carried interest, which may be treated as having the same nature of the income giving rise thereto or as a variable component of the management fee, depending on the structure of the fund.

5.2 Tax Treaty Network

Mexico has a broad treaty network that is comprised of over 60 tax treaties and conventions for the exchange of information and, as a result, funds are typically structured in a way that allows non-Mexican investors to avail themselves of the tax treaty benefits on an individual basis (which will also require that the various applicable requirements be complied with individually and not at the fund level).

5.3 FATCA and CRS Regimes

Mexico has entered into a Model 1 Intergovernmental Agreement (IGA) with the US (in force since 2014), under which the Mexican financial institutions report the relevant information to the Mexican tax authorities, who in turn exchange it with the US Internal Revenue Service.

Also, Mexico has enacted domestic legislation and regulations in order to implement the automatic exchange of information in tax matters under the CRS, and committed to first exchange in 2017.

5.4 Tax Structuring Preferences of Investors

Investors participating in a passive income Mexican trust should directly recognise the income generated through the trust as if they had received it directly, irrespective of whether the fund actually distributes it or not. Accordingly, investors may be subject to tax in terms of the Mexican tax laws (as adjusted based on any applicable tax treaty) irrespective of whether they receive a distribution, which needs to be considered when structuring a fund. Mexican investors will be subject to ordinary tax rates (as mentioned above, there is no specific carried interest regime), whereas non-resident investors will be subject to withholding tax rates ranging between 4.9% and 35% (although generally reduced under an applicable tax treaty, where withholding on interest is generally capped at 10% or 15% depending on the country; capital gains may be subject to an exemption for minority participations or to a reduced 10% withholding tax on the gain, depending on the country; and dividends will generally be subject to a maximum 10% tax).

In cases where the fund is structured as a FICAP trust, investors will be subject to taxes only upon receiving a distribution, which results in a more convenient treatment since taxes will only be payable when investors actually receive a distribution from the fund. Given that FICAP trusts are also transparent, the same tax rates as previously mentioned would apply.

Therefore, assuming that the objectives of the fund allow for the compliance of the requirements that are relevant to the FICAP regime, this treatment may be more convenient for the investors.

In the case of international funds, Mexican-resident investors will need to define the legal and tax nature of the fund in order to determine whether they will be subject to tax in respect of income allocated to them, or only upon receiving a distribution. The legal nature of the fund in the country of formation, the taxes payable abroad (if any) and the control of the investor over the distributions of the fund will guide the analysis.

6. Miscellaneous

6.1 Asset Management Industry Bodies

The main industry organisation for investment funds in Mexico is the Mexican Private Equity Association (AMEXCAP). It represents fund managers in the private equity and venture capital ecosystem in Mexico. As per its web page, AMEXCAP's main objectives are:

- “the development and strengthening of the relationship with institutional investors;
- the generation of a higher number and frequency of transactions;
- maintain relationships with authorities and regulators to improve the competitiveness of the industry;
- promotion and diffusion of the Mexican industry nationally and internationally; and
- generation of statistical information and the development of relevant studies in the private equity industry in Mexico.”

6.2 Preference for Courts or Arbitration

Courts are generally preferred in the private equity and venture capital ecosystem in Mexico.

6.3 Level of Litigation/Arbitration

This firm has not seen litigation against fund managers of private or listed funds. As to litigation regarding investments made by Mexican funds, the firm has seen very low litigation generally stemming from joint ventures entered into by these funds with third parties.

6.4 Periodic Reporting Requirements

There are no regulatory periodic reporting requirements for private funds, although the common practice is that all fund managers have a periodic reporting obligation, which is by nature not publicly available.

Due to the fact that listed funds are public issuers in Mexico, managers are required to provide monthly reports to their fund investors, which are published in the Mexican stock exchange and subject to stock market disclosure rules.

6.5 Powers of Attorney

Mexican funds structured as trusts are managed through a management agreement between the trustee and the manager and therefore there is no need for the manager to represent investors. Trustees of Mexican funds generally grant powers of attorney to the managers to act on behalf of the relevant fund.

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