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## CVM RELEASES PUBLIC CONSULTATION ON THE ESTABLISHMENT OF A "REGULATORY SANDBOX" IN BRAZIL

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On August 28, 2019, the Brazilian Securities and Exchange Commission (*Comissão de Valores Mobiliários* – "CVM") released a public consultation containing draft regulations for the establishment and operation of a controlled regulatory environment for innovative financial products and services to be tested for a limited period of time ("Regulatory Sandbox"). The deadline for submitting comments on the draft regulations is **September 27, 2019**.

The CVM's proposal only covers capital market products and services, although the draft regulations set forth cooperation mechanisms that may lead to the establishment of a joint Regulatory Sandbox with the regulators in charge of the financial and insurance markets – the Central Bank of Brazil ("*Banco Central do Brasil*") and the Brazilian Superintendence of Private Insurance ("*SUSEP*"), respectively.

### WHAT IS A REGULATORY SANDBOX?

**Concept.** A Regulatory Sandbox is an experimental regulatory environment that allows fintechs and startups in general to be granted provisional authorizations to offer innovative products and services to the market without being subject to the full range of restrictions imposed by the regulations in force. The expression stems from the concept of a sandbox in which participants have some level of freedom and are limited only by basic rules that are previously laid out by the regulators. Among the tools used by regulators for tests carried out within Regulatory Sandboxes are the granting of waivers re. regulatory requirements and the issuance of no enforcement action letters (i.e. the temporary non-application of corrective measures by regulators)<sup>[1]</sup>.

**Background.** The UK's Financial Conduct Authority ("*FCA*") was a pioneer in establishing the world's first Regulatory Sandbox in 2015. Its Regulatory Sandbox model is based on annual cycles of selected participants (i.e. cohorts). In 2019, the FCA received 99 applications for its fifth cohort, which is a demonstration of how successful this regulatory model has been in the UK.

**Operation.** Regulatory Sandboxes may operate continuously or be divided into cycles with a specified term and defined group of participants (cohorts).

**Benefits.** Companies benefit from having the opportunity to test new products and services in a controlled regulatory environment, with a reduced regulatory burden. Regulators ease regulatory standards and requirements in order to enable testing and to give participants a certain level of autonomy, while controlling the financial system as a whole's exposure to risk. Regulatory Sandboxes allow regulators to acquire valuable information on the practical application of new

technologies and to transform this acquired knowledge into better and more efficient regulation for market players. The CVM expects the establishment of a Regulatory Sandbox in Brazil to (i) foster competition between services providers and suppliers of financial products; and (ii) promote financial inclusion by reducing costs of financial products and services for end users.

**Possible applications.** The financial and capital markets are constantly being transformed by the way technology is applied to the offering of innovative products and services. Among the products/services that could be tested within the Regulatory Sandbox are:

- security token offerings, whenever the tokens are considered to be securities;
- cryptoexchanges that offer trading with security tokens and financial assets in general;
- robo-advisors; and
- building a secondary market for equity crowdfunding offerings (currently not within the scope of the equity crowdfunding regulations).

To cope with the evolution of fintech, in addition to the UK, Regulatory Sandbox models were introduced in Australia, Singapore, Hong Kong and Mexico. This shows an international trend towards the adoption of this regulatory model to foster innovation.

## RECENT DISCUSSIONS

**Central Bank's leadership of the agenda.** Since 2013, Law 12,865/13 (legal framework of the Brazilian payments system) and the Central Bank's regulations waive certain payment arrangements and payment institutions from requesting authorization to operate from the Central Bank while operating below certain thresholds. Although not under direct supervision, these entities are monitored by the Central Bank periodically in order to assess their relevance to the Brazilian Financial System. This model follows a similar logic to that of the Regulatory Sandbox.

**Financial Innovation Laboratory ("LAB").** Founded in 2017, the LAB's mission is to foster innovation in the Brazilian Financial System. In addition to market representatives and multilateral organizations (such as the Inter-American Development Bank – IDB), the CVM, the Central Bank and SUSEP are also members of the LAB. Discussions within such entity have led to the publication of general guidelines for the establishment of a joint Regulatory Sandbox model in Brazil, in cooperation between the CVM, the Central Bank and SUSEP.

**Brazilian Strategy for Digital Transformation (*Estratégia Brasileira para Transformação Digital – "E-Digital"*).** The E-Digital was established in 2018, by Decree No. 9,319/18. According to the CVM, the Regulatory Sandbox proposal is aligned with strategic actions intended to transform Brazil into a friendlier ecosystem for digital entrepreneurship.

**Economic Freedom Act.** Provisional Measure (*Medida Provisória*) No. 881/19 (also known as the "Economic Freedom Act") allows new products or services to be tested within private quarters and/or restricted groups of individuals with loosened government oversight. This measure was perceived as an incentive to creating a Regulatory Sandbox in Brazil. As with any Provisional Measure in Brazil, the Economic Freedom Act has force of law immediately upon publication, but needs to be converted into law within 120 days from publication. Brazilian Congress approved the Economic Freedom Act on August 21, 2019. If the President does not act on the approved text until September 12, 2019 (with or without vetoes), it will be automatically converted into law.

Below is a timeline of recent Regulatory Sandbox discussions in Brazil, as described above:

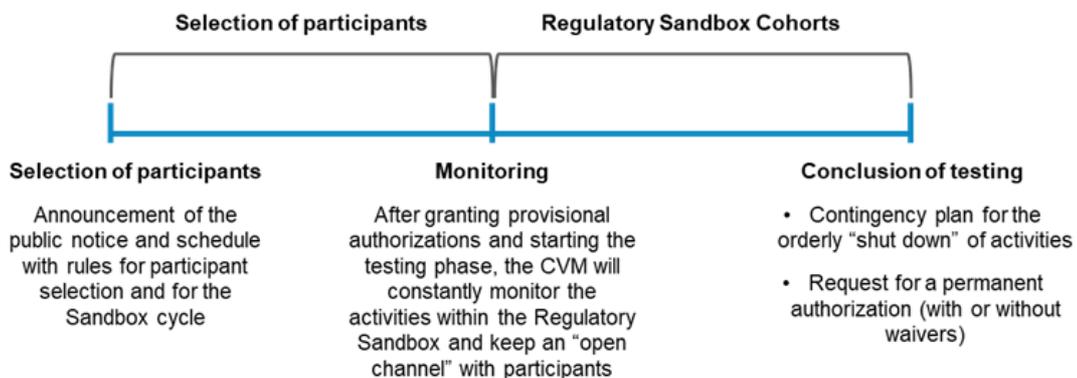


## THE CVM'S PROPOSAL

The draft regulations proposed by the CVM are inspired on the FCA's Regulatory Sandbox model for the UK. A contest is opened for the selection of each cohort, and selected participants are then invited to test their products or services within the Regulatory Sandbox for a limited period of time.

**Sandbox Committee.** The proposed regulations provide that the Regulatory Sandbox will be managed by a committee ("Sandbox Committee"). The Sandbox Committee must evaluate submissions filed by Regulatory Sandbox candidates to select the projects that best fit the Regulatory Sandbox goals. The selection will be filtered by certain eligibility criteria that potential candidates must meet as a condition precedent to being part of each Regulatory Sandbox cohort. The Sandbox Committee will centralize the management of Regulatory Sandbox-related activities and, under the CVM's draft regulations, would be composed exclusively by CVM officials. The Sandbox Committee is responsible for defining eligibility criteria applicable to participants and for setting each cohort's timetable, including its term (see below).

**Regulatory Sandbox operation.** According to the CVM's draft regulations, each Regulatory Sandbox cohort may have a term of up to two years (initially one year, renewable for another year) and will go through the following main steps:



**Participant selection.** In addition to the fulfilment of the eligibility criteria, the Sandbox Committee may impose a limit on the maximum number of participants of each Regulatory Sandbox cohort. This maximum number (if established) will be calculated according to the CVM's monitoring resources. We understand that the issue of access to the Regulatory Sandbox will be a source of interest and debate with interested parties in the context of the CVM's public consultation.

- Restriction according to the activity. The Committee may also restrict participation in each cohort of the Regulatory Sandbox according to the participants' activities, by limiting the scope of each cohort.

**Monitoring.** The proposal provides for the continuous interaction between the CVM and the Regulatory Sandbox participants in the form of regular meetings, by granting full access to the CVM to relevant business-related information, as well as cooperation in the discussion on improving the regulations in force and oversight by the CVM. The proposed regulations provide that participants must notify the CVM should extraordinary risks materialize.

- Regulatory guidance: The CVM understands that the maintenance of an “open channel” with the regulator to guide participants on the limits of their activities and the rules applicable to each activity is a valuable source of legal certainty and of cost reduction, allowing participants to develop innovative products and services. The CVM will also guide Regulatory Sandbox participants in their request for permanent authorizations upon the term of each cohort, and the conclusion of the testing period (including re. any waivers to be requested, as appropriate).

**Conclusion of testing.** Participation in the Regulatory Sandbox may end (i) at the request of the participant; (ii) upon cancellation of the provisional authorization granted by the CVM, should the CVM detect any risk to the regular functioning of the market; or (iii) upon obtaining a permanent authorization from the CVM (with or without waivers).

- Contingency plan. Regulatory Sandbox participants must have a contingency plan in place providing for the orderly “shut down” of activities. The contingency plan must provide for the treatment to be extended to customers, investors and stakeholders, as appropriate.

**Access to the Regulatory Sandbox.** Access to the Regulatory Sandbox will be conditioned upon participants meeting certain eligibility criteria and upon the presentation of a business plan to the CVM.

**Eligibility criteria.** Minimum eligibility criteria for participation in the Regulatory Sandbox consist of (i) having the participant’s product or service meet the threshold for “innovative business model” (see below); (ii) carrying out the activity primarily in the Brazilian market; and (iii) providing sufficient evidence of the participant’s technical and financial capacity to perform the proposed activities.

**Business plan.** In addition to meeting the threshold for “innovative business model” (see below), all Regulatory Sandbox participants must present a business plan addressing the following points:

(i) waivers that are required in order to the carry out the participant’s intended activity;

(ii) suggestions of conditions, limits and safeguards to be adopted by the CVM in connection with the participant’s intended activity (see below);

(iii) procedures necessary to begin operations;

(iv) risk assessment in connection with the activity (including matters of cybersecurity); and

(v) contingency plan for the orderly “shut down” of activities (as mentioned above).

**“Innovative business model”.** The draft regulations define “innovative business model” as the activities that offer a relevant difference vis-à-vis those traditionally offered within the Brazilian Financial System, especially regarding the technology, methodology or structure employed. “Innovative business models” must:

- (i) make innovative use of technology;
- (ii) develop a product or service not yet offered in the Brazilian capital markets; or
- (iii) promote efficiency gains, cost reductions or increase the access of the general public to products or services within the Brazilian capital markets.

**Regulatory waivers and safeguards to be established by the CVM.** Each candidate must suggest the waivers that it understands to be required in order to carry out the intended activity. Each candidate must also suggest operational limits that it understands to be sufficient to mitigate the risks stemming from the intended activity within the Regulatory Sandbox (such as maximum number of clients and limited volume of funds that may be transacted by the participant).

**Self-Awareness Term.** Whenever the intended activity involves raising or managing third-party funds, clients will be required to sign a “Self-Awareness Term” acknowledging that the information needed for the investment decision has been provided and that the risks associated with the investment are duly understood.

**Restrictive interpretation of regulatory waivers.** The CVM’s proposal is clear in the sense that the regulatory waivers granted to Regulatory Sandbox cohort participants should be interpreted restrictively. Participants will be required to comply with all other regulations applicable to the intended activity that are not specifically waived or loosened by the CVM in granting the provisional authorizations to operate within the Regulatory Sandbox.

**Non-compliance with the regulations in force.** Should any participants fail to comply with the applicable laws or regulations in force, in violation of the rules set forth in the provisional authorization (including any waivers or loosened provisions), the CVM will issue notice compelling the participant to comply with the applicable rules. Failure to comply with the CVM’s notice will subject participants to the penalty of exclusion from the Regulatory Sandbox, as well as to punishment of the agents at fault within a punitive administrative proceeding opened by the CVM (penalties include fines and temporary prohibitions).

**General concession of waivers.** At the end of each Regulatory Sandbox cohort, the CVM will evaluate editing specific regulations designed to extend to all market participants (not limited to Regulatory Sandbox participants) certain waivers/loosened regulations that were tested during any given Regulatory Sandbox cohort. This measure aims at increasing the efficiency of the CVM’s oversight activity by reverting the experience gained within the Regulatory Sandbox cohorts to the benefit of the market as a whole.

**Cooperation between regulators (joint Regulatory Sandbox).** Additional procedures may be established for participants performing activities that exceed the legal mandate of the CVM and that are also subject to the oversight of other regulators (the Central Bank and/or SUSEP). The joint Regulatory Sandbox serves the purpose of aligning procedures among regulators for testing new products and services within the Brazilian Financial System (financial, capital and insurance markets).

**International activity.** The CVM also provided a mechanism in the draft regulations for participants to engage in international activities, in order to enable:

(i) Brazilian participants to expand their activities to other countries whose regulatory models are compatible with Brazil's; and

(ii) foreign participants to join the Brazilian Regulatory Sandbox, as long as there is prior alignment in that sense between the regulator of the country of origin and the CVM.

The full text of the CVM's Public Consultation SDM No. 05/19 containing the draft regulations is available in the following [link](#).

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[1] The issuance of no enforcement action letters is one of the "sandbox tools" adopted by the FCA in the UK.

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