

3 Regulatory changes in prudential supervision in 2006

This chapter includes the most significant changes to the legal provisions that regulate the activity of CIs and other financial intermediaries or auxiliaries subject to supervision by the BE.

In 2006, hardly any significant legislative changes were made to national organisational and disciplinary rules. However, this does not mean that it was a year of inactivity in terms of banking regulation. On the contrary, 2006 was a year of intense work both for the regulator and for financial institutions.

The regulator, in its task of promoting and compiling future laws, was obliged to devote significant efforts to preparing the national legislation to transpose three key directives of the so-called Financial Services Action Plan, which seeks to develop an effective single European market in the provision of such services. Two of these directives, 2006/48/EC and 2006/49/EC of the European Parliament and of the Council, both of 14 June 2006, on, among other aspects, the capital adequacy of financial institutions, appeared in 2006. The third, Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments, was subject to various regulatory developments at the Community level in 2006.

Financial institutions, meanwhile, have already commenced the necessary adaptation of their systems, strategies and procedures to the forthcoming regulations that will be derived from this transposition. This adaptation will entail profound changes both to the conceptualisation and management of financial businesses.

Among other minor initiatives, reform of the legislative framework for the mortgage market was undertaken in 2006, in order to adapt it to the continuous technical changes to assets and liabilities of a mortgage nature. This reform, the ultimate aim of which is to make this market more dynamic, flexible and competitive, has also given rise to legislative preparation work which, although not as significant as that mentioned above, will also have a notable influence on the daily activity of institutions.

This chapter first refers briefly to the regulatory changes at the EU level referred to above. Given their extensive treatment in other parts of this report, the approach in this chapter is more conceptual, and avoids technical-type parameters. Subsequently, the national provisions which, as mentioned above, are most relevant in the sphere of supervision by the BE are presented, particularly distinguishing those specifically related to the solvency and prudential supervision of credit institutions and their groups.

3.1 Community provisions

*Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast)*¹

Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 unified and codified all the directives relating to the taking up and pursuit of the business of credit institutions², regrouping them into a single text.

1. OJEU L 177/1 2006, of 30 June 2006. 2. The most significant ones are the following: Council Directive 73/183/EEC of 28 June 1973 on the abolition of restrictions on freedom of establishment and freedom to provide services in respect of self-employed activities of banks and other financial institutions; Council Directive 77/780/EEC of 12 December 1977 (First Banking Co-ordination Directive); Council Directive 89/646/EEC of 15 December 1989 (Second Banking Co-ordination Directive); Council Directive 89/299/EEC of 17 April 1989 on the own funds of credit institutions; Council Directive 89/647/EEC of 18 December 1989 on a solvency ratio for credit institutions; Directive 92/30/EEC of 6 April 1992 on the supervision of credit institutions on a consolidated basis, and Council Directive 92/121/EEC of 21 December 1992 on the monitoring and control of large exposures of credit institutions.

Since then, this Directive has been significantly amended on various occasions. Thus, for reasons of clarity and legal certainty, the latest amendments have been included in a recast Directive, which repeals Directive 2000/12/EC and contains all the changes made to it to date. This Directive is 2006/48/EC of the European Parliament and of the Council of 14 June relating to the taking up and pursuit of the business of credit institutions.

The key change introduced by the Directive is that it incorporates into EU law the provisions of the document approved on 26 June 2004 by the Basel Committee on Banking Supervision, relating to minimum capital requirements and other rules applicable to credit institutions (known as Basel II and referred to extensively in other chapters and previous editions of this report). Its ultimate aim is to strengthen the banking system in the internal market, using as a tool for this purpose the solvency regulations, which have been amended to make them more rigorous and risk sensitive and to encourage improvement to the system's management.

For the same purpose, closer and more regular co-operation between the competent authorities of the Member States and other authorities or agencies is encouraged, through a greater and more fluid exchange of information.

In relation to the greater degree of rigour in solvency determination, the Directive addresses new types of risk. Thus, it establishes that credit institutions will be obliged to calculate capital requirements to cover, *inter alia*, their operational risk for which, apart from simple supervisory approaches, they may use advanced measurement approaches based on their own systems for measuring such risk. However, the use of some of these measurement systems will require prior authorisation from the competent authority. It further envisages special procedures to determine and cover dilution risk as a specific risk that complements credit risk in eligible purchase receivables.

As a factor of sensitivity to risk and as an incentive for enhanced management thereof, the Directive makes some important changes to the assessment of credit risk. Thus, the latter may be determined either by means of application to each of the categories in which the exposures are classified of the weights established in the Directive itself (Standardised Approach), or by means of the application of internal ratings-based approaches established by the institutions themselves (IRB Approach). This approach is based on the calculation of the probabilities of default and the losses that may be expected to be incurred as a result (severity), and may be applied to different degrees: foundation IRB and advanced IRB. In any event, the use of this method requires prior authorisation from the supervisory authority.

In addition, in order to assess that greater sensitivity to risk, the Directive has introduced a precise and at once complete treatment of the various techniques available both for reducing counterparty credit risk (including derivative instruments, repurchase agreements, deferred settlement) and transferring it (securitisation).

As regards the determination of capital requirements for exchange risk and the specific requirements for the held-for-trading portfolio and commodities, the Directive refers to Directive 2006/49/EC of the European Parliament and the Council of 14 June 2006, which supplements it for these purposes. This Directive, however, makes no significant changes to the treatment of the risks referred to, so that it is not studied in this chapter.

As part of the above-mentioned process of strengthening the solvency of credit institutions, Directive 2006/48 empowers the supervisor to assess the different systems, strategies and mechanisms established by institutions to comply with the Directive and, in particular, to cal-

culate the amounts, types and distributions of internal capital considered appropriate to cover all those risks to which they are exposed. This assessment will be global and shall cover all the risks referred to by the Directive, including concentration, liquidity and interest risk.

To supplement the foregoing and to boost market transparency, competition between institutions and, ultimately, market discipline as a way of ensuring rigour in their operations, the Directive establishes various disclosure measures both for credit institutions and competent authorities. In the case of the former these obligations refer, among other aspects, to risk management objectives, the characteristics of own funds and the exposure to certain risks. In the case of the latter, to the legal provisions, the criteria and general methodologies used in assessing the procedures used by the institutions to comply with the requirements of the Directive.

The treatment of the solvency of credit institutions is thus based on three pillars: minimum capital requirements (pillar 1), supervisory review (pillar 2) and information to the market (pillar 3); pillars that must be jointly observed so that institutions have a level of capital commensurate with their overall risk profile.

The other modifications merely seek to assist the implementation of the changes mentioned above and are therefore of secondary importance. The aspects relating to supervision of the financial soundness of credit institutions do merit special attention however. This supervision continues to be the responsibility of the institution's home Member State, while the competent authority of the host Member State remains responsible for branch liquidity. Nevertheless, the application of this principle of supervision on a consolidated basis requires a high degree of planning and coordination between supervisory authorities, especially as regards the process of authorisation of the use of internal approaches to calculate exposure to credit and operational risk, which is formally the responsibility of the home Member State of the parent institution.

In any event, it should be taken into account that the obligation to comply with minimum capital requirements on the basis of the consolidated financial situation does not mean that such requirements do not have to be satisfied at the individual level, both by the parent and by the subsidiary institutions. Notwithstanding this, the Directive establishes the possibility that, when certain conditions are satisfied, Member States may exempt from individual compliance either the parent institution or subsidiary institutions or both.

Commission Directive 2006/73/EC of 10 August 2006³ implementing Directive 2004/39/EC of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms

This Directive contains provisions applicable not only to investment services firms, but to all institutions that provide investment services professionally or regularly. As a result, and since the main providers of these services in the Spanish financial system are credit institutions, this section describes the provisions relating to the performance of such services, without mentioning those that regulate other aspects also addressed in the Directive in relation to investment services firms and multilateral trading systems.

Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 established the general framework of the regulatory regime for financial markets in the European

3. OJEU L 241/26 2006, of 2 September 2006.

Union, regulating the operating conditions for the performance of investment services, the organisational requirements applicable to the firms that provide them and to the markets on which they are performed, and the reporting requirements and rules of conduct applicable to the conduct of operations.

In application of the Lamfalussy procedure, Commission Directive 2006/73/EC implements Directive 2004/39/EC as regards, on the one hand, the organisational requirements and, on the other, the operating conditions of the institutions that provide investment services. Since credit institutions are already subject pursuant to their sectoral regulations to specific organisational requirements, those organisational requirements should be included among these more general requirements.

Institutions must take into account the nature, scale and complexity of their business, and the nature and range of services provided, when applying such requirements, which consist of:

- a) the establishment of decision-making procedures that give special attention to:
(i) the verification of compliance with the law and internal procedures, (ii) the management of risks and conflicts of interest, (iii) the treatment of claims and (iv) the outsourcing of transactions;
- b) the establishment of an organisational structure which clearly and in documented manner specifies reporting lines and allocates functions and responsibilities, as well as the procedures to fulfil them properly;
- c) personnel with sufficient skills to perform the functions assigned to them, and
- d) maintenance of adequate and orderly records of their business and internal organisation.

In particular they shall have a compliance function and, where appropriate in view of the scale and complexity of their business, they shall organise and maintain an internal audit function which shall be independent of their operational structures. This function shall establish, implement and maintain an audit plan to examine and evaluate the adequacy and effectiveness of the systems and internal control mechanisms established by the institution.

The Directive gives special attention to the outsourcing of important operational functions, defined as those in the performance of which a defect or failure would materially impair the continuing compliance of a firm with its obligations. In this respect, institutions shall continue to be responsible for compliance with their obligations under Directive 2004/39/EC; in particular, the outsourcing must not result in the delegation by senior management of its responsibility, nor shall the relationship and obligations of firms that provide investment services in relation to their clients be altered

With regard to risk management, the Directive merely establishes, in general terms, that Member States shall require that the risk management procedures and policies that entities adopt must enable the risks present in the provision of services to be identified and, where appropriate, set the maximum tolerable levels. These procedures shall be subject to continuous monitoring in order to ensure their efficiency.

As for the terms on which investment services should be provided, the Directive puts special emphasis on certain aspects. Thus, in relation to the complaints received from clients or po-

tential clients, firms are required to establish effective and transparent procedures that permit reasonable and prompt handling of the complaints received, as well as the recording of each complaint and of the measures taken for its resolution.

The Directive also establishes mechanisms to protect against conflicts of interest based on the definition of relevant persons, who are understood to be directors, partners, tied agents and employees of the entity that provides the service, and those who, in turn, provide services to the entity. In this respect, the Directive gives special attention to the receipt and payment of inducements.

With regard to rules of conduct, the Directive establishes that information to retail clients or potential clients must be fair, clear, readily understandable and not misleading. Also, it shall be accurate and in particular shall not emphasise any potential benefits of an investment service or financial instrument without also giving a fair and prominent indication of any relevant risks.

The regulation by the Directive of information to be disclosed is very broad and extremely detailed and ranges from that which should be provided on the entity providing the service itself to that relating to client categorisation, and that corresponding to the execution of orders including the best execution criteria and the general principles that will govern their processing.

As regards information on financial instruments in particular, the Directive requires institutions to provide clients or potential clients with a general description of the nature and risks of financial instruments, taking into account, in particular, the client's classification as a retail or professional client. That description must explain the nature of and risks particular to the specific instrument to enable the client to take investment decisions on an informed basis.

Finally, the Directive, concerns itself, again in great detail, with safeguarding client financial instruments and funds, for which purpose it establishes that the Member States shall impose certain restrictions on the operations that can be performed with them and require compliance with a number of requirements. In particular, entities must keep such records and accounts as are necessary to enable them at any time and without delay to distinguish held for one client from assets held for any other client, and from their own assets. Entities are also required to conduct, on a regular basis, reconciliations between their internal accounts and records and those of any third parties by whom those assets are held.

Commission Regulation (EC) No 1287/2006 of 10 August 2006⁴ implementing Directive 2004/39/EC of the European Parliament and of the Council as regards record-keeping obligations for investment firms, transaction reporting, market transparency and admission of financial instruments to trading

Commission Regulation No 1287/2006 was published a result of the Commission's desire to ensure the harmonised implementation across all the Member States of Directive 2004/39/EC in relation to the record-keeping obligations of investment firms, market transparency and the information that must be reported on transactions, and the admission of financial instruments to trading.

As in the previous section, only those provisions that specifically affect the provision of investment services are referred to here, while those which would solely be applicable to entities not supervised by the BE are not mentioned.

4. OJEU L 241/1 2006, of 2 September 2006.

Thus, as regards the record-keeping of transactions and client orders, the entities that provide investment services will have to collect immediately, in relation to each order received and each transaction performed, a specified set of data: identification of the client and of any relevant person⁵ acting on behalf of the client, the nature and type of order, date, time and other data identifying the transaction (unit price and total price, price notation, quantity, etc.), the person who executed the order or transmitted it, and any other details, conditions and particular instructions. This harmonisation will minimise the differences that may arise in the reporting of cross-border transactions.

As regards the information on transactions in financial instruments, the Regulation establishes that it shall be compiled, save in exceptional circumstances, in electronic form, and it specifies the conditions that shall be satisfied by the methods used in its compilation. It also specifies the way in which the competent authorities shall be notified of the transactions carried out and it regulates the exchange of information with the competent authorities of other Member States.

3.2 National provisions

3.2.1 REGULATION OF THE SOLVENCY OF CREDIT INSTITUTIONS

CBE 2/2006 of 30 June 2006⁶ amending Circular 5/1993 of 26 March 1993 on the determination and control of minimum capital

Law 5/2005 of 22 April 2005 on supervision of financial conglomerates, which amends other financial sector laws, and Royal Decree 1332/2005 of 11 November 2005 which implements it, transposed into Spanish law Directive 2002/87/EC of the European Parliament and of the Council of 16 December 2002 on the supplementary supervision of credit institutions, insurance companies and investment firms in a financial conglomerate⁷. They also made important changes to the law on the solvency and capital of credit institutions.

Within the context of these changes, and in exercise of the Banco de España's powers pursuant to the above-mentioned Royal Decree, Circular CBE 2/2006 was published in order to adapt banking law to the above-mentioned amendments.

First, the Circular introduces significant changes in relation to the eligibility and deductibility of certain elements of capital. Thus, in the section on reserves, certain capital gains arising from the application of international accounting standards are eligible, as are positive valuation adjustments in respect of hedges of net investments in foreign operations. In particular, in the reserves for regularising, updating or revaluing assets, certain percentages are added to the gross amounts of gains (net of losses) that are recorded as valuation adjustments on available-for-sale financial assets within equity. These percentages are 35% for amounts generated in debt securities and 45% for those arising in equity instruments.

Likewise, included in the calculation of capital is the book value of the general provision relating to customers' insolvency risk, i.e. that linked to inherent losses or losses not specifically allocated for credit risk impairment of up to 1.25% of the risk-weighted assets that have formed the basis for calculating the provisions.

Also, the regime for non-voting shares and callable shares and other similar instruments is clarified, the part of these instruments that is actually paid up being eligible. In the same way, it is explicitly recognised that the Banco de España has the power to verify such instruments

5. As defined in Directive 2006/73/EC; see previous section. 6. BOE of 8 July 2006. 7. See section 3.1.1 of the 2005 Report on Banking Supervision in Spain.

(non-voting, callable and preference shares), in order to classify their eligibility as capital and their assignment to the relevant elements thereof.

Reflecting the provisions of Royal Decree 1332/2005, new deductions are made from capital, *inter alia*, for holdings in insurance and reinsurance companies or in entities whose main business consists of taking holdings in insurance companies, when the holding is more than 20% of the capital of the investee.

Second, the Circular specifies the obligations of groups of financial institutions to have risk management and internal control procedures, and provides for the supervision of their intra-group operations, as already established in the higher-ranking provisions. The risk management procedures and internal control mechanisms shall be based on policies that are clearly defined by the governing bodies and implemented by means of an adequate, integrated, transparent organisational structure with well defined lines of responsibility, taking into consideration all the risks of the activity performed.

In these procedures, the processes of decision taking and risk identification, assumption, measurement, management, monitoring and control shall be approved by competent bodies at the appropriate level. These processes shall be based on objective criteria and shall take into consideration: the appropriate separation of functions, the establishment of operational limits, the frequency of the analysis and revision of both the risks and processes, the periodic preparation of rigorous stress tests, the necessary emergency plans, the adjustment to the policies defined by senior management and the quality, quantity and periodicity of the information reported to the governing bodies.

In addition, the management bodies of the institutions shall have adequate resources to allow them at all times to carry out a comprehensive assessment of the risks that have been incurred or may be incurred and to adopt the strategies of maintenance of the necessary capital levels in each case, anticipating the potential impact on solvency, profitability, liquidity and the risk profile of the institution of, among other factors, their commercial strategies, the development of competition and developments in the economic environment.

Third, some minor changes have been introduced into the definition of consolidable groups, especially when they are controlled by a financial institution situated in a third country. In the case of co-ordination groups of Spanish credit institutions controlled by a foreign financial institution with registered office outside the European Union, the Banco de España shall check, after hearing the institutions concerned, that they are not subject to supervision on a consolidated basis by the competent authority of a third country, which is equivalent to that provided for in Spanish law, in which case the consolidated supervision regime provided for in this Circular shall be applicable to such group.

In the section on the definition of large exposures and limits on concentration, the conditions are established to ensure that, in the aggregation and calculation of the exposures subject to these limits, the gains recorded as valuation adjustments of available-for-sale financial assets are not taken into account.

Finally, section eight of Circular 5/1993 (previously devoted to prudential monitoring of mixed groups) has been revised to also include the information that must be reported by financial conglomerates in relation to which Spain performs the function of co-ordinator, in accordance with the provisions of Law 5/2005 of 22 April 2005.

Law 26/2006 of 17 July 2006⁸ on private insurance and reinsurance mediation

This law, which repeals Law 9/1992 of 30 April 1992 on private insurance mediation, previously the basic legal framework for this business, has a twofold aim. On one hand, it transposes into Spanish law Directive 2002/92/EC of the European Parliament and of the Council of 9 December 2002 on insurance mediation (this being the Directive that contained the foundations for the harmonisation of insurance mediation in the European Union). On the other, it updates the national regulation of this activity, adapting it to the actual situation of the Spanish insurance market.

This new regulation is based on three basic principles;

- a) The regulation of new forms of mediation, covering insurance agents tied to various insurance undertakings and reinsurance brokers, hitherto non-existent categories of agent.
- b) The principle of equal treatment for the different types of intermediary, for which purpose equivalent professional requirements are envisaged for all of them, according to their special nature.
- c) The principle of transparency, to ensure that consumers are sufficiently protected in this area.

For the purposes of this chapter it is merely necessary to note here the activity of mediation through the distribution networks of credit institutions, an activity that is widely consolidated in the Spanish market. The law calls credit institutions that engage in this activity by the special name "*operadores de banca-seguros*" (bankassurance operators). According to the law, bankassurance operators are credit institutions and commercial companies that they control or have a stake in which, through the execution of an insurance agency contract with one (exclusive bankassurance operator⁹) or more insurance undertakings (tied bancassurance operator), perform the activity of insurance mediation as insurance agents, using credit institutions' distribution networks.

The performance of this activity is expressly made subject to the general rules for insurance agents and to the specific provisions for exclusive and tied agents. A number of particular rules are added to the foregoing, relating to three aspects:

- a) The qualifications of persons working in the mediation business, for which purpose the Law requires that half the members of the management body responsible for insurance mediation and those persons responsible for technical management or a similar function shall demonstrate that they have passed a training course or aptitude test in financial matters and private insurance, which fulfils the requirements laid down by the Directorate General for Insurance and Pension Funds¹⁰. At the same time, persons who form part of the distribution network and who participate directly in insurance mediation shall receive sufficient continuous training, for which purpose credit institutions shall design and impart a specific training programme.

8. BOE of 18 July 2006. 9. Exclusive insurance agents can be tied to two insurance undertakings provided that they have the authorisation of the first one and in the second one they act in relation to businesses, risks or contracts in which the authorising undertaking does not operate. 10. As for other agents, this requirement only applies to tied ones; exclusive ones are only required generally to have the knowledge necessary to do their work.

- b) In addition to the general reporting obligations applicable to all intermediaries, bancassurance operators are required to notify their clients that the advice given by them is supplied for the purpose of their taking out insurance, and not in respect of any other product that may be sold by the credit institution.
- c) Bancassurance operators are also required to perform the activity with a certain degree of exclusivity. Thus, credit institutions may only place their distribution network at the disposal of one bancassurance operator and may not simultaneously be the operator and auxiliary of other insurance intermediaries. In any event, bancassurance operators may use, like any other agent, the services of external auxiliaries who, acting for their own account, shall collaborate in the distribution of insurance products on the terms agreed with the insurance undertaking in the agency agreement.

In all other aspects of their activity as bancassurance operators, credit institutions and their groups are subject to the same provisions as are generally established for other insurance intermediaries.

Order EHA/1439/2006 of 3 May 2006¹¹ regulating the declaration of movements of means of payment within the context of the prevention of money laundering

Order EHA/1439/2006, complementing the modification of the legal regime for capital movements and cross-border financial transactions initiated by Law 19/2003 of 4 July 2003, was published last year. This Order implements the regime applicable to declarations of movements of means of payment.

For the purposes of this chapter, it is only necessary to note that when regulating the declaration of movements of means of payment (banknotes, coins and banker's cheques in an amount of more than €10,000 in the case of cross-border movements and €100,000 in the case of movements within national territory), the Order envisages that the declaration may be made in advance at credit institutions, provided that the movements are at least partially subject to debit in accounts at the institution.

Having received the declaration, the credit institution shall verify that the form (there is only one and it is included as an annex to the Order) has been fully completed, after which it shall process the declaration and return it to the declarant, sending the information contained therein to the Executive Branch of the Commission for the Prevention of Money Laundering.

In addition, credit institutions shall notify the above-mentioned Executive Branch of any transactions in which they act that involve movements of means of payments subject to compulsory declaration. This is without prejudice to the general obligation to notify every transaction showing signs of being or that is definitely related to money laundering.

Order EHA/2619/2006 of 28 July 2006¹², which implements certain obligations relating to the prevention of money laundering incumbent upon subject persons engaging in currency exchange or cross-border transfer management activities

This Order which, like the one mentioned above, is part of the process of updating the legal regime for capital movements and cross-border financial transactions, aims to harmonise and

11. BOE of 13 May 2006. 12. BOE of 10 August 2006.

strengthen the law on the prevention of money laundering in relation to all subject persons who engage in currency exchange or cross-border transfer management activities.

The order applies to all persons subject to obligations in relation to the prevention of money laundering who engage in currency exchange or cross-border transfer management activities, with respect to transactions that are not subject to a debit or credit in the account of the customer at the entity.

Thus, for those currency exchange or cross-border management transfer transactions without any debit or credit in the customer's account, the order provides for the application of measures for customer identification and knowledge additional to those established generally when their amount, either individually or cumulatively over a calendar quarter, exceeds €3,000, in the case of cross-border transfers, or €6,000, in the case of currency exchanges.

When cross-border transfers are ordered from a distance by telephone or electronic or telematic means, the Order imposes certain precautions relating to customer identification, the provision of funds and the transaction documentation.

The Order requires documents to be retained for at least six years, with specific criteria established for the various types of documentation required by law.

Finally, the order gives subject persons precise and very detailed instructions for the establishment of appropriate internal control and communication procedures and bodies to detect, foresee and prevent the performance of money laundering related transactions. These instructions cover the measures that must be taken and the way in which their appropriateness is verified, based on the results that they should enable to be obtained.

ORDER EHA/1199/2006 of 25 April 2006¹³, which implements the provisions of the Regulations of Law 35/2003 of 4 November 2003 regulating collective investment institutions, in relation to hedge funds and funds of hedge funds

The purpose of this order, which is continued in Circular 1/2006 of 3 May 2006 of the National Securities Market Commission¹⁴, is to implement the provisions of the regulations for collective investment institutions contained in Royal Decree 1309/2005 of 4 November 2005 in relation to hedge funds and funds of hedge funds.

For the purposes of this chapter, it is only necessary to mention the particular aspects that the above-mentioned Order and Circular introduce into the regime applicable to credit institutions, with regard to their activity as depositaries for such institutions.

In this respect, the Order provides that hedge fund depositaries shall establish a system of control enabling them to ensure that the investment selection procedures implemented by the hedge fund management companies respect the laws in force from time to time.

In relation to these selection procedures, hedge fund management companies are obliged to include in their internal control procedures the qualitative, quantitative and operational criteria on which the assessment and analysis of investments for the funds they manage are based. These criteria shall have been agreed with the depository and shall have the approval of the Board of Directors of the manager and a person with sufficient powers at the depository.

13. BOE of 26 April 2006. 14. BOE of 17 May 2006.

The relations between the management companies and the financial intermediaries that provide financing and other services to hedge funds (prime brokers) are likewise subject to special vigilance by the depository. Thus, when a hedge fund's management company arranges a financial pledge agreement with a third-party whereunder ownership of the asset delivered as collateral is transferred to the latter, or the asset is pledged with a right of disposition in favour of the pledgee, this circumstance shall be reported to the depository. In addition, in accordance with the provisions of the Circular, the depository and the management company shall receive from the entity with which a financial pledge agreement has been entered into regular information on the assets subject to the pledge and the amount of the guaranteed financial obligations. The agreement shall regulate the procedure for the reconciliation of any differences in terms of valuation or of positions that should arise.