FINANCIAL REGULATION: 2006 Q2

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Introduction

In 2006 Q2 there were few new financial provisions relative to the preceding period. Firstly, the definition of Eurosystem reserves was amended and the threshold below which no remuneration is offered on overnight credit balances held as a cash/investment service was removed.

In the area of private securities markets, the regulations were implemented for collective investment institutions (hereafter CIIs) authorised for unrestricted investment (hedge funds) and for the funds of hedge funds, as were those for their management companies and those for custodian entities. Further, the adaptation of Spanish legislation on the activities and supervision of institutions for occupational retirement provision to Community regulations was finalised.

The period also saw the regulatory implementation of the legal regime for the prevention of money laundering, along with the prior declaration of movements of means of payments in this area.

In the Community domain three directives were promulgated, two of which are revised texts of earlier directives. The first consolidates the directives promulgated since 2000 on the taking up and pursuit of the business of credit institutions. The second does likewise with the directives promulgated since 1993 on the capital adequacy of investment firms and credit institutions. Finally, the third text harmonises (albeit not completely) legal auditing requirements for annual accounts and consolidated accounts in the European Union.

In the tax area, regarding income obtained without a permanent establishment in respect of non-residents' income tax, a special procedure has been established accrediting the residence of certain non-resident shareholders and unit-holders, and the reporting obligations of these agents vis-à-vis the Spanish tax authorities have been regulated.

Finally, Spanish regulations have been adapted to the Community legislation on public limited companies. In particular, so as to enhance financial transparency, it has been decreed that listed companies may not draw up abridged annual accounts.

European Central Bank: provision of reserve management services by the Eurosystem

The Guideline of the European Central Bank (ECB/2006/4) of 7 April 2006 (OJEU of 20 April) on the Eurosystem's provision of reserve management services in euro to central banks and countries located outside the euro area and to international organisations has been published, in order to reflect the changes in the definition of reserves and the removal of the threshold below which no remuneration is offered on overnight credit balances held as a cash/investment service. This instrument derogates the Guideline of the European Central Bank (ECB/2004/13) of 1 July 2004[1].

As to the changes in the definition of reserves, now included in addition to the previous assets are all those exclusively held in order to meet pension and related obligations of the customer vis-à-vis its former or existing staff; dedicated accounts opened with the Eurosystem member by a customer for public debt rescheduling purposes within the framework of international agreements; and such other categories of euro-denominated assets as decided by the Governing Council.

Finally, the Guideline seeks to ensure that, inter alia, the Eurosystem's reserve management services are provided under uniform conditions, that the ECB is sufficiently informed of the services and that common minimum requirements are set in agreements with customers.

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1. Guideline ECB/2004/13 set a threshold of €100,000 below which no remuneration was offered, which is now removed.

The Guideline came into force on 12 April and application thereof began effective 1 July.

Collective investment institutions authorised for unrestricted investment (hedge funds)

Law 35/2003 of 4 November 2003[2], regulatorily implemented by Royal Decree 1309/2005 of 4 November 2005[3], substantially reformed collective investment in Spain. The reform pursued three fundamental principles: to make the operating framework for CIIs more flexible, to step up investor safeguards and to improve the official intervention regime. Regarding the first principle, the investment objectives or specialities of CIIs were extended, these undertakings comprising, inter alia, CIIs authorised for unrestricted investment, commonly known as hedge funds or alternative management funds, characterised by sizable freedom in their investment policies and greater flexibility in compliance with reporting and liquidity requirements, and the funds of hedge funds, which enabled access by minority investors to hedge funds.

Ministerial Order EHA/1199/2006 of 25 April 2006 (Official State Gazette of 26 April) implemented the provisions of the Regulation of Law 35/2003 on hedge funds and on funds of hedge funds, empowering the CNMV to regulate the more technical aspects of the regulation of hedge funds. Availing itself of this provision, the CNMV published Circular CCNMV 1/2006 of 3 May 2006 (Official State Gazette of 17 May) on hedge funds, which regulates the arrangements applicable to these institutions as well as to their management companies and custodians. The key aspects of both instruments are as follows.

INVESTMENT REGIME AND DEBT POLICY

The Order and the Circular address the investment regime and debt policy of hedge funds, clarifying the elements eligible for calculating the indebtedness limit. The Regulation stipulated that the indebtedness limit could not be more than five times the net asset value of the fund. It is now stipulated that, for the purposes of complying with this limit, hedge funds shall perform the calculation bearing in mind all the funds received in cash by it, without considering assets sold under repurchase agreement, financing received via simultaneous transactions or financing received on the sale of borrowed securities.

As to funds of hedge funds, the assets in which the compulsory ratio of 60% of net asset value can be invested include, inter alia, the following: hedge funds established in Spain and CIIs domiciled in OECD member countries or whose management has been entrusted to a management company or entity that engages in similar functions to those of the management company or with analogous accountability demands, subject to supervision with its domicile in an OECD country. Significantly, they are allowed to invest in so-called separate accounts or managed accounts, these being understood as those structures that replicate the investment portfolio of a hedge fund.

REALISABLE VALUE OF SHARES AND UNITS

The Order establishes the general criteria for calculating the realisable value of the shares and units of both institutions. The basic valuation principles and general criteria established for “financial” CIIs shall be applied. The aim of these criteria will be to reflect the value at which the assets of a third party who had no special relationship with the CII and who was appropriately informed at the time of the valuation could reasonably be liquidated.

Specific aspects of the right to reimbursement and of the regime for estimated realisable values are also implemented. In this respect, a hedge fund shall be entitled not to grant a reimbursement right at all the realisable value calculation dates, provided this is expressly indicated in its prospectus. In any event, the right to reimbursement shall observe the minimum periodicity laid down in the Regulation[4]. As regards the regime of estimated realisable values, irrespec-

2. See “Financial regulation: 2003 Q4”, *Economic Bulletin,* January 2004, Banco de España, pp. 84-87. **3.** See “Financial regulation: 2005 Q4”, *Economic Bulletin,* January 2006, Banco de España, pp. 112-116. **4.** The minimum periodicity is quarterly, although in some cases it may be half-yearly, if the investments envisaged so require it.

tive of the periodicity of its calculation, the unit-holders or shareholders of the hedge fund or the fund of hedge funds may receive from the management company, as often as the latter deems advisable, and as stipulated in the prospectus, preliminary or tentative estimates of the realisable value calculated by the management company on the basis of its estimates of commission, expenses and results of the asset portfolio, and which shall not be applicable to the liquidation of subscriptions and reimbursements.

CONDITIONS OF ACCESS TO THE ACTIVITY OF MANAGEMENT COMPANIES AND SOLVENCY THEREOF

Broadly speaking, a new category of management company dedicated exclusively to hedge funds has not been created; however, special requirements - including additional equity – are demanded of management companies intending to engage in the management of new CIIs. In this respect, these companies shall have a programme of activities that explicitly covers the management of hedge funds, funds of hedge funds or both, along with a description of internal control measures, detailing their organisational structure, the specific technical and human means at their disposal, and a general description of the specific controls and procedures applicable in the management of this type of fund. Likewise, there shall be a description of the controls over the activity of institutions to which functions are delegated, and of the activity of the institutions with which financial guarantee agreements are entered into.

To better cover any future operational risks, the equity demanded of management companies subject to this Circular shall be the sum of that generally required under the Regulations of the Law on CIIs plus 4% of the gross fee revenue obtained in respect of the management of the CIIs regulated thereunder. The equity requirements thus calculated shall be determined taking the average of the last three years.

RISK CONTROL AND MEASUREMENT SYSTEMS

It is established that management companies shall have risk measurement and control systems suited to the specific investment strategies to be pursued. These systems are entrusted with measuring current and potential exposure to risk, especially, in the case of hedge funds, if they engage in leveraging operations or operations involving unlisted shares, illiquid financial instruments or derivatives whose valuation is complex, or short sales.

The Circular indicates that, periodically, the management companies of hedge funds shall conduct stress tests and tests simulating specific crisis scenarios in order to analyse the potential effects on the portfolios of the funds being managed and on the management of liquidity. As to the management companies of funds of hedge funds, they shall have mechanisms for the control of the liquidity of underlying investments, so that reimbursements can be met in time and in proper form.

The selection of the underlying funds by the management companies of funds of hedge funds is also regulated, with certain control functions being granted to the depository, within the margins with which current legislation defines the attendant powers. In this respect, the management companies shall include as part of their internal control procedures the qualitative, quantitative and operational procedures on which they base the evaluation and analysis of investments for the institutions they manage. These criteria shall have been agreed with the depository and shall have been approved by Board of Directors of the management company and by a sufficiently authorised person from the depository.

REGIME FOR ASSETS PLEDGED BY HEDGE FUNDS

Relations between the management companies and the financial intermediaries that provide financing and other services (known as prime brokers) to hedge funds have been regulated, it being considered necessary to reinforce the depository's supervisory and control functions. Thus, when a hedge fund, or its 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. Contracts entailing financial pledge agreements shall include clauses providing for and allowing supervision by the CNMV, particularly as regards financing and securities lending operations.

The Circular stipulates that the management company, or the entity - if any - to which it has delegated the related administrative functions, and the depository shall receive from the entity with which it has entered into a financial pledge agreement 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.

PROSPECTUSES

In respect of prospectuses and regular information, similar rules applicable to ordinary CIIs are established, but investors are required to sign a written statement of consent, attesting to their knowledge of the particularities of hedge funds and their differences from ordinary CIIs. These particularities include most notably the fact that the prospectus features the following aspects: information on the general policy of guarantees extended by the institution, the possibility that their beneficiaries may dispose of the assets pledged, maximum market value of the guarantees liable to be re-used in respect of the fund's obligations and minimum financial solvency of these beneficiaries. Further, hedge funds shall offer information about the level of indebtedness and about additional leverage owing to repurchase agreements, simultaneous financing, financing through securities lending and derivatives transactions.

The Order came into force on 27 April 2006 and the Circular on 4 May 2006, except for the obligatory information that the management companies of hedge funds must file with the CNMV, which will be required as from 1 October 2006.

Institutions for occupational retirement provision: adaptation to Community regulations

Directive 2003/41/EC of the European Parliament and of the Council of 3 June 2003 on the activities and supervision of institutions for occupational retirement provision was the first step towards a single market in corporate provision for the retirement of employees organised on a European scale. The Directive responds to the need to establish a Community legal framework allowing institutions for occupational retirement provision to benefit from the advantages of the internal market.

Under Spanish legislation, institutions for occupational retirement provision were governed by the consolidated text of the Law regulating pension schemes and funds, approved by Royal Legislative Decree 1/2002 of 29 November 2002[5]; by the Regulation on pension schemes and funds approved by Royal Decree 304/2004 of 20 February 2004[6]; and by other complementary rules. These regulations covered the contractual, financial and organisational aspects of the pension schemes and funds system, along with the prudential and administrative supervision rules. In general, the regulations were adapted to the prudential and supervisory provisions of Directive 2003/41/EC, and they offered a series of detailed rules on conditions of entry to operate for pension funds domiciled in Spain and their management companies, following the prudential criteria of the Directive.

Recently, Law 11/2006 of 16 May 2006 (Official State Gazette of 17 May) was enacted, adapting Spanish legislation to the regime of cross-border activities regulated in Directive 2003/41/EC of the European Parliament and of the Council of 3 June 2003 on the activities and supervision of institutions for occupational retirement provision. This Law introduces specific amendments in Royal Legislative Decree 1/2002 to adapt Spanish domestic legislation to the aforementioned Directive in those areas where such adaptation had not hitherto taken place.

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5. See "Financial regulation: 2002 Q4", *Economic Bulletin,* January 2003, Banco de España, pp. 107-108. **6.** See "Financial regulation: 2004 Q1", *Economic Bulletin,* April 2004, Banco de España, pp. 97-98.

The Law adds a new section to Royal Legislative Decree 1/2002, providing for the administrative supervision of relations between pension funds and their management companies, and other companies or institutions to which they have transferred their functions, and which have a bearing on their financial position or of importance for their effective supervision.

As regards the regime of cross-border activities of institutions for occupational retirement provision, Directive 2003/41/EC obliged Member States to allow such institutions whose registered office is in their territories to form part of pension schemes promoted or sponsored by companies located in other Member States, while companies established within their territories could sponsor pension schemes that were integrated into other Member States' institutions for occupational retirement provision. To this end, the Directive provided for co-operation between the home Member State (where the institution has its registered office) and the host Member State (whose social and labour legislation on occupational pension arrangements is applicable to the relationship between the sponsoring undertaking and the employees).

To date, Spanish regulations on pension schemes and funds had not regulated the cross-border activity of institutions for occupational retirement provision. Accordingly, the Law transposes to Spanish legislation the provisions relating to cross-border activity. To this end, a new Chapter has been added to Royal Decree 1/2002, comprising three sections: general provisions, the activity of Spanish institutions for occupational retirement provision in other Member States (development of schemes of companies established in other Member States), and the activity in Spain of other Member States' institutions for occupational retirement provision (development of schemes of companies established in Spain).

Finally, mention should be made of the activity in Spain of other Member States' institutions. Here, the Law provides for the integration into other Member States' institutions of occupational pension schemes subject to Spanish regulations, regulating the conditions of entry into other Member States' institutions, the functioning of schemes and their supervision, the compliance with Spanish legislation applicable to the scheme, and social and labour legislation.

Capital movements and prevention of money laundering

Law 19/2003 of 4 July 2003[7], on the legal regime governing capital movements and cross-border transactions and on specific measures for the prevention of money laundering, made a series of amendments to Law 19/1993 of 28 December 1993[8] aimed at adapting our legal regime for the prevention of money laundering to the provisions of Directive 2001/97/EC of the European Parliament and of the Council of 4 December 2001. As part of this adaptation, certain provisions of the Law required, for their full effectiveness, the appropriate amendment of the Regulation contained in Royal Decree 925/1995 of 9 June 1995, by means of the promulgation of Royal Decree 54/2005 of 21 January 2005.

Under the terms provided for in the Regulation, the related regulatory implementation of the prior declaration of capital movements has been by means of Ministerial Order EHA/143/2006 of 3 May 2006 (Official State Gazette of 13 May 2006), regulating the declaration of capital movements within the scope of the prevention of money laundering.

The main change here is the raising of the amounts subject to declaration, which are set at €10,000 (previously €6,000) for crossing the border, inwards or outwards, and at €100,000 (previously €80,500) for movement within national territory.

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7. See "Financial regulation: 2003 Q3", *Economic Bulletin,* October 2003, Banco de España, pp. 95-96. **8.** See "Regulación financiera: cuarto trimestre de 1993", *Boletín Económico,* January 1994, Banco de España, pp. 78 and 79.

The declaration form (included as an annex to the Order) is also regulated. There will be a single form which must be carried and shown to the authorities so they can verify compliance with the obligation to declare. Generally, the possibility of presenting the declaration through telematic means is acceptable if the person declaring has the appropriate recognised electronic signature. If the recognised electronic signature is not used, the regulations allow – in certain cases and with all due caution – registered credit institutions to receive the declarations presented by their customers.

A ceiling of €1,000 is set for a minimum survival amount, which may be agreed by the acting authority bearing in mind the particular circumstances of the case, such as the need to continue the journey or the lack of any other means of subsistence.

The information provided to travellers is also regulated so as to prevent, as far as possible, interventions as a result of mere ignorance or unawareness of those concerned.

The regulations further indicate the obligation of subject persons[9] to include in the monthly or systematic communication to the Commission for the Prevention of Money Laundering and Monetary Offences all those transactions entailing capital movements subject to an obligatory declaration. This provision shall be understood without prejudice to the remaining obligations in respect of prevention and co-operation. Accordingly, in the event of signs or certainty of money laundering, transactions shall be communicated additionally in the form stipulated in the aforementioned Royal Decree.

Finally, official co-operation and information exchange between the Commission and the State Tax Revenue Service have been regulated, and the provisions of the regime governing subsisting changes in cross-border cash movements have been repealed. Likewise, the Commission for the Prevention of Money Laundering and Monetary Offences has been authorised to issue the necessary instructions for the application of the Order, which will come into force nine months after its publication in the Official State Gazette, with the aim of providing for the establishment of the necessary procedures and technical mechanisms.

European Directive on the taking up and pursuit of the business of credit institutions (recast)

Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000[10] proceeded to unify and codify all the directives relating to the taking up and pursuit of the business of credit institutions[11], grouping them in a single text.

This Directive has since been amended on several occasions[12], as a result of which the legislator deemed it advisable, for the sake of clarity, to recast it though the publication of Directive

9. Subject persons are indicated in Royal Decree 54/2005 and include, among others, the following: credit institutions; insurance companies authorised to operate in the life segment; securities-dealer companies and securities agencies; investment companies, unless their management is entrusted to a management company; companies managing collective investment institutions and pension funds; portfolio management companies; credit card-issuing companies, and individuals or corporations engaging in currency exchange or money transfer activities, whether this is their main activity or not, in respect of operations relating to this activity. **10.** See "Financial Regulation: 2000 Q4", *Economic Bulletin,* January 2001, Banco de España, pp. 70-71. **11.** The most significant are the following: Directive 73/183/EEC of the Council of the European Communities 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; Directive 77/780/EEC of the Council of the European Communities of 12 December 1977 (First Banking Coordination Directive); Directive 89/646/EEC of the Council of the European Communities of 15 December 1989 (Second Banking Coordination Directive); Directive 89/299/EEC of the Council of the European Communities of 17 April 1989 on the own funds of credit institutions; Directive 89/647/EEC of the Council of the European Communities of 18 December 1989 on a solvency ratio for credit institutions; Directive 92/30/EEC of the Council of the European Communities of 6 April 1992 on the supervision of credit institutions on a consolidated basis, and Directive 92/121/EEC of the Council of the European Communities of 21 December 1992 on the monitoring and control of large exposures of credit institutions. **12.** Among others, it recasts the following: Directive 2000/12/EC of the European Parliament and of the Council of 18 September 2000, amending Directive 2000/12/EC on the taking up and pursuit of the business of credit institutions; Directive 2002/87/EC of the European Parliament and of the Council of 16 December 2002 on the supplementary supervision of credit institutions, insurance undertakings and

2006/48/2006 of the European Parliament and of the Council of 14 June 2006 (OJEU of 30 June) on the taking up and pursuit of the business of credit institutions (recast), which repeals Directive 2000/12/EC.

Like its predecessor, the Directive constitutes the essential legislative instrument in the Community for the achievement of the internal market in the field of credit institutions, from the dual viewpoint of both the freedom of establishment and the freedom to provide financial services, based on harmonisation and mutual recognition of authorisation and of prudential supervision systems, making possible the granting of a single licence recognised throughout the Community and the application of the principle of home Member State prudential supervision.

The Directive retains the philosophy of its predecessors in that its underlying principle is to allow credit institutions authorised in their home Member States to carry on, throughout the Community, any or all of the activities listed in Annex 1 of the Directive (list of typical activities of credit institutions benefiting from mutual recognition) by establishing branches or by providing services. Nonetheless, it substantially alters the philosophy in respect of the treatment of credit institutions' solvency, which is now based on three pillars: minimum capital requirements (pillar 1), supervisory review (pillar 2) and market discipline (pillar 3), which should be taken jointly into account so that institutions may have a level of capital in keeping with their overall risk profile.

One notable change in the Directive is the inclusion of the provisions of the document approved by the Basel Committee on Banking Supervision on 26 June 2004 (known as Basel II) regarding the above-mentioned minimum capital requirements and capital rules for credit institutions, so as to avoid the distortion of competition and to bolster the banking system in the internal market. In this connection, the solvency regulations have been modernised to make them more extensive and risk-sensitive, and to encourage better risk management.

The Directive further adds that the provisions on minimum capital requirements should be viewed in relation to other specific instruments that also harmonise the essential techniques for monitoring credit institutions.

It also states that the harmonious functioning of the internal banking market requires close and regular co-operation and significantly greater convergence of regulatory and supervisory practices between the competent authorities of the Member States. To this end, it envisages the possibility of information exchanges between the competent authorities and specific authorities or agencies that contribute, on the basis of their function, to reinforcing the stability of the financial system. To ensure the confidentiality of the information forwarded, the list of addressees should remain within strict limits.

A further change in the regulations refers to the fact that credit institutions will be obliged to calculate capital requirements to cover their operational risk. In this connection, and in addition to

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investment firms in a financial conglomerate and amending Directives 73/239/EEC, 79/267/EEC, 92/49/EEC, 92/96/EEC, 93/6/EEC and 93/22/EEC of the Council, and Directives 98/78/EC and 2000/12/EC of the European Parliament and of the Council; Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC; Directive 2004/69/EC of the Commission of 27 April 2004 amending Directive 2000/12/EC of the European Parliament and of the Council, as regards the definition of "multilateral development banks"; and Directive 2005/1/EC of the European Parliament and of the Council of 9 March 2005 amending Council Directives 73/239"EEC, 85/611/EEC, 91/675/EEC, 93/6/EEC and 94/19/EC, and Directives 2000/12/EC, 2002/83/EC and 2002/87/EC in order to establish a new organisational structure for financial services committees.

simple supervisory methods, they may use advanced measurement methods based on their own operational risk-measurement systems, provided that the competent authority expressly authorises the use of the related models to calculate their own funds requirements. Such methods, once authorised by the competent authorities, shall not be applied before 1 January 2008.

The Directive maintains that the Member States shall prohibit persons or undertakings that are not credit institutions from carrying on the business of taking deposits or other repayable funds from the public. Nonetheless, this prohibition shall not apply to the taking of deposits or other repayable funds by a Member State or by a Member State's regional or local authorities or by public international bodies, or to cases expressly covered in national or Community legislation, provided that such activities are subject to the regulations and controls intended to protect depositors or investors.

The rest of the Directive scarcely covers any new areas worthy of mention. Regarding own funds, the Directive specifies the minimum criteria to which the various accounting items constituting own funds should adjust. It further establishes, depending on their quality, the distinction between the items constituting original loan funds and those constituting additional own funds (the latter should not account for more than 100% of original own funds). The minimum capital requirements should be proportionate to the risks covered. In particular, the requirements should reflect the reduction in risk levels that may be obtained thanks to the presence of a high number of relatively low risks.

As to supervisory responsibility for the financial soundness of a credit institution and, in particular, of its solvency, this remains with the institution's home Member State, while the competent authority of the host Member State shall be responsible for supervising the liquidity of the branches and monetary policies. The supervision of market risk should be the subject of close co-operation between the competent authorities of the home and host Member States. As previously established, the Member States may refuse or withdraw banking authorisation if they consider that the structure of the group is inappropriate for the pursuit of banking activities, in particular because such activities could not be satisfactorily supervised.

By 31 December 2006, the Member States shall adopt and publish the laws, regulations and administrative provisions necessary to comply with the different sections of this Directive, not included in previous Directives subject to recast. The Directive shall therefore be applicable from 1 January 2007.

European Directive on the capital adequacy of investment firms and credit institutions (recast)

Directive 93/6/EEC of the Council of 15 March 1993[13] on the capital adequacy of investment firms and credit institutions (hereinafter referred to as the "institutions") made headway in harmonising the factors considered essential for ensuring mutual recognition of authorisation and of prudential supervision systems of investment firms and of credit institutions. In particular, it regulated the definition of own funds, the supervision of market risks and the control of the large exposures which investment firms incur, along with the supervision on a consolidated basis of groups of credit institutions that have sub-groups of investment firms.

The Directive has since been amended substantially on numerous occasions[14]. As a result, the legislator deemed it appropriate to consolidate it by means of Directive 2006/49/EC of the

13. See "Regulación financiera: segundo trimestre de 1993", *Boletin Económico*, July-August 1993, Banco de España, pp. 108-109. **14.** The most substantial amendments were the following: Directive 98/31/EC of the European Parliament and of the Council of 22 June 1998 amending Directive 93/6/EEC of the Council on the capital adequacy of investment firms and credit institutions; Directive 98/33/EC of the European Parliament and of the Council of 22 June 1998 amending Directives 77/780/EEC, 89/647/EEC and 93/6/EEC; Directive 2002/87/EC of the European Parliament and of the Council of 16 December 2002 on the supplementary supervision of credit institutions, insurance undertakings and invest-

European Parliament and of the Council of the EU of 14 June 2006 (OJEU of 30 June) on the capital adequacy of investment firms and credit institutions (recast), which repeals Directive 93/06/EEC.

Among other aspects, the recast Directive includes the objectives set by Directive 2004/39/EEC of the European Parliament and of the Council of 21 April 2004[15] on markets in financial instruments, i.e. the co-ordination of the regulations governing the authorisation and the pursuit of the activity of investment firms. Specifically, it covered the possibility of such firms creating branches and providing services freely in other Member States, on the basis of the authorisation and supervision of the home country.

Likewise, the Directive assumes the provisions of the Basel II framework agreement relating to the trading book. Nonetheless, it includes references to elements implemented in Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 on the taking up and pursuit of the business of credit institutions (discussed in the foregoing section), such as the definition of own funds that should act as a basis for determining the own funds of investment firms and of credit institutions, or the treatment of credit risk and operational risk. It further establishes specific complementary rules that take into account the different scope of capital requirements related to market risk. All these provisions are aimed at strengthening the Community financial system and avoiding distortions in competition.

Moreover, the Directive establishes common rules regarding credit institutions' market risks and provides a complementary framework for the supervision of investment firms' risks, including inter alia market risks and, most particularly, position risks, counterparty/settlement risks and foreign-exchange risks.

The rest of the Directive features some minor changes. It stipulates that minimum capital requirements be applied on the basis of the consolidated financial situation of a group to ensure adequate solvency of institutions within the group. Likewise, to ensure that own funds are appropriately distributed within the group and are available to protect investments where needed, the minimum capital requirements should apply to individual institutions within a group, unless this objective can be effectively achieved by other means. It further establishes a common framework for the supervision of investment firms on a consolidated basis.

In addition, it obliges institutions to ensure that they have internal capital which, having regard to the risks to which they are or might be exposed, is adequate in quantity, quality and distribution. Accordingly, institutions should have strategies and processes in place for assessing and maintaining the adequacy of their internal capital.

The Directive urges the competent authorities to evaluate the adequacy of own funds of institutions, having regard to the risks to which the latter are exposed. For the same reason, and to ensure that Community institutions which are active in several Member States are not disproportionately burdened as a result of the continued responsibilities of individual Member State competent

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ment firms in a financial conglomerate and amending Council Directives 73/239/EEC, 79/267/EEC, 92/49/EEC, 92/96/EEC, 93/6/EEC and 93/22/EEC, and Directives 98/78/EC and 2000/12/EC of the European Parliament and of the Council; Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on the markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC, and Directive 2000/12/EC of the European Parliament and of the Council, and repealing Council Directive 93/22/EEC, and Directive 2005/1/EC of the European Parliament and of the Council of 9 March 2005 amending Council Directives 73/239//EEC, 85/611/EC, 91/675/EEC, 92/49/EEC and 93/6/EEC and Directives 94/19/EC, 98/78/EC, 2000/12/EC, 2001/34/EC, 2002/83/EC and 2002/87/EC in order to establish a new organisational structure for financial services committees. **15.** See "Financial regulation: 2004 Q2", *Economic Bulletin*, July 2004, Banco de España, pp. 100-104.

authorities for authorisation and supervision, it is essential significantly to enhance the co-operation between competent authorities, strengthening the role of the consolidating supervisor.

In order to strengthen market discipline and stimulate institutions to improve their market strategy, risk control and internal management organisation, appropriate public disclosures by institutions should be provided for.

Member States shall adopt and publish, by 31 December 2006, the laws, regulations and administrative provisions necessary to comply with the articles of this Directive, not included in previous, recast directives. They shall apply those provisions from 1 January 2007.

Directive on statutory audits of annual accounts and consolidated accounts

Several Community directives in force[16] require that, when an institution audits its individual or consolidated annual accounts, these should be audited by one or more authorised persons. The conditions for authorising the persons responsible for conducting statutory audits were laid down in Eighth Council Directive 84/253/EEC of 10 April 1984 on the approval of persons responsible for carrying out the statutory audits of accounting documents.

The lack of a harmonised approach in this area and the accounting scandals that had occurred in Europe lay behind the enactment of Directive 2006/43/EEC of the European Parliament and of the Council of 17 May 2006 (OJEU of 9 June) on statutory audits of annual accounts and consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC.

The Directive largely harmonises statutory audit requirements. Specifically, it requires the following: the application of a single set of international auditing standards adopted by the Commission; the updating and unification of training and educational requirements for auditors (which include knowledge of international accounting and auditing standards); the definition of professional ethics and greater co-operation between competent authorities of Member States and between those authorities and the authorities of third countries, in order to further enhance and harmonise the quality of statutory audit in the European Union.

In order to protect third parties, the Directive stipulates that all approved auditors and audit firms should be entered in a register which is accessible to the public and which contains basic information concerning statutory auditors and audit firms.

Statutory auditors should be subject to professional ethics, covering at least their public-interest function, their integrity and objectivity and their professional competence and due care. Good audit quality contributes to the orderly functioning of markets by enhancing the integrity and efficiency of financial statements.

The Directive requires that statutory auditors and audit firms should be independent when carrying out statutory audits. They may inform the audited entity of matters arising from the audit, but should abstain from the internal decision processes of the audited entity. Auditors should document in working papers all significant threats to their independence, along with the safeguards applied to mitigate them. If they find themselves in the situation where the significance of the threats to their independence, even after application of safeguards to mitigate those threats, is too high, they should resign or abstain from the audit engagement.

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16. Council Directive 78/660/EEC of 25 July 1978 on the annual accounts of certain types of company; Council Directive 83/349/EEC of 13 June 1983 on consolidated accounts; Council Directive 86/635/EEC of 8 December 1986 on the annual accounts and consolidated accounts of banks and other financial institutions, and Council Directive 91/674/EEC of 19 December 1991 on the annual accounts and consolidated accounts of insurance undertakings.

In the case of consolidated accounts, the group auditor should bear full responsibility for the audit report. To this end, the group auditor will have to revise and retain the documentation of his/her evaluation of the audit engagement performed by auditors from third countries.

The Directive indicates that Member States shall ensure that all statutory auditors and audit firms are subject to a system of quality assurance that is organised in a manner which is independent from the reviewed statutory auditors and audit firms. Member States shall organise a system of quality assurance in such a manner that each individual auditor is to be subject to a quality assurance review at least every six years (every three years for auditors of public-interest entities). They shall also ensure that there are effective systems of investigations and penalties to detect, correct and prevent inadequate execution of the statutory audit, providing for effective, proportionate and persuasive penalties where statutory audits are not carried out in conformity with the provisions adopted in implementation of this Directive.

Member States should organise an effective system of public oversight for statutory auditors and auditors on the basis of home country control. The regulatory arrangements for public oversight should make possible effective co-operation at Community level in respect of the Member States' oversight activities. The system should be governed by non-practitioners who are knowledgeable in the areas relevant to statutory audit. Co-operation with third countries is also envisaged, on the basis of the principles of equivalence and reciprocity.

The statutory auditor or audit firm should be appointed by the general meeting of shareholders or owners of the audited entity. In order to protect the independence of the auditor it is important that this till should be possible only where there are proper grounds and if those grounds are communicated to the authorities responsible for public oversight.

The Directive establishes special provisions for the statutory audits of public-interest entities. Inter alia, it requires auditors of public-interest entities to publish on their website an annual transparency report and to be subject to additional requirements of independence, in particular to a minimum period of rotation of seven years for the main auditing partner. The most important requirement is that public-interest entities should have an audit committee, with Member States being entrusted to specify the functions that may be assigned to this committee or to a body performing equivalent tasks, and which shall include, among others, the oversight of the presentation of the financial information, of the effectiveness of the firm's internal control, of the statutory audits of the annual and consolidated accounts, and of the independence of the statutory auditor or of the audit firm.

Member States may also decide to exempt public-interest entities which are collective investment undertakings whose transferable securities are admitted to trading on a regulated market from the requirement to have an audit committee. This option is based on the following. Firstly, if a collective investment undertaking functions merely for the purpose of pooling assets, the employment of an audit committee will not always be appropriate. Further, the financial reporting and related risks are not comparable to those of other public-interest entities. Finally, undertakings for collective investment in transferable securities (UCITS) and their management companies operate in a strictly defined regulatory environment and are subject to specific governance mechanisms such as controls exercised by their depositary.

Before 29 June 2008 Member States shall adopt and publish the provisions necessary to comply with this Directive.

Non-resident income tax: accreditation of residence

The regulations implementing Law 35/2003 of 4 November 2003[17] on CIIs, approved by Royal Decree 1309/2005 of 4 November 2005[18], introduced a change in the form of the possibility of shares and units in Spanish CIIs being marketed in other countries through entities legally approved to do so, provided that certain requirements are met. The income obtained by non-residents may be exempt by virtue of Spanish domestic regulations (in the case of capital gains) or subject to a reduced tax (in the case of dividends).

In accordance with the rules currently in force, to make withholdings applying these limited rates, and in cases where no withholding or payment on account is appropriate, a certificate of residence for tax purposes would be required of each taxpayer, issued by the related tax authority in keeping with the procedure established by the Ministry of Economy and Finance.

By virtue of the foregoing, Ministerial Order EHA/1674/2006 of 24 May 2006 (Official State Gazette of 1 June) established, in connection with income obtained not through a permanent establishment in respect of income tax on non-residents, a special procedure for accrediting the residence of certain non-resident shareholders or unit-holders in the event of cross-border agreements for the marketing of Spanish CIIs' shares or units. The obligation of these entities to provide information to the Spanish tax authorities has also been regulated.

This procedure has two aims. First, to justify the practice of withholdings or payments on account when a tax limit set in a tax treaty is applied, or when no withholding is made and a treaty has been entered into with an information exchange clause.

Second, even if no reduced rate lower than the domestic rate or no exemption on making the withholding were applied, the marketing entity is able to accredit the fact before the obligor that the income obtained by all its clients is taxed as income obtained without a permanent establishment (in the case of income tax on non-residents).

This special procedure is based on a blanket certificate of residence for tax purposes, without identification of the taxpayers, issued by the foreign marketing entity. This entity then has to send the certificate to the management company or the investment company on the profits being received or on the CII shares or units being reimbursed or transferred, and the certificate will act as an accreditation certificate of tax residence for the purposes indicated in the foregoing paragraphs.

Finally, the Order regulates the reporting obligations imposed on marketing entities abroad and the procedure for complying with such obligations. The marketing entity shall transmit to the Spanish tax authorities, in the first three months of the year following that to which the information relates, an annual itemised list of recipients and transferors, and of investment positions as at 31 December, of all its clients. The foreign marketing entity shall likewise inform the management company, or the investment company, that it has transmitted this information.

Adaptation of the consolidated text of the Companies Law

Directive 2003/51/EC of the European Parliament and of the Council of 18 June 2003[19] was intended, among other things, to increase the financial transparency of listed companies. For this reason, it eliminated some of the exceptions envisaged for companies whose marketable securities are admitted to trading on a regulated market in any Member State (listed compa-

17. See reference in footnote 2. **18.** See reference in footnote 3. **19.** This Directive amended Directives 78/660/EEC of 25 July 1978; 83/249/EEC of 13 June 1983; 86/635/EEC of 8 December 1986, and 91/674/EEC of 19 December 1991 on the annual and consolidated accounts of certain types of companies, banks and other financial institutions and insurance undertakings.

nies), one such exception being that listed companies were permitted to draw up abridged annual accounts.

To this same end, Law 7/2006 of 24 April 2006 (Official State Gazette of 25 April) was enacted, amending the consolidated text of the Companies Law, approved by Royal Legislative Decree 1564/1989 of 22 December 1989, in order to transpose Directive 2003/51/EC. As a result, since 26 April 2006 (when the legislation came into force) listed companies, i.e. those whose marketable securities are listed on a regulated market of any EU Member State, may not prepare abridged balance sheets or income statements.

7.7.2006.