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Acronyms

AIAF	Asociación de Intermediarios de Activos Financieros/Spanish Brokers' Association
ASCRI	Asociación Española de Entidades de Capital-riesgo/Spanish association of venture capital firms
BME	Bolsas y Mercados Españoles
CEBS	Committee of European Banking Supervisors
CESR	Committee of European Securities Regulators
CNMV	Comisión Nacional del Mercado de Valores
DAC	Directive on Capital Requirements
EBITDA	Earnings Before Interests, Tax, Depreciation and Amortization
EC	European Commission
ESI	Investment services company
ETF	Exchange Traded Funds
EU	European Union
FIM	Securities investment fund
IGBM	Índice General de la Bolsa de Madrid/Madrid Stock Exchange General Index
IIC	Collective Investment Schemes
IOSCO	International Organization of Securities Commissions
IPO	Initial Public Offerings
LMV	Ley del Mercado de Valores/ Securities Markets Law
MAB	Mercado Alternativo Bursátil/Alternative Stock Market
MEFF	Mercado Español de Futuros y Opciones Financieros/Spanish market in financial futures and options
MiFID	Markets in Financial Instruments Directive
PER	Price Earnings Ratio
SENAF	Sistema Electrónico de Negociación de Activos Financieros/ An electronic trading platform for Spanish public debt
SGIIC	Collective investment scheme management company
SIBE	Sistema de Interconexión Bursátil Español/Spanish electronic market
SICAV	Open-end investment company
UCITS	Undertakings for Collective Investment in Transferable Securities

I Reports and analyses

Market survey (*)

(*) This article has been prepared by staff of the CNMV Research and Statistics Directorate.

1 Overview

The liquidity crisis that hit the United States after the financial problems emanating from the distressed sub-prime mortgage sector sent shock waves coursing though international markets in the third quarter of 2007. Rising liquidity risk in the interbank market caused a sharp surge in short-term rates. The U.S. and euro-zone monetary authorities injected emergency liquidity into their respective markets. In addition, the Federal Reserve lowered its official rates though with a message that there would be no bailing-out of troubled banks. Meantime, the European Central Bank left rates unchanged at its August and September meets. Central banks were quick to reiterate that their decisions were fully warranted by economic conditions and the outlook for inflation.

This situation caused widespread unease in the financial markets over most of August and September. Doubts about the economic and financial fall-out from the recent crisis caused steep falls in stock indices, until the federal funds rate cut of 18 September calmed market nerves and sent share prices heading upwards once more. Main European stock markets suffered losses in the third quarter[1], averaging around 4%, while the U.S. markets managed small gains of approximately 2%. Market volatility increased significantly, though without reaching the average levels of the 1999-2003 period.

Long-term interest rates fell significantly but stopped short of reserving the run-up of the previous quarter. Credit risk premiums pulled out of the downward course of the year's opening quarters and registered historic highs in both the United States and euro zone (see table 1).

The main Spanish stock market indices dropped back 3%, reducing year-to-date gains to 2%. Losses were heaviest in the banking sector, due to the crisis of confidence, and construction, on the projected cooling of residential housing demand. Real estate companies remained immersed in a correction of the large gains accumulated in the last two years, though with falls rather gentler than in the preceding quarter. Technology and telecommunications was the quarter's only winner thanks to the pull effect of the Telefónica share. Meantime, the companies making up the Madrid General Index (IGBM) kept up a strong pace of earnings growth; 26.9% in the first six months versus the same period in 2006.

1 The data available at the time of preparing this report run to 20 September. So references to the third quarter correspond to the period from 29 June to 20 September.

Summary of financial indicators

TABLE 1

	Dec 2006	Q1 07	Q2 07	Q3* 07
Short-term interest rates (%)[1]				
Official interest rate	3.50	3.75	4.00	4.00
Euribor 3 month	3.69	3.89	4.15	4.73
Euribor 12 month	3.93	4.11	4.51	4.73
Exchange rates[2]				
Dollar/euro	1.32	1.33	1.35	1.40
Yen/euro	156.93	157.32	166.63	161.43
Credit risk premium: BBB-AAA spread (basis points)[3]				
Euro zone				
3 year	37	32	28	46
5 year	53	45	43	72
10 year	84	71	62	98
United States				
3 year	54	70	65	90
5 year	68	80	70	99
10 year	96	98	90	142
Equity markets				
Performance of main world stock indices (%)[4]				
Euro Stoxx 50	15.1	1.5	7.4	-2.8
Dow Jones	16.3	-0.9	8.5	2.7
Nikkei	6.9	0.4	4.9	-9.5
Other indices (%)				
Merval (Argentina)	35.5	0.6	4.2	-4.1
Bovespa (Brazil)	32.9	3.0	18.7	4.6
Shanghai Comp (China)	130.4	19.0	20.0	43.2
BSE (India)	41.0	-5.7	15.5	11.5
Spanish stock market				
Ibex 35 (%)	31.8	3.5	1.7	-3.1
P/E of Ibex 35[5]	14.3	14.0	13.91	12.54
Volatility of Ibex 35 (%)[6]	13.1	14.6	17.2	35.7
SIBE trading volumes[7]	4,513.3	6,497.8	7,091.4	5,842.7

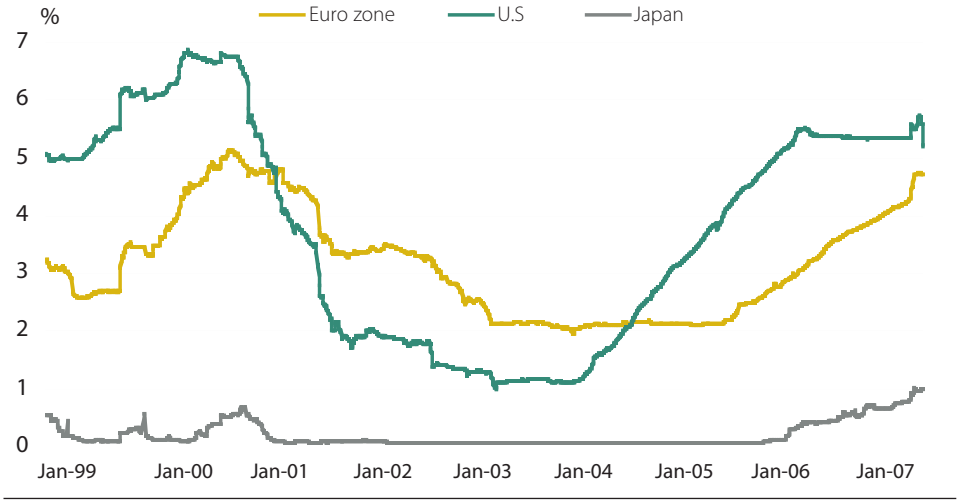
Source: CNMV, Thomson Datastream, Reuters, Banco de España, Bolsa de Madrid, MEFF and AIAF.
* Latest available data at the time of preparing this report.
na: not available.
1 Monthly average of daily data. Data for first quarter 2007 correspond to March; data for the second quarter to June and those for the third quarter correspond to the closing month up to 20 September. The official interest rate corresponds to the marginal rate at weekly auctions.
2 Data at period end. Data for the third quarter 2007 correspond to 20 September.
3 Average daily data. Data for the third quarter 2007 correspond to one month up to 20 September.
4 Annual percentage change in 2005 and 2006. In 2007, cumulative quarterly change in each period, up to 20 September in the case of the third quarter.
5 Price-earnings ratio. Data for the third quarter 2007 correspond to 20 September.
6 Implied at-the-money (ATM) volatility on nearest expiry. Data for the third quarter correspond to 20 September.
7 Daily average in million euros. Data for the third quarter 2007 correspond to July and August.

2 International financial background

2.1 Short-term interest rates

The liquidity crunch engendered by market reactions to the sub-prime lending crisis in the United States prompted a tightening movement at the shortest end of the U.S. and euro-zone money market curves (see figure 1) accompanied by a shift in interest rate expectations.

Three-month interest rates[1] FIGURE 1



Source: Thomson Datastream.
1 Data to 20 September.

In the euro zone, three- and six-month rates surged from June levels to the tune of 50-55 basis points. The Euribor 12-month moved up 25 basis points to 4.73% (see table 2). In the United States, three-month rates rose by 20 basis points with respect to June, contrasting with a 30 bp decline at the 12-month maturity on scaled-back expectations for official rates.

The monetary authorities dealt with money market turbulence two different ways. On the one hand, through emergency liquidity injections in interbank markets and, on the other, by changing their projected tack on official interest rates.

The first interest rate move came from the Federal Reserve, which on 17 August, in extraordinary session, resolved to cut its discount rate by 50 basis points to 5.75%. This provoked a renewed downshift in market expectations for the official rate (see table 3).

Short-term interest rates[1]

TABLE 2

	Dec 04	Dec 05	Dec 06	Sep 06	Dec 06	Mar 06	Jun 07	Sep 07[2]
Euro zone								
Official[3]	2.00	2.25	3.50	3.00	3.50	3.75	4.00	4.00
3 month	2.17	2.47	3.69	3.34	3.69	3.89	4.15	4.73
6 month	2.21	2.60	3.79	3.53	3.79	4.00	4.28	4.74
12 month	2.30	2.79	3.93	3.72	3.93	4.11	4.51	4.73
U.S.								
Official[4]	2.25	4.25	5.25	5.25	5.25	5.25	5.25	4.75
3 month	2.50	4.49	5.36	5.38	5.36	5.35	5.36	5.58
6 month	2.72	4.67	5.35	5.41	5.35	5.32	5.39	5.44
12 month	3.02	4.84	5.24	5.38	5.24	5.20	5.45	5.14
Japan								
Official[5]	0.15	0.15	0.25	0.25	0.25	0.50	0.50	0.50
3 month	0.05	0.07	0.56	0.42	0.56	0.70	0.74	0.98
6 month	0.07	0.08	0.63	0.48	0.63	0.72	0.84	1.08
12 month	0.09	0.12	0.74	0.60	0.74	0.78	0.98	1.15

Source: Thomson Datastream.
1 Average daily data except official rates, which correspond to the last day of the period.
2 Average from 20 August to 20 September.
3 Marginal rate at weekly auctions.
4 Federal funds rate.
5 Monetary policy rate.

By September, the market was pricing in rate cuts of at least one percentage point in the following nine months; that is, to 4.25%. Some of this downside was used by the Federal Reserve on 18 September when it announced a 50 bp cut in the federal funds rate to 4.75%.

The European Central Bank, meantime, has not renounced further tightening movements in official rates, but preferred to give the market a breather at its 6 September meeting and hold its minimum bid rate at 4%, while it gathers more information on the real impact of the crisis. The market responded by adjusting its upside expectations for official rates, which had widened in the second quarter, and is currently staking on a flat evolution instead of further hikes to 4.5%.

The tightening of money market rates extended to Japan with rises of 20-25 basis points across all maturities. Official interest rates have been kept at 0.5% since February 2006, although it appears the central bank is pondering a revise-up to 0.75% on the stronger performance of growth indicators like industrial production.

Three-month forward rates (FRAs)[1] TABLE 3

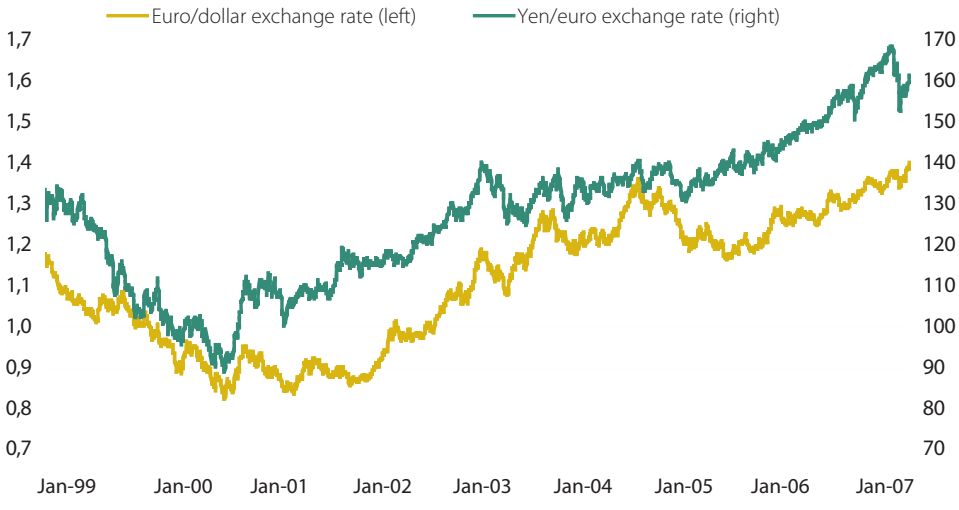
(%)	Dec 04	Dec 05	Dec 06	Sep 06	Dec 06	Mar 07	Jun 07	Sep 07[2]
Euro zone								
Spot	2.16	2.49	3.73	3.42	3.73	3.92	4.18	4.73
FRA 3x6	2.23	2.74	3.94	3.69	3.94	4.13	4.40	4.45
FRA 6x9	2.36	2.91	4.07	3.78	4.07	4.21	4.59	4.31
FRA 9x12	2.49	3.00	4.13	3.81	4.13	4.25	4.69	4.30
FRA 12x15	2.64	3.07	4.13	3.79	4.13	4.23	4.76	4.33
U.S.								
Spot	2.56	4.54	5.36	5.37	5.36	5.35	5.36	5.21
FRA 3x6	2.95	4.81	5.31	5.30	5.31	5.25	5.33	4.68
FRA 6x9	3.22	4.84	5.21	5.15	5.21	5.06	5.30	4.42
FRA 9x12	3.41	4.81	5.06	4.99	5.06	4.87	5.25	4.35
FRA 12x15	3.57	4.76	4.94	4.85	4.94	4.74	5.23	4.34

Source: Thomson Datastream.
1 Data at period end.
2 Data corresponding to 20 September.

2.2 Exchange rates

The dollar lost fresh ground against the euro in the third quarter of 2007 (see figure 2). This time round, losses were mainly about the knock-on effect on U.S. economic growth of the financial turmoil recently unleashed by the sub-prime lending crisis. The 1,403 dollars/euro exchange rate of 20 September represents a year-to-date depreciation of 6.5%. In all, this makes a 67.7% run-down for the U.S. currency against the euro since it entered decline in July 2001.

Euro/dollar and euro/yen exchange rates[1] FIGURE 2



Source: Thomson Datastream.
1 Data to 20 September.

Yen exchange rates against the euro were boosted by the shift in expectations for euro-zone official rates. Specifically, the adjustment in upside expectations in the euro zone and the prospect of official rate hikes in Japan cut short the yen's

depreciation against the euro and helped the Japanese currency to a 3.1% gain in the third quarter of 2007, as far as a 20 September rate of 161.4 yens/euro. On this performance, the yen's cumulative slide vs. the euro since July-2001 levelled off slightly, albeit to a still considerable 52.8%.

2.3 Long-term interest rates

Government bond yields came down significantly in both the United States and euro zone in the third quarter of 2007 after the strong run-up of the second quarter (see table 4). Behind these movements were fears that the sub-prime lending crisis in the United States, and subsequent financial turbulence, could damage the economy's mid-term growth. Public debt markets may also be benefitting from the fall in share prices, as investors look round for a safer place to put their money.

The decline in yields was especially steep in the United States, extending to 80-90 basis points at three- and five-year maturities and 60 basis points in the ten-year term. So much so that the lows attained were unmatched since mid 2005.

Medium and long government bond yields[1] TABLE 4

	Dec 04	Dec 05	Dec 06	Sep 06	Dec 06	Mar 07	Jun 07	Sep 07[2]
Euro zone								
3 year	2.51	2.86	3.75	3.60	3.75	3.92	4.49	4.08
5 year	2.92	3.06	3.77	3.63	3.77	3.90	4.52	4.08
10 year	3.65	3.37	3.80	3.76	3.80	3.95	4.57	4.22
U.S.								
3 year	3.20	4.39	4.59	4.69	4.59	4.51	4.99	4.09
5 year	3.60	4.39	4.54	4.67	4.54	4.48	5.02	4.22
10 year	4.23	4.46	4.57	4.72	4.57	4.56	5.09	4.52
Japan								
3 year	0.24	0.46	0.93	0.81	0.93	0.90	1.19	0.92
5 year	0.57	0.86	1.22	1.15	1.22	1.18	1.51	1.16
10 year	1.40	1.53	1.64	1.66	1.64	1.62	1.88	1.58

Source: Reuters.
1 Average daily data.
2 Average from 20 August to 20 September.

In the euro zone, government bond yields traced a more modest decline of 35-45 basis points across all curve bands, which did not wholly correct the run-up of the second quarter. The result was a 20 bp narrowing of the yield spread between the United States and the euro zone to a level of 30 basis points at the period's end.

The spate of public debt buying spread to Japan though with less force than in the U.S. and euro zone. In this case, yields dropped by a parallel 30-35 basis points in all maturities, wiping out the rises of the second quarter.

çAnother consequence of the sub-prime lending crisis was a jump in credit spreads, which had been easing back steadily since mid-2006 in both the U.S. and euro zone (see figure 3 and table 5). The sharp increases of the past few days have in some cases

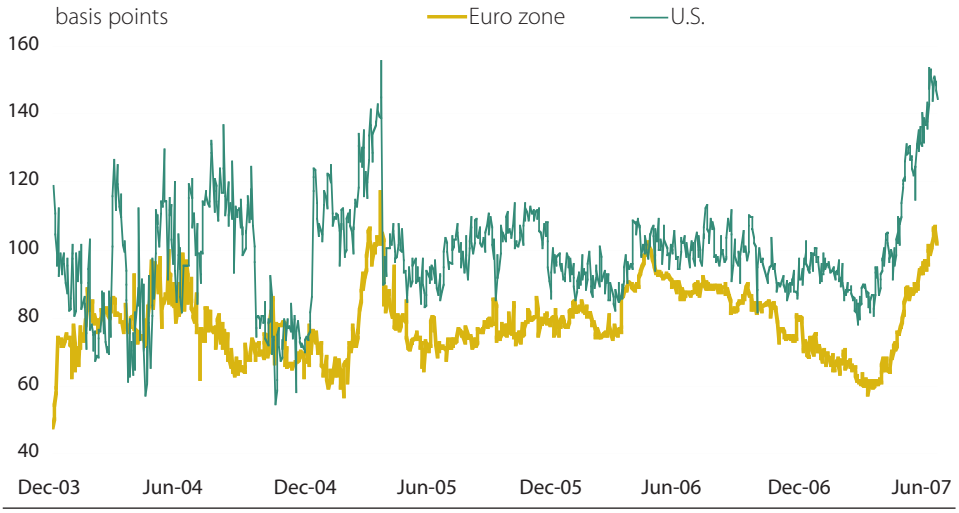
carried premiums to their highest levels since the closing months of 2003. This is the case of the long-term BBB-AAA spread in the United States, which expanded by 50 basis points to 140 basis points. Increases were rather more muted in the euro zone, though here too long-term spreads were testing 100 basis points.

Credit risk premiums: BBB-AAA spread[1] TABLE 5

basis points	Dec 04	Dec 05	Dec 06	Sep 06	Dec 06	Mar 07	Jun 07	Sep 07[2]
Euro zone								
3 year	49	43	37	41	37	32	28	46
5 year	61	53	53	56	53	45	43	72
10 year	68	77	84	89	84	71	62	98
U.S.								
3 year	63	37	54	54	54	70	65	90
5 year	71	63	68	71	68	80	70	99
10 year	81	108	96	103	96	98	90	142

Source: Reuters.
1 Average daily data.
2 Average from 20 August to 20 September.

Credit risk premiums: 10-year BBB-AAA spread[1] FIGURE 3



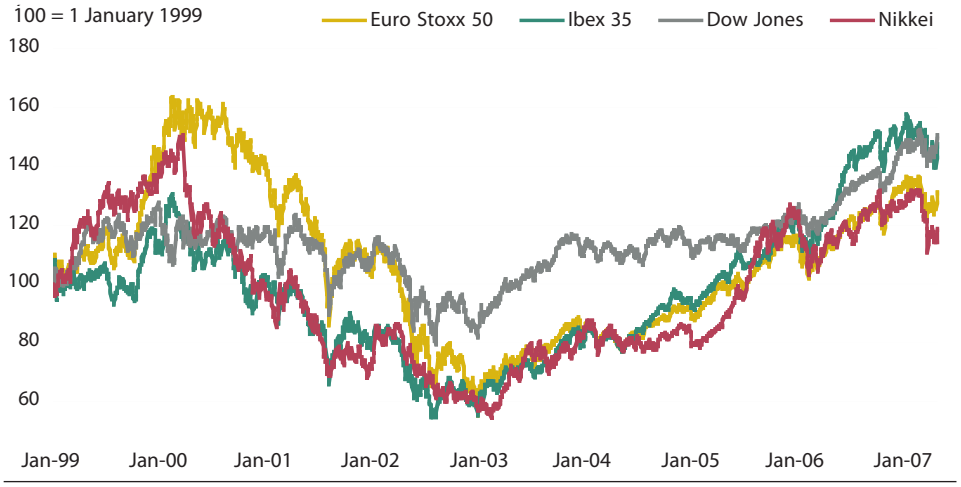
Source: Reuters.
1 Data to 20 de September.

2.4 International stock markets

The crisis in the U.S. mortgage market prompted a selling round in main international bourses over August and most of September. Sales were driven by the increased perception of risk in many financial institutions and certain industrial sectors against a backdrop of mounting pessimism about the performance of the real economy. The Federal Reserve's 18 September cut in its official interest rates served to restore investors' confidence, and produced a strong rally in share prices on the days immediately following the announcement.

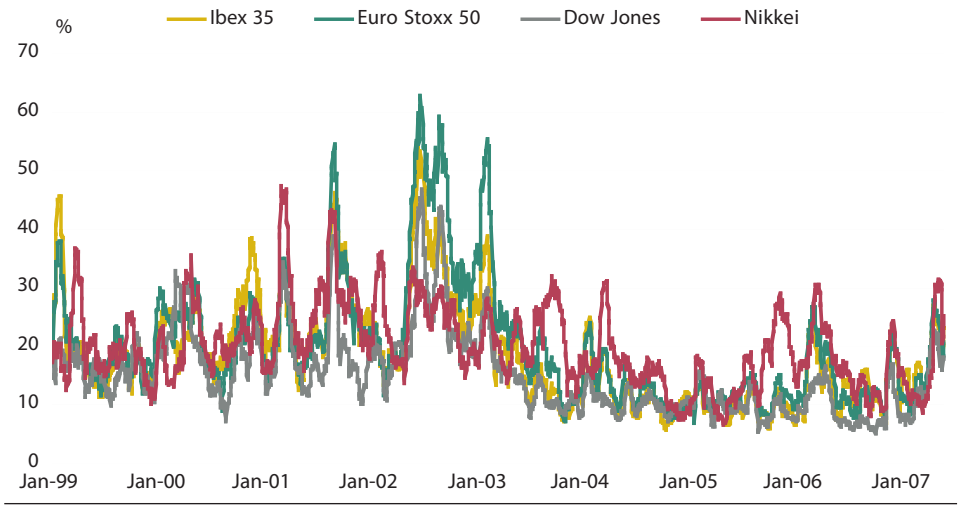
This rally helped contain quarterly losses in European markets at around 4% on average, while North American markets even managed a small gain of 2%. Hardest hit was the Japanese market, with the Nikkei index receding 9.5%.

Performance of main stock market indices[1] FIGURE 4



Source: Thomson Datastream.
1 Data to 20 de September.

Historical volatility of main stock market indices[1] FIGURE 5



Source: Thomson Datastream.
1 Data to 20 September.

This unsettled climate was also apparent in the above par volatility of main world indices, especially the Euro Stoxx 50 and Dow Jones, though without returning to the average levels of the 1999-2003 period (see figure 5 and table 6). The VIX[2] indicator of market volatility also moved significantly higher as far as a third-quarter average of 22% against the 14% of the second quarter.

2 Implied volatility of options on the S&P 500 according to the CBOE (Chicago Board Options Exchange), reflecting the market's expectations for the short-term volatility of equities. Considered a benchmark for stock market volatility.

Historical volatility of main stock indices[1]

TABLE 6

%	1999-2003	2004-2006	2004	2005	2006	Q1 07	Q2 07	Q3 07[2]
Euro Stoxx 50	25.08	12.57	13.36	10.73	13.61	13.27	12.40	19.93
Dow Jones	18.83	9.95	10.52	9.95	9.40	9.39	9.05	16.97
Nikkei	22.95	16.17	17.29	12.14	19.08	14.24	13.31	19.11
Ibex 35	23.09	11.48	12.15	9.86	12.43	13.00	14.18	19.20

Source: Thomson Datastream.
1 Average daily data.
2 Last available data corresponding to 20 September.

Performance of main stock market indices

TABLE 7

					2007 – sep[1]		
annual % unless otherwise indicated	Índice	2006	Q1 07	Q2 07	% Q	% change Dec 06	% annual
World							
	MSCI World	18.0	2.1	5.8	0.5	8.5	18.4
Euro zone							
	Euro Stoxx 50	15.1	1.5	7.4	-2.8	6.0	13.7
	Euronext 100	18.8	3.1	7.4	-5.2	4.9	12.8
Germany	Dax 30	22.0	4.9	15.8	-3.4	17.3	29.9
France	Cac 40	17.5	1.7	7.5	-6.0	2.7	9.6
Italy	Mib 30	17.5	0.3	1.3	-4.4	-2.9	6.1
Spain	Ibex 35	31.8	3.5	1.7	-3.1	2.0	16.1
United Kingdom							
	FTSE 100	10.7	1.4	4.8	-2.7	3.3	9.6
United States							
	Dow Jones	16.3	-0.9	8.5	2.7	10.5	18.5
	S&P 500	13.6	0.2	5.8	1.0	7.1	14.6
	Nasdaq-Cpte	9.5	0.3	7.5	2.0	9.9	17.8
Japan							
	Nikkei 225	6.9	0.4	4.9	-9.5	-4.7	4.4
	Topix	1.9	1.9	3.6	-11.7	-6.8	-0.2

Source: Thomson Datastream.
1 Data to 20 June. The quarterly change (% Q) corresponds to the period between 20 September and 29 June.

In the euro zone, France's Cac 40 was the worst performing of all stock indices with losses of 6%. The year-to-date performance of main European bourses has sunk to fairly modest levels, and even turned negative in the case of Italy. The best in class was again the German market, with the Dax 30 gaining 17.3% year to date and 29.9% in year-on-year terms (see table 7).

In the United States, where the recent financial turbulence ignited, the Dow Jones secured a third-quarter advance of 2.7% thanks to the share price rally of 18 to 20 September. Year-to-date gains enlarged in consequence to 10.5%. The resistance of the U.S. market owed to the fact that selling pressure was most intense in the shares accumulating the highest gains, plus the release of good earnings figures by the listed firms most favoured by a weakening dollar.

Performance of other international stock indices

TABLE 8

annual % unless otherwise indicated	Index	2006	Q1 07	Q2 07	2007 – sep[1] % Q	2007 – sep[1] % change Dec 06	2007 – sep[1] % annual
Latin America							
Argentina	Merval	35.5	0.6	4.2	-4.1	0.5	26.5
Brazil	Bovespa	32.9	3.0	18.7	4.6	28.0	61.7
Chile	IGPA	34.4	7.6	13.6	-4.3	16.9	37.8
Mexico	IPC	48.6	8.7	8.4	-2.1	15.3	39.6
Peru	IGRA	168.3	33.2	30.4	-7.2	61.1	105.7
Venezuela	IBC	156.1	-6.3	-18.9	-4.0	-27.1	8.7
Asia							
China	Shanghai Comp	130.4	19.0	20.0	43.2	104.5	215.7
India	BSE	41.0	-5.7	15.5	11.5	21.5	38.0
South Korea	Korea Cmp Ex	4.0	1.3	20.0	9.5	33.1	39.7
Philippines	Manila Comp	42.3	7.4	14.3	-6.0	15.4	37.0
Hong Kong	Hang Seng	34.2	-0.8	10.0	18.0	28.7	46.8
Indonesia	Yakarta Comp	55.3	1.4	16.8	7.7	27.6	55.8
Malaysia	Kuala Lumpur Comp	21.8	13.7	8.6	-3.4	19.4	36.4
Singapore	SES All-S'Pore	27.2	8.2	9.8	0.1	19.0	40.3
Thailand	Bangkok SET	-4.7	-0.9	15.3	5.0	19.9	16.1
Taiwan	Taiwan Weighted Pr.	19.5	0.8	12.7	1.1	14.8	30.6
Eastern Europe							
Russia	Russian RTS Index	70.7	0.7	-2.0	6.2	4.9	29.7
Poland	Warsaw G. Index	41.6	14.1	14.9	-5.3	24.2	41.7
Rumania	Romania BET	22.2	6.2	13.1	3.2	23.9	27.2
Bulgaria	Sofix	48.3	4.4	10.4	23.6	42.6	85.2
Hungary	BUX	19.5	-5.7	23.5	-5.6	9.9	23.3
Croatia	CROBEX	62.2	32.0	14.1	-0.6	49.7	52.6

Source: Thomson Datastream.
1 Data to 20 September. Quarterly change (% Q) corresponds to the period between 20 September and 29 June.

The correction extended to Latin America and, more selectively, to Eastern Europe and Asian markets (see table 8). Falls were steepest in Peru (where investors opted to cash in the large profits accumulated since 2006) with Hungary and Poland also faring fairly badly. Conversely, the Chinese market powered up a further 43.2% in the third quarter lifting year-to-date gains to 104.5%. Note that emerging country markets continue to strongly outperform main world indices in year-on-year terms, with average rises of 49.8% and 13.2% respectively.

Aside from investor returns by way of share price movements, we must also consider dividend payments. This is especially true of European indices, whose dividend yield is a tidy percentage ahead of both the United States (S&P 500) and Japan (Topix). In any case, all main indices grew their dividend yield in the third quarter of 2007. The Cac 40 and FTSE 100 remained in front with yields topping 4%. And the Dax 30 yielded 2.62% to add to the price gains notched up in the same period. In the Ibex 35, dividend yield held slightly upwards of the 3% average registered since mid 2005 (see table 9).

Dividend yield of main stock indices

TABLE 9

%	2004	2005	2006	Sep 06	Dec 06	Mar 07	Jun 07	Sep 07[1]
S&P 500	1.84	1.94	1.91	1.98	1.91	2.13	2.04	2.16
Topix	1.11	0.95	1.11	1.17	1.11	1.11	1.20	1.39
Euro Stoxx 50	3.17	3.28	3.52	3.60	3.52	3.92	3.61	3.85
Euronext 100	3.22	3.23	3.32	3.52	3.32	3.63	3.52	3.81
FTSE 100	3.61	3.59	3.77	3.94	3.77	3.88	3.82	4.03
Dax 30	1.96	2.17	2.29	2.47	2.29	2.77	2.48	2.62
Cac 40	3.32	3.43	3.79	3.91	3.79	4.26	4.09	4.51
Mib 30	3.17	3.53	3.67	4.00	3.67	3.88	3.47	3.75
Ibex 35	2.77	3.08	3.02	2.94	3.02	3.19	2.99	3.09

Source: Thomson Datastream.
1 Data to 20 September.

Falling share prices drove down the price earnings ratio (P/E) of main stock indices in the third quarter of 2007. In the euro zone, the average P/E dropped to 12.0 in September from 13.0 in June. The Euronext 100 and Ibex 35 were again the two indices recording the highest multiples, while the P/E of the Dax 30 moved lower in the period on the strong performance of listed company earnings. Both the S&P 500 and Topix recorded higher P/Es than their euro zone counterparts (see table 10 and figures 6 and 7).

PER de los principales índices bursátiles

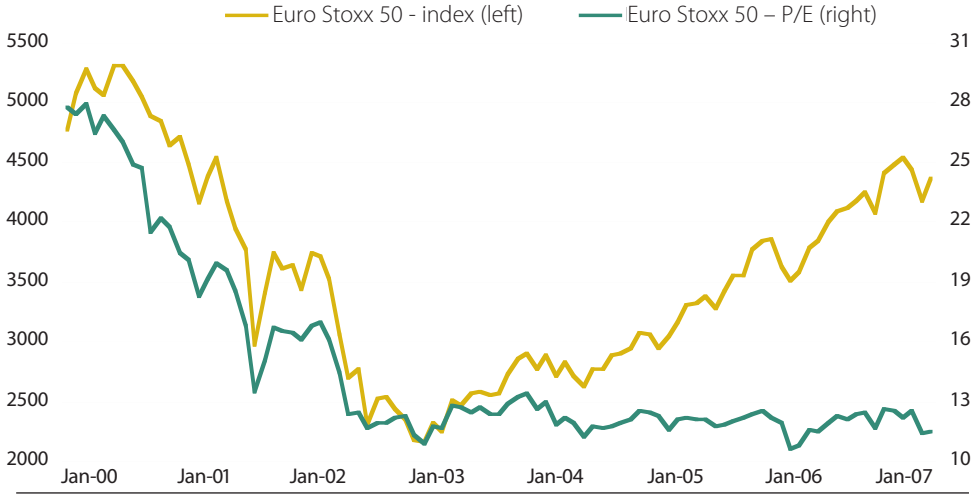
TABLE 10

	2004	2005	2006	sep-06	dic-06	mar-07	jun-07	sep-07[1]
S&P 500	16,36	14,85	15,07	14,25	15,07	14,66	15,08	14,28
Topix	15,68	19,52	17,80	16,70	17,80	17,59	18,04	15,28
Euro Stoxx 50	13,00	12,03	12,15	11,73	12,15	11,94	12,35	11,29
Euronext 100	13,06	12,46	12,93	12,47	12,93	13,00	13,68	12,39
FTSE 100	16,63	12,45	12,41	11,75	12,41	12,48	12,65	11,82
Dax 30	12,96	12,62	12,78	12,08	12,78	12,66	13,25	11,93
Cac 40	12,93	12,14	12,68	12,19	12,68	12,55	13,22	11,83
Mib 30	15,57	13,38	13,07	12,36	13,07	12,85	12,87	11,86
Ibex 35	13,78	12,88	14,29	13,35	14,29	14,04	13,91	12,54

Fuente: Thomson Datastream.
1 Datos a 20 de septiembre.

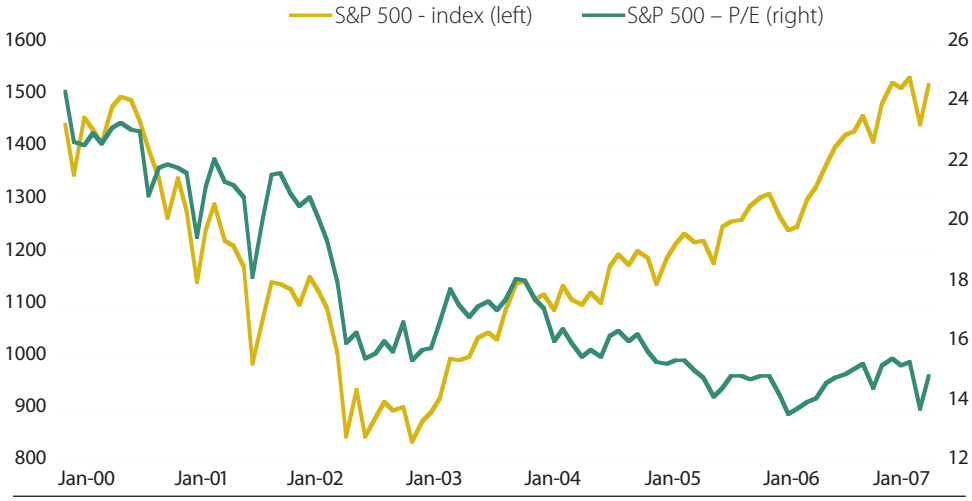
Stock indices and P/E: Euro Stoxx 50

FIGURE 6



Source: Thomson Datastream.

Stock indices and P/E: S&P 500 FIGURE 7



Source: Thomson Datastream.

Trading volumes of main international stock markets TABLE 11

Billion euros

Exchange	2004	2005	2006	Q2 06	Q3 06	Q4 06	Q1 07	Q2 07
U.S.[1]	16,813	20,042	27,044	7,128	6,091	6,646	7,439	7,740
New York	9,317	11,410	17,222	4,603	3,958	4,232	4,814	5,012
Tokyo	2,591	3,603	4,617	1,224	986	1,049	1,272	1,169
London	4,149	4,583	5,991	1,443	1,340	1,626	2,035	2,128
Euronext	1,986	2,345	3,006	891	617	736	948	1,075
Deutsche Börse	1,238	1,546	2,165	608	457	545	801	791
Borsa Italiana	778	1,051	1,258	377	231	357	388	509
BME[2]	646	859	1,154	263	265	354	419	442

Source: World Federation of Exchanges and CNMV.
1 The sum of New York Stock Exchange (NYSE), Nasdaq and American Stock Exchange.
2 Bolsas y Mercados Españoles. Not including Latibex.

The latest available data on the turnover of main world markets, stretching to the end of the second quarter, evidence the continuing strength of trading volumes, with European markets slightly ahead by the measure of year-on-year growth. Trading on the New York exchange was 9% up on the same period in 2006, while main European markets reported an average increase of 27% (see table 11). Most dynamic of all was the Spanish market where growth rates reached 68%.

3 Spanish fixed-income markets

Liquidity and credit risk augmented in Spain during the third quarter owing to the international contagion effect. Short-term rates pushed higher across all maturities though most intensely at the shortest end (three and six months) and in private fixed-income instruments.

The interest rate on three-month interbank deposits climbed 55 basis points from June levels while twelve-month rates moved up 20 basis points. At the same time, commercial paper to deposit spreads widened 5 basis points across all maturities. Significantly, these spreads are now up to their highest levels since December 2004 (see table 12).

Short-term interest rates[1] TABLE 12

%	Dec 04	Dec 05	Dec 06	Sep 06	Dec 06	Mar 07	Jun 07	Sep 07
Commercial paper[2]								
3 month	2.25	2.58	3.78	3.42	3.78	4.00	4.25	4.85
6 month	2.30	2.74	3.91	3.63	3.91	4.11	4.39	4.89
12 month	2.39	2.93	4.00	3.78	4.00	4.23	4.61	4.90
Interbank deposits								
3 month	2.16	2.46	3.67	3.32	3.67	3.86	4.13	4.69
6 month	2.20	2.59	3.77	3.50	3.77	3.93	4.26	4.70
12 month	2.29	2.77	3.91	3.69	3.91	4.08	4.49	4.71

Source: AIAF and Thomson Datastream.
1 Average daily data. September 2007 data correspond to the average between 20 September and 20 August.
2 Trading on private fixed-income market AIAF.

In contrast, medium and long-term interest rates headed lower in the quarter, partially correcting the steep rises of the three months to June 2007. Spanish government bond yields ceded 45 basis points at the three-year term and 30 bp in the case of 10-year instruments. The result was a steepening of the curve slope that left the spread between ten- and three-year bonds at 30 basis points against the 10 bp in place since September 2006 (see table 13 and figure 8).

Yields of medium- and long-term government bonds and private fixed-income[1] TABLE 13

%	Dec 04	Dec 05	Dec 06	Sep 06	Dec 06	Mar 07	Jun 07	Sep 07
Private fixed-income[2]								
3 year	2.81	3.15	4.04	3.91	4.04	4.17	4.75	4.34
5 year	3.38	3.48	4.14	4.02	4.14	4.21	4.84	4.39
10 year	4.15	3.89	4.26	4.24	4.26	4.39	5.02	4.66
Government bonds								
3 year	2.61	2.91	3.73	3.62	3.73	3.91	4.51	4.06
5 year	3.00	3.06	3.76	3.66	3.76	3.94	4.56	4.17
10 year	3.64	3.36	3.80	3.74	3.80	4.00	4.63	4.34
Spread[3]								
3 year	20	25	31	29	31	26	25	27
5 year	37	42	37	36	37	27	28	22
10 year	51	54	46	50	46	38	39	32

Source: Thomson Datastream y AIAF.
1 Average daily data. September 2007 data correspond to the average between 20 September and 21 August.
2 Medium- and long-term bonds and debentures in outright trades on the AIAF market.
3 Basis points.
Source: Thomson Datastream y AIAF.

Spanish government bond yields[1]

FIGURE 8

Source: Thomson Datastream.
1 Data to 20 September.

Corporate bond yields likewise decreased in the third quarter of 2007. The decline was 40 basis points in the three-year term, 5 bp less than with the corresponding sovereign instrument. In contrast, five- and ten-year bond yields declined more steeply than their sovereign equivalents, reducing the corporate bond spread in these maturities by 5 basis points (see table 13).

The ratings of issues registered with the CNMV and trading on the AIAF fixed-income market experienced no fall-out from the interbank crisis, or at least this was the case with the data to 31 August. As table 14 shows, a large percentage of covered bond issues conserved their "AAA" ratings, while plain bonds and debentures remained mainly bracketed in the "A" and "AA" categories. Preference shares were the lowest rated instruments, with 39% of them "BBB".

Credit ratings of CNMV registered issues trading on AIAF[1]

TABLE 14

% total unless otherwise indicated	Mortagage backed securities	Non mortagage asset backed securities	Mortagage bonds	Territorial bonds	Matador bonds	Plain bonds	Plain debentures	Preference shares	Total
Rated									
Amount (million euros)	23,698.1	275,087.6	153,338.0	14,625.0	1,358.4	86,522.1	39,914.8	21,877.1	**616,421.1**
Percentage	100.0	100.0	99.4	99.0	100.0	91.9	81.5	94.9	**97.0**
Investment grade									
AAA	94.0	94.7	98.3	97.0	81.9	5.4	3.5	0.0	**71.9**
AA	1.4	0.9	1.0	0.0	11.4	45.9	20.0	4.3	**9.2**
A	3.4	2.4	0.0	2.0	4.4	40.6	53.8	50.9	**13.2**
BBB	0.7	1.4	0.0	0.0	0.0	0.0	4.2	38.9	**2.4**
Speculative grade									
<BBB	0.5	0.6	0.0	0.0	2.3	0.0	0.0	0.7	**0.3**
Unrated									
Amount (million euros)	0.0	17.6	992.5	150.0	0.0	7,640.3	9,078.2	1,185.5	**19,064.1**
Percentage	0.0	0.0	0.6	1.0	0.0	8.1	18.5	5.1	**3.0**

Source: CNMV.
1 Outstanding balance as of 31 August 2007.

With July and August data to hand, there is nothing to indicate a contraction in CNMV-registered issues of asset-backed securities or any rating downgrades in their respect. Specifically, the average monthly issuance of asset-backed securities was 6,421 million euros over these two months; well below the 10,506 million euros of the second quarter but still 97.1% higher than the monthly average for the third quarter of 2006 (see table 15). Likewise, 93% of issues warranted an AAA rating, on a par with the 95% of the preceding quarter.

Asset-backed issues[1] registered with the CNMV: by credit rating TABLE 15

Average monthly amount in each period (million euros)

	2006		2007		
	Q3	Q4	Q1	Q2	Q3[2]
Amount	3,257	13,255	13,131	10,506	6,421
Investment grade					
AAA	3,031	12,482	12,704	9,937	5,982
AA	29	139	31	79	34
A	80	304	182	244	204
BBB	74	195	148	150	119
Speculative grade					
<BBB	44	136	66	96	82

Source: CNMV.
1 Including mortgage-backed and non mortgage asset-backed securities.
2 Data for July and August.

Spanish corporate issuers of long-term instruments retained their credit ratings unchanged, with the exception of three cases in the last quarter (see table 16), two involving an upgrade and only one a downgrade.

Revision of Spanish issuers' long-term debt ratings[1] TABLE 16

(%)	Date	Agency	Before	After	Remarks
Mapfre	02/07/07	S&P	AA-	A+	More aggressive growth and acquisitions strategy
Banco Guipuzcoano	13/07/07	Fitch	A	A2	Regulatory ratios and asset quality
Altadis	18/07/07	S&P	BBB+	BBB	Possible takeover involving a lower rated buyer

Source: Reuters.
1 Revisions from 20 June to 20 September.

4 Spanish equity markets

4.1 Prices

Distrust was the dominant mood on the Spanish stock market over most of August and September. Indeed losses were piling up heavily until 18 September, when the announcement of a rate cut in the United States prompted a share price rally that saved the quarter.

Finally, the Ibex 35 dropped just 3.1% to 14,427 points, compared to the 8% fall suffered to 17 September. The Madrid General Index (IGBM) turned in a similar performance to close the quarter 3.4% down. These losses took a large chunk from the year-to-date gains accumulated to mid-July and even took some indices into negative territory (see table 17). The Ibex 35, for instance, had gained 7.5% to 19 July, recording a year-to-date high of 15,207 points.

The biggest quarterly tumble, 13.4%, corresponded to the Ibex Medium Cap, listing 20 companies, while the best performing Spanish stock index was that of the Barcelona exchange, with a fall of 1.3%.

Among the FTSE Latibex contingent – linked to Latin American corporates – the highlight was the 8.8% rise of the FTSE Latibex Brazil on a strong quarterly showing by the home country market (see table 8). These indices continue to stand out for the scale of their 2007 advance, more closely comparable to the performance of emerging country markets.

Market fluctuations as of August occasioned a sharp upturn in volatility (see figure 9). Implied at-the-money (ATM) volatility on the nearest expiry date of Ibex 35 options averaged 27.5% in September, peaking on the 20th at 36%. The average volatility of the third quarter stood at 22.6% against the 17.7% of the previous quarter. Indeed one of the hallmarks of the Spanish stock market year has been a gradual upswing in volatility which marks a break with the subdued levels recorded since the last quarter of 2004.

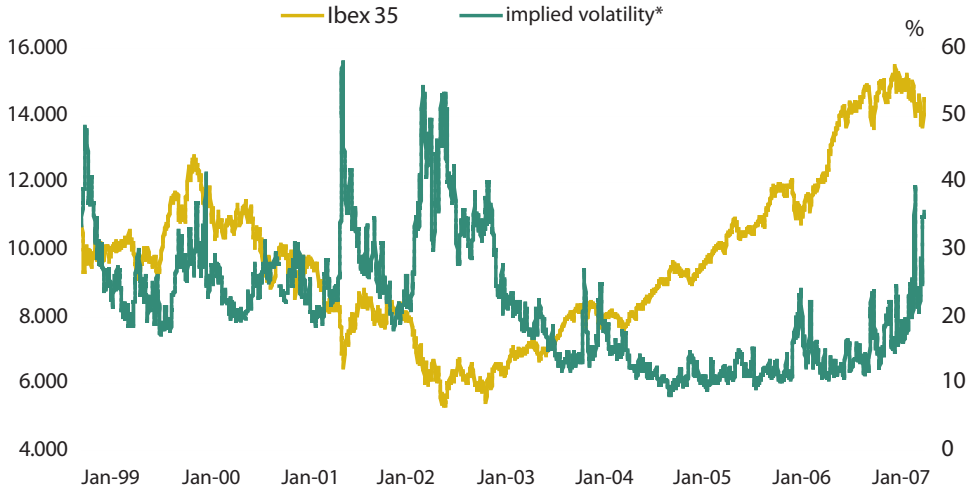
Performance of Spanish stock indices

TABLE 17

				2007 – Sep[1]			
annual % unless otherwise indicated	2006	Q1 07	Q2 07	Index	% Q	% change Dec 06	% annual
Ibex 35	31.8	3.5	1.7	13.873	-3.1	2.0	16.1
IGBM[2]	34.5	4.3	1.1	1.534	-3.4	1.9	17.1
Barcelona	29.3	3.5	1.7	1.102	-1.3	1.1	17.9
Bilbao	34.1	3.5	1.7	2.478	-4.6	-0.7	14.1
Valencia	35.3	3.5	1.7	1.270	-1.9	3.7	19.2
Ibex with dividends	36.0	14.1	-1.8	23.509	-1.9	4.9	22.9
Ibex-NM[3]	34.0	7.5	-7.4	3.461	-2.3	-2.3	17.5
Ibex Medium Cap[4]	42.1	13.1	-0.1	19.746	-13.4	-2.1	13.9
Ibex Small Cap[5]	54.4	14.1	-1.8	16.709	-5.6	5.8	28.3
BCN-Mid 50[6]	51.0	3.5	1.7	37.998	-9.0	0.6	18.6
FTSE Latibex All-share[7]	23.8	6.0	18.0	2.923	6.3	37.4	63.9
FTSE Latibex Top[8]	18.2	3.5	20.8	4.503	-1.2	27.1	50.6
FTSE Latibex Brasil[9]	24.3 **	14.1	23.0	11.071	8.8	42.6	-

Source: Thomson Datastream, Reuters, Bolsa de Madrid and Sociedad de Bolsas.
1 Data to 20 September, except Ibex with dividends corresponding to 31 August. Quarterly change (% Q) refers to the period between 20 September (31 July in Ibex with dividends) and 29 July.
2 Madrid Stock Exchange General Index.
3 Ibex Nuevo Mercado, made up of TMTs (technology, media and telecoms).
4 Index of medium-cap shares made up of 20 companies.
5 Index of small-cap shares made up of 30 companies.
6 Index of the middle segment of the Spanish stock market drawn up by the Barcelona Exchange.
7 Index of all shares quoted on the Latin American market in euros (Latibex).
8 Index of main Latibex shares.
9 Index of main Brazilian shares quoted on Latibex.
* Since the index started on 3 January 2005.
** Since the index started, on 26 September 2006.

Performance of the Ibex 35 and implied volatility FIGURE 9



Source: Thomson Datastream and MEFF.
* Implied ATM (at-the-money) volatility on nearest expiry. Data to 20 September 2007.

The fall in the IGBM traced to the negative performance of the two sectors most exposed to the confidence crunch following the sub-prime lending crisis. These were: firstly "Financial and real estate services", particularly the "Banks" sector and, within it, BBVA (loss of 8.4%); and secondly, "Basic materials, industry and construction", with the "Construction" sub-sector hardest hit (see tables 18, 19 and 20).

Remaining sectors all saw some slippage in the third quarter. The sole exception was " Technology and telecommunications" in the slipstream of a 17.4% gain by Telefónica, which seems on this occasion to have acted as a "safe have n ". The sub-sector "Real estate and others" remain immersed in a correction of the large gains accumulated in 2005 and 2006, albeit with some levelling off compared to the second quarter slump led by real estate operator Astroc. This company, in effect, clawed back 2.8% in the third quarter, though its cumulative losses continue to run high (see tables 20 and 21 and figure 10). The negative performance of "Consumer services" was largely about the punishment taken by individual companies.

Performance of the Madrid Stock Exchange by sector and leading shares[1]

TABLE 18

annual % unless otherwise indicated	weighting[2]	2006	Q1 07	Q2 07	2007 – Sep[1] % Q	% change Dec 06	% annual
Financial and real estate services	38.70	34.9	0.2	-2.1	-21.5	-23.0	-13.5
Real estate and others	1.95	111.2	-8.5	-21.1	-4.2	-30.9	-1.6
Banks	34.81	27.3	0.2	-1.3	-7.1	-8.1	-0.2
BBVA	13.07	21.0	0.8	-1.0	-8.4	-8.6	-8.1
SCH	14.16	26.8	-5.5	2.5	-2.1	-5.2	8.1
Oil and energy	24.18	33.3	7.1	9.1	-4.8	11.3	24.7
Endesa	4.35	61.2	13.0	-0.7	-0.5	11.7	37.7
Repsol YPF	4.45	28.8	-3.7	15.9	-12.7	-2.6	17.6
Iberdrola	9.92	43.4	6.8	17.4	-3.6	20.8	24.2
Basic materials, industry and construction	9.95	61.9	8.0	2.9	-13.4	-3.7	20.5
Construction	5.89	61.0	5.2	1.8	-19.6	-13.9	10.3
Technology and telecommunications	15.39	28.4	2.4	-0.5	16.2	18.4	44.7
Telefónica	14.54	26.8	2.4	0.2	17.4	20.4	46.3
Consumer goods	7.05	31.9	17.0	0.2	-2.6	14.2	30.7
Consumer services	4.73	8.6	11.8	-5.0	-8.8	-3.2	5.0

Source: Thomson Datastream and Bolsa de Madrid.
1 Shares capitalising at more than 4% of the IGBM.
2 Relative weight (%) in the IGBM as of 2 July 2007.
3 Data to 20 September. Quarterly change (% Q) corresponds to the period between 20 September and 29 June 2007.

Shares with greatest impact on IGBM change[1]

TABLE 19

Share	Sector	2007- Sep[2] Q3 07	Jan-Sep 07	last year
Rise				
Telefónica	Technology and telecommunications	2.52	2.97	6.73
Fall				
BBVA	Financial and real estate services	-1.10	-1.13	-1.06
Repsol YPF	Oil and energy	-0.57	-0.11	0.78
ACS	Basic materials, industry and construction	-0.46	-0.29	0.00
Banco Popular Español	Financial and real estate services	-0.40	-0.38	-0.13
Iberdrola	Oil and energy	-0.36	2.07	2.40
Banco Santander	Financial and real estate services	-0.30	-0.74	1.14
Banco de Sabadell	Financial and real estate services	-0.30	-0.36	-0.11
Sacyr Vallehermoso	Basic materials, industry and construction	-0.23	-0.33	-0.17
Gas Natural	Oil and energy	-0.23	0.52	0.72
Bankinter	Financial and real estate services	-0.20	-0.12	-0.06
Grupo Ferrovial	Basic materials, industry and construction	-0.19	-0.20	0.00
Zardoya	Basic materials, industry and construction	-0.18	0.00	0.02

Source: Thomson Datastream y Bolsa de Madrid.
1 The shares listed are those having most impact (equal to or more than 0.15 points) on the change in the IGBM.
2 Data to 20 September.

IGBM shares with biggest quarterly change

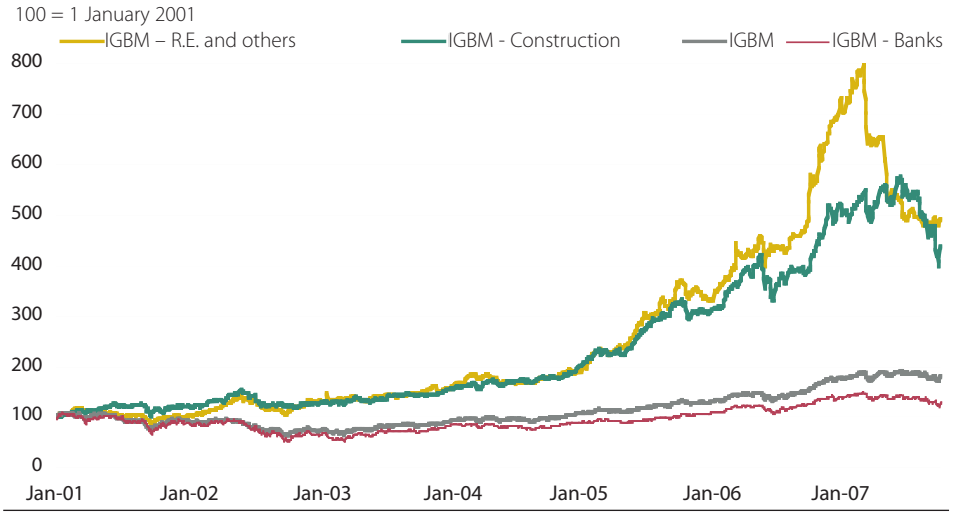
TABLE 20

Share	Sector	2007- Sep[1] % Q	% change Dec 06	% annual
Ganan				
Solaria Energía y Medio Ambiente	Oil and energy	41.04	-	-
Amper	Technology and telecommunications	18.37	12.94	33.08
Telefónica	Technology and telecommunications	17.35	20.41	46.27
Federico Paternina	Consumer goods	15.43	15.43	21.43
Elecnor	Basic materials, industry and construction	15.32	38.43	47.84
Fall				
Vueling Airlines	Consumer services	-55.87	-63.21	-
Sacyr Vallehermoso	Basic materials, industry and construction	-33.05	-46.84	-23.87
Corp. Dermoestética	Consumer services	-32.73	-9.69	8.15
Dogi	Consumer goods	-29.37	-41.45	-42.02
Inypsa	Basic materials, industry and construction	-29.29	-15.29	-5.04

Source: Thomson Datastream and Bolsa de Madrid.
1 Data to 20 de September. Quarterly change (% Q) between 20 September and 29 June 2007.

Performance of Real estate and others, Construction and Banks[1]

FIGURE 10



Source: Bolsa de Madrid.
1 Data to 20 September.

IGBM shares with biggest annual change

TABLE 21

		2007- Sep[1]	
Share	**Sector**	**% annual**	**% Q**
Rise			
Cleop	Basic materials, industry and construction	159.83	10.13
Construcciones y auxiliar de ferrocarriles	Basic materials, industry and construction	132.42	3.85
General de Alquiler de Maquinaria (GAM)	Basic materials, industry and construction	107.65	-5.48
Grifols	Consumer goods	105.06	-1.86
Técnicas Reunidas	Basic materials, industry and construction	91.83	-4.49
Fall			
Astroc Mediterráneo	Financial and real estate services	-47.65	2.84
Dogi International Fabrics	Consumer goods	-42.02	-29.37
Urbas Guardahermosa	Financial and real estate services	-41.26	-6.15
Ercros	Basic materials, industry and construction	-36.36	-23.64
Adolfo Domínguez	Consumer goods	-28.23	-14.39

Source: Thomson Datastream and Bolsa de Madrid.
1 Data to 20 September. Quarterly change (% Q) corresponds to the period between 20 September and 29 June 2007.

Our next table provides a useful summary of what has been a negative year for Spanish stocks, exemplified by the growing percentage of companies recording losses in each quarterly period, from the 16.8%. of the opening quarter to the 78.9% of the third. From the opposite angle, we have the shrinking percentage with gains of over 10%, from 49.6% in the first quarter to just 5.5% in the third.

Performance range of IGBM companies TABLE 22

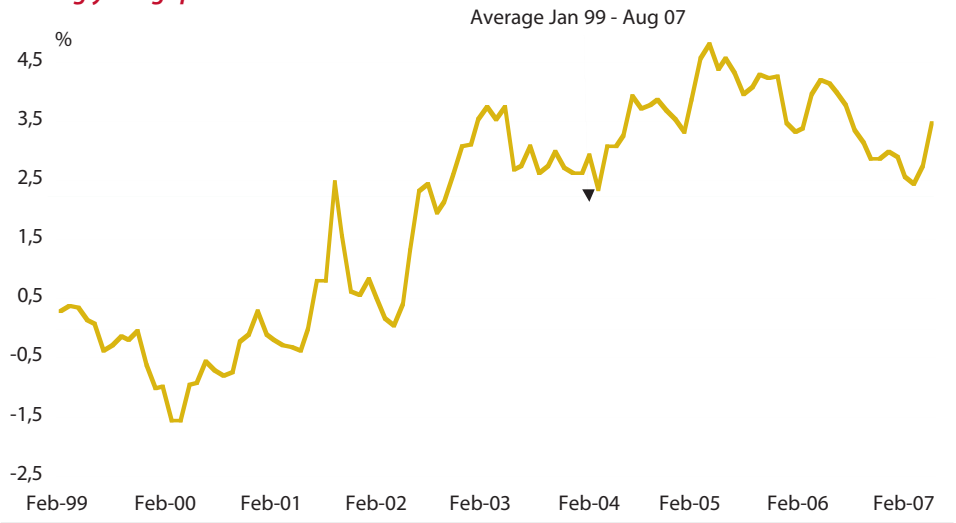
% of IGBM companies	Q3 06	Q3 06	Q1 07	Q2 07	Q3 07[1]
≥ 25%	17.2	14.8	12.0	5.7	0.8
10% to 25%	34.4	27.9	37.6	8.2	4.7
0% to 10%	36.1	36.1	33.6	30.3	15.6
≤ 0%	12.3	21.3	16.8	55.7	78.9
Pro memoria: total no. of companies					
	122	122	125	122	128

Source: Thomson Datastream.
1 Data to 20 September.

The fall in the Ibex 35 made new inroads into the price-earnings ratio (P/E), which has steadily reduced from the 14.3 of December 2006 to the 12.5 of end September 2007 (see table 10). Though bettering the average of main euro-zone stock market indices (11.9), this is still short of the historical averages registered between January 1999 and August 2007 (13.7).

Another feature of the period was the large increase in the earnings yield gap; that is, the difference between the yield on equity investment and long-term bonds. In this case the increase traced to both the decline in share prices and falling interest rates. Specifically, the Spanish yield gap reached 3.5% in the month of September compared to the 2.0% average in place from January 1999 to August 2007 (see figure 11).

***Earning yield gap*[1] of the Ibex 35** FIGURE 11



Source: Thomson Datastream and authors.
1 Difference between stock market yield, taken as earnings/price, and ten-year bond yields. Data to 8 September.

4.2 Activity: trading and liquidity

Trading on the Spanish market continued brisk over July and August though tapering off from the highs of the second quarter. As we can see from table 23, July and August volumes came near to matching the whole of the third-quarter figure for 2006.

Specifically average daily trading in the continuous electronic market amounted to 5,843 million euros in July and August, 62% ahead of the average for the equivalent period in 2006. Average daily volume in Q2 2007 was 7,091 million euros.

Trading on the Spanish stock market

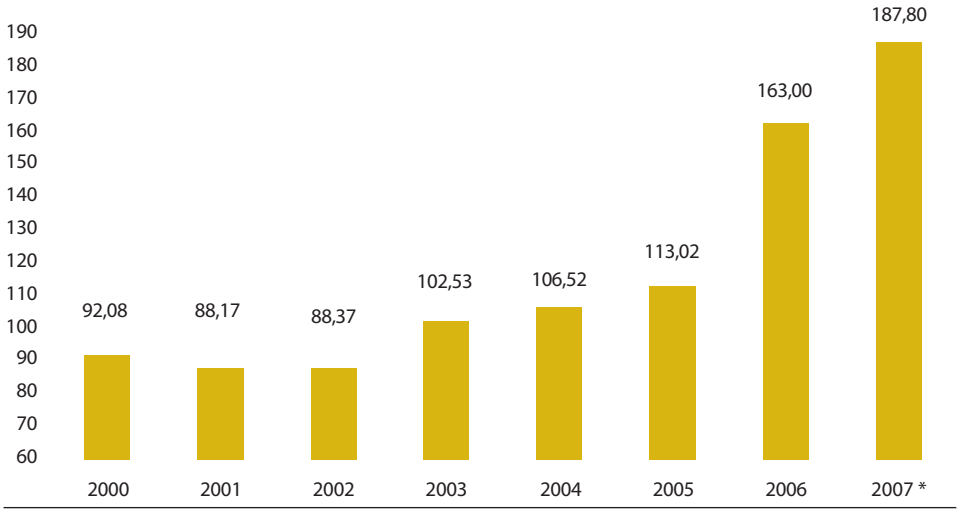
TABLE 23

Million euros	2004	2005	2006	Q3 06	Q4 06	Q1 07	Q2 07	Q3 07[1]
All exchanges	642,109	854,145	1,154,294	265,181	354,260	418,540	441,725	264,111
Electronic market	636,527	847,664	1,146,390	263,943	351,020	415,857	439,664	262,924
Open outcry	5,194	5,899	5,318	974	1,358	574	209	71
of which SICAV[2]	4,541	4,864	3,980	867	1,091	258	57	25
MAB[3]	-	-	1,814	93	1,705	1,771	1,605	933
Second market	21	26	49	11	20	122	22	35
Latibex	366	557	723	160	158	217	226	148
Pro memoria: non resident trading (% all exchanges)								
	57.6	57.1	58.2	58.3	59.3	59.3	na	na

Source: CNMV and Directorate-General of Trade and Investments.
1 Cumulative data for July and August.
2 Open-ended investment companies.
3 Alternative investment market. Data since the start of trading on 29 May 2006.
na: data not available at the time of preparing this report.

Turnover velocity[1] of the Spanish stock market

FIGURE 12



Source: CNMV and Sociedad de Bolsas.
1 Ratio of cumulative trading volume in the electronic market in the past twelve months and average monthly capitalisation in the same period.
* Data to August.

Brisk trading plus the lower capitalisation since May of the electronic market caused turnover velocity, the ratio between market trading and capitalisation, to quicken once more in the third quarter. At 187, this ratio was substantially higher than the record 2006 figure of 163 (see figure 12).

4.3 Listed company earnings

Despite the share price corrections of the third quarter, corporate earnings have continued to shine. On the latest data available, the aggregate pre-tax profits of IGBM companies rose 26.9% in first-half 2007 compared to the same period last year. Only nine of the 127 companies reported losses, for a combined amount that barely equalled 1% of aggregate profits. Divergences by sector (see table 24) are explained by differences in business performance but also by large-scale disposals and acquisitions at some of the top listed companies.

The only sector reporting lower pre-tax earnings was "Oil and energy" with a fall of 2.3%. The main culprit here was Endesa, which reported a 15.2% slide at this P&L line, though the cause was the absence of extraordinaries in 2007 compared to the gains booked the year before from its sell-off of telecoms firm Auna. In contrast, Iberdrola raised its profits 14.9% thanks to new acquisition Scottish Power.

Remaining sectors continued to grow their profits at a solid rate. Among the strongest performing was "Basic materials, industry and construction" specifically its "Construction" sub-sector which reported first-half profits up by 110.9% compared to the same period in 2006. All component companies shared in the advance, which in the case of FCC and ACS drew on divestments from Realia and Continental Auto respectively.

" Technology and telecommunications" also saw profits growth on a significant scale with Telefónica in particular reporting pre-tax earnings 54.9% up on the year-ago period.

In "Financial and real estate services" the "Real estate and others" sub-sector posted a 34.2% increase in pre-tax profits, despite red numbers at Astroc and Reyal Urbis, both of them still in profit during the same period in 2006[3]. Finally, the "Banks" sub-sector managed profits growth of 23.4%, notably Grupo Santander (+40.5%), Banco de Sabadell (+53.1%) and Bankinter (+98.7% on the part disposal of its insurance business).

Pre-tax profits[1] of IGBM companies

TABLE 24

Thousand euros, unless otherwise indicated	H1 2006	H1 2007	% annual change
Financial and real estate services[2]	**13,043,651**	**15,954,478**	**22.3**
Real estate and others[3]	753,610	1,011,481	34.2
Banks	11,044,277	13,626,850	23.4
BBVA	4,475,320	4,701,008	5.0
SCH	4,243,783	5,960,622	40.5
Oil and energy	**9,554,287**	**9,334,423**	**-2.3**
Endesa	2,715,000	2,303,000	-15.2
Repsol YPF	3,112,000	2,857,000	-8.2
Iberdrola	1,280,090	1,470,451	14.9
Basic materials, industry and construction	**2,673,535**	**5,412,728**	**102.5**
Construction	1,806,227	3,808,988	110.9
Technology and telecommunications	**3,336,238**	**5,269,800**	**58.0**
Telefónica	3,356,991	5,199,747	54.9
Consumer goods	**1,118,950**	**1,293,058**	**15.6**
Consumer services	**1,200,378**	**1,596,479**	**33.0**
Total electronic market	**31,796,099**	**40,341,245**	**26.9**

Source: CNMV and authors.
1 In the case of companies not belonging to a consolidated group, data are on an individual basis.
2 In the case of Metrovacesa, figures for the two periods correspond to the percentage of the company's capital that will continue to be exchange quoted.

3 Astroc went from profits of 99,338 thousand euros in the first six months of 2006 to losses of 75,521 thousand euros in H1 2007. Reyal Urbis reported 8,699 thousand profits in H1 2006 and 63,908 thousand losses one year later.

Independent financial regulators

Gonzalo Gil (*)

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1 Introduction

In a well known article, the authors state that "clearly politicians do delegate substantial decision power, but then, and this is the second question, why? Two are the potential answers. One is 'optimistic' and relates to the need for divisions of labour, allocation of skills, etc. Others are more cynical... and the type of delegation chosen is the one that maximises the benefits for elected politicians rather than social welfare..." that is, "they might want to delegate tasks that expose them to risk with few advantages (maximizing rents, strengthening coalitions, etc.)" (Alesina and Tabellini, 2005).

Whichever explanation we see as likelier, the optimistic or the cynical, the point is that delegation should be real and effective. Delegation as a means to offload political risk or to maximise social welfare, in its broadest sense, can end up equally beneficial or damaging for both politicians and the public good.

This article looks at the how best to organise delegation to independent agencies that operate as such, but are at the same time accountable for their actions.

In essence, the characteristics stated are valid for any type of independent agency to which the Government "delegates" certain powers (an energy watchdog or anti-trust commission, or a financial agency).

Each of these organisations will have its own characteristics as well as a number of elements in common. This article focuses on financial system regulatory/supervisory agencies (henceforth agencies), the latest to appear on the scene[1].

2 The origins of regulatory/supervisory agencies

The issue of independent agencies, their rationale and their ability to operate within a democratic political framework without infringing its basic principles has been the motive of long debate as well as of successive changes in the history of each country; a process spearheaded by the United States in which the European countries, Continental Europe in particular, have arrived late and in some disarray.

Politics and administration are not two separate spheres of action and those entrusted with their conduct cannot act as if they were. Agenda setting may be a prerogative of political power but no agenda, it is logical to think, can be carried

1 The text refers to the independent regulatory/supervisory agencies working in the financial sector. For the sake of simplicity, I refer to them as regulatory agencies though they usually perform both functions. They are what in the Spanish legal system are known as independent authorities.

forward in a vacuum. And nor can the agencies charged with executing and administering determined tasks remain wholly aloof from the design of policy objectives. In other words, there must be an interaction between the political authorities and independent regulatory agencies.

Majone (1993) puts it thus: "A top-down process of policymaking in which the administrators would derive specific programmes deductively from general policy goals decided at the top is practically impossible, and undesirable too". But by the same token: "a bottom-up approach in which the political executives would renounce the responsibility of setting general policy goals is impossible — since bureaucrats do not have the requisite information and decision criteria — and also undesirable, since it would greatly complicate the problem of political accountability".

Attempts to resolve the dilemma between the need for this kind of independent institution, with a specific remit and the technical skills to manage complex and changing situations, and the risk that they might end up as a sort of unaccountable "fourth branch" of government, have gone though many different stages, during which the role of agencies has met with varying degrees of acceptance or rejection[2].

It was not until well into the 1980s that, for a series of practical and theoretical reasons[3], the focus of analysis and debate shifted from whether or not these independent agencies could be subject to democratic control to the acceptance that such control is an objective fact and the real question is how to employ it.

The approach underlying the exercise of democratic control over these independent institutions is what we call the "dialogue model". A solution whereby policymakers and agencies establish different levels of communication channels characterised by the complete absence of ambiguity in the instructions and suggestions conveyed. This model, which I will come back to later, goes a long way to resolving the above dilemma. Its institutional articulation calls for a series of key informal elements which will operate more or less forcefully depending on the unyieldingness or acceptance of each country's constitutional, administrative and political traditions and the way they translate to practice.

The question of tradition is central here, and largely explains why Europe was slow to set up regulatory agencies compared to the United States (Majone, 1993) and indeed has only recently overcome a widespread resistance to their existence[4].

2 See (Majone, 1993) for a detailed analysis of these vicissitudes; above all the case of the United States in comparison with developments in Europe.

3 Among those expressly cited: "developments in formal modelling of the control problem; statistical analyses correlating time series of agency outputs with various indicators of the orefernces of political principals; design of control mechansims as a practical application of the theory of 'new institutionalism'; the rise to power of political leaders like President Reagan and Mrs. Thatcher committed to the goal of rolling back the state and reducing the power of 'government bureaucracies'…. From a theoretical standpoint, the developments in the application of the economics of organisation and in particular of agency theory to the study of bureaucratic discretion" (Majone, 1993).

4 "….instead, important regulatory functions were assigned to some obscure office buried in the bowels of a large ministry or to an interministerial committee efficiently protected from any kind of judicial review or independent scrutiny. Hence the low visibility of regulatory policymaking in Europe" (Majone, 1993).

3 Why agencies are at the centre of interest

Various factors explain the resurgence of interest in this kind of agency over the past few years. Firstly, it is acknowledged that the 1990s crises and their speedy contagion could, in many cases, have been better handled by an independent regulatory presence (Quintyn, Taylor, 2002). Put succinctly: "policymakers in the countries affected have sought to intervene in the work of regulators — often with disastrous results. It is now increasingly recognised that political meddling has consistently caused or worsened financial instability." (Quintyn, Taylor, 2004).

The appearance of these crises and their rapid spread also lent new importance to the work of international organisations in drawing up generally applicable standards and rules of conduct. This period also witnessed the first steps of the Financial Sector Assessment Program (FSAP) exercises implemented by the International Monetary Fund (IMF) and the World Bank (WB) and whose impact I will deal with later.

Perhaps not directly caused but certainly influenced by the crisis were the major changes made in the ensuing years in financial markets and systems, accompanied by no less radical changes in regulatory and supervisory systems both nationally and internationally (Gil, Segura, 2007).

Finally, the fact that the Central Banks (CB) had advanced so fast down the path to independence proved an added spur to agencies' development. In some cases, regulatory agencies were set up within CBs and therefore "infected" by their independence. Others had a separate existence but took the CB as their model.

4 Distinguishing traits of financial vs. other agencies

The overall objectives of regulators/supervisors are to ensure the stability of financial institutions and the financial system as a whole. The regulations the Government hands down to this kind of agency have the twin goal of protecting the consumer, i.e., the clients of financial institutions, and favouring the upkeep of financial stability, which is deemed to be a "public good".

The constituency of financial agencies has certain singular characteristics that set them apart from peer institutions in other sectors. Moreover, their actions have far greater repercussions both in intensity and in the breadth of interests they potentially affect; and all this before any decision has been taken. This calls for good governance criteria that are not only different but also stricter than those applied elsewhere in the regulatory industry.

In effect, the financial system comes under closer and tougher supervision than remaining sectors. Regulators/supervisors do not just engage in off-site monitoring and analysis, they are also continually carrying out direct, on-site

inspections and, above all, "may intervene when banks fail to meet minimum requirements designed to ensure their financial soundness. They may even, in extreme cases, take ownership rights away from the owners of failed or failing institutions" (Quintyn, Taylor, 2004). In other words, supervisors wield the "coercive power of the State against the private citizen when they revoke bank licences" (Lastra, Word, 1999).

Finally, supervisory processes vary in nature from one sector to the next. Supervision in non financial sectors is generally more concrete and acts when signs emerge of non compliance, whereas in the financial area supervisory actions tend to be intense, ongoing and, in many cases, prior to external symptoms of distress.

Although most of the analyses that follow apply to all regulatory agencies working in the financial system — insurance, securities, banks – they are certainly biased to the last of the three. Some of the issues discussed may be valid to all, but this should not blind us to the fact that the goals of each agency and the way they translate into practice are not the same in every sector, and this may have implications for the good governance structure applicable in each case.

Hence securities regulators' paramount concern is with the efficient operation of the markets, while their bank system counterparts prize solvency and systemic stability and insurance agencies the protection of the policyholder.

Likewise, FSAP analyses do not just follow a checklist of blanket principles. They also assess compliance with specific codes: "Core Principles for Effective Banking Supervision" and the "IOSCO Principles for Securities Regulation".

But nor will it do to overstate the differences. All these agencies pursue a similar end, each in their own terrain, and the protection of consumers, investors or policyholders, more efficient, effective markets and enhanced soundness are all key considerations for the upkeep of financial stability.

5 Independent agencies

Once we accept the need for financial market regulation, the next step is to decide which institutional form best fits the purpose. The "delegation" of the regulatory and supervisory task is a popular solution if only because of the amount of specialist knowledge required, the need for a flexible operation that can manage change, etc., but there are other reasons of greater weight. Delegation can and, indeed, does take different forms. In some cases, delegation is channelled through some government department or an agency reporting direct to the Government. This system was fairly common in the past, when levels of economic and institutional development, democratic organisation and the sophistication of financial systems were far less than they are today. The alternative kind of delegation is the one covered in this article; namely, delegation to an independent agency.

This second alternative has some undeniable virtues in our modern financial systems, in that it "theoretically offers the advantage of potentially shielding market interventions from political interference and improving transparency, stability and expertise of the regulatory and supervisory processes, particularly when responses are needed for complex situations" (Quintyn and Taylor, 2002).

The independence of such agencies now seems generally accepted though not without some or many reservations. Their work is evidently "delegated" by the Government, causing genuine concern that they might turn into a "fourth estate" excluded from the checks and balances operating on other state powers in a democratic society.

For this reason, their institutional arrangements are of prime importance and must be carefully studied and designed. There are two pitfalls to be avoided here, each as dangerous as the other; firstly, political interference and, secondly, regulator capture by the industry. The political independence of agencies has aroused fears that they could pursue their own agendas, at odds with the political agendas reflecting the will of the parliamentary majority. Likewise, the existence of agencies with a deficient system of accountability (unbalanced independence) could facilitate their capture by lobbyists or private interests. In effect, given that "industry, as a rule, captures regulation and uses it to its benefit" (Stigilz, 1971), agencies must be regulated so as to ward off this danger.

The risk of their becoming a "fourth estate" unbound by the restraints affecting other state powers requires careful handling in which "informal elements" play or should play a crucial part. The factors at work here are not easy to pin down. Because what decides whether a country is able to attain real regulatory and supervisory independence is first and foremost its political culture. If it lacks longstanding, transparent political institutions with clear divisions between the three powers; if civil society, politicians and the media are not at home with institutions, financial or otherwise, exercising balanced independence; if its system of constitutional checks and balances is failing in its purpose, then the Government will be hard pressed to establish independent agencies equipped with the formal mechanisms to ensure their effectiveness.

Still on the subject of what we might call the preconditions for designing an effective frame of reference for these independent agencies, it is worth pausing to consider certain often misunderstood points. First of all, independence can never be absolute. No such situation can ever exist and it would be foolish to think otherwise. Hence the importance, as we will later discuss, of establishing formal, transparent reporting mechanisms. For an agency to perform effectively, it must be in constant contact with interlocutors of every description. Obviously it must maintain communication channels with the organisations doing business in the markets it supervises, but it should also "as a good governance principle, stay in contact with political realities while fulfilling its mandate" (Das and Quintyn, 2002).

The available evidence on the performance of these agencies suggest it is only in rare cases that they act irresponsibly, with most opting to establish a dialogue model for their dealings with political authorities. Some authors (Majone, 1993,

Das and Quintyn, 2002, among them) have stated that "One of the currently prevailing theoretical models on the interaction between political authorities and independent agencies is the "dialogue model", which supports the view that regulators (even statutory independent ones) should do their best to be informed about the intentions, wishes and opinions of the political leadership and to anticipate their reactions to new policy proposals. In other words, the model indicates that independent regulatory agencies are subject some form of political control – almost self-imposed censorship". Obviously, this thinking should be enlarged to contacts and information flows, in both directions, with all participants in relegated markets.

The same line of thought can be expressed more colloquially as follows: "What does independence mean? Does it mean not talking to anyone about the problems to be addressed? Only a fool would think the best decisions are taken in isolation, with the least possible information. Those who must take decisions and abide by the consequences have not only the right but also the obligation to procure all relevant information and hear the arguments and opinions, firstly, of their own expert staff, but also of all stakeholders, including the industry as the case may be, other supervisors and the regulator, i.e., the Government. They may all have an interest in capturing the supervisor, and all are potentially implicated in conflicts of interests. Be apprised of their arguments and views, but do not accept instructions" (Segura, 2007).

The above, as stated, should be seen as the ideological and political foundations, the necessary subsoil for independent agencies to function properly. They inevitably confront us with the "human and political factor", so run the risk of being viewed, in the best of cases, as good intentions more or less prone to bending with the dominant wind. They are also the reason attention has shifted in the past few years towards building up a formal, transparent institutional structure to demarcate agency operations and make them accountable as well as independent. The purpose being to at least mitigate, if not wholly eliminate, the risks attached to the “factor” in question.

6 Institutional arrangements

The institutional structure sustaining these agencies requires a number of interacting elements which must combine to maximise performance efficiency while avoiding the risks outlined in the preceding pages. In the second half of the 1990s, the way agencies were regulated was subject to heavy criticism regarding the supposed imbalance between powers and controls. The argument ran in the following vein ".... The American experience shows that a highly complex and specialised activity like regulation can be monitored and kept politically accountable only by a combination of control instruments: legislative and executive oversight, strict procedural requirements, public participation, and, most importantly, substantive judicial review. Measured against these standards, regulation in Europe is seen to be highly discretionary, suffering from weak

accountability to Parliament,... absence of procedural safeguards and insufficient public participation" (Majone, 1994).

Discussions at the time — mainly the academic, parliamentary and political debate around the new financial services authority (FSA) then getting off the ground — started from the tried or at least trusted procedure whereby regulatory agencies were accountable to Parliament through the medium of the relevant minister. But this principle was more and more called into question[5] and a new, more complex model began to emerge which did not rely exclusively on the traditional reporting line.

There is broad consensus around the elements that should underpin a supportive institutional structure for these agencies to do their work. These elements are: independence, accountability, transparency and integrity. Although the academic literature views independence and accountability as the core principles of good governance, the remaining two, transparency and integrity, are overlapping principles that at the same time add strength and coherence to the whole. Independence without these two qualities would have unacceptable results or, more plainly, would not exist. The play of all these elements is also necessary because independence has two dimensions: independence from political power, but also independence from the industry concerned as we remarked in a previous section (Quintyn and Taylor, 2002).

6.1 On independence

Empirical evidence supports the view that operational independence is vital for these agencies to function (Quintyn, Ramírez and Taylor, 2007)[6].

Unlike the CBs, whose independence is in almost all respects a battle won, the supervisory/regulatory agencies are still fighting for their ground. Hence the frequent reference in the relevant literature to the experience and achievements of most CBs (Fischer, 1995)[7]. Broadly speaking, the idea is to equip this kind of agency with the powers it needs to proceed autonomously in establishing technical standards and regulations, within the framework set by law; that is, to enjoy full freedom of action in the sector under supervision/regulation.

The nature of the regulator/supervisor's work, its complexity and degree of specialisation along with the speed of change in financial systems and in the issues agencies are called on to addresses means this is not a suitable job for a Government or some ministerial committee. This is why it is entrusted to agencies who are in a position to act swiftly, consistently and knowledgably in furtherance of their legal mandates.

5 "The traditional approach whereby regulators are accountable to Parliament through the relevant ministers fails to convince, representing a vision that is profoundly wrong, frequently absurd, extremely cumbersome and at times even harmful, as it blocks the development of genuine instruments to ensure accountability". C. Foster "Two concepts of accountability. Is a bridge possible between them?" (Public Policy and Management Association, 1999).

6 Note that in the IMF's financial sector assessment exercises, operational independence is one of the "Core Principles for Effective Supervision" least likely to receive a "full compliance" score.

7 The reference to CBs allows a distinction to be drawn between independence in setting objectives and operational independence. "The most important conclusion of both the theoretical and empirical literatures is that a central bank should have instrument independence but should not have goal independence" (Debelle and Fischer, 1994 and Fischer, 1995).

At the same time, the political lawmaking process is of necessity a slow one, subject to numerous interferences, so it is more practical and useful for the agency to take charge of regulatory output and/or amendments in the light of the political objectives of the day. A regulatory process along the lines of Lamfalussy could be just as effective in this terrain as it has proved to be in the preparation of EU directives.

These arguments are taken further in the literature on time inconsistency: "the time-inconsistency literature tells us that it is indeed very difficult for political executives to commit themselves credibly to long-term strategies and solutions. Politicians live with the short-term cycles of elections and their horizons usually do not go beyond the next election. In addition, politicians face another commitment problem in that they cannot bind a subsequent legislature and government, making public policies vulnerable to reneging and therefore a lack of credibility " (Majone, 1997) (Das and Quintyn, 2002). The delegating of regulatory power to an independence agency is a way to overcome this kind of government credibility gap and stands in itself as proof of good governance. Moreover, agencies may carry their work out more effectively if they have helped write the regulations they are called on to apply (Das, Quintyn, Kauffman, 2000 and others).

Although the power delegated to agencies has a number of checks that we will later discuss in detail, there is one constraint where the state of the art remains primitive, despite its growing importance. This is the condition, that before implementing any regulation, agencies should determine its cost for the industry or, in more precise terms, carry out a cost/benefit analysis.

In sum, the study of independence must consider four facets of the same: institutional, regulatory, supervisory and budgetary.

The sections that follow offer a brief analysis of the considerations influencing each.

6.1.1 Institutional independence

The founding statutes should define it as an institution independent of the political powers with regard to its activity. The key elements expressing this independence are:

a) **Clear rules for the appointment and removal of the institution's senior representatives and members of its governing boards.** In both cases unforeseen problems can easily arise due to what, in accounting terms, are referred to as "intangibles". But the basic criteria are obvious enough: ensure the agency is headed by suitably qualified professionals with experience in the sector, and establish removal procedures relating solely to the competence and probity of governing bodies; never to the concrete decisions they might take, i.e., to possible discrepancies with the policies laid down by those appointing them.

b) **A specified tenure.** Tenure should be assured for a reasonable period, that is, not too long a time; probably 6/7 years but without quibbling over one more or less. It is more important to have clear rules on non renewal and the decoupling of renewals from the electoral calendar.

c) **Appointment by the executive and initial parliamentary appearance.** Other possibilities have been tried and mooted. Appointment by the executive power gives the agency more security and support and sets it working along clear lines from the outset, which should not give rise to any later difficulties providing accountability rules are sufficiently sound. Also, the executive is directly responsible for legislation and its approval process; not forgetting that membership of the European Union — where financial affairs occupy a prime position — puts important demands on countries in terms of national and international coordination. In this context, the ministerial department responsible is best placed to fulfil a coordinating role, with the agencies providing vital input. Of course, going back to the "intangibles" mentioned earlier, this option too can prove problematic if the selection is for the wrong reasons (Majone, 1993)[8].

Parliamentary appointment can prove trickier — and there are abundant examples of this — because other discussions tend to get lumped in with those referring strictly to the work of these agencies, with the counterproductive effect of isolating them from political debate. And a joint Executive-Legislative appointment would not solve the problem. The "two bosses" solution has never been a good one, either here or in any other financial institution, because of the ambiguity it brings to institutional life.

d) **Governance structure: collegiate bodies with the involvement of reputed professionals.** Chairman and Vice Chairman should be appointed by the Executive on its own initiative and responsibility though seeking to recruit the broadest possible support. The Chairman should be the maximum authority even though decisions are taken on a collegiate basis. Care should be taken to ensure Chairman and Vice Chairman work in tandem without pursuing any offset between them other than in technical skills and other complementary aspects. The Chairman should accordingly have a large say in vice chairmanship nominations. This can be organised different ways, all of which will be equally valid if they guarantee the above outcome.

The effectiveness of Boards — their composition, functions and member selection — is vital to the success of regulatory and supervisory agencies. A well defined Board is a key ingredient of agency good governance and a spur to the internal accountability that is one of the best guarantors of independence.

The model of Board (or Boards) chosen will largely depend on each country's institutional make-up and its degree of socioeconomic and financial development. It makes little sense, given the diversity of cases, to catalogue and evaluate each individually; there are, however, some general ideas that bear closer consideration.

8 "The most important instrument of executive control appears to be the power of appointment and removal. Wood and Waterman (1991) note that 'the Reagan presidency more than any other epitomised the use of political appointments to affect political control. The Reagan transitino team spent months screening those who would serve, emphasising loyalty and ideology above all other attributes'".

Board members (independent or non executive directors) tend to be appointed by the Government "on the sole basis of their individual integrity and experience"[9]. Although their exact functions will depend on the way each organisation works, they will normally be appointed for a specified tenure, with or without the possibility of renewal, and their rotation will be staggered so as to ensure continuity and so they exercise true independence in the discharge of their functions.

At times the model differs and Boards will have directors not qualifying as independent in the above sense. These are individuals who combine directorships in the institution in question, whether independent or state controlled, with the exercise of similar functions on the Boards of other public bodies. Such situations most commonly arise from a strategy of closer coordination between different institutions or as part of a process of agency merger or transformation. They tend to be temporary by nature, either because coordination efforts have switched to a more efficient route (cooperation agreements for instance) facilitated by financial sector development, or because the merger or transformation has come to a close.

Although useful, these mechanisms carry certain risks in that "circumstantial" directors could find themselves taking part in decisions for which they are technically unprepared or which cause them a conflict of responsibilities.

The appointments of chairmen, vice chairman and directors are crucially important, but no less so are the selection of qualified staff to do the agency's work and an efficient model of internal organisation. Political interference frequently preys on organisational defects and can be neutralised, where it exists, if agencies have the right working mechanisms and processes in place. The institution's reputation hangs on its technical expertise, which must be the mainstay of its organisation[10]. A good reputation is of enormous help in the tasks of regulation and supervision, which gain not only in efficiency but also in flexibility. It is a fact that "moral persuasion" and negotiation, with the attendant legal coverage, are effective means for agencies to meet their objectives, but they will only do their work if the institution's prestige is beyond reproach.

e) **The question of transparency.** Transparency can take multiple forms and its virtues are still hotly debated. That said, all or nothing is rarely the best approach and there are many cases where it can be usefully applied. A sensible solution would be to admit that there are some decisions where transparency is out of the question, and others involving the setting of conditions or adoption of a given stance whose disclosure is beneficial

9 This obviously means discarding other ad-hoc criteria like the need to cover certain quotas. "But can the Parliament and Government of any serious state really go around negotiating the appointments of magistrates, board members, directors and other key figures of the political Parnassus with the territorial governments of that same state?" (Sosa Wagner and Sosa Mayor, 2006).

10 And there is nothing more vulnerable than an institution's repute; as powerful an instrument as it is elusive. One of the speakers at a CEMLA conference expressed this idea graphically if rather idiosyncratically, remarking that: "Institutions gain repute in the time it takes for the palm tree to grow, and lose it in the time it takes for the coconut to fall".

and should be mandatory. We should also bear in mind that the tensions between transparency and confidentiality are considerably greater at an independent regulatory agency than a CB: "whereas the reasons for monetary policy decisions cease to have any commercial sensitivity or importance after a very short time, the same is not true of regulatory decisions. In the course of an enforcement procedure, agencies must protect the interests of all stakeholders and ensure the fairness and impartiality of the process. Publicity could negatively affect the conduct of investigations and prevent impartial decision making" (Hüpkes, Quintyn, Taylor, 2006).

Another take on transparency is that which links its degree of enforcement to the effectiveness of market discipline. This discipline can of course greatly facilitate the supervisory task in cases where the market itself is able to judge issuing companies by the quality of their risk management.

For market discipline to exercise this discriminatory role with regard to risk, market participants must have ready access to all the right input information. And a fluid interaction between market and supervisor is essential to this end.

The Basle Committee on Banking Supervision underscores this need for joint action when it states that "the complementary interaction of prudential supervision and market discipline is critical to promoting the long-term stability of both individual institutions and banking systems. The effectiveness of the interaction depends greatly on meaningful public disclosure" (Basle 1998).

6.1.2 Regulatory independence

Referring to agencies' capacity to establish the rules and regulations applicable to financial institutions in the conduct of their business so as to safeguard the soundness and stability of individual institutions and the system as a whole. Political lawmaking is by nature a slow process and subject to interferences, political or otherwise, which may draw it out unnecessarily. For this reason, agencies should be charged with the design of regulations, informed by the policy objectives of the day, thereby also ensuring they can be amended at speed as and when the need arises. It is widely acknowledged (the ownership argument) that regulator-made rules are much easier to enforce and, above all, to change.

This play of powers and necessary balances also poses some risk of overregulation, such that regulatory output is hindered by the sheer weight of the formalising apparatus. Graver still, the regulator's attention can end up being diverted elsewhere, leading to "the breakdown of the regulatory process, which can no longer protect people against arbitrary action" (Hamilton cited by Page, 2001).

The risks of overregulation can be offset by internal rules, as in the case of the FSA, but striking the right balance is far from easy. Indeed "because the measure of success of regulators is the prevention of disasters, there is a natural tendency for a regulator/supervisor to try and insure against bad outcomes... by overregulation

and oversupervision and, if something then does goes wrong, by trying to prevent that outcome being recognised as a failure" (Goodhart, 2001)[11].

The FSA was also the opportunity to try out new formulas for a balanced regulatory system. This institution has been invested with very broad powers which it conserved throughout the corresponding parliamentary discussions albeit with a series of checks imposed. Aside from safeguards relative to consultations with the supervised industry, the publication of drafts, discussion groups around proposed measures, reasoned explanations of each measure and its purpose, etc., these included two obligations not hitherto imposed on a regulatory agency: the obligation to accompany each measure with an analysis of cost/benefit and its compatibility with the FSA mandate, and an analysis of competition impact.

An important element, though one which other regulators have been slow to take up, is that all draft regulations should be subject to a cost/benefit analysis, providing an internal check on whether they are really needed. It is a plain fact that excessive regulation lays a heavy cost burden on regulated entities, which in some cases comes on top of the costs of financing the supervisor itself. Overregulation and the associated costs exert a negative impact on the financial system and, ultimately, on the whole economy, by eroding the competitiveness of obligated entities and discouraging new investments.

In furtherance of its statute, the FSA applies cost/benefit analysis to diverse aspects of its regulatory activity. This analysis also considers the broader economic context, specifically the need to carefully distinguish between regulatory impacts that divert resources from one group to another and those that leave their market on the real economy (Simpson, Meeks and Klumpes, 2000).

6.1.3 Supervisory independence

Academic theory and practical experience concur that this facet of agency independence causes the most complications and is hardest to implement. Yet supervisory independence is the most crucial of agency responsibilities, as the best guarantor of the proper functioning of the financial system and, thereby, of the country's financial stability.

Supervision spans a range of agency activities in respect of financial institutions, from the granting and revocation of bank licences to the opening of disciplinary proceedings and the issuing of sanctions or reprimands, by way of on-site and off-site inspections.

The exercise of supervisory activity is informed by one characteristic that conditions it strongly but is also the key to its effectiveness. And that is the confidentiality that must govern all dealings between supervisor and supervised. Given the nature of financial systems, their exposure to contagion and vulnerability to news and

11 This can come about through too easy a tolerance of the supervised entities. This may produce profitive results in some cases, but it can also cause systemic losses. Goodhart puts it thus: "The question is how regulators should try to achieve the 'optimal' extent of financial losses. Note that the optimal will always be greater than zero, since the cost in intrusive supervision, restrictive regulation and constraints on competition and innovation of trying to bring losses absolutely to zero will always outweigh in costs to the financial system the benefits that might be achieved by preventing all possible losses".

rumours (true or false), enhanced discretion is required. The literature alerts to the danger that this necessary confidentiality could encourage interferences that will be less visible and, therefore, more damaging.

But this does not seem sufficient reason to question the absolute need for confidentiality, remembering that when independence is exercised in tandem with other qualities, like accountability, the above problem disappears.

There are some specific points to make on the subject of supervisory independence:

The supervisor should have the last word with regard to the granting and revocation of licences, as the sole actor with the capacity and means to know and pronounce on "who gets in" (characteristics of the candidate, financial capacity, projects proposed, wider considerations regarding the system as a whole, etc.) and "who has to leave", obviously once all procedural rules have been properly observed. Any limitation on this power of the supervisor will tend to weaken its position, encourage undesirable interferences from other government bodies and complicate administrative processes; and all this in the best-case scenario that the parties involved coincide in the final decision. This point was at the core of one of the IMF recommendations ensuing from its FSAP exercise on Spain (FSAP, 2006).

Other conditions must also be present for supervisors to fulfill their missions. Among the most importance is legal protection. Naturally, there must be a right of appeal against their decisions and all relevant procedures before the courts must be strictly adhered to. That said, it makes sense to avoid long, drawn out judicial proceedings which generate a climate of distrust, force institutions to conduct their business under non optimal conditions and can end up harming them more with a ruling in favour, because of the time and resources consumed and the interim damage to their image with clients. In such cases, the system as a whole suffers the consequences, as does the supervisor's reputation.

Supervisors should be in a position to offer reasonable salary levels and a transparent career structure (including lifelong training), in order to conserve skilled, experienced human resources and prevent specialists being "captured" or "poached" from within the industry.

The last point to consider is the difficult but necessary reconciliation between supervisory discretion and flexibility and the equitable (not equal) treatment of supervised entities. This is something that often causes confusion and merits further discussion.

The actions of the supervisor must be predictable and respond to known if not invariable criteria (Segura 2007). They have to be lasting in order to lay a solid groundwork for future initiatives, but must also be open to change as market circumstances require provided such changes are fully disclosed — through the good medium of transparency — as quickly as possible.

Equality for all is not a useful criterion, since it can prove unfair as well as impractical. Supervisory actions should be neutral and symmetrical but not the

same for all without regard to individual circumstances. "Supervised entities must be convinced that any of their competitors in similar circumstances would be accorded the same treatment by the supervisor" (Segura, 2007).

Difficult, perhaps, but clearly necessary. And this difficulty may accentuate if we see a continuation of the current shift away from the traditional system based on a closed book of rules to a more open system based on principles. Indeed we may already be in a process of transition between these two models, with the FSA as its clearest exponent (McCarthy, 2007).

6.1.4 Budgetary independence

This last facet of independence is easily formulated but can also spell the difference between an effective and ineffective agency. Budgetary control and the ability to apply funds to the priorities decided by the agency are operational requisites of the first order. They allow agencies to carry out their functions and stay ahead of events with flexibility and without interferences. The traditional administrative procedures of the state administration, particularly with regard to staff hirings and incentive systems, but also others of a more bureaucratic nature like service tenders, etc., pose important constraints on the activity of regulatory/supervisory agencies. The nature of the terrain where they operate calls for a more agile framework, not to be confused with the absence of controls.

The models in current use are relatively simple. On the one hand, we have dependence on the state budget, which tends to keep agencies on a tight leash as well as exposing them to cutbacks at times of crisis. Another drawback can be the excessive burden of red tape. In such circumstances, agencies will face serious constraints in planning their mid-term activities and may suffer problems of continuity (political dependence).

One alternative is to finance the supervisory function through charges levied on supervised entities. The danger here is an excessive dependence on the industry. However, all said, it seems a better system than the preceding one. There is a risk that when the system enters crisis, precisely the time when the supervisor must be most active, the industry may be slow in meeting its payments. The FSA has used this financing system since its year-2000 reform. A combination of the two formats could help to get round some of the problems mentioned (Gil and Segura, 2007).

In effect, the other possibilities include mixed models of state and finance industry funding or even a different institutional arrangement whereby the supervisor is integrated within the CB and draws resources from its budget. This option has much to recommend it, uniting the advantages of the CB with the fact that financing flows would share "by association" in the acknowledged autonomy of the central bank.

6.2 On accountability

The existence of independent financial agencies has been frequently questioned, with suspicions centring on their broad powers and the fact that the independence granted them was insufficiently accompanied by mechanisms of responsibility (in the fullest sense) that ensured their accountability. The concept of accountability is a complex and rather elusive one. Not only that, its content has varied in recent years in response to a swiftly changing political, social and economic-financial environment which has imposed ever more stringent standards.

A series of circumstances relative to the way these agencies operate explains why their "accountability" is harder to define than that of other entities, CBs among them. On the one hand, the difficulty of the concept means it may be confused with "control", a mechanism wholly at odds with independence. In fact, accountability and independence are complementary and mutually reinforcing qualities. On the other, it is true that the powers invested in these agencies are complicated to apply, given their major repercussions on supervised entities and the sector as a whole and the presence of various "principals".

In effect, "although the legislative, executive and judicial powers are, for obvious reasons, the most important 'principals' for supervisory agencies, they are also directly 'accountable' to a larger number of 'principals' —including supervised entities, the clients of these entities, the public at large and peer organisations" (Hüpkes, Quintyn and Taylor, 2006).

The idea, then, is to establish mechanisms that act as countervailing powers and at the same time justify these agencies' independence, without in any way impairing its exercise. This can only be achieved through the play of complementary elements, of which accountability is just one more, leading to "a situation where no single element can control the agency, yet the agency is under control" (Majone, 1994; Moe, 1987).

All the facets of independence dealt with previously have their corresponding type of accountability. The fact of holding delegated powers from the executive and legislative branches — that is, institutional independence — makes the agency accountable to both these authorities. With the legislative branch, this involves a series of contacts and appearances as legally established, and at the authority's request when circumstances so demand. With the executive branch, such institutional communication channels should be supplemented by "a regular dialogue between the agency and the ministry of finance. Information about the supervised sector, however, should only be disclosed in aggregate format. No individual or confidential bank data should be shared under normal circumstances, and protection of the confidentiality of supervisory information is usually enshrined in law" (Quintyn, Ramírez and Taylor, 2007).

The regulatory power conferred by its original holders requires that agencies should operate accountability mechanisms with supervised entities and their clients. In cases where the agency is wholly or partly financed out of contributions from the industry, such accountability requirements will be stricter still. The publication of regulations and supervisory practices and the establishment of

consultation channels with supervised entities, regular reporting and, above all, the assessment of regulatory efficiency and its costs for the industry, are key elements of transparency: "transparency, consultation, participation and representation are powerful vehicles to establish and maintain accountability".

Given the immunity and protection that agency members usually enjoy in carrying out their supervisory duties, it is only fair that an important part of accountability should be the right of supervised entities to appeal against their actions through preestablished legal mechanisms. This right of appeal should also extend to the clients of supervised entities.

The simultaneous presence of all the above elements and the interrelation between them are what ultimately justifies the existence of independent agencies. As some authors have stated: "once we accept that accountability confers legitimacy, and that legitimacy endorses independence, it is clear that the relation between accountability and independence does not involve any trade-off, but is in fact a relation based on complementarity".

7 Empirical studies

Some few studies have sought to analyse how far we have progressed in recent times — basically the two decades spanning the turn of the century — towards endowing these agencies with the operational characteristics described in the preceding sections.

One such study (Quintyn, Ramírez and Taylor, 2007)[12] examines this progress from the standpoint of how far "independence" and "accountability" have gained ground in the exercise of agencies' activities.

The scope of the study is confined to agencies entrusted with bank supervision/regulation in countries that have undertaken a reform of their regulatory/supervisory systems in the reference period (32 in all, 13 on a purely legislative basis and the other 19 with additional institutional changes).

The study goes into considerable detail that we have no room for here, but among its general conclusions is that the commitment to independence is not without fissures and that there is some scepticism about agencies' "accountability", undermining its interaction with independence. The authors also find that politicians are loath to confer full independence on these agencies and frequently submit them to official controls under the false guise of "accountability".

Another empirical study (Arnone, Darbar, Gambini, 2007) with a different methodology uses IMF/WB assessment exercises from the time of their commencement to 2004 to analyse the relationship between the quality of bank

12 The study examines reforms from a stricly legislative standpoint, that is, without going into their practical application.

supervision and the governance rules of supervisory agencies. To this end, it examines compliance with the core principles for effective supervision (Basle principles) and compliance with the financial policy transparency code of good practices (IMF) along with the correlations between the two.

Its conclusions are along the same lines as those of the previous study, specifically: "we find a positive correlation between supervisor transparency and the efficacy of the banking system; moreover, more accountability and integrity on the part of the supervisor are associated with greater independence, which is associated in turn with fuller compliance with Basle principles".

8 The practice: international standards and assessment exercises

The thread running through all the preceding discussion has been the importance for the upkeep of financial stability of having financial systems[13] supervised and regulated by agencies uniting a given set of characteristics —"independence", "accountability", "integrity" and "transparency" — which play a fundamental role in the avoidance of crises or in crisis management should the need arise[14]. Regardless of the doubts uncovered in the aforementioned studies, it seems fair to say that the penetration of these ideas, and of the associated practices, has been steadily advancing in recent years.

Among the factors in support has been the good work of international organisations in establishing rules and standards for financial systems and the agencies entrusted with their regulation/supervision[15].

Valuable input has also come from a related source: the financial sector assessment exercises performed by the IMF and WB since the outbreak of the 1990s Asian crisis, and designed to encourage governments to apply the right policies to avoid a repetition of these events (to date over 100 countries spanning every continent have taken part in assessment exercises).

The Asian experience was also an object lesson in how easy it is for one country to "infect" another, accentuating the need for international cooperation in order to strengthen the foundations of the international financial architecture.

13 The same arguments apply, with the relevant adjustments, to agencies operating in sectors other than the financial system. Indeed these "others" have existed for a considerably longer time.

14 A review of the most celebrated cases in which agencies' deficiencies have contributed to the onset of financial instability can be found in various studies included in our bibliography. After an analysis of the same, Quintyn and Taylor (2002) conclude that: …"protection of weak regulations by politicians and forebearance as a result of political pressures (preventing the regulators from taking action against institutions that they were aware needed to be intervened) are the two most common types of undermining the integrity of the supervisory function". It bears mention that the cases in queston are: Korea, Japan, Indonesia and Venezuela.

15 The most important of these codes are those drawn up by the three sectoral organisations: banks, markets and insurance respectively: Core Principles for Effective Banking Supervision (Basle Committee on Banking Supervision, BSBC); Principles of Securities Market Regulation (International Organisation of Securities Commissions, IOSCO); Insurance Core Principles (International Association of Insurance Supervisors, IAIS); and, additionally, Core Principles for Systemically Important Payment Systems (Committee on Payment and Settlement Systems, CPSS); Code of Good Practices on Transparency in Monetary and Financial Policies (IMF).

Drawing on their own rules and the rules and guidelines of other organisations like those just mentioned, these exercises have served to improve the resilience of financial systems. Their importance, as such, cannot be underestimated[16]. The undertake an independent assessment of all aspects of the financial system in search of potential weak points, and though it is up to national authorities whether or not to publish all of the final report, the IMF recommends the publication of all the tests run and results obtained (as happened in Spain) so markets are cognisant with all the risks. Such reports also provide an excellent opportunity for closer international cooperation, one of the founding goals of the FSAP initiative[17].

Their methodology is aligned with the programme's objectives; namely "to measure system capacity and resistance, reduce the probability of systemic crises, limit the severity of any crises that may occur and resolve the weaknesses identified" (Baliño, 2006). Their tools are quantitative — stress tests, system health indicators — and qualitative — evaluation of compliance with rules and guidelines and the robustness of mechanisms in place to prevent and manage crisis episodes[18].

9 Summary

1) Regulation is the third main instrument governments use to work to their objectives, along with taxation and public spending.

   Regulation is basically generated in and around the Government and its ministerial departments, since this is where the authority is lodged. However, for reasons discussed in this article, the Government may at times prefer to "delegate" a part of its powers, by means of established legal and parliamentary procedures, to independent institutions acting in specific areas. This "delegation" and the existence of independent regulatory agencies has moved in and out of favour, though since the nineteen nineties their presence has become an increasingly accepted fact.

   This article is concerned with a specific type of independent agency, those operating in the financial sector, but the observations it makes are in essence applicable to other agencies engaged elsewhere (energy, competition protection, etc.). It is now generally acknowledged that this kind of regulatory/supervisory agency, established with all the proper guarantees, is vital to the upkeep of financial stability, itself considered a "public good".

16 A detailed anlaysis of how these exercises work can be found in Baliño (2006). A description of their application to Spain is provided in "El Banco de España y la Evolución del Sistema Financiero", sundry authors (2006), and a discussion of their contribution to stability and development in Garrido (2005).).

17 Intenational cooperation is also favoured by the make-up of the teams performing the FSAP exercises; normally 10/15 persons headed by IMF and WB officers and including experts from different countries. In the case of the Spanish exercise (2006) members were of varying provenance: Comptroller of the Currency (USA), Banco de la Reserva (Peru), Securities and Exchange Commission (USA), Autorite des Marches Financieres (France), Comisión Nacional de Seguros y Finanzas (Mexico) and Riskbank (Sweden).

18 For a wider analysis of the financial system resistance tests undertaken in the programme, see Blanco, Roberto and García-Herrero, Alicia (2004).

2) The crises of the 1990s and their rapid contagion, the absence of this kind of agency (plus the presence, at times, of political interferences) and the speed of change in international financial markets were seen to call for a battery of measures, among them the strengthening of independent institutions.

   Their development received a decisive stimulus from two separate quarters: firstly, the work of international organisations in drafting standards, rules of conduct, etc., of international application; and, secondly, the start-up of IMF/WB financial sector assessment exercises which advocated the creation and strengthening of independent regulators/supervisors in all subject countries.

3) Since the above transition period, the need for agencies has been more or less beyond dispute; hence the theoretical literature and empirical studies have shifted their focus from the rationale for independent agencies, whose value they now take for granted, to the conditions most supportive for the optimal exercise of the regulatory/supervisory function. This objective, though complex, can be straightforwardly expressed: the establishment of independent entities that do not however act like a "fourth estate" neither answerable nor subject to the rules of democratic control.

4) The approach underlying the exercise of such democratic control is a "dialogue model" whereby policymakers and agencies establish different levels of communication channels characterised by the complete absence of ambiguity in the instructions and suggestions conveyed. There is an important point to make here: the independence of such agencies can never be absolute under any circumstances. For an agency to do its work properly, it needs to be in regular contact with a variety of interlocutors. This includes the obvious information channels with supervised entities, market participants and the intermediaries engaging with the investor public, but contact should also be maintained, as a good governance principle, with the political realities of the day, so agencies know the desires and intentions of the political class and become skilled at anticipating their reactions.

   Starting from this premise, the configuration of agencies requires careful thought in which informal elements — to do with constitutional, administrative and political traditions — play a crucial part. These elements frequently depend on intangible or unquantifiable properties. In effect, it is a country's political culture, more than any other factor, that determines whether or not it can attain true regulatory and supervisory independence. If a country lacks longstanding and transparent political institutions, with clear dividing lines between the three powers; if the idea of institutions with balanced independence has not taken deep root in its civil society, political class and mass media, and if its system of constitutional checks and balances is not functioning in practice, then it will be far harder for this kind of institution to find a real and lasting place.

5) Most of the foregoing considerations refer to the "human and political factor" so are at risk of being judged, in the best of cases, as good intentions prone to bend with the prevailing wind. Hence the need for a formal, transparent institutional arrangement that lets them go confidently about their work.

6) There is a broad consensus about the right ingredients of this arrangement: independence, accountability, transparency and integrity are the core principles on which agencies should base their operation. Independence and accountability are seen as the twin pillars of agency "good governance", while transparency and integrity are overlapping qualities that add strength and coherence to the whole. All four elements applied together are an assurance of agency excellence as regards building the resilience of financial institutions and reinforcing their individual stability and that of the financial system as a whole.

7) The action of these independent regulatory agencies has been an important force for the upkeep of financial stability whenever the above principles are correctly adhered to. That said, an institutional structure, however perfect, can prove instrumentally sterile — unbalanced independence — if what we refer to as the "human and political factor" is sceptical about the instrument's worth. It may be fitting, then, to close this article with the same reflection made at the beginning: whatever the motivation behind it, optimistic or cynical, the point is that delegation should be sufficient and real.

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The consolidation of international stock exchanges

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1 Introduction

International stock exchanges are moving to adapt their structure and operations to the far-reaching changes of the last few decades. One of the most significant steps in this process has been exchange demutualisation whereby management companies have regeared their strategies to the goals of profitability, efficiency and the competitive satisfaction of member and user needs. Technological advances and the liberalising bent of European Union legislation have weakened the traditional monopoly of the exchanges by allowing alternative trading systems to compete on an equal footing with the old-style bourses.

Competition between international securities markets has also hotted up considerably, and strategic integration movements have become increasingly the order of the day as exchange managers cast around for new ways to strengthen their competitive position. The consolidation process continues as we write and future developments are hard to predict. To date, the main mergers underway are those involving NYSE-Euronext and LSE-Borsa Italiana.

This article offers an overview of the processes of change on international exchanges. We look firstly at the factors driving the transformation of markets and their impact on sector competition, before going on to examine the consolidation and integration options available to markets, with their attendant advantages and drawbacks. The main strategic moves concluded or planned in exchanges and derivative markets are dealt with in the following section. And finally, we consider the regulatory challenges posed by these changes, and what the authorities must do to prevent any impairment of market integrity or investor protection.

2 Market competition and integration

International stock exchanges now operate in a far more competitive environment than a decade ago. The changes have been radical in nature and will continue to be so in future years. Numerous factors have combined to intensity sector competition: among them, the demutualisation of exchange management companies, technological advances, deregulation, increased transparency and access to information, liberalised access to trading systems, etc.

This increased competition has so far acted as a stimulus to stock exchange mergers and alliances. However concerns have been growing that the opposite might happen, i.e., that we could shortly see a process of market fragmentation. In the following sections, we look at the main elements driving sector competition and their effects on integration or fragmentation.

2.1 Exchange demutualisation

The ownership and management structure of exchange management companies has varied substantially since the second half of the 1990s. The old not-for-profit mutual associations, concerned primarily about attending to the needs of market members and in which each member had a vote, have turned themselves into financial organisations devoted to maximising value for their shareholder-proprietors, a group whose membership is no longer confined to market members or market users.

Demutualisation, as such, entails the separation of trading rights from exchange ownership, to the extent that new shareholders uninvolved in intermediation activity can hold the power of decision in the company. The process generally concludes, as we will later discuss, with the management company going public and being listed on its own exchange.

One of the main aims of demutualisation is to reduce the decision-making power of intermediaries, on the grounds that their decisions could clash with the needs of the other two major market participants, listed companies and final investors.

Demutualisation and subsequent flotation is also a way for exchange management companies to raise funds on the capital market. The proliferation of low-cost alternative trading platforms has intensified competition to capture order flows from an increasingly global set of intermediaries. And markets have responded to the challenge by modernising their trading and settlement systems so they become swifter and more cost efficient.

Some leading world exchanges have also opted to expand or buy into other markets (see section 3). Demutualisation – by broadening the shareholder base – and market flotation – by allowing them to issue new shares – means they can raise the capital they need to invest in technology and bankroll mergers and takeovers of other markets. It also means they can extend market access to non resident or institutional investors.

Demutualisation has the following main effects:

(i) elimination of barriers to the transfer of shares in exchange management companies. In the case of listed organisations, their shares can be freely traded, normally on their own exchange.

(ii) encouragement of the market integration process. The fact of having shares admitted to trading facilitates their valuation in the case of friendly takeovers as well as opening the door to hostile bids.

(iii) changes in the corporate governance of stock markets. The new ownership structure, as remarked, seeks to improve management efficiency by loosening intermediaries' grip on the board of directors. This is achieved by appointing independent directors or directors who will defend the interests of non market member proprietors.

Also, stock exchanges, like any public limited company, must comply with international corporate governance standards, as recently revised in both the European Union and the United States. Exchange competitiveness can only gain from the take-up of these practices, which will help transform them into more transparent, liquid and forward-looking organisations.

As we can see from table 1, demutualisations were mainly bunched between the years 2000 and 2001. Almost all European exchanges are currently demutualised, while U.S. markets have been slower off the mark. The result is that major centres like the Chicago Board Options Exchange (CBOE) or American Stock Exchange (AMEX) have yet to be demutualised.

Demutualisation and listing of international stock exchanges TABLE 1

Market	Demutualisation	Listing
Stockholm Exchange (OMX)	1993	1998
Helsinki Exchange	1995	Yes, part of OMX
Australian Exchange	1996	October 1998
Copenhagen Exchange	1996	Yes, part of OMX
Amsterdam Exchange	1997	Yes, part of Euronext
Borsa Italiana	1997	No
Iceland Exchange	1999	Yes, part of OMX
Toronto Exchange	1999	2002
Singapore Exchange	1999	November 2000
Hong Kong Exchange	2000	June 2000
Nasdaq	2000	February 2005[1]
London Stock Exchange (LSE)	2000	July 2001
Sydney Futures Market	2000	April 2002[2]
Euronext	2000[5]	July 2001
Chicago Mercantile Exchange (CME)	2000	December 2002[3]
Bolsas y Mercados Españoles (BME)	2000	July 2006
Greek Exchange	2000	August 2000
Deutsche Börse	2001	February 2001
Oslo Exchange	2001	Yes[4]
Swiss Exchanges SWX)	2001	No
New York Stock Exchange (NYSE)	2006	March 2006
Chicago Board of Trade (CBOT)	2005	October 2005

1 Traded OTC from demutualisation to the present day.
2 Due to be listed on the Australian Exchange.
3 Traded on NYSE.
4 Traded OTC.
5 Date of its constitution as the holding company of the Amsterdam, Brussels and Paris bourses.
Source: Bolsa de Madrid and IOSCO.

Admission to trading generally follows shortly after demutualisation. The first regulated market to be exchange traded was the Australian Securities Exchange, in October 1998. The main European markets (London Stock Exchange, Deutsche Börse and Euronext) followed suit in the first half of 2001. The North American markets (Nasdaq and NYSE) held back longer, until February 2005 and March 2006 respectively. And last of all came the Spanish exchanges (BME) in July 2006.

There are also demutualised markets that have not gone public, though most have plans to do so in the short/medium term. This is the case of Borsa Italiana and the Tokyo and Warsaw exchanges.

2.2 Technological development

Increased competition between securities markets is also a product of the major technological advances of the past decade. These advances have encouraged the formation of alternative trading systems or ATS catering for investor demands largely unmet by traditional regulated exchanges, dominated by floor or open outcry trading. These last formats cannot provide the scale of liquidity required by today's increasingly global and sophisticated financial marketplace in which institutional investors (mutual funds, hedge funds, pension funds and insurance companies) are an ever growing force.

Electronic trading and automatic order processing have meant a concentration of liquidity, the possibility of closing bulk transactions and the prevention of abusive practices like "front-running" that can go undetected in the open outcry system. The result has been a reduction in transaction costs and faster order processing. The new electronic trading systems provide other advantages such as unlimited trading hours, access to a wider range of securities, the participation of non-member institutional investors, trading anonymity and adaptation to specific needs such as block trading.

The importance of working from an efficient technological base has persuaded many exchanges to invest heavily in modernising their trading platforms. For instance, in March 2006, the NYSE purchased the Archipelago platform to turn itself around to a wholly electronic trading system. Until then, market trades was still conducted by the open outcry system.

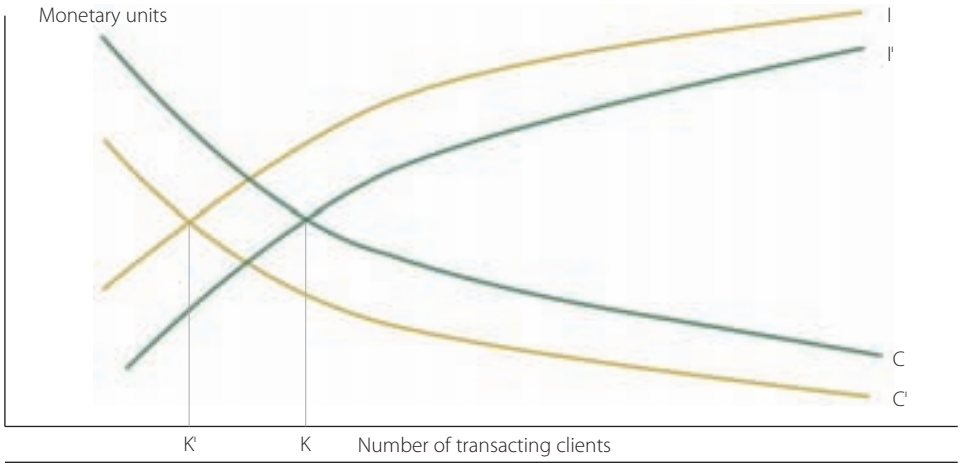
Alternative trading systems have become keen competitors of traditional stock exchanges, above all in spot transactions. We could say, then, that technology has weakened the exchanges' natural monopoly on share trading and has served to boost international competition. The implementation of electronic trading systems has lowered the breakeven point in cost and income as of which a company starts to generate profits (see figure 1).

On the one hand, electronic trading gives access to the economies of scale arising from the high fixed costs of system rollout. The existence of these high fixed costs means average costs will diminish in line with increases in transaction numbers or in the number of customers operating in the market. The technological development of trading platforms beings down average costs per transacting client, i.e., the service cost reduces even on the same size of client base. Figure 1 depicts this in the shift of the average cost curve from position C to position C´.

Not only that, electronic trading systems harness network economies on the income side of the equation thanks to the large number of users connected to a single platform. This pushes up average client revenues without any variation in number. Figure 1 shows the resulting shift in the average income curve from position I to I´. This is what produces the aforementioned lowering of breakeven point, which we see in figure 1 shifting from K to K´. The result is that each market requires fewer clients to enter positive earnings territory.

1 This practice involves using information on the buy and sell orders of a large-volume client for the benefit of the broker, who steps in first to buy the securities at a lower price or sell them at a higher price than the customer is seeking.

Effect of technology on the breakeven point of securities markets FIGURE 1



2.3 Regulation

The law governing securities market activity have also played a large part in fostering competition. In Europe, the Investment Services Directive (ISD)[2] of 1993 enshrined the rights of financial intermediaries to operate in the securities markets of other European Union Member States.

The provisions of the ISD have since been amply revised. The text itself was replaced by the MiFID directive[3] of 2004, which introduces major changes in the activity of intermediaries and securities markets and comes into force in Member States in November 2007.

The MiFID invites new entrants to compete head on with the stock exchanges by allowing buy and sell orders to be executed through "multilateral trading facilities" or MTFs[4]. These are off-exchange trading venues operated by investment firms or market managers which connect buyers and sellers under an explicit set of operating rules.

A case in point is the project Turquoise, an MTF promoted by a consortium of seven leading international investment banks[5] whose goal is to construct a pan-European stock market handling cross-border trades that would bring down transaction costs in comparison to operating through national markets. Plans are for this MTF to function as a not-for-profit utility serving financial intermediaries and investors such as banks, broker-dealers and fund managers.

Another MiFID novelty is what is known as "systemic order internalisation", whereby an intermediary can execute orders against its own positions in a given

2 Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field.
3 Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments.
4 Including Alternative Trading Systems or ATS.
5 The seven investment banks are Citigroup, Credit Suisse, Deutsche Bank, Goldman Sachs, Merrill Lynch, Morgan Stanley and UBS.

security. In other words, the MiFID will allow intermediaries to deal on their own account on an organised, frequent and systematic basis by executing orders outside of regulated markets or multilateral trading facilities.

The competitive challenge eventually mounted by these "systematic internalisers" will depend on the volume of transactions they can channel, since this form of trading is subject to significant requirements. On such requirement is pre-trade transparency referring mainly to transactions below what the text refers to as "standard market size". Specifically, the systematic internaliser must publish firm bid and offer prices at which it will buy and sell securities listed on regulated markets. Larger orders can be internalised without the need for price discovery, which may confer a competitive edge over traditional exchanges. The eventual impact will largely depend on the level specified for "standard market size".

Another factor is the condition that internalisers comply with the "best execution" principle. This means orders must go through on the trading systems that offer the client the best conditions. In other words, trading through an MTF or via automatic internalisers will be ruled out on occasions where regulated markets offer a better deal. The elements determining the "best execution" will primarily be price and transaction cost, though the speed and form of execution and settlement may also be taken into account.

The MiFID also introduces greater competition among post-trade registration, clearing and settlement systems by granting the intermediary freedom of choice and obliging markets to act accordingly. Especially affected will be the managers of exchanges running an integrated registration, clearing and settlement system. This " vertical integration" model has been adopted by Deutsche Börse, Bolsas y Mercados Españoles and Borsa Italiana, among others, but may now have to be abandoned.

These new trading alternatives are causing concern in the European sector about a possible contraction in market liquidity which would widen bid-offer spreads and push up transaction costs. In particular, some fear the formation of "dark liquidity pools" under the control of the biggest market participants. The benefits pertaining to investors through greater competition could be wiped out entirely by the costs of market fragmentation: widening spreads, reduced transparency and a higher price on market information.

In the United States, meantime, some leading exchanges have been seeking out merger or acquisition opportunities in Europe (see section 3). These transcontinental transactions owe more, it seems, to prevailing U.S. legislation than to purely economic motives.

The Sabarnes-Oxley Act[6] of July 2002 imposed tough new requirements on firms listed on U.S. markets, leading to a slower flow of admissions relative to other

6 The Sabarnes-Oxley Act was passed in July 2002 in response to the corporate and financial scandals of the previous year. Its goal was to improve shareholder protection by imposing stricter measures on both listed companies and the professionals supplying them with financial services. Among these obligations are enhanced disclosure regarding company financial statements, whose truthfulness must be vouched for by the company's directors. The text also expands liability with regard to corporate governance and the management of confidential information, and toughens the penalty regime for non compliance. Auditor regulation and supervision are likewise tightened up.

international markets with somewhat laxer rules. In addition, many institutional investors are against the "trade-through" rule which imposes best execution across all United States securities markets. What this means, in practice, is that a buy order routed to the NYSE has to be crossed with a sell order in another market (say the Nasdaq or Philadelphia Exchange) if the seller is asking for a lower price.

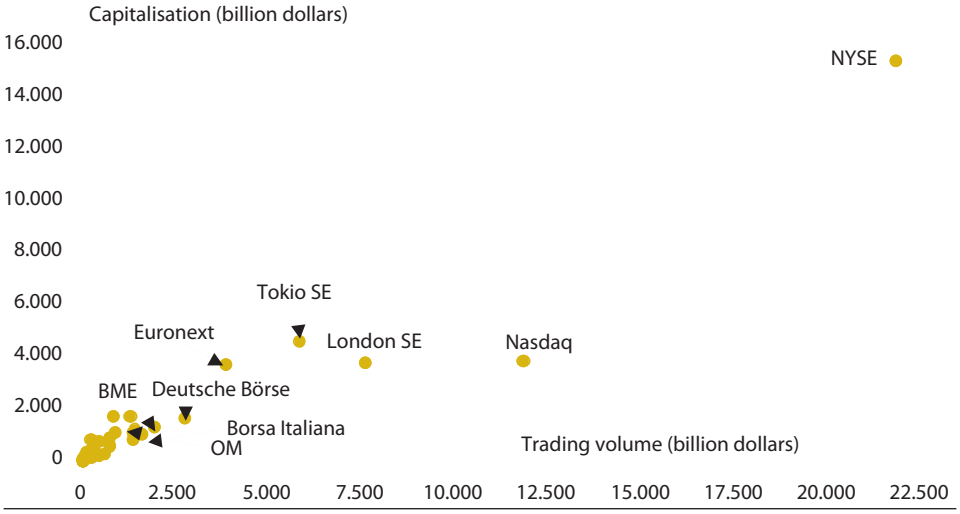
This rule if undoubtedly good news for ordinary investors but less so for their institutional cousins. This is because the latter operate with large blocks of shares, and the "trade-though" requirement may force them to split orders into several of smaller size, with the resultant increase in execution costs and processing time. Such investors would rather operate in markets with sufficient liquidity to permit large-volume trades, even if this involves some sacrifice in price.

3 Current status of the integration round in world securities markets

The last decade has witnessed a wave of strategic alliances, mergers and acquisitions involving securities markets. As we can see from table 1, until 2006 such moves were mainly confined to European markets. In these cases, demutualisation and technological development were joined by two other factors driving the integration process: namely, the adoption of the euro and the legislative campaign in favour of a European financial services market.

In the last two years, the process of European integration has taken on a more transatlantic hue, with U.S. exchanges increasingly eager to take an ownership share in their European equivalents. Hence the biggest merger to date was protagonised by the New York Stock Exchange (NYSE) and the Euronext group, who sealed their agreement in June 2006 and completed the process in early 2007. The new NYSE-Euronext holding company strengthens the U.S. market's international position in terms of both capitalisation and trading volume (see figure 2). The merger will also unlock significant economies of scale through the integration of information and technology platforms and systems.

Capitalisation and trading volume[1] of main world markets FIGURE 2



Source: World Federation of Exchanges.
1 Trading volume is the cumulative figure for 2006. Capitalisation as at year-end 2006.

One of the NYSE's concerns prior to the merger was the flight of U.S. companies to the London Stock Exchange (LSE) which they saw as comparing favourably in both requirements and costs since the entry to force of Sarbanes-Oxley (especially so for small or medium cap companies). The merger with Euronext allows the NYSE to compete for listings with the LSE, especially of companies in emerging markets like India and China, who have shown themselves keen to tap the North American capital markets. Indeed the NYSE's expansion plans are not confined to Europe, but also extend to Asia, where it acquired 5% of the National Stock Exchange of India in February 2007 and signed a letter of intent with the Tokyo Exchange in March this year for a possible future alliance.

The strategy line defended by Deutsche Börse (DB) centres on the creation of a European exchange or, concretely, a European exchange organisation working to a federal model. This was the goal behind the merger plan put to the Euronext group in May 2006, whereby DB and Euronext would be brought within a new group, including DB's post-trade activities. DB also began talks with the Italian exchange for what would be the second step towards a single European market. However, neither of these proposals made it past the discussion stage.

Euronext accepted a merger offer from NYSE that would leave its hands freer at European level, despite the objections of the Paris Exchange operators as figuring in the Lachmann Report of October 2006. This report looked at various consolidation scenarios for Euronext. On the option of a Euronext–NYSE merger, it identified the following advantages: (i) the development opportunities for Euronext markets, especially in the derivatives business and (ii) the fact that implementation would be eased by the similar strategies, organisation and culture of the two partners and the absence of technical and legal obstacles, especially regarding competition impact.

However, the Lachmann Report also came up with arguments against. First of all, because the merger project did not specify an outlet for the considerable cost synergies projected, meaning it was not clear how far the operation would benefit Euronext users. Not was it sure about the improved liquidity of Euronext-listed shares, since the merger conditions did not contemplate a liquidity "pool" to be held in common by the two markets. On top of this, it argued, the corporate governance structures and location of the head offices meant effective control would be lodged with the NYSE.

The second scenario considered by Lachmann was the merging of Euronext and DB. In this case, although identifying expansion opportunities for Euronext markets, the report also warned of possible risks of instrumentation given the divergences existing in the partners' activities and market model. The third and last scenario was to bring DB's cash equities trading business within the merged Euronext-NYSE operation. This option, it was felt, was the best fit with the wishes of Euronext users, given the synergies to be harnessed from an enlarged liquidity "pool" in equities trading. DB would retain full control of its other main business lines, derivatives trading and post-trade activities. This scenario was rejected by DB.

The LSE has grown in attractiveness over recent years. North American companies increasingly use it as the nerve centre of their operations, encouraged by the more flexible treatment dispensed to foreign companies and investors in comparison with the United States.

Europe's largest exchange, the LSE has had numerous suitors since the hostile bid launched by Swedish exchange OM in the year 2000. DB made two failed attempts between end 2004 and March 2005, followed in the closing months of the same year by Australia's Macquaire. Euronext too stated a purchase interest in late 2004 though without going so far as to table an offer. And the last to declare itself was the U.S.'s Nasdaq, which presented its bid in late 2006 after raising its ownership interest in the London exchange to approximately 30%.

None of these bids made it through to the finish. In most cases, LSE alleged that the offer price was below its market value. In others, the shareholders of the bidding company dissented from the bid conditions. For the moment, the LSE maintains its independence and has opted to merge with the Italian exchange (Borsa Italiana). This decision, taken in June 2007, is intended, in the words of it protagonists, to combine complementary activities (equities, fixed-income securities traded on the MTS platform[7], derivatives, ETFs, asset-backed securities) and gain in efficiency (the LSE trading system plus Borsa Italiana's post-trade infrastructure), facilitating broader diversification of the customer and product base and enhancing the two markets' overall liquidity. But some analysts have interpreted the LSE's decision as a defensive move ahead of future takeover bids from Nasdaq and/or other markets.

Meantime, the Scandinavian and Baltic markets have come together in the OMX group. The integration process has proceeded at a leisurely pace. The story started with the NOREX alliance formed between 1998 and 2000 by the Stockholm, Copenhagen, Oslo and Iceland exchanges. Then in 2002, the Helsinki Stock Exchange created HEX after taking over the Baltic exchanges of Tallin and Riga.

HEX then merged with the Stockholm Exchange (OM) in 2003, bringing OMHEX into being. The new organisation acquired the Vilnius exchange in first-quarter 2004 and one year later merged with Copenhagen, adopting the new name of OMX. The latest to join has been the Iceland exchange, in 2006.

Today's OMX operates in the equities markets of seven countries[8] in the Scandinavian and Baltic regions. The Oslo Stock Exchange is not a member, though the OMX group holds 10% of its capital. Recently, OMX had been targeted by two competing takeover bids: one from the North American Nasdaq, following the failure of its bid for the LSE, and the other from the stock market operator of Dubai. The process is still outstanding as we write.

The holding company grouping the Spanish markets, Bolsas y Mercados Españoles (BME), has so far stood aloof in the European context. That said, its strong earnings figures make it a front-line candidate in the sector concentration process.

In fact, the prospectus issued for BME's public offering mentions DB's unilateral initiative to look at ways of combining the business of the Spanish and German markets. A point to bear in mind here is that the Comisión Nacional del Mercado de Valores and Ministry of Economy and Finance are empowered to challenge the acquisition or transfer of a significant stake[9] in BME's capital if they deem that Spanish firms would not have the same opportunities in the acquirer's country of origin.

Consolidation moves are also building in the derivative products sector. At end 2003, LSE and the OMX group formed a joint venture known as EDX London specialised in trading in equity derivatives. Also in 2003, Spanish derivatives market MEFF acquired 7.5% of the Mexican Derivatives Exchange, which it brought within its electronic trading platform. In 2004, the U.S. and European leader in derivatives, the Eurex market (see table 2), forming part of Deustche Börse, launched an expansion drive in the United States with the purchase of Brokertec Futures, a North American market backed by a group of investment bankers, and set up in Chicago under the name Eurex US. Eurex's next move, in April 2007, was to merge with the Securities Exchange (ISE). This followed on from the merger announcement in late 2006 of the top two U.S. derivatives markets, the Chicago Mercantile Exchange (CME) and Chicago Board of Trade (CBOT).

7 The MTS platform is European leader in the electronic trading of fixed-income securities. Borsa Italiana has held a majority interest (60.3%) through MBE Holding since August 2007 when it exercised its purchase option on the 51% stake owned by Euronext.

8 The seven countries are: Denmark, Finland, Iceland, Sweden, Estonia, Latvia and Lithuania.

A holding is deemed significant when its extends directly or indirectly to at least 1% of capital or voting rights.

Trading on international futures and options markets TABLE 2

no. of contracts, in thousands

Market	2006	2005
Korea Exchange	2,474,593	2,593,088
Eurex[1]	1,526,752	1,248,748
Chicago Mercantile Exchange (CME)	1,403,264	1,090,352
Chicago Board of Trade (CBOT)	805,884	674,651
Euronext. Liffe[2]	730,303	757,927
Chicago Board Options Exchange (CBOE)	674,735	468,249
International Securities Exchange (ISE)	591,962	448,696
Mexican Derivatives Exchange	275,218	108,177
OMX	123,168	103,510
MEFF	46,974	40,218
Italian Derivatives Market (IDEM)	31,606	25,871

1 Part of the Deutsche Börse group.
2 Part of the Euronext group.
Source: Futures Industry Association.

We can see, then, that the concentration of world securities markets is continuing apace, albeit not without obstacles (of a business, cultural, technical, legal or other nature). Although more moves are to be expected, it is clear that we are already seeing the formation of large international trading hubs: NYSE-Euronext, Nasdaq-OMX, LSE-Borsa Italiana and Deutsche Börse. In derivatives markets, the standardisation of contracts has led to each product finding its own niche market: the case of Eurex with futures on euro-zone government bonds, Euronext.Liffe for euro short-term interest rate futures and CME-CBOT for futures on U.S. interest rates.

These large trading centres, geared especially to the big institutional investors operating with a global reach, pursue competitive advantages over rival electronic trading systems in the shape of lower transacting costs and a wide product offering by both asset type and geographical area of provenance. Smaller securities markets, uninvolved in these concentration processes, base their business more on local securities, diversification and the provision of specialised financial services.

4 The regulatory response to demutualisation and the consolidation of international exchanges

4.1 Regulatory challenges

The changes in the ownership structure and business objectives of stock exchanges pose a series of regulatory challenges. Chief among them, the threat that in the presence of a management model geared to maximising profits in a competitive framework, regulation is neither sufficient or efficient enough to ensure that markets fulfil the public function, normally in their care, of regulating and supervising listed companies and intermediaries. As for-profit enterprises, markets (or more correctly their managers) could readily subordinate their decisions to the achievement of annual profits growth on a given scale. The more so with a broad shareholder base presumably less concerned about the public function side.

Among the risks arising from this conflict of interest would be a relaxing of admission rules and obligations so as to attract in more issuers and investors. Likewise, markets could opt to prioritise commercial activities or the maximising of shareholder returns, translating as fewer resources devoted to regulatory compliance, the assumption of more commercial risk and quite possibly a drain on equity. It is therefore important to ensure that competition does not undermine market integrity and investor protection.

Conflicts of interest also loom larger when markets, as for-profit enterprises, are listed on their own exchanges. In such cases, it bears considering whether it is appropriate for the market to review and approve its own registration statements or those of its shareholders, and whether it can credibly perform a regulator's duties in regard to its own traded shares.

At the same time, the creation of plurinational groups of markets poses a challenge to national supervisory authorities who are called on to oversee more and more participants from different countries. In these cases, supervisors need to lay down information exchange mechanisms and procedures that can adequately safeguard investor interests.

4.2 The response to regulatory challenges and recommendations

The abovementioned risks underscore the need for measures to guarantee the proper functioning of newly demutualised markets. According to an IOSCO report[9], most regulatory authorities have opted either to change existing regulations or tighten up their supervisory controls. In cases where exchanges are listed on their own trading platforms, all IOSCO member jurisdictions have taken steps to deal with the conflicts of interest potentially arising.

Measures adopted touch on the following main areas:

- corporate governance: changes have been made in governing boards to ensure they include directors either directly representing the general public interest or, at least, sufficiently independent to gauge whether the exchange is doing enough to fulfil its regulatory responsibilities

- separation of functions: separation of the divisions dealing with commercial and regulatory matters

- ownership restrictions: in many jurisdictions, the regulatory authorities have taken on additional powers over significant or controlling shareholders, ranging from the obligation to notify the regulator and/or publicly disclose holdings above a given threshold to the capping of equity interests.

- levels of supervision: supervision has been tightened up with regard to all for-profit exchanges, especially those listed on their own platforms. Supervisory interest will focus especially on market's financial resources

9 Report of the Technical Committee of IOSCO: Regulatory Issues Arising from Exchange Evolution, March 2006. IOSCO is the International Organisation of Securities Commissions.

- the transfer or removal of regulatory functions

IOSCO has addressed the abovementioned regulatory challenges in a series of recommendations to market supervisors, whom it urges to identify and evaluate developments in the exchange environment in order to promptly decide whether regulatory amendments are required. Particular attention should go to changes potentially affecting market integrity or efficiency, or the protection of investors.

A fluid dialogue with the markets is viewed as the key to supervisory effectiveness. In the event that the regulatory model is to be modified, a resource impact assessment should be carried out to ensure that markets are adequately organised and funded. Finally, the regulatory authorities should be prepared to share significant information on cross-border transactions and enter into information exchange agreements to this end.

Some regulatory authorities have already hammered out ways to adapt the regulatory model to multinational market groups. A pioneer move here was the memorandum of understanding (MOU) signed by the regulators of the exchanges then making up the Euronext group (Paris, Amsterdam and Brussels). More recently, in January 2007, an MOU was concluded by all the regulatory authorities[10] dealing with the NYSE-Euronext group. Its text stipulated, among other matters, the establishment of consultation, cooperation and discussion committees under a "regulators board", with room made for permanent steering committees and thematic working groups. The same authorities also agreed to hold regular meetings to deal with regulatory issues of concern to any of their number, and to consider the regulatory implications of closer market integration.

This shift from occasional or ad hoc consultations or meetings between supervisors to the establishment of ongoing cooperation protocols and routines is one of the main trends emerging in the industry. Such arrangements, however, can vary in both form and intensity, ranging from more or less explicit bilateral or multilateral agreements to a simple commitment to fluid dialogue between regulatory authorities.

5 Conclusions

In the nineteen nineties, international stock exchanges embarked on a thoroughgoing transformation spurred by the rapid growth of cross-border trading. The first big step was the demutualisation of exchanges and subsequent listing on their own trading platforms, marking their transformation into financial companies with the mission to maximise the value of their shares. As we write, most leading exchanges are demutualised and market traded. Europe's bourses were the first to take the plunge, with the North Americans joining in more recently.

10 Report of the Technical Committee of IOSCO: Regulatory Issues Arising from Exchange Evolution, March 2006. IOSCO is the International Organisation of Securities Commissions.

Exchange demutualisation has intensified sector competition, but it is not the only cause. Technological advances have weakened markets' natural monopolies by encouraging the growth of alternative trading systems based on electronic platforms. These new competitors offer a number of advantages like lower transaction costs, delivered by network economies and economies of scale, and greater speed in order processing and execution. The regulatory authorities have also been active in promoting inter-market competition. This is especially true of the euro zone, where the imminent application of the MiFID will bring new entrants into the fray while permitting "systematic order internalisation" by market intermediaries.

This increased competition has, in turn, spurred the concentration process among international exchanges, though concern has recently been growing about a reverse trend towards greater market fragmentation.

The new demutualised, listed exchanges have regeared their strategies to improving their business prospects and international competitive standing. Mergers and alliances between markets have been a regular feature of the last decade. Until 2006 this restructuring drive was concentrated in Europe, but in the last two years it has taken a transatlantic turn, with U.S. markets increasingly keen to acquire positions in their European counterparts. A keynote operation here was the merger, announced in mid 2006, between the world number-one exchange, the NYSE, and the Euronext group. Americans' interest in Europe owes, among other factors, to the tough requirements of the Sabarnes-Oxley Act of July 2002, which have caused them to lose out to European competitors, the LSE particularly, in listings of new emerging market companies.

To date the international concentration wave has produced four major trading hubs: NYSE-Euronext, Nasdaq-OMX, LSE-Borsa Italiana and Deustche Börse. But the process is very far from over and may in future extend its net to Spanish markets.

These changes in international securities markets have posed fresh challenges for the regulator. The transforming of the management and ownership models of exchange management companies can generate conflicts of interest that impair the fulfilment of their public function. Most regulators have sought to preclude any damage to market integrity or investor interests by adopting new measures relative to corporate governance, supervision levels or even the transfer or removal of exchanges' regulatory functions.

The formation of transnational market groups also complicates the oversight function. For this reason, national supervisors must closely scrutinise each integration move for its impact on market integrity and investor protection. Finally, financial integration in Europe and the rest of the world calls for the strengthening of cooperation mechanisms between national supervisory authorities.

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Changing financial markets and their reflection in Spain

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1 Introduction

There has been a significant transformation in the financial systems of the major economies over recent years, both in terms of their increased relative importance and the development of new products and management techniques. In this process, the relationship of these systems with the real economy has undergone important changes.

These changes have considerably increased the complexity of markets. The result, in a context of increasing internationalisation of capital flows, is that markets are increasingly difficult to analyse and understand. This makes specialisation a necessary value for participating in the markets, which in turn can at times make it difficult to maintain a global perspective.

This article offers some reflections on the changes that have taken place in the international securities markets. Its objective is to help the understanding and analysis of the new relationships and their increasing importance, as well as to offer a general review of the experience of Spanish securities markets in this context.

Our work is organised as follows: The second section reviews in summary form the main elements that have led to the transformation of the securities markets; the third section reflects on the possible effects of these transformations; the fourth section reviews the specific experience of the Spanish securities markets; and the final section sums up the conclusions.

2 Recent transformations in the financial markets

A number of changes have taken place lately which have moulded the development and growth of the financial markets, and resulted in their increasing relevance today in the productive structure of the major economies.

Financial globalisation, meaning the increase of cross-border financial flows beginning after the liberalisation of the capital markets towards the end of the 20th century, has been one of the main transformations that explain the development of the financial markets. Specifically, cross-border capital flows are estimated to have doubled as a percentage of global GDP since the start of 2000, and they are now more than three times what they were at the start of the 1990s[1]. Although there is no absolute consensus on the benefits of increased financial integration in terms

1 See speech by John Lipsky, "The Global Economy and Financial Markets: Where Next?", IMF (2007).

of stability and growth[2], the idea is growing that globalisation of the financial markets plays a significant role as a catalyst for developing domestic markets (though this depends on their original economic situation). Among its important effects are that it encourages improvements in corporate governance practices, which tend to adapt to the demands of international investors, and generates benefits in terms of macroeconomic policy.

One of the obvious manifestations of the process of market integration is the shifting organisation of the main trading and post-trading infrastructures over the past decade, in a market whose excessive fragmentation means that economies of scale are still to be exploited. Thus recent years have seen alliances and acquisitions designed to improve positions in the light of the inexorable process of integration of market infrastructures. There is still no consensus with respect to the model of integration resulting from this process. Until now, the only really successful project has been Euronext[3], which recently agreed a merger with the New York Stock Exchange (NYSE), creating NYSE-Euronext. One of the characteristics of the process of integration that has taken place so far has been respect for the location of the existing financial exchanges, which have been interconnected in a way similar to the system of the Spanish electronic continuous market. In Europe, the new Community regulations have intensified the integration process. They have also introduced additional trading environments to the traditional system of stock exchanges through multilateral trading systems and systematic internalisers, which will represent a further modification in the market structure.

In recent years the process of change propelled by the globalisation of the financial markets has accelerated as a result of the intensity of financial innovation. In its broadest sense, this innovation has led to the appearance of new products, new processes, and even new securities markets. Among the elements fostering this innovation process has been the development of new information and communication technologies. And of course the gradual development of an appropriate legal framework has been an essential factor.

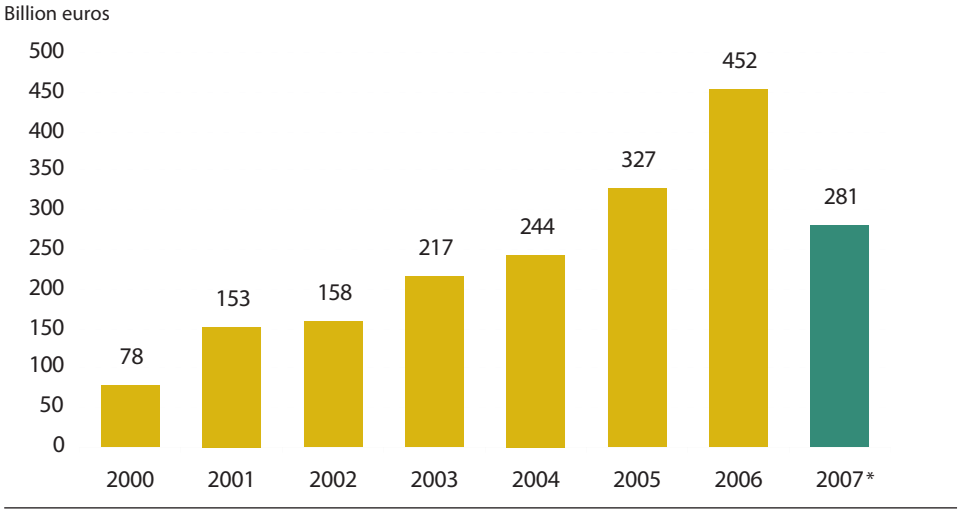
There has been notable innovation in terms of products, particularly in the instruments designed to transfer risk, in other words credit derivatives such as credit default swaps, and other structured products designed for the same purpose. Their trend has been on the increase since the appearance of the first interest-rate swaps.

The boom in financial innovation was initially propelled as a risk management instrument. It has had a significant impact on the market of asset securitisation, i.e. securities backed by a portfolio of assets which tend to have little or no liquidity, and which are structured in general terms into tranches transforming the risk and return of the underlying assets. Without attempting an exhaustive description, asset securitisation can be divided according to the type of asset backing the issues. If the securitisation is backed by mortgage loans, it tends to be called mortgage securitisation or Mortgage Backed Securities (MBS), with the term Asset-Backed Securities (ABS) being reserved for other assets such as consumer loans. If the

2 Kose, AM. Et al. (2006) offer an interesting review of the current literature.
3 This brings together the Paris, Brussels, Amsterdam, Lisbon and Oporto exchanges, as well as the British derivatives market Liffe.

underlying portfolio consists of corporate debt, they are known as a Collateralised Debt Obligations (CDOs), and in turn they can be composed of loans or bonds, or even credit derivatives (synthetic CDOs)[4]. The growth of this kind of issue has been intense in the U.S. since the middle of the 1990s, and has now also taken off in Europe in recent years, as can be seen in Figure 1.

Securitisation issues in Europe FIGURE 1



Source: European Securitisation Forum.
*Data to Q2 2007.

The growing demand and supply of structured products has contributed to the development of a major industry, proving the growing attractiveness of this type of market for a wide variety of agents: issuers, securitisation funds, managers, counterparties, depositories and insurance companies are some of the participants in these markets. In fact, the attraction of structuring seems to extend beyond simple risk transfer, as it also responds to a growing demand by some institutional investors for high credit-quality assets. Without the specialisation into tranches offered by these structures, assets of this kind would have little or no liquidity in the markets.

Financial innovation can also be understood from a broader point of view to include the development of asset management techniques. The growth in the use of active portfolio management techniques through leveraged strategies, rather than traditional investment fund management (subject to greater investment and leverage restrictions), has resulted in the development of new agents and intermediaries in the financial markets. Examples of these are hedge funds and venture capital, in which investors are increasingly interested. Although the importance of hedge funds in the markets as a whole is difficult to quantify[5] by their volume or number, the persistent opacity in the sector and the bias offered by some of the data mean that no one doubts their growing importance. The great

4 For more details on the different structures of asset securitisation, and specifically CDOs, see the CNMV monograph "Estructuras de Titulización. Modelos de Valoración de CDOs" ["Securitisation Structures: Models for Evaluating CDOs"] by Ramiro Losada (2006).
5 Total managed assets in the industry tend to be estimated at between $1 trillion and $1.5 trillion.

trading volume generated by these funds every day is an example often used when pointing to their increased relevance. Because of the high rate of portfolio turnover and the use of derivatives and short positions, this volume is much greater than the volume of assets under management.

Thus changes already introduced have substantially increased the variety of investment on offer for savers, and given an additional boost to collective investment channelled through these intermediaries.

This new reality is at the same time a new source of liquidity for the financial markets. The new agents intensify their operations borrowing short and investing long, as they invest in assets with a lower liquidity whose premium compensates the exchange. In this way they develop a function which traditionally was exclusive to financial institutions. This phenomenon has been one of the factors increasing liquidity in recent years, with a macroeconomic scenario of moderate inflation rates maintaining interest rates at low levels.

Overall, the increase in capital flows, institutional change, the development of new risk management techniques, product innovation and the growing importance of intermediation in the markets, are elements that have transformed the architecture of the securities markets against the background of an environment of significant liquidity. There does not appear to be any consensus with regard to the implications of this for the system as a whole in terms of risk and efficiency. The following section offers some reflections on this subject.

3 Some implications of the transformation of the financial markets

In theory, increased liquidity and the development of new products are positive elements to the extent that they transform the financial markets in the correct direction, i.e. towards more complete markets, as defined by Arrow and Debreu[6], despite the maintenance of certain transaction costs and informational asymmetries whose complete elimination is impossible in the real world. In this sense, to the extent that it helps to complete the markets, the development of financial markets should of itself increase the welfare of the system as a whole, generating benefits for each of its component parts.

For example, the development of new products such as credit derivatives or structured products allows risk to be transferred between different agents, improving its management and thus its global distribution. The diversification of risk is in fact one of the main reasons given to explain the increasing use of credit derivatives or the issue of securitised assets by financial institutions. The data do not appear to be conclusive in terms of whether there is or not a real transfer of the

6 The Arrow-Debreu model hypothesises that complete markets are those in which there is a market, and thus a price, for every commodity.

risk level outside the banking sector. Some estimates suggest that although the amount was limited, 13% of all the credit default swap market in 2006 was a net risk transfer outside the banking sector. In any event, even if the transfer of credit risk occurred within the same sector, the advantages in terms of improved risk allocation would be maintained, although to a lesser extent.

The benefits of diversification and the consequent reduced cost of capital for additional financing by the institutions are the main reasons underlying risk transfer. The buyers of these products receive a premium in exchange because of the asymmetries of information and moral risk. The institution issuing the securitised assets has more information about the credit risk of the product than the potential buyer, so the buyer has to be compensated for this uncertainty. In addition, because the issuer transfers a large part of the risk of the underlying assets he loses the incentive to properly monitor the underlying risk, which could result in an inadequate risk management. As a result, the potential buyer demands a premium to compensate for this uncertainty.

As well as this, in the specific case of securitisation, its proliferation is encouraged by demand from certain agents such as pension funds and other institutional investors for high credit-quality assets whose presence in the market would otherwise be limited. Thanks to securitisation of assets in tranches with different risk levels, the supply of high credit-quality assets increases, because the credit risk is concentrated in the lower tranches. Pension funds, given the nature of their investment policy, demand these kinds of products.

Increased liquidity, meaning the ability to buy and sell an asset without it affecting its price, could also be interpreted as a synonym of increased confidence in the system, as after all confidence reflects the possibility of carrying out transactions in the market and guaranteeing the system works correctly. In addition, for the final investor an increase in the supply of products and the chance of accessing new investment strategies allows increased competitiveness for collective investment, a reduction of costs and an undoubted improvement in efficiency. All in all, the balance can only be positive for the system as a whole.

Nevertheless, although the above would suggest markets are becoming more efficient and with lower risk levels, it is also true that there are some uncertainties which still have not been clarified.

First, voices are frequently raised alerting to the problems of evaluating structured products, given their increasing complexity. This process ends up being a difficult task for the agents. The evaluation of the risks and performance of a structured asset requires an estimate of the distribution of losses of the underlying assets, which is not easy given their usually heterogeneous nature. At the same time the evaluation should be in the context of the structuring capacity offered by the product, the various credit improvements which tend to be agreed in the issues, and the degree of existing correlation. Each of the existing evaluation models offers advantages and disadvantages when it comes to representing market reality. The resulting uncertainty regarding the asset prices is a source of inefficiency for assigning risk. Errors in the evaluation of products may produce unexpected losses, price sensitivity of assets that do not

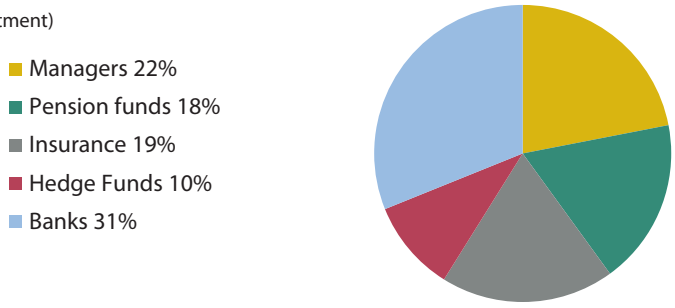
correspond to what is estimated by the models, and in short coverage that may not be as effective as expected.

In addition, there is little information with regard to the current distribution of risks within the system. For example, with regard to trends in CDOs (see Figure 2), existing data show that hedge funds, which are so often referred to as being among the main operators, hold hardly 10% of the total CDOs issued. This could suggest we should minimise their role in the CDO market. However, it is also true that this percentage could represent a significant amount of their portfolio as a whole, and given the structuring of the CDOs by tranches of different risk levels, the holdings could be concentrated in tranches with the highest risk levels.

In theory, given the information asymmetries explained above, the best thing for issuing institutions tends to be to retain the lower credit quality assets (toxic waste) as a signal[7]. Nevertheless, the literature is not conclusive. Recent research concludes that under certain circumstances the issuer, as a result of the benefits in terms of reducing the cost of additional capital, prefers to sell the most risky assets rather than those of a lower risk level[8]. This would imply that risk transfers could be concentrated in assets with highest risk levels, with the provisos explained above. In this way, institutional investors that are subject to a lower level or regulation and transparency, like hedge funds, could be holders of a significant percentage of these high risk assets.

CDOs by investor class FIGURE 2

(no delta adjustment)



Source: IMF, Lipskey (2007).

Finally, we do not know the degree of interrelation which there may be in capital markets in the current context of globalisation and integration of securities markets. This generates uncertainty with regard to adverse effects whose initial scope may be initially estimated as limited, but which could lead to global shocks or price movements. As a result, confidence in the sound operation of the system would be reduced, and the level of global risk would increase.

Some recent studies assigning greater levels of uncertainty to the markets as a result of the lack of transparency conclude that if there is a reduction of liquidity the response by the agents could lead to a crisis of global proportions. In other words, the

7 See Fender, 1 and Mitchell, J (2005).
8 See Duffie, Darrel (2007).

new reality of the markets would imply that periods of instability are inherent to the new structure[9]. All in all, it could be said that there is evidence of a greater connection between the price of assets, the liquidity of markets and the mechanisms for risk transfer as a result of the change in the architecture of the markets.

In any event, the market continues in a constant state of transformation, and many of the changes mentioned are in fact at their initial stages of development. Thus the complexity of the markets may grow, and the tools available for improving risk management and thus the liquidity of the markets will be increased, while new markets are developed. The key appears to lie in the path which still has to be taken. It is possible that some uncertainties will be generated during the change, such as the migration of risk from areas normally subject to high levels of vigilance by the supervisor, and that normally enjoy greater transparency, to others that historically have not required this supervision. The implications of this change should thus be monitored regularly to maintain an adequate degree of transparency, both in the supervisory function and to ensure that the market agents can perform their activity with an adequate assessment of the risks which they want to assume.

4 Analysis of the Spanish markets

Spain has not remained on the sidelines in terms of the events and phenomena outlined in the section above. The Spanish securities markets have been involved in a process of financial innovation, technological development comparable to that in other developed countries, there has been a full participation in the process of European integration and financial globalisation, the country has enjoyed an environment of considerably increased liquidity thanks to the favourable macroeconomic environment and the appearance of new agents in the market, and the process of banking disintermediation (the gradual abandoning by credit institutions of their traditional role of attracting savings and offering loans) has been intensified, although the banks have retained their leading role as intermediaries in the Spanish markets. However, the Spanish case presents certain peculiarities which we will highlight below.

4.1 Development of the trading infrastructure in Spain

From the point of view of the development of the securities markets, little more than twenty years ago the market infrastructures were only beginning to appear in Spain, as was their supervisory function. So it may be said that since the end of the 1980s there has been a revolution in the Spanish securities markets.

The year 1988 had particular relevance in that it saw the entry into force of the Stock Market Act, LMV (No. 24/1988 of 28 July). This meant the disappearance

9 See Caballero, Ricardo and Krishnamurhty, Arvind (2007).

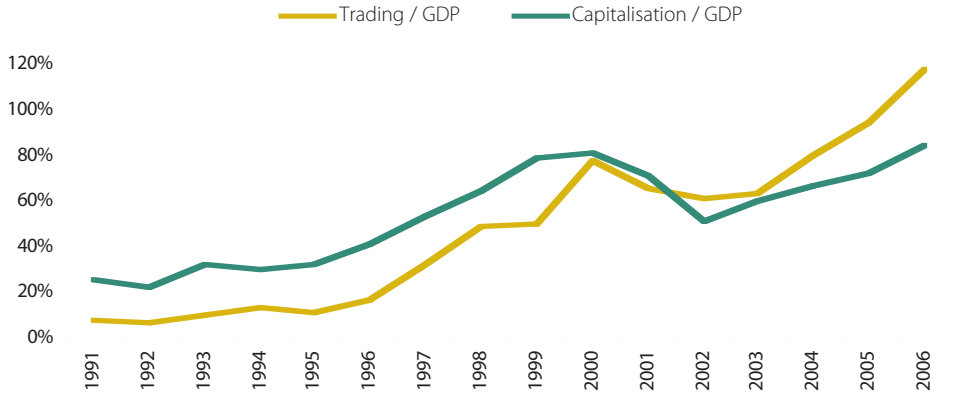
of traditional stock market intermediation based on the figure of exchange and stock market agents, who were public notaries that won their right to operate through competitive exams. They were substituted by financial institutions, broker-dealers and brokers who became entities subject to supervision and requirements as to assets and free competition in the sector, as long as they complied with a series of stipulations.

In addition, the Act also saw the birth of the single supervisor of the security markets, the National Securities Market Commission (CNMV), whose function is to oversee correct pricing, market transparency, and of course the protection of investors.

Two years later, the stock market interconnection system (or continuous market) was created, unifying the stock market operations of the four Spanish exchanges. The foundations were thus laid for the creation of securities markets other than stock markets, and for ensuring that contracted transactions were honoured and their settlement made in the most efficient way possible. In addition a process known as "dematerialisation" of negotiable securities was undertaken starting in 1992. This meant the transformation of the physical securities certificates used until then into electronic book-entries.

In this initial development phase, a key factor was that the regulations worked in favour of the changes. The legislation which appeared after the passing of the LMV set the foundations for the future development of securities markets in Spain. Among the figures worth highlighting in this respect are the trading volume and market capitalisation in Spanish stock exchanges. Measured as a percentage of GDP, they have continued to grow since the time discussed to the present.

Trading and capitalisation of Spanish stock exchanges (% GDP) FIGURE 3



Source: CNMV.

In the last years of the 20th century two events occurred that allowed market infrastructures to take a significant step forward towards maturity:

- First, the exclusivity of the broker-dealers and brokers as members of the stock markets was eliminated. This allowed other financial intermediaries to join their ranks, and was particularly important in the case of credit institutions.

- Secondly, there was continued demutualisation of the stock markets and of securities markets in general. This process broke with the identity between members of the markets and shareholders of the companies that managed them. It meant that there may be members who are not shareholders in the market, and vice versa.

These two events were the seeds from which the process unifying the ownership of the managing companies of the markets grew. After a series of steps, it culminated in 2002 with the constitution of Bolsas y Mercados Españoles, Sociedad Holding de Mercados y Sistemas Financieros, S.A. (BME), a company that integrates the securities markets and financial system in Spain. The culmination of this demutualisation process led to the full development of the market infrastructures and was given substance when BME became publicly listed on the stock market in July 2006. This meant that the company began to be quoted in the in the market which it managed, as had happened in other securities markets outside Spain in recent years.

4.2 Products and financial agents in the Spanish securities markets: financial innovation

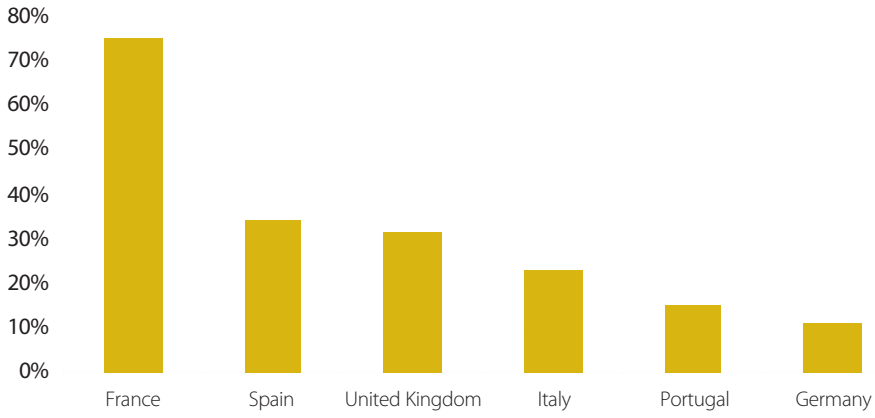
Another phenomenon of the 1990s worth highlighting, together with the reform of trading platforms, is the banking disintermediation giving retail investors access to securities markets, increasing the supply of instruments in which they could channel their savings apart from traditional bank deposits.

This was mainly possible thanks to the development of collective investment. In fact, from the start of the 1990s, mutual funds experienced a significant increase both in number of institutions and in managed assets, reaching a peak in 1998. At the same time, the process of disintermediation also allowed direct investment in the markets, with a period of maximum levels in 1998-2000, coinciding with the privatisations of the major state-owned companies and the explosion in share prices of technological companies.

At present, collective investment in Spain is a fundamental part of the Spanish financial system. It is the main vehicle through which the individual investor participates in the securities markets. In fact, comparing Spain with the main European countries, it is the second biggest country in terms of assets in collective investment as a proportion of GDP after France (see Figure 4 below).

Total assets of collective investment institutions FIGURE 4

% GDP(2006)



Source: INVERCO and Eurostat.

Proof of the process of globalisation and financial innovation in Spain could be seen in the appearance of completely new instruments. Thus 1984 saw the passing of the first Act dealing with collective investment institutions; in 1986 the first Act referring to risk capital; 1987 saw the regulation of pension funds; 1988 the appearance of broker-dealers and brokers mentioned in the previous section; and in 1992 the first regulations dealing with securitisation arrived. Other instruments were the object of later legal treatment. For example, hedge funds were regulated for the first time in 2005.

Nevertheless, it is worth pointing out that despite the fact that some of these instruments began to be regulated early on, their real general development did not begin until years later. This has happened, for example, with the risk capital institutions, which only began to proliferate in 2003. At present, there are just over 250 such institutions, including funds, companies and managing companies. Hedge funds began to be created in Spain in 2006, and it was not until 2007 that they began to acquire a certain importance, although still with modest figures in terms of the number of entities and the managed assets in relation to traditional mutual funds and to the experience of other countries.

Although the development of new intermediaries is still at an early stage in Spain, the same cannot be said for product innovation. In particular, the phenomenon of securitisation has developed at a rate similar to or even greater than that in other European countries.

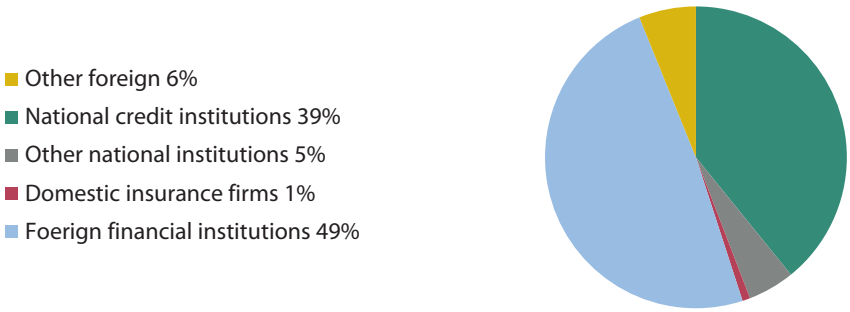
The securitisation market in Spain is one of the most important in Europe, and the second after Great Britain in terms of total volume of issues. In 2006, Spanish issues represented nearly 12% of the total in Europe, compared to the 51.8% of British issues. In the first half of 2007, the figures were 14% and 55% respectively[10]. It is worth remembering that Great Britain is the country with the highest volume of issues thanks to the fact that many institutions resident in other

10 Data from the European Securitisation Forum.

countries issue there, since London is the main financial centre in Europe, and one of the most important in the world.

In terms of risk distribution, we should ask who ends up holding these issues. At present, and using data for the year 2007, the securities issued through these operations are subscribed almost in their entirety by financial institutions, whether national or foreign. If these data are compared to those of 2005[11], there is no significant change in the nature of the subscribers to these securities. A large number of the subscribers are still financial institutions, whether national or foreign. At the same time, about 55% of issues are subscribed by foreign institutions (this figure peaked at 58% in 2005), with fewer than 50% left in Spain.

Subscribers to securitisation bond issues in Spain 2007 FIGURE 5



Source: CNMV.

Nevertheless, given that these products are structured into tranches with very different risk levels, the credit rating of each tranche subscribed should be examined in detail to obtain a conclusion about the trends in terms of risk distribution.

In this respect, although in 2005 the tranche with the lowest credit rating, the equity tranche, was taken up completely by the national financial institutions themselves, in 2007 it can be seen that there are new subscribers who have acquired 10% of the equity tranches. Specifically, national financial institutions other than credit institutions, which include institutional investors, have taken up 7.5% of these issues, while foreign financial institutions held on to a little over 2%. In other words, although national credit institutions continue to be the main holders of the most risky tranches of the issues, other financial institutions, despite maintaining a greater appetite for lower risk, also hold tranches with a lower credit rating.

11 Available in a monograph published by the CNMV "Estructuras de Titulización: características e implicaciones para el sistema financiero" ["Securitisation structures: characteristics and implications for the financial system"], by Ramiro Losada (2006).

Securitisation structures: Nominal subscription by credit rating 2007 TABLE 1

Data to 31 August.

Million euros

Standard & Poors credit rating	AAA	(AA+,A-)	(BBB+,B-)	<B-	TOTAL
Total Spanish Market	**35,377.4**	**1,074.2**	**865.3**	**366.3**	**37,683.2**
Bank of Spain	0.0	0.0	0.0	0.0	0.0
Credit Institutions	30,663.7	996.4	716.3	338.3	32,714.7
Other financial institutions	4,037.0	76.8	131.0	0.0	4,272.8
Insurance firms	666.7	1.0	18.0	0.0	685.7
Government	10.0	0.0	0.0	0.0	10.00
Total Foreign Market	**44,507.4**	**1,010.6**	**542.4**	**7.7**	**46,068.1**
Foreign financial institutions	39,834.1	743.1	394.7	7.7	40,979.6
Other	4,673.3	267.5	147.7	0.0	5,088.5
Total subscribed	**79,884.8**	**2,084.8**	**1,407.7**	**374.0**	**83,751.3**

Source: CNMV.

It is worth adding a few additional facts here. First, although these securities are traded in the regulated AIAF private bond market, they have a limited liquidity because of the number of transactions which are carried out with them (in 2006 cross transactions with these kinds of securities in the AIAF market represented 1.4% of the total, while the nominal balance in circulation as of 31 December was 37.8% of the whole of the AIAF[12]). In addition, there is little information about the final holders of these assets, which increases the lack of transparency in this market.

Another feature of the Spanish securitisation market is the predominance (above the European average) of securitisations whose assets are made up of securities derived from mortgage loans. In terms of figures, in 2006 the average percentage in Europe of mortgage-backed issues was 66%, compared to 83% in the case of Spain[13]. This predominance can be explained by the significant growth in the real estate market in Spain. There are a number of reasons for this growth: low interest rates; a significant increase in the population within a short period of time; the maintenance of some tax incentives for home buying rather than renting; and possibly a relaxation of the requirements for granting loans. All in all, the Spanish securitisation market is more sensitive to changes in the real estate market than others. Changes in the conditions of the mortgage loan market will have a greater effect on financial institutions, both in terms of mortgage loans on their balance sheet and because they have taken up a large proportion of mortgage-backed securities. Additionally, given the growing demand for mortgage loans, some institutions are securitising mortgage loans as a way of obtaining finance with which to grant new mortgage loans, and in turn they securitise these, retaining the tranches with the worst credit rating. Institutional investors whose demand for lower-rated tranches is growing are also increasing their sensitivity.

Finally, a characteristic of the Spanish market that differentiates it from others is the high credit quality of the securities issued until now. This is the result of the

12 Data from the CNMV.
13 Data from the European Securitisation Forum.

notable degree of solvency of the issuing banking institutions, which continue to maintain most of the risk on their balance sheets, and the reduced rates of bad debts affecting the mortgage loans that act as collateral for the securities issued.

To sum up, the Spanish securities markets have experienced a notable development in the last twenty years, above all if we consider the long journey they had to make given the position they started from. At present, the markets play an important role for the economy of our country, and have taken up their position in the front rank at an international level. The development of new products such as mutual funds, and the consequent process of disintermediation, led to a boom in collective investment in its various forms. This sector continues to be in constant evolution as new instruments are being introduced. The new intermediation functions of institutional investors and the constant innovation in products is also being reflected in Spain, although still to a limited extent. Asset securitisation, concentrated in the mortgage sector, has demonstrated an outstanding level of activity. This has allowed financial institutions to improve the management of their balance sheets. Despite the fact that they continue be the main holders of these securities, changes can be seen in the distribution of issues which should be monitored in the future. Overall, new functions and new agents have made their appearance. They have to be regulated and supervised in a context of constant integration and innovation of the securities markets.

5 Conclusions

The changing nature of financial markets requires constant attention in order to understand their new reality. In a context of growing interrelation and integration of markets and constant financial innovation, there is need for an analysis with a global perspective to properly assess the costs and benefits of the developments taking place.

There is no doubt that the new elements to have appeared over recent years allow us to make progress towards more complete and efficient markets. But it is also true that their growth, including new products and new agents, is taking place in an environment of growing complexity, and is being concentrated in areas or sectors characterised by looser regulatory controls or controls that are perhaps not suitable for the new operations that are being developed at present.

The function of regulation and supervision, which has been notably successful in helping the development of the markets in recent years, should now be adjusted to the new reality, and adapted so that it maintains the consistency, effectiveness and efficiency of the regulatory and supervisory framework. For this to take place, first it is essential that we should have a legal framework which is sufficiently flexible to adapt to constant changes; and secondly, that we should make progress in promoting transparency, both to facilitate the work of regulation and supervision, and to allow agents to carry out a proper assessment of their risks.

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II Studies

Safeguarding in the Spanish Stock Market 1996-2005

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1 Introduction

Growth in the Spanish stock market over the last decade has meant there is a greater presence of private investors basically as a result of the process of privatising large companies quoted on the stock market. This process has gone hand in hand with the presence of large shareholders, for the main part families and financial entities, at the helm of large Spanish stock market quoted companies.

Thus, concentration of ownership in the hands of a few shareholders is one of the main characteristics of corporate governance in Spain (*e.g.* La Porta *et al.*, Faccio and Lang, 2002; Santana and Aguiar, 2004). Therefore, the broker or agent problem faced by stock market quoted companies in our country is far removed from the classic conflict between shareholders and executives on which Jensen and Meckling (1976) focus, given that the Spanish companies are not controlled by a group of executives on behalf of a multitude of shareholders, but rather by owner shareholders with significant holdings in the company itself. The incentives exist therefore for such large shareholders to become involved in the decision making procedures and also in controlling the company.

In this sense, the degree of control by internal agents (basically directors and/or large shareholders) can become even more intense if 'safeguarding' (*blindaje*) measures are adopted. Safeguarding measures can therefore be defined as a set of instruments which infer greater power for agents in control of corporate decision taking. Such measures are adopted by agents in order to increase the likelihood of retaining their position and this can lead to decisions being taken that serve their own interests. Safeguarding measures can thus be used as instruments allowing wealth to be expropriated from minority shareholders, in that the enforced discipline of the corporate control market and the shareholders meeting is reduced. One finds among the various defensive measures, on the one hand, some which require the approval of the Shareholders' general meeting in order to be adopted. These include issuing shares with different voting powers or including safeguard clauses within the company Articles of Association. On the other hand, safeguarding measures not requiring the approval of the general shareholders' meeting may be used by the controlling agents and these include changing the company capital structure, litigation against potential purchasers or restructuring corporate investment.

Corporate governance, in this context, takes on particularly transcendental importance as a system with the principal function of defending the interests of external investors. This fact has been made out to be one of the main reasons for justifying the development of regulations in Spain relating to the governance of stock market quoted companies between 1996 and 2005. Thus, the publication of the Olivencia Commission Report in 1998 and the Aldama Commission Report in 2003 and particularly the coming into force of Law 26/2003 have led to a greater degree of transparency and responsibility on the part of the governing bodies of

Spanish stock market quoted companies. The development of regulations has, in this manner, permitted a substantial increase in awareness of the systems of governance in Spanish stock market quoted companies.

Among the different mechanisms for corporate governance, the analysis of safeguard clause measures built in to company Articles of Association has become particularly relevant in view of the influence this can have on protecting minority shareholder rights and as a consequence of the substantial lack of transparency typical of Spanish companies up until 2003 in this regard. For this reason, therefore, there are few available studies[1] dealing with safeguarding measures to reveal how these have evolved, over a decade that saw strong development on the part of Spanish markets and deep dynamism within institutions, which are one of the instruments which can be used by government to exert a greater effect on the behaviour of Spanish stock market quoted companies.

Thus, if we consider that safeguarding measures constitute a mechanism limiting minority shareholder rights, then the purpose of this study is to analyse safeguarding measures as contained within the Articles of Association of non-financial Spanish stock market quoted companies for the decade 1996-2005[2] - and to try and find an answer to a series of questions such as: What percentage of stock market quoted companies have built in safeguard clauses and what changes have there been to that percentage over the 1996-2005 period? What degree of safeguards is built in and how what variations have there been in that factor? What safeguarding measures are most frequently used by Spanish stock market quoted companies? Have these preferences remained the same throughout the decade under review? What strategy has been adopted by companies coming on to the Spanish stock market over this period? Have the regulations concerning securities markets transparency which came into force in the year 2003 had any effect?

In order to provide an answer to these questions, the second section deals with the influence of the legal system on the degree of safeguarding built in by companies to their Articles of Association. Section Three looks at aspects of methodology and with particular reference to setting up a safeguard rating index. Section Four sets out the results of the empirical research, which is the central theme of this study, and attempts to answer some of the queries highlighted. Finally the main conclusions are set down.

2 Defensive measures and the institutional environment

Safeguard clause measures can be used by internal agents as a mechanism for expropriating wealth from external investors due to the fact that they can serve to reduce any threat that may come from the corporate control market. Stulz

1 See Santana and Aguiar (2004) for an analysis of developments in safeguarding measures built in to company Articles of Association for Spanish stock market quoted companies between 1996 and 2002.
2 This study is the synthesis of a more extensive work Publisher by the Spanish Securities Commission. A decade of Safeguarding Measures in Spain. 1996-2005. Essay No. 22.

(1988) argues in this sense that defensive provisions effectively reduce the likelihood of a takeover bid occurring and that might in itself provide internal agents with an incentive to dig themselves in protectively. The use of defensive instruments furthermore has the effect of limiting the disciplinary guidelines that can be exercised by the general shareholders´ meeting over the Board of Directors and executives. Thus, the fact that the internal governing bodies become weaker when defensive instruments exists, means that there is a greater likelihood that agents involved in the decision making process will take opportunist actions which will benefit them individually. Danielson and Karpoff (1998) state along these lines that the existence of safeguard measures affects not only the external corporate control market but also the internal corporate control market i.e. that relating to changes in power structure brought about by shareholders themselves as they affect corporate policies by exercising their voting rights at general shareholders meetings.

Among possible motives for justifying approval on the part of shareholders of safeguard provisions within the company Articles of Association which can go against their own interests, DeAngelo and Rice (1983) highlight a preference for the current executives to continue in their positions, the substantial information gathering and operational costs involved in combating approval of such provisions, and also the presence of controlling shareholders for whom the main objective is not to increase the value of the company but for personal gain. Cuervo (2002), in this sense, argues that the behaviour of controlling shareholders or "core shareholders" in European Continent countries goes to explain the use of safeguard mechanisms and that these are put forward for approval as instruments to protect the general interest, whereas in the majority of cases they serve basically to protect the interests of executives and controlling shareholders. Thus the ownership structure can serve to explain why companies adopt safeguard measures. Thus, as internal agents gain greater shareholdings, so the benefits of adopting safeguard measures decreases (e.g. Malatesta and Walking, 1988; Bebchuk, 1999; Field and Karpoff, 2002).

Furthermore, the use of safeguards can be as a result of factors that are external to companies, specifically of the institutional environment. On the one hand there is legislation put in place at state level for general regulation of the relationships between such investors, and on the other there are specific government regulations dealt with under company Articles of Association having to do with such possibilities, lacunae or absences of state legislation. In this manner, the legislative system can affect the extent to which safeguard measures are used. In this regard, since the Spanish Securities Commission was first set up in 1988 (*Comisión Nacional del Mercado de Valores (CNMV)*), Spain has undergone significant changes at the legal and institutional level mainly for the purpose of increasing the transparency of information of securities markets and the level of defence afforded to external investors´ interests by the Spanish legal system. The way the institutions have developed was accelerated with the coming into force of Law 26/2003, further developed by EU Order ECO/3722/2003 and Official Note 1/2004 issued by the Spanish Securities Commission. This legislative framework has meant a considerable increase in the level of transparency and liability of governing bodies of Spanish stock market quoted companies.

The most recent legal precepts on which legislation has been developed in relation to the corporate governance of companies quoted on the stock market in Spain are found under Law 44/2002, regarding Measures for reforming the financial system. This covers, among other aspects, the duty of Spanish stock market quoted companies to have an Audit Commission, it sets out mechanisms to ensure that auditors are more independent and changes have been made to relevant communications to the market on the part of stock market quoted companies. The reports prepared by the Olivencia Committee, on the other hand, and more specifically by the Aldama Committee, profiled a series of recommendations so that the legislator can set out a legislative framework which will adequately develop control over the system of corporate governance of Spanish stock market quoted companies. These recommendations fall specifically into three categories: duties to inform and of transparency, definition and the regime of company administrator obligations, particularly with regard to conflicts of interest and the fact that companies quoted on the stock market are obliged to have governance mechanisms in place such as, for example, regulations governing the operation of the Board of Directors and the Shareholders Meeting.

These regulations are backed up by provisions set down under Law 26/2003 which, among other aspects, introduces a new section into Law 24/1988 regarding the Securities Market dealing with stock market quoted companies and, specifically, the governance thereof. In this sense, there is a duty to inform the market about the system of corporate governance by drawing up an annual report, for which the Board of Directors is liable and this must be made available to all shareholders and investors by publication on the company website. Furthermore, there has been a tightening of mechanisms to ensure information is passed on that is of relevance to external shareholders and their participation in decision making has been strengthened. EU Order ECO/3722/2003 and Official Note 1/2004 issued by the Spanish Securities Commission went on to complete the above mentioned legislation as they defined the minimum contents and structure to be set out in the corporate governance annual report, and also set down the technical and judicial specifications for websites of Spanish stock market quoted companies.

In this manner, the overall regulations relating to governance of stock market quoted companies has meant that Spain, despite being a country which uses the French legal system, has been able to provide above average levels of defence to minority shareholders when compared to the all the states forming part of that legal family. La Porta *et al* (1998) have developed a rating index which measures the level of defence afforded to minority shareholders by any given legal system in the face of executives and large shareholders and referred to as ´antidirector rights´. Application of that rating index gives Spain, in accordance with Spanish legislation in force in 1993, 4 points as compared to the 2.33 average points for French origin legal system countries. Djankov *et al.* (2006) later revised that index in accordance with legislation in force in 2003, and Spain attained a rating of 5 points as compared to the 2.91 average for French legal system countries. Indices regarding disclosure and liability guaranteed under the legal system as constructed by La Porta et al. (2006) are along the same lines. Spain therefore rated 0.5 on the disclosure requirements as compared against the 0.45 average for French legal system countries. Equally, where the internal agent liability standard is concerned, Spain achieved 0.66 points when the average for French legal system countries is 0.39.

Thus, if one takes safeguard clauses to be a mechanism restricting minority shareholder rights, then given the improvement observed in the protection level afforded by Spanish legislation, one should look at whether this has led to a reduction in company safeguard clauses built in to Spanish stock market quoted company Articles of Association and, if this is so, then one must ask how this possible reduction in defence levels of quoted companies has taken place.

3 Aspects of Methodology

3.1 Sample and data sources

The sample taken was of 108 non-financial companies quoted continuously on the market as at 31 December 2005, of which five companies were set aside as they were not registered at an address within Spain. The final sample thus comprised 103 non-financial Spanish stock market quoted companies. The study was carried out on the basis of company Articles of Association in force as at 31 December between 1996 and 2005. It should be pointed out that the number of companies analysed differs for each year of the period studied due to companies coming on and off the stock market. As one can see from Table 1, the greatest net number of companies coming on to the stock market occurred over 1997-1999, in that from the year 2000 onwards the total number of companies stabilises.

No. of Companies. 1996-2005 TABLE 1

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
All	52	65	72	80	85	89	93	95	98	103
Common	52	52	52	52	52	52	52	52	52	52

The sources of information used to gather data from the Articles of Association differ according to two periods. The first period, from 1996 to 2002, is characterised by the fact that the companies concerned were not under any legal obligation to publish their Articles of Association. For that reason, each company forming part of the sample was asked to provide a copy of their Articles of Association in force between the end of 1996 and the end of 2002, together with any amendments carried out to them during that period. The number of positive replies was very low (approximately 10% of the companies analysed). In view of that situation, Companies Registers in each province where the stock market quoted companies had their registered company addresses were asked for a ´simple record´ of the information as described above. This is because neither the Central Companies Register nor the provincial registers have a database holding Articles of Association for companies with registered addresses in Spain. During the second period, from 2003 to 2005, Law 26/2003 was approved and later developed, and made it possible to obtain the Articles of Association for the stock market quoted companies together with the most recent amendments, through the company websites.

3.2 Safeguard provisions in Articles of Association and the frequency of safeguard clauses

Having duly gathered all company Articles of Association from non-financial Spanish stock market quoted companies between 1996 and 2005, and after studying these, five statutory safeguard provisions can be separated out from their specific governance regulations: limiting the percentage vote that any one shareholder may have, requiring qualified majorities in order for certain decisions to be adopted, specified length of time as shareholder before being able to become a director, specified length of time as director in order to hold the position of Chairperson and gradual renewal of Board of Directors. The nature of these provisions is set out under Table 1.

Safeguard provisions under Articles of Association for Spanish stock market quoted companies. 1996-2005 BOX 1

Limiting the percentage vote	A maximum percentage of votes that can be issued by any one shareholder is introduced into the company Articles of Association (usually 10%) even if they have a larger shareholding.
Qualified majorities	The company Articles of Association require larger majorities than set down in the Revised Law governing Spanish Public Limited Companies in order to the so-called special scenarios to be adopted (issuing securities, either increasing or decreasing company capital, merger, amendments to Articles of Association, etc.) A majority of somewhere between 75 and 90 per cent of company capital is usually required.
Length of time as shareholder in order to be a director	The company Articles of Association set down a requirement that one has to be a shareholder for a certain length of time, usually between 1 and 3 years, in order to be a director.
Length of time as director in order to be Chairperson	The company Articles of Association set down a requirement that one has to be a director for a certain length of time, usually between 1 and 3 years, in order to be either Chairperson and/or vice-chairperson of the Board of Directors.
Gradual renewal of Board of Directors	The company Articles of Association set down that the Board of Directors will be gradually renewed, usually in half-yearly, quarterly or two yearly periods.

Provisions built in to Articles of Association of Spanish stock market quoted companies can be deemed, according to the classification criteria put forward by Danielson and Karpoff (1998), to be internal control provisions. On that basis we can state that any such provisions do not have a direct effect on the cost to a possible buyer of accumulating a significant package of shares, i.e. they do not directly either the effect the price that must be paid or the number of shares that will have to be bought in order to acquire a company. They rather seek to raise the cost of exercising control for any shareholder not involved in taking company decisions. This serves indirectly as an obstacle to any possible hostile bid for current internal agents.

On the other hand, these provisions can be categorised according to the governing company body for which they are intended. Thus, the limit on percentage vote which any one shareholder may issue and the necessity for qualified majorities in addition to those set down generally under the Revised Text governing Spanish Public Limited Companies for the approval of special

scenarios (changes in company Articles of Association, issuing securities, changes in company capital, etc.), are provisions principally aimed at regulating voting procedures at the General Shareholders´ Meeting. The requirement for length of time in a position and gradual renewal of the Board of Directors, - are safeguards built into the Articles of Association aimed basically at regulating the composition of that company governing body[3].

After having identified and gathered the provisions built in to company Articles of Association a "Safeguard Clause Index" was drawn up. This has been set up so that the rating is 1 if the company does have such a provision built into its Articles of Association and is 0 if not. Thus the index rating can be anywhere between zero and five. The higher the index rating the greater the degree of safeguarding built into the company Articles of Association. Using a simple safeguard clause index involves certain limitations, including:- not taking into account the relative importance of each of the safeguard clause provisions. Nevertheless, the above mentioned works which have set down safeguard clause ratings ((e.g. Danielson and Karpoff, 1998; Gompers, et al, 2003; Nenova, 2003) have used simple indices arguing that this provides a greater degree of transparency and is easier to repeat and that there is no need to reach any opinion as to the efficacy of each measure analysed.

Company safeguard clauses have been analysed from a quantitative point of view, attempting to ascertain the relative size of safeguarded companies and the level of safeguarding, and also from a qualitative point of view, analysing what kind of safeguard measures built into Articles of Association are used by Spanish stock market quoted companies. Furthermore, in view of the fact that the overall companies analysed include both those which have been in the database since 1996 as well as those which were added in later, then it becomes interesting to conduct the analysis taking the way the two groupings of companies progress: the total group and common group (which remained on the database throughout the period analysed.)

This double analysis makes it possible to ascertain whether any change in safeguarding levels, whether in the percentage of safeguarded companies or in the index rate of safeguard clauses, is due to variations which occurred in relation to the companies themselves or whether, to the contrary, it is affected by new companies being included for quotation on the stock market.

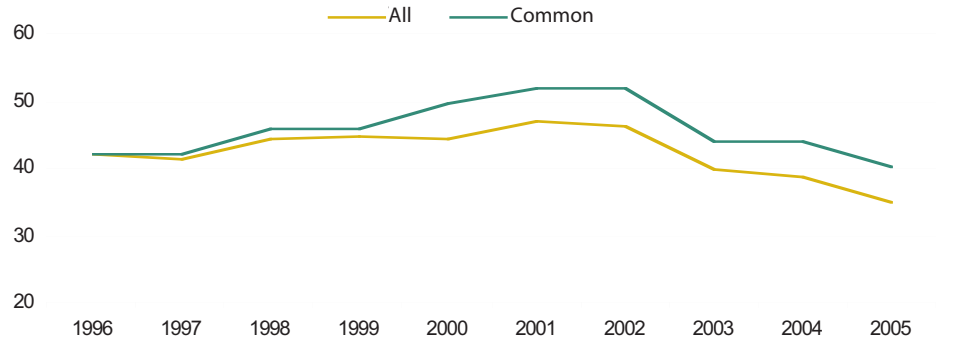
3 There are other sources of safeguarding not analysed herein for two basic reasons. The first of these is if that measure is not public throughout the period analysed (e.g. safeguard clauses for chief executives built in to their contracts) or if they had only recently been made public (e.g. regulations governing the General Shareholders´ Meeting or regulations governing Board of Directors). The latter because they are deemed to be a second line of defence in the event of any possible loss of control by current internal agents who only act if companies do not have sufficient safeguard measures in place within their Articles of Association or if those adopted therein have not worked as a defence mechanism.

4 Safeguard Clauses in Spanish stock market quoted companies. 1996-2005

4.1 Analysis of safeguarded companies

As can be seen from Figure 1 (data provided under Table A1 annex), the percentage of companies with Articles of Association containing at least one safeguard provision, hereafter safeguarded companies, dropped between the beginning and the end of the ten year period analysed, from 42% to 35% for the total number of companies. Nevertheless, that change did not take place in a linear fashion. Thus, during the period from 1996-2002 the percentage of safeguarded companies went up to around 47% and after 2003 a significant and ongoing drop occurred in the number of safeguarded companies which went down to 40% and continued to drop reaching the above mentioned figure of 35% in 2005.

Percentage of safeguarded companies. 1996-2005 FIGURE 1



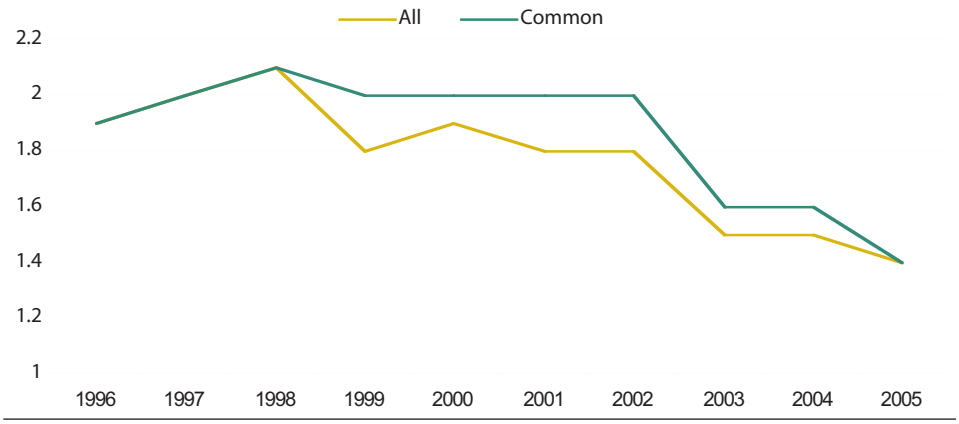
The group comprising common companies shows a similar trend to that for all companies as a whole between 1996 and 1999, with the percentage of safeguarded companies rising from 42% to 46%. The growth was sharper for the years 2000 to 2002 when it reached peak levels for the period, over 50%, and dropped sharply in 2003 when it fell back to 44% and was at 40% when the decade came to an end.

It is worth pointing out that during the 1996 – 1999 period, with the greatest number of companies joining the stock market (specifically 28 of the 51 entered between 1997 and 1999),the percentage of safeguarded companies is virtually identical both for all companies and for the group of common companies. In the period between 1999-2001, however, despite that fact that far fewer companies joined the stock market than in the preceding years (8 companies in 2001 and 2002), the percentage of safeguarded companies was much higher for common companies. This goes to show that during the 2000 to 2002 period it was the companies that had been quoted on the stock market over the previous years which introduced safeguarding measures into their Articles of Association. All in all, during the period overall the percentage of safeguarded companies increased from 1996 to 2002 and dropped after 2003, which mirrors the regulation on transparency coming into force in that particular year.

4.2 An analysis of the safeguard rating

The average values for safeguard clause rating between the years fro 1996 to 2005, for all the stock market quoted companies are shown under Figure 2 (see descriptive statistics under Table A2 annexed). One can see from that graph that the safeguard clause rating for Spanish companies stood, at an average, somewhere between 2.1 achieved in 1998 and 1.4 in 2005. It nevertheless remained above 1.8 between 1996 and 2002, falling from 2003 onwards. As for common companies, one should highlight the stability observed in the mean rating value, which sat at 2 up until the year 2002 and fell from 2003 onwards until it hit the lowest point 1.4 in 2005.

Safeguard clause rating. 1996-2005. Mean values FIGURE 2



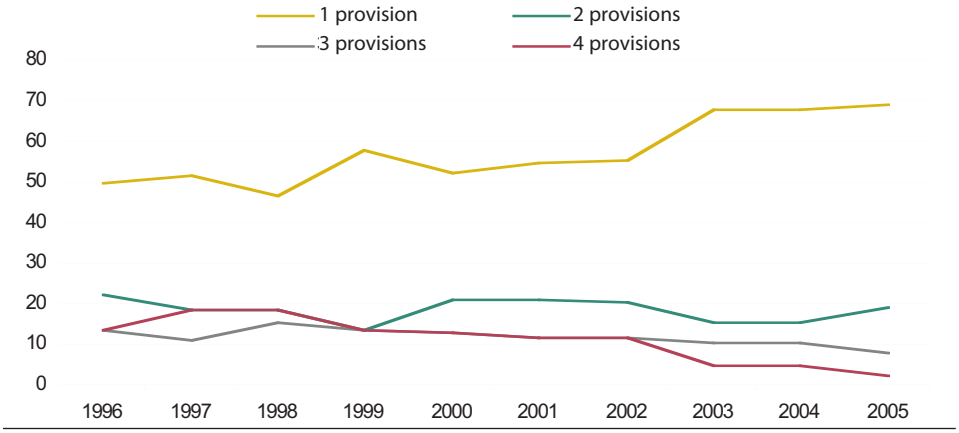
As can be seen, the mean valued for the safeguard clause rating for common companies are greater than or equal for each year to the companies overall. This reflects the fact that stock market quoted companies maintained their levels of defence throughout the entire period, whereas the companies newly incorporated into the stock market do so which a lesser degree of defence measure. This is particularly so from 1999 onwards, given that over the 1996-1998 period the mean values are exactly the same for both collective groups. This goes to show that companies coming on to the stock market had a lower degree of safeguarding and that this helped to bring down the average rating value.

It should be noted that the effect of the regulation governing transparency of securities markets can be seen, manifested in a significant reduction in safeguarding clauses from 2003 onwards. This drop is statistically significant, as shown by the Wilcoxon contrast, both for the companies overall and for the grouping of common companies (see Table A2 annexed).

Given that only discreet values can be adopted by the rating index, which is dimensioned both at the lower and upper extremes, then an analysis of the rating index and its evolution can be carried out on the basis of the frequency spread. As far as the total number of companies is concerned (see Figure 3 and Table A3 annexed) what one notices first of all is a predominance of companies that have

only one safeguard provision built in to the company Articles of Association and, furthermore, that they tended to increase over the period, from 50% in 1996 to 69% in 2005. The greatest increase was in 2003 when the 68% mark was reached.

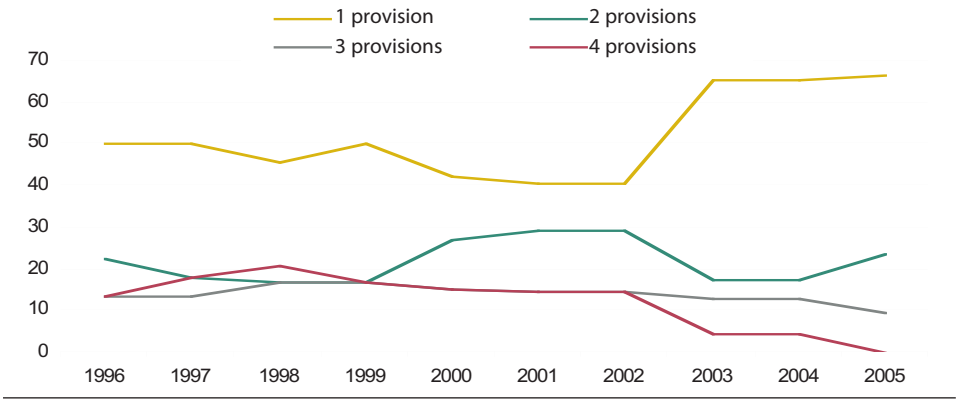
Spread of Safeguard clause rating. 1996-2005. All FIGURE 3



The percentage of companies with two safeguard provisions remained stable at around 20% for this period, except for 1999, when it dropped to 13.8%. This recovered to over 20% for the years 2000-2002. From 2003 onwards the percentage of companies with three safeguard clauses dropped to 8.3% and a drastic drop occurred in the number of companies with four safeguarding clauses from 11.6% in 2001 to 2.77% in the year 2005. Thus none of the stock market quoted companies have five safeguard clauses built in to their company Articles of Association.

With regard to the common companies (see Figure 4), the development trend is similar to that already mentioned with regard to companies overall, although the values given in the case of one single defence provision are lower, whereas for ratings values higher than one, the opposite occurs. The only exception observed is for the maximum rating value (4 provisions) and in that case the percentages for common companies are higher than the percentage referred to above for all companies, over the 2003-2005 period. There was in fact no company at all with four safeguard provisions among the common company grouping.

Spread of Safeguard clause rating. 1996-2005. Common FIGURE 4

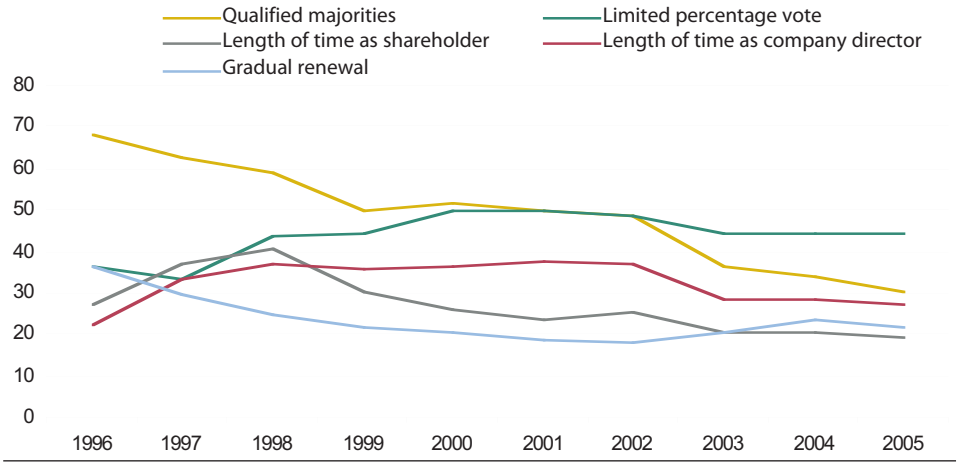


4.3 Analysis of safeguarding provisions

The qualitative analysis, as already mentioned, looks at what type of provisions are most frequently used by companies. The spread of each of the safeguarding provisions throughout the whole of the period analysed is set out under Figures 5 and 6, for all companies and for common companies, respectively (see data under Table A4 annexed).

As one can see from Figure 5 referring to companies overall, up until the year 2000 the provision most frequently used by companies quoted on the stock market was the requirement for qualified majorities, although the percentage of companies with this safeguard in place dropped from 68% in 1996 to 52% in 2000. The percentage relating to restricting the voting percentage evolved in inverse fashion as it increased from 36% in 1999 to 50% in 2000. The way both percentages evolved, furthermore, came together during the above mentioned period attaining 50% for 2000 to 2002. From 2003 onwards the trends reversed and whereas in both cases the percentage dropped, the values for the voting percentage restriction were higher than for the qualified majorities, and it was the most frequently used provision during this period.

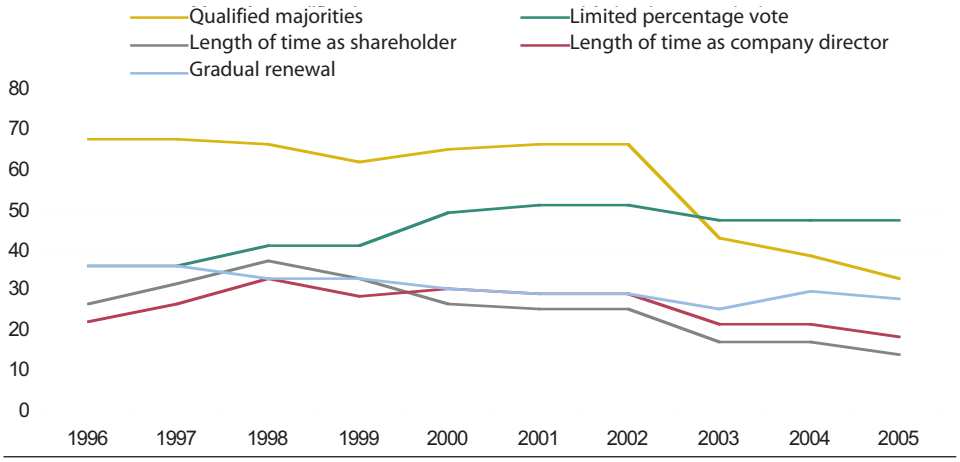
Spread of safeguarding provisions. 1996-2005. All companies FIGURE 5



With regard to setting down requirements regarding length of time as shareholder in order to be company director, this is used as a safeguard by a percentage of companies as high as 40% in 1998. From that point in time onward the percentage gradually fell and then stopped in 2002, when the level was 25%, and reduced significantly in 2003 down to 21%, where it stabilised. As far as the requirement for a certain length of time as a company director in order to chair the Board of Directors, this measure is used by a growing number of companies over more than 30% up until 2002 and began to drop in 2003 from 37% to 28%, although it has consolidated since that year. This is the third most frequently used provision for the 2003-2005 period. Lastly, gradual renewal of the Board of Directors is the only provision showing an increase in the percentage of companies which use it from 2003 onwards, despite having dropped between 1996 and 2002.

As set out in Graph 6, the same as for the all companies, the requirement for qualified majorities is the safeguarding measure most frequently used by common companies, although a great degree of stability can be observed in this case in the percentage of companies, which was about 66% between 1996 and 2002, producing a sharp drop to 43% in the year 2003 and a progressive decline in following years until it reached a minimum value of 33% in 2005. The way it evolved was in sharp contrast to the above mentioned evolution with regard to companies overall, where the process of eliminating this provision happened gradually over the whole ten year period. In both cases, however, the greatest drop took place in 2003. This demonstrates that companies which remained on the stock market throughout the period concerned were not likely to eliminate this safeguard, whilst companies which recently joined the stock market used it less.

Spread of safeguarding provisions. 1996-2005. Common companies FIGURE 6



As far as limiting the percentage vote that any one shareholder can issue, the values vary in common companies between 36% in 1996 to 51% for 2001 and 2002, with slightly higher values than the total group of companies but with similar variations. In 2003 yhis dropped to 47% and remained at that level until 2005. It is important to note that this provision becomes ranked as the top provision from 2003 onwards. The percentage of companies which retain the requirement to complete a certain length of time with a company in order to become a Director fell over the period as a whole. This reflects the gradual erosion of these types of provisions under Articles of Association for stock market quoted companies. The most noteworthy difference between the total companies and the common companies can be seen in the *ranking*, given that in this case third place goes to gradual renewal of the board of Directors rather than length of time as a shareholder in order to be a director. This duly reflects the fact that companies starting to be quoted on the stock market already include more stringent requirements of length of time as shareholder than in the case of common companies.

All in all, just as in the previous analyses, changes in the percentage of companies using the different provisions generally show that each and all of these have been decreasing since 2003, other than the gradual renewal of board members.

5 Conclusions

This study has analysed company safeguarding in Spain by looking at provisions built into the Articles of Association of non-financial companies quoted on the stock market over the ten year period from 1996-2005. Provisions contained in the Articles of Association of the companies analysed were gathered and grouped according to which company governing body they were aimed at. Thus, restricting the percentage vote that any one shareholder can issue and introducing qualified majorities in addition to those set down generally under the Spanish law governing public limited companies for approving what are termed special scenarios (changes to company Articles of Association, issuing securities, alterations to company capital, etc.) are provisions which are mainly aimed at regulating the voting procedure at General Shareholders´ meetings. On the other hand, requirements regarding the length of time as a shareholder in order to become a company director, or length of time as a director in order to chair the Board of Directors, as well as gradual renewal of the Board of Directors are all safeguarding provisions which are basically aimed at regulating the composition of that governing body. Thus having identified and gathered the provisions contained in company Articles of Association, an "safeguard rating index" was drawn up, with values from zero to five, in such a manner that the higher the rating the greater the level of safeguarding contained in a company Articles of Association.

In relation to stock market quoted companies overall, there was a drop in the percentage of safeguarded companies between the beginning and the end of the ten year period analysed, from 42% to 35%. Nevertheless, that evolution did not happen in a linear fashion. Thus, for the period from 1996-2002, the percentage of safeguarded companies increased and reached about 47%, showing a significant and progressive drop in importance from 2003 onwards when it went down to 40%. It then continued to go down until reaching the above mentioned level of 35% in the year 2005. As for the average values of the safeguard rating index, these varied between 2.1 which was the figure in 1998 and 1.4 in 2005, dropping significantly after 2003. In so far as all measures adopted by safeguarded companies, the analysis showed that the percentage of companies using the different provisions dropped, in general terms, from 2003 onwards, except for the gradual renewal of the Board of Directors. Thus, up until the year 2000 the provision most frequently used by companies quoted on the stock market is the requirement for qualified majorities, although this was overtaken from 2003 onwards by the restriction in percentage vote.

With regard to safeguarding the grouping of companies quoted on the stock market throughout the years analysed (common companies) one should point out that this group follows a similar trend to the companies overall, although the percentage of companies with safeguarding provisions is higher among common companies. It is further worth highlighting the stability observed in the average index rating value which was 2 up unitl 2002 and dropped after 2003 to a minimum of 1.4 in the year 2005. In the same fashion, the average values for the safeguard rating index in common companies are higher than or equal for all the years concerned to those for companies overall. This reflects the fact that companies that were quoted on the stock market throughout the period kept their

safeguarding levels, whereas those newly joining the stock market do so with fewer safeguarding measures in place, particularly after 1999. This goes means that companies joining the stock market throughout the period adopted a lower proportion of safeguarding provisions built in to their company Articles of Association. Those companies in turn showed a lower safeguard index rating and this helped to bring the average index rating down.

This study has therefore helped to disclose the influence of institutional development which has taken place in Spain, with regard to legislation on corporate governance of stock market quoted companies, having to do with safeguard clauses in such companies. In this sense, the regulatory change has helped to bring down corporate safeguarding, and this can be clearly seen not only in the number of safeguarded company but in the degree of defence. The results furthermore go to show the predominance of defensive mechanisms aimed at restricting shareholder rights when adopting agreements in General Shareholders' Meetings.

One should therefore highlight the change in defence strategy for Spanish stock market quoted companies given that that the restriction on the percentage vote that any one shareholder may issue went from being one of the least used provisions at the start of the decade to being the most frequently used from 2003 onwards. In this manner, the way that safeguarding has evolved in our country reflects the fact that the development of legal standards has brought about a greater defence of external shareholders on the part of the legal system. Nevertheless, one should particularly note the special importance taken on by the provisions regarding the right to vote as defence mechanisms which can safeguard internal agents to the detriment of the interests of the remaining investors.

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7 Annex

Safeguarded companies. 1996-2005

TABLE A1

(%)	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
All	42.30	41.54	44.44	45.00	44.70	47.19	46.23	40.00	38.77	34.95
Common	42.30	42.30	46.15	46.15	50.00	51.92	51.92	44.23	44.23	40.38
No. Companies.										
All	52	65	72	80	85	89	93	95	98	103
Common	52	52	52	52	52	52	52	52	52	52

Descriptive Statistics for the Safeguard Rating of Spanish stock market quoted companies *. 1996-2005

TABLE A2

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
						All				
Average	1.9	2	2.1	1.8	1.9	1.8	1.8	1.5	1.5	1.4
T.Deviation	1.5	1.2	1.2	1.1	1.1	1.1	1.1	0.9	0.9	0.8
Mean	1.1	1	2	1	1	1	1	1	1	1
Wilcoxon Z			1996-1999			1999-2002			2002-2005	
Comparison			-0.357 (0.721)			-0.219 (0.827)			-1.752* (0.08)	
						Common				
Average	1.9	2	2.1	2	2	2	2	1.6	1.6	1.4
T.Deviation	1.5	1.2	1.2	1.2	1.1	1.1	1.1	0.9	0.9	0.7
Mean	1.1	1.5	2	2	2	2	2	1	1	1
Wilcoxon Z			1996-1999			1999-2002			2002-2005	
Comparison			-0.853 (0.394)			-0.342 (0.732)			-2.138** (0.03)	

* Calculated on safeguarded companies.

Spread of Safeguard Measures index

TABLE A3

% of safeguarded companies						**All**				
Nº of Provisions	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**
1	50	51.8	46.8	58.3	52.6	54.7	55.8	68.4	68.4	69.4
2	22.7	18.5	18.7	13.8	21.0	21.4	20.9	15.7	15.7	19.4
3	13.6	11.1	15.6	13.8	13.1	11.9	11.6	10.5	10.5	8.3
4	13.6	18.5	18.7	13.8	13.1	11.9	11.6	5.2	5.2	2.7
5	0	0	0	0	0	0	0	0	0	0
						Common				
Nº of Provisions	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**
1	50	50	45.8	50	42.3	40.7	40.7	65.2	65.2	66.6
2	22.7	18.1	16.6	16.6	26.9	29.6	29.6	17.3	17.3	23.8
3	13.6	13.6	16.6	16.6	15.3	14.8	14.8	13.0	13.0	9.52
4	13.6	18.1	20.8	16.6	15.3	14.8	14.8	4.34	4.34	0
5	0	0	0	0	0	0	0	0	0	0

Spread of provisions under Articles of Association as used by Spanish stock market quoted companies. 1996-2005

TABLE A4

% of safeguarded companies	All									
	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Qualified Majorities	68.1	62.9	59.3	50.0	52.0	50.0	48.8	36.8	34.2	30.5
Percentage vote restriction	36.3	33.3	43.7	44.4	50.0	50.0	48.8	44.7	44.7	44.4
Length of time as shareholder	27.2	37.0	40.6	30.5	26.3	23.8	25.5	21.0	21.0	19.4
Length of time as Company Director	22.7	33.3	37.5	36.1	36.8	38.1	37.2	28.9	28.9	27.7
Gradual renewal of the board of Directors	36.3	29.6	25.0	22.2	21.0	19.0	18.6	21.0	23.6	22.2
	Common									
	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Qualified Majorities	68.1	68.1	66.6	62.5	65.3	66.6	66.6	43.4	39.1	33.3
Percentage vote restriction	36.3	36.3	41.6	41.6	50	51.8	51.8	47.8	47.8	47.6
Length of time as shareholder	27.2	31.8	37.5	33.3	26.9	25.9	25.9	17.3	17.3	14.2
Length of time as Company Director	22.7	27.2	33.3	29.1	30.7	29.6	29.6	21.7	21.7	19.0
Gradual renewal of the board of Directors	36.3	36.3	33.3	33.3	30.7	29.6	29.6	26.0	30.4	28.5

Regulating takeover bids and profitability for minority shareholder in bids for Spanish companies

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1 Introduction

A takeover bid (OPA – *Oferta Pública de Adquisición de Acciones*) is one of the regulatory mechanisms available for controlling political power in companies, specific to securities quoted on the stock market. The substantial degree of attention given to these kinds of transactions by investors, analysts and the media is justified both in that these types of bids effectively determine the composition of governing bodies for large companies and also because they are generally extremely profitable for their shareholders. At the same time they also affect the creditors of companies involved in such transactions, their current management teams, employees, end clients and also the public administration bodies.

Aside from the usual interest generated by these kinds of operations, interest in regulating takeover bids is currently at a peak. This is due to transposing Directive 2004/25/EC governing takeover bids to the national (*Spanish*) regulatory framework, heightened activity in countries everywhere to control companies and a series of bid attempts on the Spanish company Endesa.

The regulatory framework governing takeover bids is complex given that the objectives sought after are occasionally contradictory to one another. Thus, for example, the greater the protection for the company shareholder following presentation of a takeover bid then possibly the lower the likelihood of such a takeover bid occurring. Other additional objectives can exist that will not be analysed in this document given that they go beyond the securities market itself, e.g. competition defence policy, stable employment and defending the existence of *national champions*.

Part 2 provides a summary of the economic theory for regulating takeover bids and covers incentives for the three types of agents involved: the bidder, the minority shareholders and the current controlling shareholder in the company.

Part 3 explains the methodology used in analysing the effect on shareholders' wealth of takeover bids that occurred in Spain during the period from 1999 to July 2006. Part 4 subsequently lists the results obtained.

2 Economic Theory on Takeover Bids

2.1 Changes in company management

The purpose of regulating takeover bids is to control the way changes take place in the company management structure, the target company, by acquiring securities which

convey political rights. In order to analyse this one has to study the incentives brought in by regulations relating to the agents involved and the effects on their wealth.

One initial effect that was the originating cause behind these regulations is that whenever a company with a diverse shareholder base changes over to having a controlling shareholder, then one part of the political rights of the minority shareholders is temporarily suspended. Regulation attempts, therefore, to make sure they are compensated by the compulsory purchase of either part or all of their shares.

In order to analyse such changes in control one has to explain the reasons behind them and specify their effect of the wealth of shareholders of the companies involved and on the controlling equity of their management teams. In some cases the benefit obtained centres on the increased value of shares in the target company, due to the improved company management, alteration of the financial structure, etc. In other cases improvement may be observed in the merger of the two companies concerned taking greater advantage of economies of scale, reduced competition or financial costs. Lastly, the reasons which led to the acquisition may be to construct business empires so that the management have the advantage of greater controlling equity.

In addition to these benefits, one should bear in mind that whenever a takeover bid is launched, even if it is not eventually successful, it implies a series of fixed and sunk costs for the bidder, which we shall term transaction costs. Examples of these types of costs are preliminary studies on the target company, the cost of obtaining the necessary financial guarantees and the cost of complying with regulations[1].

In this document, a takeover bid will be deemed to have been efficient if the sum total of the wealth of all the agents involved is greater after the change in control to that which existed previously plus the costs of the operation. This type of efficiency does not imply that all kinds of wealth increase following the operation, given that it is possible for share value to drop to a lower value with the increased controlling equity whereas the operation would be deemed to have been efficient. Regulation can, however, require payment to be made to the beneficiaries of those harmed in such a way that not only does an operation take place which increases the wealth of the economy overall, but also that none of the parties involved are harmed thereby. That regulation is the takeover bid regulatory framework.

The issue starts to become complex when it comes to ascertaining which source should be used to regulate company takeovers. There are therefore two positions in favour:

- Individual self-regulation[2]: a company founder to whom all the financial liabilities pertain should set down rules regarding takeover of company control within the company Articles of Association prior to any possible sale of those assets. Grounds for defending this position are as follows: i) said company founder possesses the greatest details regarding the nature of the

1 According to news articles published in the press, Gas Natural and E.ON spent 111 and 300 million Euros, respectively, in their failed bids to take over Endesa.

2 Self-regulation of takeover bids does not imply an absence either of public regulations or of public powers which apply to them. This being so, such contractual regulations would have no value were it not for the existence of public regulations and state agencies to ensure compliance.

company he/she founded and ii) as owner of the rights to the entire profits generated by the company he/she has every incentive to draw up some rules to maximise their value.

- Compulsory public regulation: individual self-regulation brings with it a series of challenges which can effectively be reduced by means of regulations set down either by the State or by another entity for collective action. Those challenges are: i) that the founder may not take into account all the interests at stake, such as either the possible bidders or the employees; ii) that this kind of regulation would not apply to companies that are already quoted on the stock market, which are the most important in the short and medium term; iii) that according to the logic set out above, any later amendments to company Articles of Association would necessarily have to imply the unanimous agreement of all the parties affected. If this is not achieved, then it can lead to the company becoming stuck in an inefficient situation and iv) if unanimity is not required for the change to take place, then the regulations would lose credibility and individual self-regulation would no longer be effective as described above.

Given the problems relating to individual self-regulation, the European Union and its Member States have proceeded to establish a system based on compulsory public regulations. The regulations are not described in detail herein but are available for consultation under Aparicio (2006) and González and Pereiró (2007).

2.2 Takeover bids directed against minority shareholders

A shareholder is considered to be a minority shareholder whenever: i) said shareholder has no capacity to coordinate by entering into compulsory undertakings with other shareholders, ii) has no capability to block a bidder's take over and iii) whenever, on their own, they are not in a position to assign a holding of company shares that can provide the bidder with a controlling stake.

The main problem with this kind of bid, as Grossman and Hart (1980) point out, is that given the lack of coordination among shareholders and they do not consider selling their shares as necessary for the operation to take place, they will actually not sell their shares unless offered a price that is either equal to or more than the value of those titles in the future. The bidder does not, therefore, benefit from the purchase of such shares but must nevertheless bear the operational cost of carrying out the transaction, given that minority shareholders tend to act as free-riders with regard to such costs. If this is not otherwise compensated by other profits to be made by the bidder, then any takeover bid entails losses for the bidder, who will therefore not launch the bid in any case.

Said authors have suggested that one might permit part of the share price increase as arising out of the change of management to be diluted in favour of the bidder. Such a dilution would mean that the minority shareholders would bring down their reserve price for the sale and share some of the operational costs with the bidder, thereby enabling some mutually beneficial takeover bids to take place. It would, however, be extremely complicated to regulate for the

possibility of diluting share value for minority shareholders as the correct use of such a regulation in cases to which the theory applies would be both difficult to monitor and politically inconvenient.

The most common way for a takeover bid aimed at minority shareholders to succeed is when the bidder already holds shares prior to the transaction. If one takes the explanation proffered by Shleifer and Vishny (1986), given that the increased value will increase the value of the bidder shareholding, then the takeover bid will be profitable for as long as the amount of profit gained by such shareholding remains higher than the operation costs to be covered by the bidder. For that reason, some of the efficient bids will go through despite minority shareholders requiring full payment of the future share value.

One refinement to the above model consists of assuming asymmetrical information regarding any increased share value arising as a result of the change in company control, in such a manner that only the bidder is aware of it. Any minority shareholders when deciding the minimum selling price for their shares will do so on the basis of information known to them: the statistical share of improved value, the prior shareholding by the bidder, the operational costs and, particularly, the will of the bidder to launch the bid operation, imply that this is profitable for the bidder at said share price.

The variable factors given above will determine the expected payments for a minority shareholder takeover, i.e. the price that shareholder would receive if a bid occurred and the likelihood of it occurring:

- The price received in takeover bid:
    - Will decrease the greater the previous shareholding of the bidder, given that this facilitates the existence of profitable takeovers even where the increase in share value is lower.
    - Is greater the larger the number of shares have to be purchased in order to gain control over the company, as this implies a greater cost in media and therefore a higher expected increase in share value.
    - Will increase the greater the transaction costs, in view of the implication that the improvement must necessarily be great enough to compensate for the costs involved.
- The probability of a takeover bid taking place:
    - Is greater whenever the bidder is already a shareholder.
    - Decreases in inverse proportion to the size of the necessary bid spread.
    - Reduces as the transaction cost increases.

The effect that the existence of a previous shareholding has on the likelihood of a takeover bid taking place and on its offer price goes some way to explaining the

premium on a share market price that occurs when there is awareness of a substantial shareholder acquisition on the part of a possible future bidder.

This simple model allows one to capture the effects of three stock market regulatory mechanisms:

- The percentage share that any one shareholder may own prior to launching a takeover bid: the greater that share, the greater the likelihood that such a bid might take place, but the lower the price paid.

- Transparency with regard to any substantial prior shareholding. If a possible future bidder is allowed to acquire large shareholdings of which the market is unaware, then the acquisition of those shares becomes cheaper and the likelihood of takeover bids is thus increased. The end price received by the minority shareholders nevertheless goes down, both for those who sell prior to the acquisition becoming public knowledge, and for those who sell during the takeover bid.

- The percentage shareholding over which the takeover bid has to be launched. Total takeovers mean that such a transaction is less probable than in the case of partial takeovers but also imply a higher price to be paid to the minority shareholder in the event that such a bid occurs.

Nevertheless, if one considers that the effects on wealth expected by minority shareholders are ambiguous, then it becomes impossible to ascertain the optimum level of protection from such bids.

2.3 Takeover bids aimed at controlling shareholders

A controlling shareholder is defined as a one having a shareholding which must be bought out and would be sufficient to take control over the company[3]. When this type of shareholder exists the minority shareholder *free-rider* problem disappears although it gives rise to an external factor in that the current controlling shareholder and the bidder will take decisions which affect minority shareholders without those shareholders being able to take part in those decisions. That is why one customary mechanism used to regulate takeover bids is to make it compulsory to buy either part or all of the minority shareholdings at the same price as that paid to the controlling shareholder, thereby increasing the protection for minority shareholders.

The share price paid to the controlling shareholder must at least compensate the value of shares prior to the change of control and also for the loss of controlling equity owned. Given that there is no direct relation between these and the percentage of shares owned, the minimum price demanded by the controlling shareholder will be higher the lower percentage shareholding owned[4].

3 For the sake of simplicity, we shall assume that the bidder has no prior shareholding in the company concerned.
4 This theoretical understanding also explains the need for current company managers who do not own a shareholding in the company themselves to effectively control shares. If they have the ability to block the bid, then the price required by them might be infinite in that they have no shareholding in the company and would therefore lose their controlling equity without receiving any compensation from the takeover bid.

The maximum price the bidder will be prepared to pay will be the price at which the transaction profit, arising out of the improved value of shares acquired – from the controlling shareholder and from the minority shareholders – with regard to the price paid and the new controlling equity, is zero. Controlling equity does not depend either in this instance directly on shares acquired, and the maximum price will therefore decrease the wider the takeover bid is spread.

The final transaction price is not defined in this model but should fall somewhere between the minimum price acceptable to the controlling shareholder and the maximum price which will permit the bidder not to make a loss.

The main regulatory mechanism in this type of takeover bid is the compulsory spread of the offer to either part or all of the minority shareholdings at the same price as paid to the controlling shareholder. The effects of such a spread are:

- A smaller number of possible takeover bids, even though some of them would be economically viable.

- A generally lower negotiated price, as the maximum price offered by the bidder goes down.

- It allows part of the premium price for controlling equity to be extended to the target company minority shareholders.

- It would remove the incentive from operations which bring about reduced share value, thereby protecting the minority shareholders.

- Compulsory extension of the takeover bid to all the shares would remove the possibility of inefficient transactions according to Burkart and Panunzi (2003) as all profits and costs would be taken on by the controlling shareholder and the bidder, removing any external involvement[5].

The model described is a very simple one and does not allow for all situations that may possibly occur with this type of bid. Nevertheless, it can be further adjusted to help analyse other common situations that occur in these operations such as: i) takeover bids involving reliant on acceptance by a specific percentage in the event that agreement is not reached with the controlling shareholder, ii) explicit agreements in which the current controlling shareholder reserves the possibility of not going through with the sale if another bid is proposed at a higher price and iii) situations in which the controlling shareholder does not have a sufficiently large shareholding to take over control and that shares then have to be purchased from minority shareholders. The model described under Section 2.2 must also be used in such cases.

5 The fact that inefficient takeover bids are not possible does not imply that all efficient operations are. That why compulsory extension of the bid to include all the target company shares will not necessarily imply the improved status of the parties involved.

2.4 Compulsory sell out

The Directive governing takeover bids and its transposition to the Spanish regulatory framework deal with the right of the bidder to squeeze out minority shareholdings and the right of those minority shareholders to sell out their shares to the bidder, who is obliged to buy them. According to the Directive, these rights may only be exercised within a three month period following the date of completion of a takeover bid in which a shareholding of at least 90% has been achieved (national Spanish legislation may raise this threshold to 95%) and at the price paid under said bid.

The effect of the sell out would, in principle, mean less protection for the remaining shareholders, in that this makes it harder for them to resist purchase of the company. This regulation could, however, be advantageous to all shareholders in other ways in that it facilitates such bids and avoids discriminating between minority shareholders who sell their shares as part of the takeover and those who do not. The ultimate reason behind these two positive effects is explained in Burkart and Panunzi (2003). According to these authors, the very existence of a minute percentage of shareholdings in the hands of minority shareholders imposes costs which are more than proportionate for the company, such as the requirement to continue being quoted on the stock market. Being aware of this, certain minority shareholders offered a takeover bid might find they have an incentive to hold on to their shares so that, following a successful takeover bid, they could demand an additional premium for selling their shares and eliminating the above mentioned costs. By removing this possibility through compulsory sell out the likelihood of a successful takeover bid occurring is increased and all minority shareholders receive the same price as a result, whether they choose to sell their shares or not.

Compulsory sell out reduces the pressure on minority shareholders to sell their shares during a takeover bid and therefore reduces the likelihood that these will occur. At the same time, however, it serves to protect minority shareholders because they are guaranteed a minimum price if the takeover bid brings about a reduction in the future share value and provides them with a fair way out if the market liquidity of their titles is drastically reduced as a result of that takeover bid.

2.5 Competitive takeover bids

A special case occurs in the event that more than one bidder comes forward to take control of a company. Regulation must provide a route for such competition to occur, in that it is generally very beneficial for shareholders and to ensure that it develops in an orderly fashion and with sufficient judicial safety.

Competitive takeover bids will be dealt in this analysis as auctions. The sellers' reserve price in such auctions has already been set out under the previous sections. The purpose of regulating these processes are: i) to maximise the expected wealth of target company shareholders and ii) so that the person or entity gaining control is the one with the most efficient proposal. These two objectives are not necessarily contradictory in themselves, given that the bidder with the most profitable proposal will be the one willing to offer the highest payment.

Several procedures exist for asset auction. This document will only analyse the four most common procedures.

- English or highest bidder auction. This is the most popular type of proceeding at which the contenders withdraw from the auction until only one remains who then acquires the asset at a slightly higher price that was offered by the runner-up and provides the highest asset value. This kind of auction ensures an efficient result as mentioned above and if any uncertainty exists among the purchasers with regard to the value of the company concerned then this allows the *winner's curse* to be reduced due to the fact that the procedure allows them to indirectly share their forecasts. This means that the final price offered will be higher than if they had not shared that information.

  As far as regulation is concerned, however, this procedure has the drawback of possibly removing the incentive for competitors to become involved. This is because the takeover bids take place shortly after one another in time, implying a series of fixed and sunk entry costs. Thus, given the company value will be the same, the possible runner up contender knows they will be paying the exact price for the company in this type of bid and that they will have to incur entry costs to join in and therefore end up incurring losses. They may therefore prefer not to compete. In the event that a possible bidder exists with a higher valuation for the company than the other bidders, then the latter will not compete for the company either in that they know that they will end up losing the auction and incurring the entrance costs.

- Sealed second price bid. This procedure has the same advantages and drawbacks as the previous one. It also, however, has the additional problem that the price the winner would pay is known, even when the second price is the one that is paid. In cases where the difference between the two is substantial, this procedure would attract a great deal of criticism which, even if unfounded, would serve to weaken the regulation.

- Sealed first price bid. The main advantage of these methods is that this encourages competitors to get involved. This is because the dominant strategy for bidders is to make offers at lower amounts than the company valuation. This leaves a narrow margin for a competitor to place a winning and profitable bid, and therefore provides an incentive for competitors to take part.

  The main advantage of this method is its main drawback at the same time, as it does not guarantee that it will be the bidder with the most valuable business proposal which acquires the company. Furthermore, due to the *winner's curse*, the price paid will not be as high as in a hypothetical English auction when there is more than one bidder.

- Dutch or descending price auction. This procedure is similar to the one above, except for the fact that the prices the losers would have been willing to pay are not known. This means certain advantages in terms of the bid value in that if these were known the amount the company administrator for the bidding company is prepared[6] to pay might be reduced and also that the losers do not give out strategic information regarding their valuation of this

kind of company, and this can go against them for any future acquisitions of other companies.

Whilst the conclusion is to generically recommend the use of best price auctions one should also bear in mind the argument put forward by Bullow et al (1999) regarding the possibility of potential bidders already holding shares in the target company. In such cases the authors recommend English auctions, given the fact that each participant has the incentive to push up their bid because, at one and the same time: i) they increase the likelihood they will acquire the company and ii) they are increasing the amount they will be paid if they lose the auction.

3 Measuring profitability for the minority shareholder

Several models were set out under the previous section which can be used to predict the effects of takeover regulation as to their probability and price. This section will attempt to analyse takeover bids that have occurred in Spain since 1999 and thereby discover the average return received by shareholders in these cases and whether these comply with any of the above theoretical provisions. Given the small sample, however and the large spread of data, no model has been set out regarding the probability of a company takeover occurring and it will therefore not be possible to completely evaluate the regulation of such operations.

3.1 Data sample

The sample used comprised takeover bid approved by the Spanish Securities Commission from January 1999 to July 2006 for taking out or increasing significant shareholdings. Out of all such possible cases, only those carried out with regard to companies quoted on the stock exchange are taken into account so as to avoid any problems arising with pricing data.

In some cases an initial operation is altered at a later date, usually due to a competitor takeover bid being brought. The sample considers the initial offer as separate from the later offer. Furthermore, some operations which did not succeed have been kept as part of the sample due to the fact that the information provided by the characteristics from the period when that failure was not a known fact is valuable.

Two data samples were created:

- Sample A, comprising 66 takeover bids, includes all non-competitive offers as well as those competitors which eventually did bid and serves to review the effect on prices prior to the takeover being approved.

6 A company administrator, despite acting in the best interest of the company, knows that if they win the bid by paying a price which is significantly more that the runner up bid then he/she will be criticised and may even lose their job. This is why he/she is deemed to be affected by the winners administrator's curse which keeps the bidding low.

- Sample B, comprising 57 takeover bids, only includes the bids which were ultimately successful and permitted the bidder to acquire the shares concerned. It serves to examine the effect on prices following the takeover bid authorisation.

Takeover bids will be categorised either as partial or total according to the data contained in the Spanish Securities Commission register. Sample A includes 46 total takeover bids and 20 partial takeover bids. Sample B contains 40 total takeover bids and 17 partial takeover bids.

The bids will be deemed uncompetitive whenever i) it is the only takeover bid for the target company or ii) whenever further bids are made apart from the first one presented. As long as they do not have either of the aforementioned characteristics then they are deemed to be competitive. Sample A includes 58 non-competitive takeover bids and 8 competitive takeover bids, whereas sample B includes 49 of the former and 8 of the latter.

Lastly, takeover bids are categorised as directed at minority shareholders either whenever the bidder is the main company shareholder or whenever there is no other shareholder with a holding greater than 10%[7]. All remaining bids are deemed to be aimed at a controlling shareholder, even in cases where no explicit agreement for purchasing their shares exists. 29 bids aimed at minority shareholders and 37 bids aimed at controlling shareholders are included in sample A. Sample B has 27 of the former and 30 of the latter.

The economic theory described under Section 2 considers that due to the minority shareholder free-rider problem, any takeover bids aimed at these are hardly likely to be deemed profitable unless i) less than the whole increase in value arising out of taking control is reflected in the future price of company shares or that ii) the bidder already held shares in the company. The sample analysed would appear to comply with expectations, in that of the takeover bids deemed to have been aimed at the minority shareholders, there are only 2 cases where the bidder did not own more than 10% of the company[8].

One observation which broke with theoretical expectations was that in virtually none of the cases had the bidders either acquired or increased their significant shareholdings during the year running up to the takeover bid being presented. According to the theory put forward, such purchases would facilitate and bring down the price of these purchases and one would therefore expect such acquisitions to have occurred quite frequently.

7 According to information held on the Spanish Securities Commission register of significant shareholdings.

8 The 2 takeover bids concerned do not fit the expectations of the theory described. The reason for this is that they do not meet the initial premise. In the first instance, the aim of the takeover bid was to gain a 10% holding in the company concerned and this did not imply a change in company control. In the second instance, the bidder was buying another major company in a field of industry with few competitors and very high entry costs, and was therefore benefiting both from economies of scale and reduced competition, and this was reflected in the value of both the target company and the bidding company.

3.2 Profitability for minority shareholders according to different strategies

In order to analyse the short term effect of takeover bids on shareholder wealth, we shall use the same methodology as was used to prepare the Australian Ministerial Council Report on partial takeover bids (1985). The variables used in this regard are:

- **P**, takeover bid offer price.

- **PAD,** (*Spanish = Precio de Cierre del día anterior*) closing price the day prior to the takeover bid being announced. If there were several either competitive or amended operations then the price on the day prior to the relevant event for the first of these is used.

- **PO**, (*Spanish = precio de cierre del día posterior*) closing price either the day after the takeover bid was announced or immediately following suspension of its share trading during that day. With regard to the first operation, also in the event of competitive or amended operations.

- **PT**, (*Spanish = precio de cierre del día*) closing price either on the day the takeover bid is authorised or on the immediately following day if the stock market quotation was suspended for that day.

- **PI**, (*Spanish = precio de cierre del día inicial*) closing price on the first day of the period in which the takeover bid is accepted or the day immediately following if the stock market quotation was suspended for that day.

- **PF**, (*Spanish = precio de cierre del día posterior*) closing price on the day following publication of the takeover bid outcome.

- λ, prorated approximation. This refers to the number of shares acquired by the bidder, divided by the number of shares that accepted the takeover bid. The maximum figure would be one[9].

- **d**, dividends paid during the takeover bid, if the takeover bid was not adjusted in that regard.

The possible strategies available to the shareholder and their profitability are considered on the basis of the variable factors set out above. The first available strategy would be to turn to takeovers and the other four would be based on selling shares at their market value during the bid process. The reason why several strategies selling to the market should be considered is that the procedure for sale during a takeover can be a relatively long one[10] and the shareholder may either decide or require the sale before the operation is concluded.

If one assumes that general stock market developments bear little effect on share price, then in order to analyse the profitability of these strategies no market-linked

9 Thus, for example, if the offer was for 10% of company shares and 15% of the shares were made available for sale, then this ratio would be 2/3. In the event that the takeover bid were not successful then this ratio will be deemed to be equal to 1.

10 In the sample considered here, the average time period elapsed between the first relevant event relating to purchase and the publication of the outcome is 99 calendar days in the case of procedures when there were no competitive takeover bids and 160 calendar days when these were involved.

development model will be used. When analysing longer time periods outside the period between the time the takeover bid is announced and publication of the outcome then a CAPM model will be used and reference index will be the General Madrid Stock Market Index. Profitability will be adjusted in both instances to reflect gross dividends shares by the companies concerned.

- Strategy 1. Accept the takeover bid and offer all shares held to the bidder. If it is a partial takeover, then a prorated figure could be applied, given that the shareholder concerned will not be able to sell all the shares they hold. The assumption is that said shareholder will place the remaining shares for sale on the market following closure of the takeover bid acceptance period.

  Thus, profitability for Strategy 1:

  $$R_1 = \lambda \cdot (P - PAD + d)/PAD + (1 - \lambda) \cdot (PF - PAD + d)/PAD$$

  If prorated figures are not involved, λ equals 1, in that the same number of shares will be purchased as the number of shares sold.

- Strategy 2. Shareholdings are offered for sale on the market immediately after the takeover bid is announced. Profitability would be $R_2 = (PO - PAD + d)/PAD$

- Strategy 3. Shareholdings are offered for sale on the market immediately after the takeover bid *authorisation is known*. $R_3 = (PT - PAD + d)/PAD$

- Strategy 4. Shareholdings are offered for sale on the market at the beginning of the takeover bid acceptance period. $R_4 = (PI - PAD + d)/PAD$

- Strategy 5. Shareholdings are offered for sale on the market when the takeover bid outcome is known $R_5 = (PF - PAD + d)/PAD$

3.3 Profitability of takeover bids in Europe

To put forward Spanish data within its international context a summary is provided below of the results of two studies published by the European Institute for Corporate Governance[11]. These were carried out by Goergen and Renneboog (2003) and Martynova and Rennegoog (2006). The focus of both studies is to analyse market profitability for companies involved in mergers or acquisitions, both on the day the operation is announced and in the periods before and after. Both studies analyse operations in which at least one of the parties involved was a European company quoted on the stock market for the purpose of studying its effects both on the target company and the bidding company. The results set out below are comparable to the profitability obtained under Strategy 2 described in the paragraph above.

The first of the above mentioned strategies dealt with relatively large transactions, in that the value paid had to be greater than 100 million dollars. The period analysed ran from 1993 to 2000 and the sample comprised 187 operations, of

11 These and other documents can be consulted on the web page for the institute itself: www.ecgi.org.

which in 136 cases the target company was quoted on the stock market. The average unusual profitability for these operations was 9% for target companies on the day the operation was announced.

In the study carried out by Martynova and Renneboog (2006) certain control operations were described during the so-called fifth wave of acquisitions (1993-2001). This study differed from the previous one in that in this case all operations of this kind involving a stock market quoted company were included, whatever their size, and the sample therefore comprised 2,419 companies. In 889 of these cases the target company was quoted on the stock market and the average profitability on the day the takeover was announced was 9.1%. Furthermore, this document shows there is a negative relationship between the titles previously acquired by the bidder in the company and the profitability arising out of the takeover bid announcement. This result fits with the theory on previous bidder shareholding, set out under paragraph 2.2.

4 Results

4.1 Profitability for the shareholder in takeover bids

The most outstanding piece of information is that takeover bids generate an extraordinarily positive return for the minority shareholder. This profitability is significantly different from zero for any share sale strategy, as can be seen under Table 1. According to strategy type one can specify that:

- The average profitability for shareholders who accepted the bid offer (Strategy 1) was 13.2%, with regard to the price prior to the relevant event.

- Without waiting until then, any shareholders who sold immediately after the relevant event was published (Strategy 2) obtained a profitability of 11.9%.

- Any shareholders who sold on the stock market following the takeover bid being authorised (Strategy 3), achieved a profitability of 11.6%.

- Shareholders selling their shares at the beginning of the acceptance period (Strategy 4) obtained 12.6% profitability.

- Those who sold after the outcome was published obtained an average 12.3% profitability.

Profitability for shareholder according to the different strategies TABLE 1

%, except number, which appears as units

		Sample A			Sample B			
		No.	Strategy 1	Strategy 2	No.	Strategy 3	Strategy 4	Strategy 5
All		66	13.2	11.9	57	11.6	12.6	12.3
			1.7	*1.5*		*1.7*	*1.6*	*2.2*
Non-competitive		58	11.6	10.3	49	10.4	11.4	10.5
			1.7	*1.5*		*1.8*	*1.8*	*2.2*
	Total	39	12.2	10.7	33	11.1	12.0	11.0
			2.4	*2.1*		*2.6*	*2.5*	*2.9*
	Partial	19	10.3	9.4	16	8.9	10.2	9.6
			2.0	*1.6*		*1.8*	*2.0*	*3.2*
	Minority Shareholder	25	13.3	11.2	23	9.8	11.0	9.9
			2.8	*2.7*		*2.8*	*2.9*	*3.5*
	Controlling Shareholder	33	10.3	9.6	26	10.9	11.8	11.1
			2.2	*1.7*		*2.4*	*2.3*	*2.8*
Competitive		8	24.8	23.9	8	18.8	19.6	23.3
			5.1	*5.0*		*3.0*	*3.1*	*6.5*
	Total	7	24.9	24.4	7	19.6	20.5	20.4
			5.8	*5.8*		*3.3*	*3.4*	*6.8*
	Partial	1	24.7	20.1	1	13.7	13.5	43.3
			--	--		--	--	--
	Minority Shareholder	4	32.5	30.8	4	20.7	23.0	37.3
			8.0	*8.4*		*4.8*	*4.8*	*6.7*
	Controlling Shareholder	4	17.2	17.0	4	17.0	16.2	9.2
			4.1	*4.0*		*4.0*	*3.7*	*4.8*

Data regarding average profitability is shown in normal font. Data regarding typical estimated profitability variance from the average by is shown in italics.
Non-competitive refers to procedures when there was no competition. Competitive refers to final procedures where there was competition. Total refers to takeover bids for all shares in the company whereas Partial refers to takeover bids for part of the shares. Minority shareholder bids are takeover bids aimed at minority shareholders, whereas Controlling Shareholder bids are takeover bids aimed at large shareholder.

4.2 Competitive and non-competitive takeover bids

The sample contains 3 competitive regulated bids under the original regulatory framework[12], which only provided to the initial bidder to increase their offer. In these three cases it was the original bidder that eventually succeeded, despite the fact that two of them were not the largest shareholders.

Regulations in force since 2003 regarding competitive takeover bids set down that a closed first price auction must take place in order to ascertain the final bids. This regulation governed the remaining competitive procedures in the sample. The new regulation did away with the privilege previously held by the initial bidder and the end results are more in line with the theoretical assumptions regarding the possible winner, in the sense that whosoever has a prior shareholding starts out with an advantage.

Table 1 shows significant differences in profitability for any shareholder that gives rise to the competitive procedures for gaining control of companies. Shareholders who sold their shares during the takeover bid (Strategy 1) achieved an average profit of 11.6% in non-competitive processes. In cases where competitors were involved, the average profitability was 24.8%. Shareholders who preferred not to wait until the operation was closed and sold their shares after the relevant event (Strategy 2) achieved an average 10.3% profitability in non-competitive bids, as compared to 23.9% in competitive bids. Both differences are statistically significant.

12 In this sample is is Inmobiliaria Zabalburu, Hidroeléctrica del Cantábrico and Ibérica de Autopistas.

Strategies of selling after takeover bids are authorised, in the initial acceptance period and on publication of the outcome (Strategies 3,4 and 5 respectively) demonstrate that when there are competitors for the company this has a statistically significant positive effect for minority shareholders. Thus, in bidding processes when there were no rivals the average profitability was 10.4%, 11.4% and 10.5%, in each strategy, whereas when several bidders were involved then average profitability increased to 18.8%, 19.6% and 23.3% respectively.

4.3 Total and partial Takeover bids

One of the specific characteristics of takeover bid regulation in Spain, up until the 2007 reform, is the existence of partial compulsory takeover bids. For this reason it may be of particular interest to analyse their effect on shareholder profitability. As mentioned previously, a weighted price is used in Strategy one in order to control the shareholder prorated profitability effect. Table 1 shows average profitability both for that strategy and for the other four defined strategies, which are not adjusted for the prorated effect.

In order to compare both types of operations, total and partial, we shall only analyse non-competitive bids due to the fact that the sample only contains one partial competitive takeover bid.

Whereas average shareholder profitability is slightly higher for total takeover bids in all five strategies, in no case is that difference statistically significant. It is therefore not possible to say that takeover bids being partial caused any significant reduction in payments to shareholders, contrary to the theoretical forecast. Nevertheless, such a statement should be considered with caution, given that the sample size is small and contains a wide spread and that the possibility of contrasting is therefore reduced.

4.4 Takeover bids aimed at minority shareholders as opposed to takeover bids aimed at controlling shareholders

Two different models have been used for the theoretical description: i) those where the bidder approached minority shareholders, whether or not it had a prior shareholding in the company and ii) those where a controlling shareholder other than the bidder existed, to whom the bid was offered.

Economic theory is ambiguous regarding the comparative profitability of the two cases. It is therefore useful to attempt to analyse whether or not any differences can be observed between these types of operations and whether the characteristics of each type can affect shareholder profitability.

In the first two strategies, analysed under sub-sample A, the average profitability of takeover bids on companies with concentrated capital is slightly higher, whereas in the other three strategies, sub-sample B, the opposite occurs. Nevertheless, neither difference is statistically significant.

5 Conclusions

This study is divided into two parts. The first part sums up some of the explanations and forecasts of economic theory regarding takeover bids and how these are affected by the way such bids are regulated. The second part analyses takeover bids on Spanish stock market quoted companies during the period from January 1999 to July 2006 from the point of view of shareholder profitability.

The main conclusion of the first part of this study is that economic theory does not permit clear conclusions to be drawn with regard to the optimum way to regulate these bids. The reason for this is that the greater the degree of protection afforded to minority shareholders following the launch of a takeover bid means that there is less likelihood that such a bid will occur. The final effect of such protection of the expected wealth of minority shareholders is therefore not possible to ascertain.

In some cases where the theory is ambiguous, one can use observed reality in order to decide the most appropriate regulation. In the case of takeover bids, however, neither do empirical studies provide clear conclusions, in that one can only observe bids that have taken place and one is not aware of those which did not occur due to excessive protection of minority shareholders.

One conclusion from the theoretical and empirical parts which would seem to be clear is that when competition is involved in takeover bids this clearly favours minority shareholders. Among the various types of procedures for sorting competition among when there are multiple bids, the first price auctions are the best option in that while they do not guarantee the best price they do provide an incentive for several bidders to take part.

A series of statistically important conclusions may be drawn from the analysis of data gathered from takeover bids in Spain, whereas it has not been possible to derive any conclusive results from other cases. It is particularly important to note that: i) takeover bids, whatever type they are, generate an extraordinarily positive return for minority shareholders, ii) in terms of minority shareholder profitability no difference can be drawn between partial and total takeover bids and iii) whenever there are competitive takeover bids, profitability is doubled for the minority shareholder and that difference is statistically significant. One can also highlight the fact that there are no significant differences between the profitability of takeover bids aimed at minority shareholders and those aimed at controlling shareholders.

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III International Reports

The effects of transparency in the bond market: the European debate

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1 Introduction

There has been a profound change in the bond market in recent years. The increase in the volume of issues has been accompanied by a rise in trading in the secondary market as a result of the variety of instruments available and a greater use of electronic trading. Unlike stock markets, bond markets have traditionally been decentralised, with trading taking place mainly by phone between institutional participants. As well as this, prices were not publicly known and the information on deals was not immediately visible. Although the technological change affecting these markets has gradually modified this situation and increased transparency, at the same time the deficiencies in the market have been made more manifest when it comes to satisfying the needs of smaller investors who do not have access to most of the market information. As a result, there has been a debate between participants and market regulators about what the optimum level of market transparency is.

Article 65 of the Market in Financial Instruments Directive (MiFID), whose planned date for transposition is 1 November 2007, establishes that the European Commission should decide on the transparency of the market in instruments other than shares. The European Commission requested that the Committee of European Securities Regulators (CESR) provide its technical assistance to determine how to regulate this matter. CESR carried out a series of consultations in 2006 and 2007 requesting the opinion of the European securities markets about whether it would be a good idea to establish an obligatory regime in the European fixed-income markets.

At the same time, coinciding with the resulting debate, a number of studies have been carried out on the American and European bond markets using theoretical and practical models to assess the effects of transparency on market efficiency and liquidity.

This article comments on some of the studies carried out on the effect of implementing the transparency requirements in the bond market, above all the corporate bond market. It briefly reviews the level of transparency in the American, European and Spanish markets, and includes a description of the consultation and analysis process carried out by CESR in preparing its recommendations for the European Commission on this matter.

2 Transparency in the bond market

Transparency in a financial market means a situation in which the participants have a high level of information available about the conditions in which it is possible to operate (pre-trade transparency), and information about the transactions actually carried out in the market (post-trade transparency). Thus a transparent market would be one in which any individual knows in real time the prices and volumes at which it is possible to buy or sell a security; and at the same time has available information on the prices and volumes of the latest transactions carried out with the securities. Stock markets are, in general, markets managed via centralised orders, with a good level of transparency. Fixed-income markets have been examples of markets run by prices, decentralised, and with a greater degree of opacity.

In comparing the two markets it should be remembered that the bond market is very different from the share market. Whereas in the share market an issuer generally trades through only one instrument, in the fixed-income market it is not unusual for the same issuer to have a multitude of securities trading with very different characteristics, maturities, coupons and structures, so that the liquidity is dispersed between these securities. Thus it is normal for a bond issue to present a scarce liquidity which falls with the life of the issue. As a result, in this market it is more difficult to find a counterparty than in the share market. In addition, among the main investors in the bond market are insurance companies or pension fund managers, whose strategies tend to be to buy and maintain the asset until its maturity. On occasions these investors may even buy most of an issue, limiting its activity in the secondary market. These factors largely restrict the liquidity of the corporate fixed-income secondary market.

In addition, the structure of the market plays a decisive role in its transparency. For example, in bilateral phone markets, there is no pre-trade transparency, as a participant who wants to carry out a transaction does not know in advance the prices of the different dealers, and at the same time, the dealers do not have access to the prices of other dealers. In a market of this type, the implementation of pre-trade transparency could mean significant changes in the very structure of the market, while in other kinds of markets, such as multilateral electronic markets, the development of a regime of pre-trade transparency should in theory be a simpler task. In addition, because post-trade transparency refers to the results of the market trading, it would present fewer problems for implementation in any type of market.

An extremely relevant factor in financial markets in general, and in bond markets in particular, are transaction costs, one of whose possible measures is the bid-ask spread. A reduced spread will imply lower transaction costs for market participants, improve market efficiency and lower financing costs for issuers. According to various analyses of this subject, transaction costs appear to be lower for high-volume operations than lower-volume operations. This would reflect the greater negotiating power of institutional participants over retail investors. Other theories claim that dealers assess their transactions bearing in mind they have to cover fixed costs derived from the establishment of their own market activity,

which would not benefit lower volume operations. In any case, it appears that corporate bond activity implies high transaction costs for retail investors. Establishing greater levels of transparency in bond markets, which are totally or partially opaque, would increase the negotiating power of smaller investors and competition for dealers and intermediaries, leading to a reduction in transaction spreads and costs. As a result, there should be a greater participation of investors in the market.

Although there appears to be a consensus that transparency produces positive effects (lower operating costs in the market via reduced bid-ask spreads), it is also true that transparency could lead to destructive effects in the liquidity of bond markets. This is because dealers commit capital in their activity, and if there are significant operations taking up positions in the market, the fact that their operations could be known by the rest of the market represents an increased risk in handling their positions. The negotiating power of other participants in the interdealer market increases if they know the details of the transactions carried out by other dealers. In addition, the fact that the information contained in pricings is public takes away the incentive for the dealers to generate information, given that their expected income is reduced. Dealers may also react to a reduction of expected income from the narrowing of spreads (caused by greater transparency) by reducing their activity in some business areas which result higher risk for them, such as for example operations with very illiquid issues or with a high credit risk level (high-yield bonds).

At the same time, the fact that these securities cannot be short traded plays an important role in the bond market, because in comparison with the equity market it makes risk management by traders more difficult, and in the final resort, reduces liquidity. In this sense, the bond market has been favoured by the emergence in recent years of credit derivatives. CDSs (credit default swaps) are a measure of an issuer's risk, as they represent the cost of the protection which may be bought or sold to insure against the fact that an issuer may not meet the payments on the issues within a determined time. They also enable equivalent positions to short sales to be established, and to concentrate the measurement of an issuer's risk in a single instrument (given the dispersion of issues in the cash bond market). As well as being very liquid for the most significant issues, the CDS market enjoys a high level of transparency, with a wide range of information on listings on the screens of the main suppliers of financial information. However, it has to be pointed out that this market is only for major participants, so that a large number of investors does not have a simple access to this source of liquidity. In all, the development of the credit derivatives market has benefited the bond market as a whole, particularly through the increase of liquidity derived from improvements in the capacity of traders to manage risk (they find it easier to carry out cover trades).

3 Transparency in the American market: the TRACE system

The American corporate bond market is an OTC market which had very limited transparency until the introduction of TRACE (Trade Reporting and Compliance Engine) in July 2002. The TRACE system began to be implemented on this date over various phases. It is a service for distributing information on prices in real time for the US corporate bond market, which includes 99% of transactions and 95% of the nominal traded volume. Its implementation was completed in 2006 and currently access to information is public via the internet, with data on the latest price and volume in real time, except for certain transactions with a volume of more than a million dollars corresponding to high-yield issues with low liquidity[1]. It is thus a model of a very high level of post-trade transparency, which according to the analyses carried out has narrowed market spread in the American corporate bond market and reduced the market share of dominant dealers, thus increasing competition. There is a similar system of transparency for municipal bonds through the RTRS (Real Time Transaction Reporting System). These bonds have a wide acceptance among investors in the United States because of their tax benefits.

In recent years there have been numerous analyses of the effects of implementing transparency requirements.

Thus the study by Goldstein and others (2006) does not conclude that the increase in trans-parency since the introduction of TRACE has resulted in an increase in market activity, measured as effective daily volume and average of operations per session. Nevertheless, there is an observable reduction in the bid-ask spreads for instruments subject to transparency requirements, particularly those frequently negotiated. Along the same lines, Edwards and others (2006) sustain that transaction costs, measured as the cost in basis points of carrying out a purchase transaction plus a sale transaction, are lower for those securities with transparent trading prices, and it could be seen how these costs were reduced when the TRACE system began to publish their prices. Given that the conclusion is that transaction costs are lower for bonds with more information, the interpretation is that transparency has improved liquidity in the corporate bond markets. At the same time, they state that corporate bonds are instruments which currently involve a high transaction cost for retail investors, so it could be expected that their participation in the fixed-income market would increase with the reduction of these costs in a transparent market.

Beseembinder and others (2006) find that the existence of transparency for a set of market bonds (not for all of them) produces beneficial effects for the rest of the bond market, leading to an effect they call the "externality" of liquidity. This would make sense, as a non-transparent fixed-income instrument can be valued according to information obtained from other transparent values for which the market price is known.

1 The operations are communicated within the 15 minutes following their execution and published immediately in the system.

Thus the three empirical studies mentioned above agree that TRACE has led to a narrowing of spreads in the American corporate bond market (which means a reduction in transaction costs), although it is not clear that this reduction has resulted in increased liquidity or activity in the market.

4 Transparency in the European market

With respect to the transparency regimes that can be found in the European bond markets, according to information reported to CESR by the different jurisdictions, it can be said that there is considerable transparency in terms of the securities contracted through regulated markets and multilateral trading facilities (MTFs). In general, a certain pre-trade transparency is reported as normal for instruments admitted to quotation in these markets (available for members of the market), as is the publication of information on transactions executed. Nevertheless, there is a great variety of transparency regimes, given the fragmentation of the European market, with different regulations and peculiarities. This fragmentation also implies that the same asset may be negotiated in different markets located in different countries, leading to difficulties for the consolidation of market information.

Despite this fragmentation of the European markets, a significant volume of trading is between major European banks in OTC operations, making up an active and liquid European OTC market. This market is characterised by its opacity, as data on prices or transactions carried out are rarely reported. However, according to various studies this European corporate bond market would present greater competition than the American because of the greater number of dealers, which would be reflected in lower bid-ask spreads. While there is a small number of large banks dominating the OTC bond market in the United States, in Europe trading is spread between global, European and local banks.

The CEPR report (2006) on European corporate bonds points out that the bid-ask spreads increase in the remaining time to maturity and the credit risk, but reduce with the size of the order. This is consistent with what has been commented on the negotiating power of the large institutions compared to smaller investor. It also explains that liquidity in the European market is greater than in the American market, even after the implementation of the TRACE system there. This could be the result of the existence of greater competition in the European market, with a greater number of buyers and sellers in a market with a single currency. This greater competition would be reflected in a greater market liquidity, as shown by the traded volumes. In addition, various interviews conducted by the CEPR with market participants (both dealers and investors) reflect the industry's satisfaction with the way the market currently operates. They also say that the current dealer-based market model satisfies the participants' needs; they expect that electronic platforms will develop further; and they do not want regulations to introduce an order-driven (multilateral) system. Most of those consulted were neutral or favourable to the

implementation of a post-trade transparency regime. Only a few participants on the sell-side (dealers) were against post-trade transparency, which reaffirms the hypothesis that an increase in transparency would reduce the income of dealers. Thus it does not appear that we could expect an increase in transparency to be initiated by the financial intermediaries. The report states that a regulation imposing pre-trade transparency at present does not appear wise, because of the risk that traders may leave the system and damage its liquidity. In terms of post-trade transparency, if it is implemented via regulation, the proposal is that it should be moderate and limited, avoiding publication of the identity of the traders and limiting information on transaction volumes.

At the same time, CEPR comments that one of the characteristics of the current system is that retail investors are not active in the bond market for reasons related to costs and technology. Orders from retail customers are sent manually, normally through banking networks. This generates high fixed costs and large transactions costs which in the end mean that the business is unattractive for both customers and for financial intermediaries. CEPR suggests that one solution could be to centralise all the retail orders in an electronic market, which would achieve a certain level of liquidity and attract some professional liquidity suppliers. This system would also have the advantage of facilitating compliance with best execution rules.

According to CEPR, the empirical analyses carried out in the corporate bond market support the idea that transparency increases liquidity. In a post-trade transparent market, dealers observe transactions already carried out, and obtain information about the value of an asset. In this way there is greater competition between dealers and narrower price spreads. In addition, dealers carry out the job of collecting information with which to assign value to assets. This information is asymmetrical between dealers, as there will be a disparity between their strategies, so they will offer different prices for the same bonds. Taking this into account, CEPR has drawn up an econometric model to assess the effects of transparency in competition between dealers and in price spreads. This analysis concludes that post-trade transparency reduces information asymmetries between dealers, enhances competition and reduces spreads. Ex post, dealers would prefer to have access to their competitors' quotes, although ex ante they prefer the market to be opaque, since this increases their expected rents. Thus excess transparency could have a negative effect on the market, as if profits derived from trading in the bond market are reduced for issues with low liquidity, dealers may exit from it, with the consequent reduction in liquidity and increase in spreads.

In addition, in the case of government debt markets, CEPR observed that in the American market the spreads are narrower than in the European market, reflecting greater liquidity in the American markets. This is because they have a single set of reference bonds, unlike the case in Europe, in which there is fragmentation derived from a greater number of government debt issues.

5 Transparency in the Spanish market

In Spain, the AIAF is the main exchange on which corporate bonds are listed. It is a decentralised price-directed market, in which quotes are obtained bilaterally through the members. Thus there is no pre-trade transparency, as the prices at which the members are prepared to trade are not known in advance. In terms of post-trade transparency, the market communicates average prices for each issue, the number of trades and the trade volume through its website. They are published as they are communicated to the market by its members. A historical database is also available on the website. At the same time, at the end of the day the AIAF publishes on its website the daily market bulletin, which reports prices and average yields for the day, and the nominal and real trading volume in the session. It has to be pointed out, however, that the trades between market members and their customers are not reported until the day after the trade date, so there is a delay in the publication of information on these trades, which represent most of the market activity (96% of the effective trading volume in outright transactions on the AIAF in July 2007[2].) It is thus a market with a limited post-trade transparency. It is probably worth pointing out here that the participation of retail investors in the AIAF market is certainly significant, at least if we count the number of transactions carried out. According to data for the month of July 2007, retail investors represented 2.6% of the total trading volume in the market, but 74.3% of transactions (with transactions by retail investors being understood to be those worth under 60,100 euros).

The other Spanish market in which corporate fixed-income securities are traded, the Mercado Electrónico de Renta Fija, is much smaller in terms of trading volume, but is extremely transparent. It uses the Sistema de Interconexción Bursátil Español SIBE (Spanish Stock-Market Interconnection System), so it has real-time pre-trade and post-trade transparency for traders with access to market screens or to the services offered by suppliers of financial information. In addition, the website of the Madrid stock exchange publishes the latest traded prices with a small time lag, as well as the nominal and real traded volume in the previous session and a database of historical prices.

Nevertheless, it has to be taken into account that much of the trade in securities issued by Spanish entities is in the form of OTC trades between major institutions in a European market that lacks transparency, as was mentioned above. Consequently, it is difficult for a large section of the market participants, particularly the smallest ones, to know the data on the prices at which these issues are being traded. Information on indicative prices, and in some cases firm quotations, may be found in the professional publishers of financial information Bloomberg and Reuters, although there is no information on prices and volumes of transactions executed.

2 Report of AIAF activity, July 2007.

6 The CESR consultative process

In 2006 CESR received a mandate from the European Commission to offer technical advice in relation to Article 65 (1) of MiFID. This deals with a possible extension of the scope of the provisions of the Directive concerning pre- and post-trade transparency obligations; the idea would be to make them applicable to transactions in classes of financial instruments other than shares. It indicated that the study was limited to the market of cash government bonds and investment-grade and high-yield bonds corporate bonds. CESR accepted the Commission questions and drew of a consultation paper dealing with the following points:

- The possibility that there is a market failure in the bond market with respect to transparency.

- Evidence that a mandatory transparency regime could mitigate this market failure.

- Foreseeable effects of the way the new MiFID provisions may change the current market situation.

- Cases in which investor protection has been compromised by lack of transparency.

- Possibility of applying transparency only to certain market segments.

- Criteria which should be applied by the European Commission in determining whether self-regulation by the industry is adequate to address the issues above.

After reviewing the responses from the industry in a consultation document and a public meeting, CESR published its document[3] responding to the Commission. Its main aspects are outlined below.

In general, the industry does not recognise there is a failure in the bond market that would warrant regulatory intervention. The existence of this failure was questioned, in particular by major market participants, because the bond market has in recent years experienced considerable growth, with a significant increase in trading, financial innovation with the arrival of credit default swaps and the advance of electronic trading (Bloomberg, MarketAxess, iBOXX, Tradeweb, MTS, SENAF, BrokerTec). The fact that these electronic media also have a positive effect on transparency has been used as an argument by the larger participants to defend their view that the evolution of the market itself will increase transparency levels, and that it is not necessary to impose regulation on this question. Overall the institutional participants also declared themselves satisfied with the level of transparency and with the form in which the markets operate at present. Various participants in the consultation process indicated the possibility that establishing too much transparency could damage the liquidity of the system, particularly in the markets depending on the activity of dealers.

3 This link gives access to the CESR document responding to the Commission on the transparency of instruments other than shares: http://www.cesr.eu/index.php?docid=4708.

Other answers highlighted the fact that the characteristics of the bond market are not the most suitable for the activity of retail investors. Small investors who participate in this market have to face a difficult environment in terms of obtaining information in the same conditions as institutional traders. Overall the result of this situation is that information is obtained by retail investors with a delay or some limitation in the data, compared with the information handled by professional investors. This means that retail investors frequently operate at a disadvantage against other participants.

Some industry comments from jurisdictions with a significant retail participation in the corporate bond market have pointed to the importance of creating a pan-European market with a transparency regime common to all countries, to improve protection for investors and ensure market integrity.

CESR agrees with the fact that greater transparency could increase retail participation in the bond market, although it argues that other factors play a determining role, such as the structure of the bond markets, the understanding individual investors have of them, and the distribution channels used for securities.

In addition, a number of responses express concern that the lack of pre-trade transparency could limit the ability of intermediaries to comply with the best execution obligations laid down in MiFID, and applicable to all financial instruments. A non-transparent market would affect the intermediaries' ability to identify the best market for executing orders. At the same time, it makes it difficult for intermediaries, investors and regulators to monitor execution quality.

MiFID includes a series of provisions significantly increasing protection for the retail investor. Among them are rules on best execution and the adapting of financial instruments to the classes of customers. As some of the participants have stated, it is probable that retail participation is determined more by the best execution obtained by financial intermediaries than by the transparency of the markets. Given the intense activity of banking networks in trading fixed-income products in some European markets, it is considered relevant to adapt these instruments to the degree of sophistication of retail customers. In addition, on numerous occasions liquidity is supplied by the entity trading the securities through the internalisation of orders. This fact complicates best execution, because of the difficulty and costs that the search for a counterparty in other institutions or venues involves. In this sense, it is to be expected that the requirements of MiFID as mentioned above improve the position of the retail trader in his participation in the bond market, although a margin of time will be needed to be able to assess the effects of the new regulations. Additionally, various responses sent to CESR claim that increased competition between dealers and intermediaries to offer the best price within the framework of new best execution obligations will have positive effects, not only in protecting investors but also as a boost to initiatives for improving pre-trade transparency.

At the same time, given the wide range of products in the fixed-income market, from simple bonds to high-yield or structured bonds, it may be that institutions resist placing more complex instruments with retail investors in compliance with MiFID provisions. Instead, they may propose other simpler investments, such as fixed-income mutual funds, for example.

CESR has also indicated that harmonising the regulatory requirements for the operators of regulated markets and MTFs through MiFID will probably result in an increase of transparency in the bond markets. This should assist intermediaries in delivering best execution to their clients. Nevertheless, it is important to recall that the majority of trading in the bond market is carried out OTC, away from organised markets.

The education of retail investors has also been highlighted as a relevant factor determining their activity in the fixed-income market. It is believed that at times retail investors do not have sufficient basic knowledge about markets and the way they operate, so an increase in information available via transparency would lose its effectiveness if it were not accompanied by the willingness of the investors to learn. Thus CESR recognises the efforts made by the industry and regulators to educate investors and stresses the importance that this task should continue in the future.

Another important question dealt with is the possibility of segmenting transparency. Doing this by type of instrument, investor class or other factors appears reasonable, given the different needs of the various participants in the market and the risks associated with excessive transparency in some markets (illiquid markets, for example). Even so, the task does not appear simple, given the rapid changes taking place in the market (new products, if segmentation is carried out by financial instruments) and the limited access to certain securities this could mean for retail investors (products for the institutional market, opaque for the small investor).

Finally, the consultation asked about the criteria which the European Commission should apply if it opts for self-regulation by the industry. Some of the responses were of the opinion that there was no need for additional transparency, whether self-regulated or imposed. Others highlighted the most important factors in the process of self-regulation: that the transparency regime should meet the objectives established by the Commission; and that cost efficiency is one of the basic requirements in a system of transparency.

In terms of the next steps to take in the decision-making process on the transparency of instruments other than shares, once the CESR consultation is complete, the final report by the European Commission on this question is expected for the start of 2008.

7 Conclusions

The debate on transparency in the bond market reflects the widely different positions that have been manifested in several CESR consultations. There are market participants, generally on the sell-side, who claim that the European bond market has evolved very favourably in recent years: volumes have increased rapidly, financial innovation has led to an increase in liquidity and improved risk management (for example, through credit derivatives), and the technological development of the market continues evolving very positively through electronic trading tools. They also claim that this evolution has produced significant improvements in market transparency and benefits for all participants. In addition, they highlight that it has taken place in a market characterised by a high degree of self-regulation. Nevertheless, some of these large participants in the market admit that there could be improvements in post-trade transparency which would be useful for smaller investors.

On the other hand there are the other participants, generally medium and small institutions, retail investors and markets (the Spanish fixed-income AIAF market holds this view), who are fully in favour of a more transparent model of market, with a broad regime of pre- and post-trade transparency. These participants not only expect that transparency will help reduce the imbalances between dominant market operators and investors with fewer possibilities of access to information; they also believe that there will be positive effects on liquidity and efficiency in the bond market.

An increase in information available would also result useful for the regulators as a whole. It would facilitate the supervision of market integrity and compliance with the provisions relating to investor protection.

Studies carried out until now on the subject of transparency in the bond market have had to deal with the scarcity of existing data, precisely because of the limited information publicly available in this market at present. Despite this, theoretical and practical analyses share some common conclusions: an increase in transparency in the bond market increases competition and lowers trading costs (measured as the difference between buying and selling prices), and no harmful effects on liquidity have been observed.

After the consultative process carried out with the industry, CESR has concluded that a certain increase in current transparency levels could be useful in protecting retail investors. However, before any decision is made, there should be a profound analysis of the costs and benefits of the transparency measures to be taken, so that neither the liquidity nor the positive evolution of the bond market is harmed. In addition, there is the possibility of allowing the industry itself to self-regulate transparency under the guidelines of the objectives defined by the Commission. However, CESR does not see this issue as a matter requiring immediate intervention. It considers that the effect of the MiFID provisions on markets should be assessed first.

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Cross-border and cross-sector financial supervision: The Joint Forum

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1 Introduction

There is a widespread consensus among the regulators of financial markets about the need to improve and reinforce supervision of financial institutions, in particular those of significant size with interests in different financial sectors and active in various jurisdictions. Some of the reasons justifying this conviction are as follows:

a) The growing integration of financial and capital markets.

b) The cross-border activities of an increasing number of financial institutions.

c) The existence of financial conglomerates offering or marketing banking, securities and insurance products.

d) The marketing of financial products that combine the characteristic elements of banking, securities and/or insurance.

e) The complexity of financial instruments which, in an extreme case, could affect the system and ultimately financial stability.

Because of this, the new financial environment is promoting the co-ordination and co-operation of regulators both at a local and cross-border level. And it is here where the international working groups focus their activities: the Joint Forum has a global brief and is closely linked to the most financially developed countries. To a certain extent it could be considered a European response or version of the previous forum, the Three Level-3 Committees known as the "3L3".

The Joint Forum was created in 1996 under the aegis of the Basel Committee on Banking Supervision, the International Organisation of Securities Commissions and the International Association of Insurance Supervisors. Although its initial mandate was closely linked to the action of international financial conglomerates, over time it has extended its field of activity to other areas: risk management, the sale of financial products, money laundering, corporate governance, etc. At the same time it has increased its collaboration with the Financial Stability Forum, where the main representatives are the economic authorities of the G7.

The 3L3 reflects in its name its composition of three representatives from the so-called Level 3 Committees within the Lamfalussy scheme: the Committee of European Securities Regulators (CESR), the Committee of European Banking Supervisors (CEBS), and the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS). Given the cross-sector character of this committee, 3L3 works on both a joint and a country-specific response.

In addition, it is in terms of cross-border co-operation and co-ordination of regulators where the participation of the Spanish National Securities Commission

CNMV could be included in the two international forums mentioned above. In both cases the action of the CNMV is usually prepared in partnership with the other Spanish regulators: the Bank of Spain and the General Directorate for Insurance and Pension Funds.

The following pages describe in some detail the way the Joint Forum functions, highlighting its most recent publications or reports. It has also been thought a good idea to include brief details of the operation of its "European version", the 3L3 group.

2 The Joint Forum

2.1 A brief history

The Joint Forum, initially called the Joint Forum on Financial Conglomerates, was set up in 1996 under the aegis of the Basel Committee on Banking Supervision BCBS (the Basel Committee), the International Organisation of Securities Commissions IOSCO and the International Association of Insurance Supervisors IAIS.

The direct predecessor of the Joint Forum was the Tripartite Group created in 1993 by the initiative of the Basel Committee with the aim of revising and exploring new themes related to the supervision of financial conglomerates. The Tripartite Group issued a report in July 1995 describing the cross-sector trends in the supervision of financial conglomerates, identifying the challenges addressed by supervisors and their responses to them.

The continuous development of financial conglomerates[1], and the increasing difficulty in distinguishing the activities of financial institutions in each sector, highlight the need to establish mechanisms or tools to improve cross-sector and cross-border supervision. The Joint Forum was created in 1996 to continue with the tasks carried out by the Tripartite Group.

The Joint Forum has since its creation benefited from a clearly cross-sector composition with an equal number of participants representing the banking, securities and insurance sectors. Table 1 shows the current geographical composition of the Joint Forum, as well as the national institution representing each financial sector.

1 The definition of financial conglomerates used by the Joint Forum is "any group of companies under common control whose exclusive or predominant activities consist of providing significant services in at least two different financial sectors (banking, securities, insurance)".

Composition of the Joint Forum September 2007

TABLE 1

Country	Banking	Insurance	Securities
Australia		Australian Prudential Regulation Authority	Australian Securities and Investments Commission
Belgium	Banking, Finance and Insurance Commission		
Canada		Office of the Superintendent of Financial Institutions	Autorité des marchés financiers (Québec)[1]
Denmark		Danish Financial Supervisory Authority	
France	Commission Bancaire	Commission de Contrôle des Assurances	Autorité des marchés financiers
Germany	Bundesanstalt für Finanzdienstleistungs-aufsicht –BAFIN-	Bundesanstalt für Finanzdienstleistungs-aufsicht –BAFIN-	Bundesanstalt für Finanzdienstleistungs-aufsicht –BAFIN-
Italy	Banca d'Italia		Commissione Nazionale per le Società e la Borsa
Japan	Bank of Japan	Financial Services Agency	Financial Services Agency
Netherlands		De Nederlandsche Bank	
Spain			CNMV
Switzerland	Eidg. Bankenkommission		
United Kingdom	Financial Services Authority	Financial Services Authority	Financial Services Authority
United States	Federal Reserve Board Office of the Comptroller of the Currency	National Association of Insurance Commissioners	Securities and Exchange Commission

Basel Committee on Banking Supervision (BCBS): Secretary General
International Association of Insurance Supervisors (IAIS): Secretary General
International Organisation of Securities Commissions: Secretary General
European Commission (Observer)
Secretariat: Basel Committee on Banking Supervision

1 Effective from August 2005. The Ontario Securities Commission and the Autorité des marchés financiers (Québec) (AMF) The first meeting attended by AMF was in November 2005.

The Joint Forum usually meets three times a year. The Chairmanship rotates every two years between the three sector committees. The chairman participates in the meetings of the Co-ordination Group, formed by the chairmen and general secretaries of the parent committees, and in the Financial Stability Forum. Table 2 shows the list of Joint Forum chairmen until now. The next mandate will begin in 2008. It will be held by a representative nominated by the Basel Committee.

Chairmen of the Joint Forum

TABLE 2

Current	Dirk Witteveen[1], De Nederlandsche Bank (2006-2007)
Previous	Ian Johnston, Hong Kong Securities and Futures Commission (Jun-Dic 2005)
	Gay Huey Evans, UK Financial Services Authority (2004-June 2005)
	José María Roldán, Banco de España (2002-2003)
	Jarl Symreng, Finansinspektionen - Sweden (2000-2001)
	Alan Cameron, Australian Securities and Investments Commission (1998-1999)
	Tom de Swaan, de Nederlandsche Bank (1996-1997)

1 As this article was going to press, news was released of the death of the current Chairman of the Joint Forum, Dirk Witteveen, the Executive Director of the Netherlands Bank and the last Chairman of the Insurance Authority before its integration into the Netherlands Bank.

CNMV is a founding member of the Joint Forum. As well as attending plenary meetings, it has participated actively in a number of working groups which have issued public reports or reports restricted to supervisors.

2.2 Mandate

The latest mandate under which the Joint Forum is undertaking its activity was established in 2002. It incorporates subjects which should be the object of study by the group, as well as the role which should be played by sector committees (BCBS, IOSCO and IAIS) and other international groups that share priorities and common interests, for example the Financial Stability Forum. Some examples of the subjects which may be analysed by the Joint Forum are as follows:

- Risk assessment and management, including risk modelling and stress testing.
- Assessment and interaction of financial and regulatory capital.
- Basic supervisory principles.
- Supervisory tools and techniques.
- Corporate governance.
- Practices regarding disclosure of financial information and supervisory requirements.
- Operational practices of financial institutions: outsourcing, business continuity, etc.
- Money laundering.

In general terms, the Joint Forum analyses the risks to which financial institutions are exposed. Specifically, these are credit risk, market risk, liquidity risk, operational risk, and other risks derived from the management of rules of conduct, for example legal or reputational risk. In all these areas, the Joint Forum tries to identify cross-sector differences in the risk management undertaken by financial institutions. At the same time it assesses the supervisory techniques used by the regulators, identifying potential regulatory arbitrages and legal or functional loopholes in supervision.

At present the Joint Forum mandate of 2002 is being revised to extend its scope of action, whilst maintaining the working approach outlined above. Thus the main objective of the Joint Forum will be to maintain financial stability, promoting a mechanism for co-operation and exchange of information between the sector committee members on subjects of common interest. The supervision of financial conglomerates is only one of these subjects.

Equally, the revised mandate will set out the way the Joint Forum should co-operate with other international bodies and institutions on matters of common interest to avoid duplicating work. Emphasis is also placed on the necessary participation and collaboration of the financial industry in the work undertaken by the Joint Forum, though this collaboration should not result onerous.

2.3 Works in progress

At present the Joint Forum has three sub-groups in operation. Below I will set out the objectives, main activities, current state of the work and degree of participation by the CNMV in the three current sub-groups of the Joint Forum, and comment briefly on two potential future mandates:

1 **Supervision of financial conglomerates:**

Preliminary conclusions have been presented following the reception and analysis of the responses received to the consultation document prepared by the working group on the degree of acceptance in different jurisdictions of the principles of the Joint Forum of 1999 on the supervision of financial conglomerates. The Bank of Spain has co-ordinated the response of the Spanish regulators, with the participation of the CNMV in the aspects related to investment services firms. The initial conclusions agree on the following points:

a) Each agency supervises a low number of financial conglomerates.

b) Regulators have a variety of approaches towards supervising conglomerates.

c) There is a high level of difficulty in establishing an optimum capital level.

d) Supervisors face challenges and tests derived from the fact that some of the conglomerates include unregulated institutions, as for example hedge funds.

A possible continuation of the mandate to cover countries that are not members of the Joint Forum will be discussed at a later stage of the work in progress.

2 **Identification and management of concentration risk:**

An interim report has been presented by the working group on "Risk management and capital". It identifies, from a sector perspective, the management and identification of concentration risk for financial institutions, the use of stress testing mechanisms and instruments, and the scenario analysis, as well as the activities and practices of supervisors. The definitive report will incorporate specific current practices of supervisors and include recommendations and observations.

The CNMV is a permanent member of the "Risk management and capital group". It has participated actively in drawing up this report in partnership with the Bank of Spain, and has also included information from the General Directorate for Insurance. At the same time the two main Spanish financial conglomerates have supplied information and taken part in interviews.

3 **Customer suitability:**

The report includes an extensive review of the industry practices regarding the offer of financial products to retail customers, as well as the risk management, whether legal, reputational, or operational carried out by institutions. The report also includes a review of regulatory practices.

The working group will incorporate a number of case studies to give examples of the industry's actions and of the response of supervisors. Equally, it will strengthen the cross-sector and cross-border aspect in the conclusions of the report.

The CNMV participates in the working group and has co-ordinated its activity with the Bank of Spain and the General Directorate for Insurance, in order to present a single cross-sector perspective of these practices in Spain.

4 **Future mandates:**

Recently the Joint Forum has received an express request from the Financial Stability Forum and has analysed a potential new mandate. The characteristics of these two proposals are as follows:

a) Credit risk transfer (CRT):

The Financial Stability Forum has asked the Joint Forum to update the March 2005 report on CRT, given the exponential growth of new financial instruments, credit derivatives, securitisation, etc. and the arrival of new participants such as hedge funds in the financial markets. This work will be carried out by the working group on risk management and capital of which CNMV forms a part, and will report to the Financial Stability Forum at its meeting in March 2008.

b) Validation of risk models:

A potential mandate on the validation of the financial institutions' internal risk models was proposed in the last plenary meeting of the Joint Forum.

2.4 Completed work and reports

When the Joint Forum considers it appropriate, it undertakes and publishes reports reflecting the discussions between its members, either in its plenary meetings or working groups. Depending on the results obtained, the reports may be descriptive in nature, for example when the aim is to inform about a series of practices; or they may adopt the form of principles or guides for financial institutions or supervisors. The publications of the Joint Forum reflect the consensus of its members and the support of the sector committees. Although its principles and guides are not legally applicable, it is true that they have had a notable influence when it comes to drafting legislation. For example, the initial work of the Joint Forum on the

supervision of financial conglomerates was undoubtedly the foundation for the Directive of the European Parliament and of the Council on the prudential supervision of financial conglomerates.

The following are some of the most important publications by the Joint Forum[2]:

a) High-Level Principles for Business Continuity (August 2006): The report on High-Level Principles for Business Continuity was drawn up in response to a request form the Financial Stability Forum. It lays down seven general principles on which the activities of regulators and financial institutions can be based in managing business continuity. The report also includes an analysis of various practical cases and the lessons to be learned from them.

b) Regulatory and Market Differences (May 2006): This report identifies and explains regulatory differences in the context of convergent market practices in financial conglomerates. The working group and the resulting document were focused on aspects relating to the regulatory response to risk management. The report's main conclusion is that existing differences pose challenges both for the financial conglomerates and for regulators in terms of the assessment and management of risk concentrations and inter-group risk transfers.

c) The Management of Liquidity Risk in Financial Groups (May 2006): This report presents the conclusions of the working group on the practices of financial conglomerates in the management of liquidity risk. The report analyses a number of questions including the following: management of liquidity risk by financial conglomerates across different jurisdictions, sectors and subsidiaries; the impact of regulation and supervisors on liquidity management; and the scale of liquidity shocks and the measures institutions have implemented to tackle them.

d) Credit Risk Transfer (March 2005): This report was the result of a request from the Financial Stability Forum. It covers the following three points: a) whether the instruments or transactions involve an effective transfer of credit risk; b) the degree of understanding by the market participants of these transactions; and c) whether these activities lead to a greater risk concentration outside the regulated financial sector, and thus whether there should be greater transparency on the risks transferred to non-regulated institutions.

e) Outsourcing in Financial Services (February 2005): This report analyses the risks associated with the transfer of essential activities from the financial institutions to other unregulated entities which may be registered offshore. The report contains high-level principles on outsourcing that are applicable, from a cross-sector perspective, to the banking, securities and insurance sectors.

2 All the joint forum publications can be consulted and downloaded freely from the IOSCO and BIS websites: www.iosco.org and www.bis.org .

f) Financial Disclosure in the Banking, Insurance and Securities Sectors (May 2004): This report is a continuation of the work published in 2001 (known as the "Fisher II Report") by the multidisciplinary group on enhancing the transparency of financial risks incurred by financial institutions. The report contains an analysis of the practices of the financial industry, and of the regulations dealing with this subject in different jurisdictions designed to reinforce market discipline.

g) Trends in risk integration and aggregation and Operational risk transfer across financial sectors (August 2003): Both reports have been drawn up by the single permanent group in the Joint Forum, the working group on risk and capital management. The first of the reports studies the practices of 31 financial institutions in 12 jurisdictions. It concludes that they manage their risk in an integrated way; and that normally risk aggregation is done using mathematical risk models.

   The report on operational risk lists industry practices, and includes differing definitions of operational risk, as well as factors determining the management of operational risk, including regulatory requirements, for example capital requirements, trade-off between risk and expected return and various techniques of risk mitigation.

3 The 3L3

This committee is formed by the chairmen and general secretaries of the level 3 regulatory committees for securities, banking and insurance, CESR, CEBS and CEIOPS respectively, in accordance with the Lamfalussy approach. Its main task is to analyse, and if necessary, make proposals on cross-sector issues to European institutions, for example the Financial Services Committee or the European Commission Internal Market Directorate General.

In accordance with the protocol signed by the chairmen of the committees in November 2005, the areas of work or guidelines for 3L3 were decided on according to three criteria:

a) Subjects on which there is clearly a high risk of regulatory arbitrage.

b) Cross-sector co-operation can offer effective gains in terms of supervisory efficacy.

c) Co-operation between the three committees represents a real gain in its efficient operation.

Without entering into detail on the various areas of work of 3L3, some of them designed to advise the European Commission on the current revision of the Lamfalussy process, it is worth focusing on the activity of the group regarding the

regulation and supervision of financial conglomerates. This line of activity, as has been explained above, provides a link at the European level with the work of the Joint Forum over the last decade on financial conglomerates and financial stability.

It is worth mentioning the tasks being carried out by the Joint Interim Working Committee on Financial Conglomerates. Among the projects this committee is working on are the following:

a) Identifying and mapping financial conglomerates, as well as defining a framework procedure for co-operation in the supervision of these financial institutions.

b) Advising the European Commission in the area of capital requirements, particularly on issues related to:

   - Cross-sector comparison of the rules determining the choice of capital instruments.

   - Analysis of the effects of sector and local regulation on the supervision of financial conglomerates.

   - Drafting recommendations to regulators for the supervision of financial conglomerates.

c) Equivalence in the supervision of financial conglomerates in other relevant jurisdictions, particularly the United State and Switzerland.

The CNMV has participated actively in the work carried out by the 3L3 group in partnership with the Bank of Spain and the General Directorate of Insurance and Pension Funds. For example, it has been involved in studying the equivalence between the supervision of financial conglomerates, or the management of liquidity risk by financial institutions and their regulatory treatment.

4 Conclusions

Among the characteristics of the new global financial scenario are increasing financial integration and cross-border activities by a significant number of institutions. This makes it advisable to reinforce and improve financial supervision in general and prudential supervision in particular.

In response to this, the regulators have aimed basically to promote co-ordination and co-operation between different national supervisors. It is worth here highlighting the activities of the cross-sector working groups composed of representatives from the three financial sectors: banking, securities and insurance. Among them the Joint Forum deserves to be mentioned at the global level, and 3L3 in Europe.

The activity by these working groups is if anything even more necessary now that the international regulations on capital requirements for financial and insurance institutions, known as Basel II and Solvency II respectively, are being incorporated into the national legal systems. These common rules of activity promote a greater market discipline and reinforce the role of the regulators when it comes to approving internal models of risk management for financial institutions.

The work, fundamentally in the form of reports, carried out both by the Joint Forum and the 3L3 in their respective geographical areas of activity, may contain recommendations, guides, etc. that do not form part of applicable and mandatory regulations. However, the institutions to which these two groups normally report - sector committees and in particular the Financial Stability Fund in the case of the Joint Forum, and the European Commission in the case of 3L3 - may use the information or advice received to draft new legislation or simply suggest guidelines that over time may become codes of conduct.

In a regulatory scenario characterised by continuous calls for better regulation and in which regulation based on principles and not detailed rules appears to be gaining favour at present, the suggestions of the cross-sector working groups become even more important.

Finally, it is worth pointing out that the growing participation of the CNMV in these cross-sector forums allows it to reinforce its collaboration with the other two Spanish financial regulators, the Bank of Spain and the General Directorate for Insurance and Pension Funds, inasmuch as the reports of the Joint Forum and 3L3 contain an integrated vision of financial regulation and supervision in Spain.

IV Regulatory Novelties

Financial analysis and rules of conduct: the regulatory path up to the MiFID

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1 Introduction

Information is the sap of modern capital markets[1]. This means that an adequate flow of punctual and rigorous information between market participants is the driving force behind investor confidence and, consequently, of the flow of capital into investment.

However, the huge volume and complexity of the information and data available on listed securities, which include financial statements of issuers, macroeconomic statistics for countries, and reports on commercial and business trends from highly diverse private sources, can overwhelm and confuse investors. It is very difficult for any unspecialised investor to adequately process all this information by himself and reach correctly founded conclusions on which to base his investment decisions. Financial analysts consequently play a fundamental role in the relation between the issuers of financial instruments and investors, both institutional and retail.

Financial analysts[2] study undertakings, their businesses and the sectors in which they operate, analyse highly disparate available statistics and data in a raw state, frequently also make predictions and recommendations to buy, sell or hold a security in portfolio. Investors see analysts as professional experts who constitute a very important source of processed information on issuers and rely on their advice.

Not only investors benefit from financial analysis however. Issuers and the markets in which their securities are traded also benefit from the increase in transparency involved in the dissemination of information through published reports.

However, analysts who work in multi-disciplinary investment services entities frequently face conflicts of interest which interfere with the objectivity of their analysis. As explained over the course of this article, these conflicts arise because investment firms often play many and varying roles with interests which are potentially conflicting, such as acting as securities broker for retail investors alongside activities for their own account, for example, and at the same time the underwriting and placement of issues. Many analysts work in organisations assisting or advising on all these conflicting activities, which can compromise their independence and bias their recommendations. When conflicts seriously prejudice the objectivity of the analysis they may even erode the confidence of investors, which also potentially prejudices the market in general as has been seen from certain scandals in the United States with large international media coverage.

Notwithstanding the importance of conflicts of interest to which analysts are subjected, the problems of financial analysis services have a further dimension related to the protection of market integrity, insofar as the recommendations of

1 John C. Coffee Jr.

2 In Anglo-Saxon terminology the service is commonly known in general as "investment research", and analysts can be given the following names: "financial analyst", "securities analyst", "research analyst", "equity analyst", "investment analyst".

analysts have an undeniable impact on the process of forming prices in securities markets. Consequently, even though analysts' reports do not strictly speaking constitute privileged information, their treatment as sensitive or relevant information with a view to correct price formation must also be taken into account.

The foregoing as a whole has been the subject of in-depth research and studies during the last ten years by institutions regulating financial markets, such as the US Securities and Exchange Commission (SEC) and the European Commission, international bodies such as the International Organization of Securities Commissions (IOSCO) and the Committee of European Securities Regulators (CESR), and also in the academic world, and civil and criminal courts. In the following sections the principles and conclusions of these studies are dealt with which have eventually given rise to regulatory initiatives which are not free from controversy both in the United States and the European Union.

The purpose of this article is to place in context the development of the new Community rules which regulate the service of financial analysis, basically comprising two level 2 Directives:

- Directive 2003/125/EC on the fair presentation of investment recommendations and the disclosure of conflicts of interest in analysis reports (pursuant to the Market Abuse Directive[3]), and

- Directive 2004/39/EC relating to the organisational requirements and conditions for functioning of investment services undertakings (in development of the MiFID[4]).

2 Some particular features of the profession

2.1 Principal characteristic aspects

The profession of financial analyst has a series of connotations and characteristics which must be taken into account when evaluating the need to regulate it.

1 **Degree of development**

- It is a relatively young profession which came into being around the 1920s.

- There are a small number of professionals when compared with other bodies, such as auditors or lawyers, for example. Analysts belonging to the CFA[5] Institute in 2006 numbered 75,000 worldwide[6], whilst just the number of practising lawyers in the United States was already one

3 Level 1 Directive, 2003/6/EC, on insider dealing and market manipulation.
4 Level 1 Directive, 2004/39/EC, relating to markets in financial instruments which repeals the Investment Services Directive (ISD).
5 Chartered Financial Analyst
6 Estimates in accordance with CFA Institute data, www.cfainstitute.org.

million in 2003. Members of the Spanish Institute of Financial Analysts (Instituto Español de Analistas Financieros) numbered 1,307 in 2006[7].

- Unlike the case with auditors, in order to prepare and disseminate financial analysis on companies there are no "generally accepted principles" and therefore it is not subject to a particular quality standard in its preparation.

2 Access requirements

No academic qualification or accreditation is required to enter the profession, which takes place on the basis of professional merit and experience. Nevertheless, in general analysts normally have a combination of university qualifications together with specialist post-graduate studies such as CFA ("Chartered Financial Analyst"), CPA ("Certified Public Accountant"), or CIIA (Certified International Investment Analyst)[8], plus a certain experience in the sectors which they cover.

According to a comparative study carried out in 2003 by IOSCO amongst its members, regulators do not require either specific qualifications or a particular system of registration for analysts. Only one of the jurisdictions which took part in the study stated that it had an examination of general knowledge of the sector and regulations. Other jurisdictions acknowledged that they were studying the possibility of requiring registration and accreditation of a particular qualification for professional exercise of the activity of financial analyst. The study also affirmed that many analysts prefer to voluntarily join national or international associations, or even institutions with self-regulatory codes ("SRO"), for which purpose they must demonstrate certain knowledge and experience or even obtain a qualification and pass certain examinations as a condition for becoming member.

At the present time neither is it regular practice for regulators to require analysts to disseminate their qualifications or curriculum vitae, but some associations and SRO publish them on their Internet websites together with the financial reports signed by the analyst.

3 Supervision

The IOSCO study also highlighted the existence of a large disparity in supervisory systems and scope of action amongst supervisors. Not all jurisdictions examined had supervision mechanisms and in many they varied on the basis of the situation, functions, type of employer undertaking and activities of the analyst. The existing supervision mechanisms can be classified into four main groups:

a) Carried out by the firms themselves which hire analysts.

b) Under the responsibility of SRO.

7 According to the 2006 annual report.
8 Website of the Spanish Institute of Financial Analysts, IAE, www. iae.es.

c) With the participation of various governmental institutions or supervisory authorities.

d) On the initiative of professional associations.

To complicate the scenario, the IOSCO study recognised that both the depth of control and supervision exercised in each case, as well as the co-ordination between supervisors, was subject to in-depth review in several of the jurisdictions studied. As part of this review some jurisdictions had promulgated, or were in the course of promulgating, mandatory rules on the treatment of analyst conflicts of interest. In any event, in 2003 virtually no country had specifically regulated the provision of this service or the professional activity of analysts and the content of the scant existing regulation was of a generic and indirect nature: rules of conduct and good practice, organisational requirements of firms, laws prohibiting abuse of privileged information or the dissemination of false and deceptive information.

2.2 Types of financial analyst and remuneration systems

Before going into the events and causes which gave rise to the different regulatory initiatives developed as from 2000 in detail, we need to look in more depth at the type of analyst since, as we will see later, there are different types of analysts who work in contexts with very distinct problems, which significantly conditions their independence and the objectives sought.

Financial analysts are usually contracted in one of the three following manners:

- The majority (estimated at 60%[9]) work on the buy-side, in other words they are hired and remunerated by institutional investors such as collective investment institutions, pension funds or hedge funds. The role of the analyst is to issue reports and recommendations which are not distributed to third parties since they serve as the basis for investment decision-making by the portfolio managers of the financial groups or entities themselves for which they work. In this case it is considered that the interests of the analyst are aligned with those of his employers and those of his clients, and therefore there is no general perception that this analysis is contaminated by the conflicts of interest described in the second chapter of this article. In addition, since buy-side reports are not publicly disseminated, neither are they normally linked to problems connected with correct price formation or market abuse practices.

- A further large portion of analysts (estimated at around 30%[10]) work on the sell-side. Their employers are large multi-disciplinary investment firms, in other words which also provide a diversity of general financial or investment services. Reports from these analysts are disseminated in writing and physically distributed amongst clients. These reports not only analyse

9 Estimates in accordance with CFA Institute data, www.cfainstitute.org.
10 Estimates in accordance with CFA Institute data, www.cfainstitute.org.

the information publicly available regarding a security, they also normally conclude with investment strategies or recommendations in relation to the securities analysed, make predictions as to their future evolution, and may include recommended or target prices.

In the IOSCO study previously referred to, many jurisdictions recognise that analysts also cooperage very directly with other departments, contributing ideas in order to generate business, evaluating target companies or advising on strategies for gaining clients and selling products or services. These activities carried out by sell-side analysts for their organisations include support for corporate banking departments, technical assistance in commercial initiatives of undertakings in respect of particular securities or issuers, advising own or third party portfolio management departments, and making public or private presentations to clients or staff of the undertaking (sellers, dealing room operators, etc.).

As a result of all these additional functions, analysts permanently interact with other departments, business or commercial, which directly or indirectly support the costs of the analysis and the analyst's remuneration and therefore it is normal that this situation leads to the existence of a series of conflicts of interest within organisations. These conflicts can seriously prejudice the independence of the analyst during the analysis process, as illustrated by the public scandals in the United States which are described in the following chapters.

- Finally, a very small but growing group (around 10%[11]), work for their own account or on the sell-side, hired by independent small and medium-sized intermediaries which do not provide corporate banking services, services which as we will see later are those which generate the biggest conflicts with analysis activities. These are the so-called "independent analysts".

  Some of these analysts sell their reports and are thus directly remunerated for their principal activity and consequently have major incentives for their product to be of quality, objective and impartial. When the analyst's remuneration does not derive directly from the sale of his reports, even though it may appear that analysts who work for "independent" intermediaries and do not provide corporate banking services are free from the pressure of conflicts of interest which prejudice their independence, this is not completely true, as illustrated in the section in which the types of conflict of interest are detailed.

Analysts of the buy-side type normally cover a large number of companies, often through a comparison of assessments carried out by other independent or sell-side analysts. These latter usually specialise in sectors, but virtually never cover all companies in all sectors.

It can also be seen that for the most part the analysis which is published is not directly remunerated by the investor who receives it, in other words reports are not generally sold as a distinct product from other financial services or products.

11 Estimates in accordance with CFA Institute data, www.cfainstitute.org.

Consequently, financial analysis departments are perceived as cost centres, normally remunerated on a subsidiary basis by other departments of the financial institutions to which they belong and their remuneration is linked to the turnover generated on the basis of providing other services such as brokerage, portfolio management, and private or corporate investment banking[12]. On occasions analysts are hired as a type of advertising lure when the financial institution manages to sign up a "guru" of recognised national or international prestige.

Although, as mentioned, professionals in this sector are small in number, their capacity for influence and professional value have been historically high. Recent US studies highlight that an analyst with five years experience can earn between 400 and 500 thousand dollars. An analyst of long experience and acknowledged prestige can achieve up to 2.5 million dollars.

Finally, there are also other firms which disseminate analysis such as specialist magazines, periodicals, agencies for dissemination of consensus assessments and which consolidate information, for example such as Multex. Com Inc or Thomson Financial. Nevertheless, this group of financial analysis disseminators is not the subject of this article since neither have they been the subject of special treatment by international regulators.

3 Conflicts of interest to which financial analysts are subject

As already mentioned, sell-side analysts work in an environment in which conflicts of interest and the pressure of competition are an inherent feature. On the one hand, financial institutions want their clients to be successful with their investments over the course of time because keeping clients long term is a key element in the long term reputation of firms and the success of their business. Maintaining a team of analysts which is respected for its objectivity, quality of analysis and recommendations is a very valuable asset to a financial institution. However, the other activities of the institution may be a source of undue influence, pressures or incentives for the issue of recommendations which come into conflict with the interests of part of their clients. The different sources of conflicts of interest to which analysts are subjected are described below.

3.1 Internal conflicts resulting from the influence of other financial services and activities

3.1.1 Generation of brokerage commissions

It is not normal for intermediaries to sell the analysis which they produce and therefore its dissemination does not generate direct income for them. This means

12 Names commonly used for the services connected with mergers, acquisitions, placements or underwriting in public offerings for major institutions. Over the course of the article the term "corporate banking" will be used to refer to the departments of financial institutions which provide this type of service.

that most firms which have analysis departments generate commissions from brokerage operations from their clients, in turn recipients of the recommendations of their own analysts. In these cases analysis operates as a type of advertising lure for the generation of other types of business such as brokerage, which includes services ranging from the simple receipt and transfer of orders to executing orders in markets and their subsequent settlement. All of these services are a major source of income.

In line with the foregoing, it is more likely that analysts will generate brokerage commissions for their firm if they issue positive or buy recommendations than if they recommend selling a security. This happens because any potential investor can follow a recommendation to buy, whilst sell recommendations will only be followed by those clients who have the security in their portfolio or who are prepared to run the risk of an uncovered sale. The audience for a buy recommendation is much larger than for a sale recommendation and therefore a buy recommendation increases the likelihood of obtaining brokerage commissions compared with a sell recommendation.

Consequently, analysts of financial undertakings which depend substantially on brokerage commissions will be conditioned and very cautious before issuing recommendations which could seriously prejudice the business on which the future viability of their employer depends.

As already stated, it is not frequent for financial analysis to be remunerated as an investment service in itself. In this respect, the absence of a clear separation between tariffs and commissions for brokerage and analysis services[13] also generates a further type of problem. For example, portfolio managers need the analysis to carry out their work and, on the other hand, they can generate lucrative brokerage commissions which indirectly also remunerate the cost of the analysis which they receive. When managers do not have their own teams of analysts, the lack of transparency in remuneration for the different services means that on occasions managers do not seek the most efficient firm for their clients in terms of brokerage but the one which has analysts who cover their shortcomings, needs or expectations when justifying the investment decisions taken to their clients. Consequently, the capacity for managers to generate large mediation commissions, combined with the absence of transparency with respect to the services which are really being remunerated, not only distorts a suitable process of selecting intermediaries on the part of the manager but can significantly influence the recommendations of an analyst, affecting his independence.

3.1.2 Investment banking or corporate banking activity

Despite the fact that they have traditionally been one of the principal sources of income of investment services undertakings, it is a fact that nowadays commissions for the services of receiving, transmitting and executing orders are increasingly reduced. The fierce competition between financial institutions and the development of new technologies which facilitate remote access to markets are leading to a certain degree of reduction in intermediary activity, transforming the

13 In Anglo-Saxon terminology, bundled brokerage and soft commission arrangements.

pure brokerage service into a service with little added value for certain clients and for which it is increasingly difficult to collect profitable commissions.

IOSCO emphasised in 2003 that corporate banking could be a source of very lucrative business for financial institutions of a multi-disciplinary nature. This has led to a migration of the pure intermediary service towards offering corporate advisory services in mergers and acquisitions or underwriting issues of large clients, along with the appeal of having "star" financial analysts who can at the same time influence a positive assessment of the companies advised on the part of potential investors.

It has been traditionally been shown that the recommendations of analysts are particularly sensitive when following securities whose issuers are also good clients of the institution or group to which they belong. Analysts may then become a key part of the corporate banking or investment "team", teams which expect that the recommendations and reports of the analyst incorporated are favourable to their client. A conflict then arises between the interests of the corporate banking clients and the interests of other investors who are brokerage or managed portfolio clients, since the success of a public offering and subsequent behaviour of the security underwritten often depends on analysts' reports.

The pressure brought to bear by the corporate banking team can even force the analyst not to issue reports if they cannot be favourable, and even to using confusing terminology or expressions in these reports which cover up or conceal relevant investor data or information.

According to the IOSCO report, analysts often use a wide variety of terms to describe their recommendations, which in the more common Anglo-Saxon parlance may for example be: buy, strong buy, near-term or long-term accumulate, near-term or long-term over-perform or under-perform, neutral, hold, etc. The meaning of these terms differs from one firm to another and in some cases they conceal a "code" for sophisticated investors who interpret them in a different manner to that which a retail investor would do. For example, a recommendation of "hold" may be interpreted by expert professionals as a concealed "sell", depending on the focus of the rest of the analysis report which underlies the recommendation. But a non-professional retail investor will only interpret that he must hold the security in his portfolio.

In short, analysts who work in institutions with substantial securities underwriting activity would always be motivated more towards optimistic buy recommendations in respect of securities underwritten than sell recommendations.

3.1.3 Portfolio management for own account and for account of clients

These conflicts arise because analysts are covering securities which form part of the portfolio of the institution to which they belong or to portfolios of third parties managed by it.

The conflicts previously described regarding brokerage or corporate banking services are also reproduced in this case. As their reports can compromise the future

behaviour of the portfolio securities, analysts may be pressured by managers and have a certain inclination towards recommendations which do not prejudice the price of securities in own portfolio or the managed portfolios of their principal clients.

3.2 Analysts' personal conflicts

3.2.1 Management of the analyst's own portfolio

Analysts may issue or maintain favourable recommendations regarding a security because they themselves hold it. In a study carried out by the US SEC in 2001 it was detected that almost a third of the analysts observed had invested in securities which were subsequently the subject of public offering for sale which the analysts themselves were commissioned to cover. The study also detected that the monitoring and control of analysts' investments by their employers had been very poor. Another surprising fact was that analysts frequently operated with securities in an inconsistent manner to the recommendations made by them. For example, selling securities at the same time as they recommended their purchase. This fact could be a consequence of the additional pressure of the issuer of the securities on the analyst, which led to the latter issuing recommendations in which the analyst did not himself believe. On the other hand, buy recommendations inconsistently with a sale transaction may also mean that the analyst is attempting to take advantage of the possible increase in price generated by his recommendation, purchasing the security subject to analysis before the analysis is disseminated. This practice is what is commonly known as "dealing ahead".

3.2.2 Remuneration system and the hierarchical position of the analyst

All studies carried out to date recognise that the remuneration systems and hierarchical dependence of analysts are a major source of conflicts of interest which damage their independence and contaminate the objectivity of their analysis.

According to the IOSCO study, remuneration systems can be complex and vary considerably depending on the jurisdiction, but it was seen that they almost always had a fixed component and another variable component or bonus. In some cases firms take multiple factors into account when fixing the remuneration of an analyst, which can vary from his position in a ranking, the behaviour of his recommendations and his level of success, and take in the income generated by corporate and investment banking and intermediary activities which can be attributed to the analyst or the overall profit of the financial institution as a whole.

Cases were presented in the study in which firms linked the results of corporate banking activities in a direct and very significant manner to the analyst who covered certain companies, which in turn were clients of these departments. For example, in some cases examined the firms laid down a bonus system in analysts' contracts in a manner such that this variable remuneration was calculated on the basis of the profits generated by certain specific lines of business or departments. Some systems were also analysed in which firms rewarded through salary the "collaboration" with other departments or groups within the institution, including the corporate banking department. In other

cases the links between analyst remuneration and the results of other business lines was not totally explicit in the contract, but there was a general perception amongst personnel as to the presence of this link.

Responsibility for fixing the bonuses of analysts also differed amongst the cases examined, as well as definition of the time and persons or departments who should be recipients of their reports. Cases were also analysed in which before their dissemination analysts' reports were subject to the opinion and suggestions of other business lines.

It can be concluded from the above that the person who pays the piper calls the tune, and a person who pays more calls more, and therefore the system of direct remuneration and incentives of analysts must be particularly taken into account as a determining factor in their objective and independent actions. Consequently, regulators have shown themselves to be particularly concerned for both the system for financing analysis and systems for the remuneration of analysts.

3.2.3 Market consensus

It is true, and it was seen in the Enron case, that analysts are very reluctant to rush to disseminate bad news or worrying warnings regarding companies. This may be because an analyst has much greater fear of an individual error than a collective mistake and therefore there is a very high aversion to being the first to issue recommendations which go against the consensus, particularly if the consensus is furthermore positive with respect to a company.

Various studies concluded that the empirical evidence demonstrates that many analysts are highly conditioned by consensus and are very inclined to maintain recommendations which do not break it.

3.3 Conflicts as a result of the influence of the issuer of the security subject to analysis

Even if the issuer of the security subject to analysis is not a client, the analyst will be very cautious in issuing unfavourable recommendations since he needs to maintain his good relationship with the management of companies analysed in order not to lose the access which is a vital source of information to enable him to carry out his work adequately. It has been the norm for some issuers to provide information selectively to "friendly" analysts before its dissemination to the public in general. It has also been seen that some issuers cut off access and avoid certain analysts in public presentations, or simply do not answer telephone questions. Fear of this type of professional isolation can condition the objectively of an analyst's recommendation, particularly in respect of very important companies or those which could potentially generate a large volume of business.

The IOSCO study highlighted that some companies acknowledge that they would refuse access by an analyst to information or to its management if he disseminates reports which are unfavourable or prejudicial to their interests.

3.4 Conflicts generated by investors

A highly significant part of brokerage commissions is generated by large clients with very large portfolios, for whom it is difficult to undo short-term positions. Consequently, these clients do not look favourably on a sell recommendation by an analyst, particularly if it takes them by surprise and can precipitate the fall of a security in which they have a strong position.

In addition, this can lead to these major clients pressurising the analyst to provide them with sell reports in advance, such that they can react before the retail public in general has access to a recommendation which could generate panic and a massive selling which prejudices their portfolio investment.

4 A chain of scandals and regulatory reactions

Possibly as a consequence of the lack firstly of generally-accepted principles or standards, and secondly of codes of conduct for engaging in the profession, combined with the absence of a truly effective supervisory oversight, and an environment of conflicts of interest which without doubt affect analysts, during the 1990s and later a series of complaints were made against financial institutions which not only had a large media repercussion, but also initiated the path towards a new legislative and supervisory regime.

4.1 Some examples of major media repercussions[14]

- Back in 1992 the Wall Street Journal published an internal memorandum signed by the head of the corporate department of Morgan Stanley in which employees of the firm, including the financial analysis department, were instructed not to make negative or controversial comments regarding their clients.

- Subsequently, and as a result of the burst in 2000 of the "dot com" Internet bubble, many journalists pointed at well-known financial analysts because they had not modified their buy recommendations for companies in free-fall, which had even lost up to 80% of their market value.

- In 2001 a group of clients complained about Merrill Lynch, alleging that the recommendations of an analyst, Henry Blodget, had been contaminated by conflicts of interest and the desire of the analyst to increase his remuneration by his support for the corporate banking division. This case came to the attention of the Fiscal General of New York, Eliot Spitzer, who after an in-depth analysis of the e-mails exchanged between employees of the company, demonstrated that the enthusiastic and public support of the

14 www.cnnmoney.com; www.wikipedia.org; www.securitiesstandford.edu; www.dummies.com; www.SecuritiesFraudFYI.com.

team of analysts towards various Internet firms clearly contradicted the content of certain e-mails during the same period, in which a very negative assessment of these same firms was indicated.

Spitzer not only blamed Merrill Lynch for disloyalty to investors, but also for not having publicly declared the conflicts of interest to which its Analysis Department was subject in relation to the Corporate Banking Department, since the analysts acted almost as employees of the other Department, being forced to cover certain companies for the purpose of favouring them, to the detriment of the interests of the investors receiving their recommendations. Spitzer also however found e-mails from analysts who said they felt uncomfortable and blameworthy knowing that their recommendations would result in non-professional investors losing money, but that they did so under pressure of the fear of the reactions of executives.

- After the Merrill Lynch case, the rest of the principal US firms which engaged in issue underwriting were investigated by Spitzer, the SEC, the NASD[15] and the New York Stock Exchange. These investigations were profound and controversial since they highlighted that the irregularities and conflicts of interest observed in the Merryl Lynch case were also reproduced in the other institutions investigated. After the problems were detected and a series of long negotiations, in April 2003 the ten principal issue underwriters reached an agreement which they called the Global Settlement. One part of the agreement involved paying large fines. The other part was a commitment to establish measures which would resolve conflicts of interest between analysts and corporate banking departments. These measures included establishing Chinese Walls and making independent external analysis available to clients unrelated to their own analysts.

- In 2002 investigations began into Salomon Smith Barney, the corporate banking arm of Citigroup. Again, certain recommendations and assessments of firms were suspected of being contaminated by the desire of Salomon to win and keep major clients for corporate banking operations. Jack Grubman, the flagship of the Internet company analysts at Salomon, maintained very high assessments of telecommunications companies during the collapse of this sector in 2001.

  When Grubman began to lower his estimates and changed his buy recommendations to those of a "neutral" type in respect of companies which had virtually no value, investors had already lost millions of dollars. The case not only revolved around the scepticism regarding the integrity of the assessments made. The investigators also asked why the Managing Director of Salomon Smith Barney and some senior officers of its clients obtained millions of dollars from a privileged positioning in certain public securities offerings, one of them being World Com.

- Mary Meeker, analyst at Morgan Stanley, was also involved in a similar case relating to high assessments of companies subject to public offerings. Meeker advised Morgan Stanley on the public offerings in which they acted

as underwriters. Her reports had historically enjoyed acknowledged prestige, but when the shares began to fall Meeker continued to maintain high assessments which were inconsistent with the actual value of the companies. Not only did the SEC investigate the case, which has recently been concluded, but Morgan Stanley was also the subject of claims from the French luxury product conglomerate, Moët Hennessy Louis Vuitton (LVMH) which, furthermore, accused them of publishing biased and slanted analysis which benefited their principal competitor, the Italian firm founded in 1923 by the craftsman Guccio Gucci (GUCCI).

- One of the most recent cases which have questioned the objectively and quality of disseminated analysis took place in Spain with respect to the assessments of the Vueling company made, amongst others, by Morgan Stanley. The Vueling shares plummeted on 11 September 2007 by more than 8%, minutes after it was known that the investment bank Morgan Stanley, which advised Vueling on its flotation on 1 December, drastically reduced its valuation to ten euros per share, three times less than the price fixed for the public offering of 30 euros. The investment bank thus joined other institutions, which also included the other two placement entities of the Vueling offering, JP Morgan and Goldman Sachs, which recently reduced the valuation of the airline's securities. The former fixed a target price of 17 euros, in its most recent report of 3 August, and the second at 20 euros. Paradoxically, both Morgan Stanley and Goldman had been contracted by Iberia, the major rival of Vueling, to advise it on its sale process[16].

4.2 Initial regulatory reactions and their consequences

4.2.1 Prohibition on selective dissemination of information

Of the problems referred to which have affected the independence of analysts, the first which was the subject of reaction in the United States was the pressure brought by issuers and the separate treatment and even isolation which was seen to which certain analysts were subjected by companies on which they had issued unfavourable recommendations.

Consequently, the first initiative by the US SEC was to firmly prohibit the selective dissemination of information by issuers to analysts or to any other market participants. In this respect, in 1999 the Forum of European Securities Commissions (FESCO), the predecessor of the current CESR[17], published a document which tackled the problem of the selective dissemination of information in public securities offerings.

FESCO considered that public offerings involved not only financial intermediaries but also other types of professionals whose involvement in the offering and their access to relevant information regarding it and its issuer vary substantially. FESCO

15 The National Association of Securities Dealers is an association responsible for the self-regulation of the securities market industry in the United States, supervised by the US SEC.
16 Newspaper Expansión, 11 September 2007.
17 European Committee of Securities Regulators.

recognised that in order to strengthen the integrity of markets it is likewise important that both issuers and financial intermediaries who participate in a public offering take the necessary steps to ensure that all professionals involved maintain high standards of conduct.

Until the FESCO recommendations, European and US regulation had focused on avoiding the abuse of privileged information, but FESCO along with the US SEC commenced a process towards the handling of another type of information regarding companies outside the ambit of that defined as privileged but whose relevance is substantial because it affects appraisals of a security, and therefore its price in the market.

As a result, amongst other matters FESCO recommended that issuers ensure that all relevant information disseminated in roadshows or meetings with financial analysts, shareholders or investments, be suitably distributed to the rest of the market previously or at the same time. Although only as a recommendation and limited to the scope of public offerings, in Europe a prohibition was already being tackled of selective dissemination of information which was subsequently regulated in the Market Abuse Directive.

The prohibition on selective dissemination of information promoted by the US SEC was complex but profound, thereby strengthening the independence of analysts, and protecting those who were sceptical regarding a company from reaction and threats by it and, eventually, cutting off the supply of relevant information necessary for the analyst to carry out his work. The other side of the coin was that certain analysts saw their value to their employers reduced by ceasing to handle first-hand information which converted them into a valuable key element in respect of relations with their principally institutional clients.

Nevertheless, despite these tough initiatives other scandals occurred, with a leading role played by issuers of financial analysis. The problem had clearly not been resolved by measures on information management, since the problem remained pending of resolving conflicts of interest at the time of issuing recommendations.

4.2.2 Prevention of the influence of corporate banking

As mentioned, one of the principal sources generating conflicts of interest are the traditional systems of remuneration of the analysis service. Before the US Sarbanes-Oxley Act, auditors were also appointed, hired and remunerated by the directors and executives on whose actions they had to pronounce. Although the Sarbanes-Oxley Act dealt with the problem by the creation of Audit Committees responsible for controlling the forms of auditor compensation, it is not possible to apply a similar formula to financial analysis departments.

In addition, it must be taken into account that US regulators were particularly sensitive to the influence exercised by corporate banking departments, whose interference was always under scrutiny because they produced most income and benefited most from certain recommendations by analysts. Consequently, and although not free from controversy, other formulas were promoted to prevent contamination and undue influence, amongst others by the New York Stock

Exchange and the NASD market. In this case, in order to encourage the independence of analysis departments the establishment was advocated of a true fortress of Chinese walls between analysts and the departments which design corporate strategies and investment banking. One example of this type of measure was the rules prohibiting personnel of these departments from:

- Exercising any influence or control over the remuneration of analysts.
- Linking the remuneration of analysts to specific corporate banking projects.
- Revising, or even commenting on, any analysis report in progress.
- Influencing the opinions of analysts regarding any company covered by them.

In addition, and in order to reduce the outside pressure to which analysts were subjected, they were prohibited from participating in commercial actions[18] by corporate banking departments, and issuers were prevented from offering compensation to analysts in exchange for favourable recommendations or attracting investors. Finally, one SEC rule also required the signature of the analyst on reports, stating that the recommendations and opinions reflected should be presented on a personal basis.

4.2.3 Financing formulas

The catalogue of measures for a definitive divorce between analysts and corporate banking previously mentioned again left the following question unanswered: How to finance financial analysis without corrupting it? According to various studies carried out, only the corporate banking departments obtained sufficient income to absorb the high costs of an analysis department.

In addition, it was observed that the measures previously mentioned which were promoted unintentionally reduced the interest of financial institutions in financing analysis. This meant a fall in the number of practising analysts and only a small percentage of companies were monitored by them. The number of companies covered in the United States fell substantially from 14,000 to 6,000. This reduction mainly affected small and medium-sized listed companies.

At the present time, medium and small companies are listed without effective "supervision" by financial analysts. This not only means a loss of transparency, but these companies are more exposed to the risk of fraud and manipulation. Moreover, recent studies conclude that the evidence becomes increasingly strong which suggests that the financial analyst is a fundamental player in ensuring market efficiency and that the degree of coverage of a company by analysts affects its market value. The price paid for the measures promoting independence and objectivity was thus a drastic reduction in transparency.

Based on the effect of imposing "Chinese walls", small companies which were not followed by any analyst began to finance their cover by analysts and small brokers considered independent, in other words by analysts not forming part of any

18 Those commonly known in Anglo Saxon terminology as bakeoffs or roadshows.

financial group with corporate banking activities[19]. Faced with the criticisms from those who interpreted this initiative as totally contrary to the dissemination of objective and independent analysis, the justification by companies was that auditors who issue annual reports are also remunerated by the companies audited themselves. Furthermore it was argued that however prejudicial this form of financing analysis may be, it was much worse for no report to be published on the majority of listed companies because this was converting the market into something opaque, as was happening with the US NASDAQ[20].

In studies carried out by Thomson Financial however, it was seen that the independents are also optimists, sometimes even more optimistic than the analysts of the large financial institutions. As previously mentioned in the section on conflicts of interest, analysts of "independent" institutions are also subject to business pressures and conflicts of interest. The small firms are not major underwriters, they live on brokerage commissions and neither are they favourable to sell recommendations.

Consequently, the problem of independents continues and is tightly linked to the system for remunerating a service which is extremely costly. Nevertheless, the studies published are not pessimistic since it was seen that the percentage of buy recommendations is progressively reducing towards selling or holding securities. In the US this change in trend took place both as a result of the effect of the scandals and their investigation and the new regulatory measures.

The most recent initiatives under study relate to so-called "intermediated analysis" which consists of an intermediary remunerated by the issuer seeking and selecting independent analysts who cover its company. In this way institutions could maintain independent analysis departments without them being a mere cost centre, and even convert them into profit centres. In addition, the analyst would not only enjoy independence but would also have a true incentive to improve the quality of his analysis.

Nevertheless, the methods for "intermediating" the analysis are still subject to examination. One of the most novel proposals consists of issuers themselves being those which, through the markets on which their securities are traded, finance the independent analysis of their companies. The initiative seeks to prevent undue influence of the issuer on the analysis, proposing that it be securities markets or trading centres which should be responsible for remunerating and monitoring objective and quality analysis for all companies listed, distributing the contributions obtained from issuers amongst those analysts who cover these companies. In this way trading centres would act as a type of delegated supervisor with interests more aligned to those sought by regulators: investor protection, transparency and the integrity of markets.

19 Large issue underwriting operations can only be carried out by major stongly-capitalised institutions because they normally involves the consumption of own resources, in accordance with Community Directives and the Basle principles.
20 National Association of Securities Dealers Automated Quotations system.

5 Legislative advances in the European Union

In the opinion of experts in the field, on the basis of the events described what is needed are very demanding requirements which regulate the link between payment for the service and the establishment of controls on the room for manoeuvre of the analyst in issuing his recommendation. What has been demonstrated by experience in the US market between 2000 and 2004, and in the studies carried out by IOSCO, was that any regulatory measures which it is attempted to promote should be developed with three basic objectives:

1 Correct handling of personal conflicts of interest of the analyst.

2 Protection of the analyst from the exercise of undue influence by incentives or reprisals by the issuer of the securities subject to analysis or from his own employer.

3 A search for possibilities for financing the activity in a manner which does not pervert its content.

5.1 First initiatives based on the MiFID and the Market Abuse Directive

The present Community rules demonstrate a profound awareness of the undeniable impact, importance and social concern regarding recommendations disseminated in the field of financial analysis, since they subject them to a catalogue of requirements aimed at preserving their objectivity.

"Old Europe" was in fact aware of the scandals which occurred in the United States. Neither was there any certainty that these cases could not be reproduced in the EU, since no Community Directive had tackled the problem in detail which, moreover, as illustrated by the 2003 IOSCO study, was not being subjected to adequate supervisory scrutiny in order to prevent similar situations to those experienced on the other side of the Atlantic.

The fact that financial analysis regulated by the MiFID is included under the heading of "ancillary services" may be strike one's attention. Nevertheless, it was not thereby intended to deprecate the value provided by this service, nor minimise the risks of an inadequate provision such as those already described in previous sections. Its treatment as an ancillary service simply means that it is an investment service not subject to prior licence, i.e. it was not considered necessary that its provision be subjected to the requirements of authorisation and registration, of a basically prudential nature and not regulating conduct.

The first European Commission initiative was to promote a level 2 Directive developing the Market Abuse Directive, but in which only two matters were tackled: definition of the financial analysis subject to legislative compliance, and the obligation to disseminate information regarding analyst conflicts of interest.

This legislation considered that only financial analysis which includes

recommendations and is the subject of public dissemination (previously defined as sell-side or independent) should be considered subject to disclosure of information regarding conflicts. The European Commission considered however that mere disclosure of conflicts was not in itself a sufficient measure to prevent the consequences thereof and promote the development of quality analysis.

It should be emphasised in relation to the focus based on dissemination of information that on occasions the information functions as the "small print in contracts", such that it constructs a protective parapet for undertakings which disseminate it and does not act as a system for protecting the investors who receive it, either because they cannot understand it or manage it adequately, or because it overwhelms them and loses its interest.

Consequently, before development of the level 2 Directive under the MiFID, the European Commission formally requested the advice of the CESR on specific regulation of handling conflicts of interest to which analysts were subject. Although the MiFID already included various principles on adequate management of conflicts of interest in general, the CESR worked on a catalogue of specific recommendations which complemented the regulation arising from the Market Abuse Directive.

To this end, the CESR formed a working party made up of experts representing all Member States and headed by the Chairman of the British Financial Services Authority, Sir Callum McCarthy, who took the IOSCO recommendations summarised below as a starting point.

5.2 The IOSCO recommendations

Based on the study previously mentioned into the activity of financial analysis and its conflicts, in 2003 IOSCO published a series of recommendations for firms and regulators.

The working party which drew up the proposals was headed by the Director of the US SEC, Roel C. Campos, who stated that *"the members of IOSCO understand that investor confidence is fundamental to keep financial markets strong and healthy"*. The objective of the working party was to draw up a catalogue of recommendations *"against the conflicts of interest which corrupt sell-side analysis, and in this way protect both investors and the efficiency of securities markets"*.

Very briefly, the IOSCO measures considered the following as key to promoting legislation at international level:

Prohibitions to prevent dealing ahead practices

- Prohibiting analysts from dealing in securities or derivatives related to securities prior to publication of the analysis of the issuer of the securities.

- Prohibiting employers of analysts from inappropriate dealing in securities or derivatives related to the securities before publication of the analysis on the issuer of the securities.

The prohibition was qualified for firms, probably because an emphatic restriction could prejudice other investment activities. In this respect the establishment of Chinese walls and other internal control measures could be sufficient to consider that dealing in securities subject to restriction is not "inappropriate".

Prohibitions to prevent "undue influence" practices

- Prohibiting firms which contract analysts from undertaking to issuers of the securities a particular cover or favourable treatment; the preparation of reports, special ratings, or a price target in exchange for a future ongoing business relationship, service or investments.

- Prohibiting analysts from taking part in commercial actions of investment banking departments.

- Prohibiting analyst remuneration from being directly linked to specific transactions carried out by investment banking departments.

- Prohibiting analysts being dependent on or reporting on their activities to investment banking departments.

- With some defined exceptions, prohibiting corporate banking activities from previously approving analyst reports or recommendations.

Transparency requirements

- Requiring that the analyst or firm for which he works publicly disclose whether they are beneficiaries of compensation connected with the analysis from the issuer or other third parties.

5.3 The CESR recommendations and their subsequent adoption in Community Directive 2006/73/EC, published on 10 August 2006

After analysing the IOSCO recommendations, the CESR experts concluded that a very substantial part of the regulatory initiatives for analysts recommended by IOSCO had already been implemented in order to handle the conflicts of interest of investment firms defined by MiFID in general. In short it was seen that the conflicts generated by the simultaneous provision of different investment services, by the improper flow of information in organisations, the exercise of external or internal undue influence, or systems of hierarchical dependency and remuneration, without doubt compromise the professional, loyal and independent action of any of the persons, functions and departments in an organisation or line of business with control or administration functions.

It was therefore difficult to extend the recommendations much further to regulate the financial analysis service without falling into excessive specificity and a regulatory burden which in the end would create a brake on activities and a

disincentive for firms. A series of specific recommendations were eventually published which were subject to public consultation on several occasions. The sector showed itself to be extremely critical of the CESR proposals, but did not directly tackle the problem of financing the analysis of small companies nor formulate any proposals in this respect.

In 2005 the CESR published its advice to the European Commission[21], together with a summary of the comments received during public consultation and an explanation of the options which the CESR eventually favoured[22], the content of which is summarised below, structured into three main blocks:

a) **Definition of financial analysis subject to compliance with rules regarding conflicts of interest:**

In general, the CESR took as reference the definition already established in the Market Abuse Directives, in which regulated analysis was defined as all that which is disseminated to third parties and which also includes some type of recommendation regarding the securities analysed.

However, it also had to take into account the different ambits in which investor recommendations can be issued and their different capacity for influencing investment decision-making. The CESR consequently recommended that developments of the MiFID should clearly establish the different application of rules regarding recommendations issued in the ambit of financial analysis, in relation to other rules of conduct applicable to personalised recommendations issued in the context of providing financial advisory services, as well as other recommendations of a commercial and advertising nature.

In this respect, the CESR recognised that it was normal practice in the financial industry to use analysts' reports or a significant part of them to disseminate recommendations in communications of a commercial nature for advertising purposes. In these cases, the content of the analyst's report formed part of another type of investor communication which by its nature lacked the philosophy, technical content and objectivity in recommendation which was expected of analysis reports as such. The CESR consequently recommended excluding reports which were used for commercial and advertising purposes from compliance with the rules of conduct applicable to recommendations by analysts. If this exception were not allowed a situation could be created by which a regular and admissible practice in the market would in some way e prohibited by the rule, since a communication of a commercial and advertising nature could never comply with the rules regarding independence, objectivity and disclosure of conflicts of interest laid down in directives for the issue of recommendations by financial analysts.

21 The CESR's Technical Advice on Possible Implementing Measures of the Directive 2004/39/EC on Markets in Financial Instruments, April 2005.
22 The CESR's Technical Advice on Level 2 Implementing Measures on mandates of the first set where the deadline was extended and second set of mandates, Markets in Financial Instruments, Feedback Statement, April 2005.

Nevertheless, this exclusion had to be subject to a series of conditions whose principal intention was not to confuse the recipient of the information, making it clear that the advertising communication which includes analysis reports, or part of them, should be clearly identified as such, and the recipient must be prevented from having a perception that recommendations with commercial intentions regarding the securities subject to analysis had been drawn up on principles of independence and objectivity.

This may be the case, for example, with reports on securities subject to placement by an intermediary. The intention of the CESR was that when the placing party decides to send commercial communications to its potential investors with information on the security and its issuer prepared by analysts, it should make it clear to its potential clients that the information sent is of a commercial and advertising nature, since it is sent as part of a campaign for placement of the security amongst clients. The potential investor should not therefore in any event have an impression of objectivity and impartiality in the recommendation received from the placing party to take up the public offering publicised.

All of the foregoing was subsequently included in Article 24 of Directive 2006/73/EC published on 10 August 2006.

b) Organisational requirements to mange conflicts of interest adequately, in order to prevent them compromising impartiality during the process of producing financial analysis which will be disseminated to third parties, excluding analysis produced for internal consumption by financial institutions.

The 2005 CESR recommendations reproduced the philosophy of the IOSCO recommendations with some modifications and novelties.

The prohibitions to avoid dealing ahead practices[23] are reproduced, but only with respect to those persons involved in carrying out analysis of securities subject to the prohibition, and not in general. In addition, the CESR also recommended prohibiting dealing in contrary manner to that recommended in the analysis disseminated, in the absence of prior authorisation from the regulatory compliance function or legal department of institutions.

The prohibitions to prevent "undue influence" practices recommended by IOSCO were also included in the CESR advice, although with some qualifications regarding the scope of the prohibition. One of the most debated matters was the establishment of "Chinese walls" around analysts. Despite the initiatives already promoted in the United States on this matter, the financial community considered that they were an extreme measure which hampered the financial analysis service because it excessively isolated analysts.

After examining the variety and different seriousness as a result of their impact of the potential conflicts to which analysts are subject, the CESR

23 Also regulated by Section 79.1.g) of the Spanish Securities Market Act.

finally reached very similar conclusions to those of the US regulators and recommended that at least "Chinese walls" should be established between analysts and the corporate banking business line. With respect to other departments and activities, a horizontal imposition was avoided, recommending the requirement of Chinese walls in those cases in which the entity had diagnosed the existence of conflicts of interest which could affect the objectivity of those responsible for preparing reports. In this way responsibility for the decision to implement the preventative measure was left in the hands of the financial institutions themselves, subject to an internal analysis in each case, the suitability of which would be subsequently assessed by supervisors.

All of the foregoing was incorporated into Directive 2006/73/EC, such that those recommendations for handling conflicts of interest of analysts which were considered applicable to any other person or department of an entity were reflected in rules for handling conflicts with horizontal application (Article 22), and those which were particularly applicable to analyst activities were included in Article 25.

In relation to "Chinese walls" the Directive did not literally set out the CESR recommendation but did embrace its spirit, since the general rules stipulate, amongst other matters, that entities must:

- "adopt effective procedures to prevent or control the exchange of information between relevant persons engaged in activities involving a risk of a conflict of interest,

- prevent or limit any person from exercising inappropriate influence over the way in which a relevant person carries out investment or ancillary services or activities,

- adopt measures to prevent or control the simultaneous or sequential involvement of a relevant person in separate investment or ancillary services or activities where such involvement may impair the proper management of conflicts of interest."

These preventative measures are in short an obligation for entities to construct "Chinese walls" which prevent the perversion of analysis during its gestation period.

c) Requirements regarding the dissemination of analysis by entities other than those which produce it.

This aspect was not the subject of IOSCO recommendation, but taking into account the possibility that entities which do not have their own analysis departments may continue to disseminate amongst their clients that produced by third parties, the CESR considered that it was necessary to define a chain of responsibilities in relation to compliance with the rules previously set out. This recommendation was included in Article 25.3 of Directive 2006/73/EC, which provided that Member States shall exempt investment firms which

disseminate investment reports prepared by other persons to the public or to clients from compliance with the organisational requirements for adequately handling conflicts of interest, if they comply with the following conditions:

a) "the person that produces the investment research is not a member of the group to which the investment firm belongs;

b) the investment firm does not substantially alter the recommendations within the investment research;

c) the investment firm does not present the investment research as having been produced by it;

d) the investment firm verifies that the producer of the research is subject to requirements equivalent to the requirements under this Directive in relation to the production of that research, or has established a policy setting such requirements."

6 Conclusions

Financial analysis services without doubt make a substantial contribution to the overall development of securities markets. This service has not however been the subject of special supervisory attention until recent times.

Taking into account the existence of a series of substantial conflicts of interest and the pressure to which analysts may be subjected within their organisations, and even outside them, a perception exists that analysts have historically been excessively positive with respect to companies analysed. There are even some who say that irrespective of any prophylactic rules or control, "the analyst will always be a seller with an incorrigible tendency towards optimism"[24].

As demonstrated, bad practice and functional models have been repeated with a common denominator which places the interests of multidisciplinary financial institutions above the professional prestige of their analyst. In this manner many analysts have seen how this prestige was almost irrecoverable and how the profession was in a certain manner being demonised.

The foregoing all justifies the regulatory initiatives which have been promoted, mainly in the United States and European Union, to encourage a climate in which analysts can carry out their work with independence and objectivity. These initiatives are principally focused on adequate handling of conflicts of interest which arise in relation to the financial analysis service for the purpose of preventing conflicts seriously prejudicing the quality of the recommendations disseminated to the market.

24 John C. Coffee Jr.

Nevertheless, if one supports the view that the financial analysis of listed companies has a high added value which contributes efficiency and transparency to the market, the objectives of regulatory reform cannot be solely directed at achieving objectivity and independence. Perfect independence may involve an excessive cost if it turns out that only a minimum percentage of listed companies are covered by analysts. Consequently, it is important that in the future the impact is studied of the new rules in relation to the degree of development of the service. If it turns out that the coverage of companies continues to be low, all that will have been achieved is high quality analysis but in respect of a small number of companies.

Finally, it should be indicated that establishment of a catalogue of requirements aimed at bringing about greater independence and objectivity in recommendations which avoid them being biased, does not necessarily mean that at the same time an improvement is taking place in the quality of the product or an increase in technical qualification when making the assessments on which they are based. Regulation of access to the profession has not in any event been a supervisory priority since this access has lain in the hands of the acceptance and expulsion mechanisms of the market itself, which at the present time could be considered reasonably sufficient.

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Organisational requirements under the MiFID of firms which provide investment services

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1 Introduction

The modernisation of securities markets in Spain and the rest of Europe in recent years, particularly propelled by regulation and supervisory criteria of European organisations, is clearly orientated to incentivising competition as a means of optimising the provision of services in both quality and price and improving investor protection, an essential element for increasing confidence in the market on the part of all agents but particularly investors, both retail and institutional. The Markets in Financial Instruments Directive (MiFID[1] in its English acronym) stresses both principles as fundamental elements for strengthening the competitiveness of the European market. As one of the most important measures for achieving the two objectives, the new Directive regulates the organisational requirements of firms which provide investment services. Up to now the current regulation, contained in the Investment Services Directive – ISD, only laid down various general principles in the organisational field set between rules of conduct and prudence.

This work provides a review of the new organisational requirements for firms which provide investment services, taken to mean "*the series of rules which regulate the organisational structure of the human and material resources of an entity providing investment services which guarantee a high degree of integrity, competence and solidity in order to protect the interests of their clients*" [2]. Regulation of these aspects has intensified in recent years as a result of the growing sophistication of markets, the services provided and the organisational structures of multi-service entities. The article explains the basic characteristics of the new legislation, setting them in relation to the rules currently in force in Spain in order to identify the true novelties and, in particular, assess the actual effect of their implementation on Spanish firms.

The remainder of the article is organised in the following manner. The second section presents the evolution of regulation in Spain of organisational requirements as a reference point. The third summarises the rules contained in the MiFID in this field. The fourth details various particularly important aspects, and finally the fifth section contains various final reflections.

1 The label MiFID covers two Directives, that known as Level 1, European Parliament and Council Directive 2004/39/EC, of 21 April 2004, relating to markets in financial instruments, modifying Council Directives 85/611/EC and European Parliament and Council Directive 2000/12/EC and repealing Council Directive 93/22/EC and, what is normally called Level 2, Commission Directive 2006/73/EC of 10 August 2006, applying European Parliament and Council Directive 2004/39/EC in relation to the organisational requirements and functional conditions of investment undertakings and terms defined for the purposes of the said Directive. There is also a regulation relating to transparency, which is not referred to in the work.

2 The definition incorporates some of the objectives which the Level 2 Directive itself indicates in Recital 2.

2 Background of organisational requirements in Spain

Spanish regulation has been progressively advancing in establishing various organisational requirements for firms which provide investment services and, although in most cases they are disparate rules, and some of them closely linked to rules of conduct, in general it can be said that the MiFID does not add concepts which are new or unknown to Spanish firms. In other words, the concepts already exist in more or less detail in our regulations, as indicated below, and furthermore the gestation period of the MiFID has been long and transparent, offering few surprises to those obliged to comply with it.

The first legislative references to the need for securities brokers and dealers[3] to maintain an adequate organisation were already found in the 1988 Act and Royal Decree 276/1989 on creation of these entities[4]. As well as various high capital requirements which served as an entry barrier but which where justified by the need for firms to have human and material resources adapted to their activity, on their formation firms had to set out in detail these resources, their organisational chart and employee information systems. The business structure stated in the authorisation process logically could not be altered in the first months of operation in the absence of good reason and prior notification to the supervisor, and although there was no rule which referred to this obligation of "*prior permission*" , normal practice imposed it. It was a regulation which, viewed from a historic perspective, could be described as simple, but which responded to the objectives of prevention and control of conflicts of interest as key elements in the functioning of firms which operate in markets.

The following legislative step was the regulation of rules of action[5] by means of Royal Decree 629/1993, still in force today and scarcely altered despite almost fifteen years having elapsed since it was published, and the battery of developments which followed it and regulated aspects connected with organisational questions such as mandatory registers, information barriers or "Chinese walls", the need to have resources and capacity adequate to the services it was intended to provide, etc. Circular 1/1998, applicable solely to investment services undertakings, regulated internal control systems in a manner very similar to that established by the European legislation covered by this work.

In short, Spanish legislation already had rules whose content was very similar to those of the MiFID although those included in the latter are perhaps more clearly articulated and grouped under this new concept which has become known as organisational requirements.

3 Concept under the 1988 Act of the current Investment Service Undertakings ("ESI"), to which were added Quality Management Systems in the 1998 Act.

4 The rules on creation of banking institutions were very similarly formulated, although requirements as to capital and own funds, restrictions on activity, etc. are specific and their analysis goes beyond the scope of this work.

5 It is symptomatic that although the Royal Decree is known as the "rules of conduct" decree, it's actual denomination referred to "rules of action". The reason was that it regulated matters which did not have immediate application on relations with clients, i.e. organisational requirements.

3 The new organisational requirements under the MiFID

3.1 Basic characteristics

Organisational requirements are set out in Articles 13 of the Level 1 Directive and 5 to 23 of the Level 2 Directive. The basic characteristics of these rules are as follows:

1 *It is a regulation of principles.* The regulation enables various objectives to be achieved in several different ways without opting for any of them, given the heterogeneous types of entity (at European level) and their business vocation.

2 *They tackle virtually all areas of the undertaking.* The requirements extend to the whole of the undertaking as a result of it providing investment services and are not limited to this specific area of activity. This lacks practical importance in the case of investment services undertakings ("ISU") but is extremely important in entities in which investment services are only part of their activity, such as credit institutions and collective investment institution management companies ("SGIIC"), in which although they are logically only applied to the services provided, their effect extends to a large part or to the whole of the undertaking. This is the case for example with continuity plans or the need to identify conflicts of interest, aspects which cannot be restricted solely to activities in securities markets but necessarily extend to the whole of the organisation.

3 *Their content appears to have an effect in mitigating two types of very specific risk.* Firstly, operational risk, by creating procedures and stressing that they be known and monitored, and secondly reputational risk by stressing knowledge of and compliance with the rules. Indeed, this latter has in recent years become one of the most feared by entities as a result of the negative commercial effect of public dissemination of breaches[6], particularly those which relate to client relations, beyond their intrinsic seriousness or the quantitative importance which they may have had. It is surely because individual breaches of these rules have an effect on confidence in the system that such a prolific regulation is devoted to this area.

4 *The importance of monitoring.* This constitutes a clear message to the recipients of the rules. The requirements must be implemented but not on a fixed basis such that after complying with adaptation the proper functioning of the entity can be ensured. The rule requires an ongoing review of their utility in the light of practical evidence. Ensuring that an entity is well organised therefore becomes an affirmation necessarily linked to a moment in time which, in the sphere of securities markets, is necessarily short.

5 *Universality.* To this end an element is very properly introduced with

6 The public dissemination of breaches is a further demand of public opinion and a growing trend in supervisory policies which merits an in-depth analysis, precisely because their effects can become disproportionate with respect to the breach.

scant precedent in financial regulation, being the principle of proportionality or reasonableness, which is repeatedly stressed in several of the articles which regulate organisational requirements. It is formulated as follows: "*Member States shall ensure that, for those purposes, investment firms take into account the nature, scale and complexity of the business of the firm, and the nature and range of investment services and activities undertaken in the course of that business*" . Its purpose is to adapt the intensity of requirements to the size of the undertaking and the complexity of its structure and thereby prevent this requirement becoming a cost which cannot be borne of asymmetric application, preventing effective competition.

This proportionality merits various additional comments. For example, its application at no time is explicitly related to the type of client involved, nor to the market structure in which the activity takes place, although they could be taken as implicitly mentioned when linking it to "*the nature and range of the services provided*" . This seems to be consistent with the existence of small undertakings in volume of business or employees but providing highly specialised and complex services for institutional clients. This is a common business model, for example in Spain. In these cases the rule attempts to intensify the organisational efforts (operating procedures, adequate control measures, etc.) based on the complexity of the service and not only the size of the undertaking.

3.2 Aspects regulated

The Level 1 Directive regulates organisational requirements, but it is in the Level 2 Directive, specifically in Chapter II, entitled "*Organisational requirements*" , where they are developed to their full extent.

a) General organisational requirements (Article 5)

The Directive firstly opted to regulate various general organisational requirements (Article 5) which could well be taken to extend to any business activity. Perhaps for this reason there is no reference in this article to activities in securities markets. The need to have written procedures, a structure of authorities, efficient information channels, etc. is not exclusive to undertakings engaged in providing investment services or even to financial institutions. Nevertheless it is in these undertakings where they acquire particular importance by being subject to strong conflicts of interest and in which there is a risk that failure or fraud will affect investors and the sector in general. It is difficult to imagine an entity handling financial instruments and third party money not having adequate personnel or resources for the services it provides.

The Directive specifically requires that entities have a structure of clear and reasonable functions and responsibilities which are known to, assumed by and complied with by persons responsible for them, taking into account the principle of proportionality. In addition, Article 5 lays

down requirements for safeguarding the security, integrity and confidentiality of information, creating procedures for the purpose, preparing a contingency plan, having, applying and maintaining policies and procedures for obtaining accounting reports for supervisors which comply with current legislation and give a true picture of the financial situation of the entity. Finally entities are required regularly to monitor the procedures established.

b) Functions of compliance, risk management and internal auditing (Articles 6, 7 and 8)

The Directive formulates requirements in terms of function and not departments, in order better to apply the principle of proportionality, with the existence of three control bodies:

- *Legislative compliance*. Responsible for detecting breaches of legislation, taking measures to minimise the risk and permitting the authorities to exercise their powers.

- *Risk control*. Responsible for detecting and managing those risks incurred by the undertaking deriving from its activities.

- *Internal auditing*. In order to examine and assess the efficiency of systems, internal control mechanisms and arrangements of the undertaking and make recommendations in this respect.

Exercise of the three functions is affected by the principle of proportionality which, as will be examined later, has a different scope in each one. Furthermore requirements for independence are regulated, needed in order that they effectively fulfil the tasks entrusted to them and which consist of exclusive dedication and remuneration not linked to commercial objectives.

c) Responsibility of senior management (Article 9)

Two obligations are established: the need for senior management to be informed in writing at least annually on the activities carried out in respect of the foregoing functions and to evaluate the policies and their efficacy. The obligations extend to the senior management supervisory body.

d) Complaints handling (Article 10)

As a clear organisational requirement which has a direct implication for investor protection, the obligation is established to provide for transparent mechanisms and procedures for resolving client complaints. A rule which will have little importance in Spain since for years there have been customer care services and departments provided for this purpose and with very exhaustive regulation in this respect.

e) Personal transactions (Articles 11 and 12)

Firstly, Article 11 determines what is meant by personal transaction, *" a trade in a financial instrument effected by or on behalf of a relevant person"* . Their control (Article 12) is justified as an organisational requirement because it affects the risks of legislative breach by the firm and conflicts of interest. Regarding risks, the most relevant is the reputation of the undertaking to the extent that these transactions are detected and penalised and there is public knowledge of them. In general public opinion is very sensitive to this type of breach by those who operate with an advantage in markets. For this reason, for a firm to be involved through its employees or executives in a penalty of this type has a considerable effect on its reputation.

Precisely because of the commercial seriousness involved in this risk, control of transactions is normal in undertakings which operate in securities markets. Furthermore, this has been required in Spain since 1993[7]. The purpose of the control is to prevent persons who work in the undertaking and who have access to information which can be used for their own benefit from taking advantage of it in personal transactions, taken to be those in which the person or someone connected with the same is beneficiary. The control attempts to avoid three situations:

- The use of privileged information, defined in accordance with the Market Abuse Directive[8].

- The use of confidential information, a concept related to professional secrecy.

- The transaction being able to give rise to a conflict of interest with an obligation of the firm.

Practical application of this requirement raises important practical problems which will be examined in more detail later.

f) Outsourcing of critical and important functions (Articles 13, 14 and 15)

The establishment of conditions by the MiFID for outsourcing is a response to this being a very frequent and growing phenomenon for the following reasons:

1 *The creation of specialised investment services undertakings*. In Spain, as in other neighbouring countries, the growing complexity of securities markets is leading many undertakings to specialise in areas of business in which they have a comparative advantage, particularly amongst undertakings of small size and with businesses focused on specific activities. For these undertakings to have administrative departments or to provide services in which such specialisation does not exist is a cost which can be minimised by subcontracting.

7 Royal Decree 629/1993 already established an obligation for undertakings to establish a system of controlling personal transactions of directors, employees and representatives.
8 Directive 2003/6/EC, developed for these purposes by Directive 2003/124/EEC.

Furthermore, if the subcontractor is another specialist undertaking then as well as cost an increase in quality of service will be offered which is commercially very positive.

2 *The trend to replace fixed costs by variable costs.* A trend not solely attributable to securities market undertakings, but which is also reflected in the sector. The purpose is to lower the cost of crises and of business failure by reducing the thresholds for investment profitability. The Directive concerns itself with the risks which may be involved in outsourcing critical functions[9], given that full responsibility is maintained. These risks are:

- The vulnerability and dependency which is created with respect to the service provider insofar as the service is provided deficiently or its provision is interrupted.

- Fraud by the subcontractor, either because it conceals or falsifies information, etc.

- Abuse of privileged, confidential or commercial information to which the subcontractor has access and who may provide services to several undertakings.

In order to prevent these various measures to be adopted are laid down before outsourcing, which basically consist of assessing the capacity of the undertaking to which the functions are delegated, the grounds for termination of the contract and that there are no restrictions on access to the subcontracted entity. The Directive furthermore pays particular attention to additional conditions when functions are delegated to undertakings located in third party jurisdictions, and in particular when the activity of portfolio management is delegated given that there is no certainty that its regulation is equivalent to that in Europe. Aware of this, it deals with the matter by laying down additional requirements, in particular for outsourcing the activity of portfolio management to third party countries, or allowing for prior authorisation by the country of origin. It also establishes an obligation for supervisors to publish the policy which is applied regarding outsourcing to third party countries in a detailed manner with examples.

g) Safeguarding client funds and financial instruments (Articles 16, 17 and 18)

Under this heading the objective of the organisational rules is set out in relation to separation of client accounts, being to minimise the systemic risk in relation to an also increasing activity which is the chain of sub-deposits. It thereby attempts to avoid the very high cost in economic terms of reparatory measures in the event of non-compliance, for example the intervention of deposit and investment guarantee funds, and in terms of confidence.

9 Critical means those in which *"if a defect or failure in its performance would materially impair the continuing compliance of an investment firm with the conditions and obligations of its authorization or its other obligations under Directive 2004/39/EC, or its financial performance, or the soundness or the continuity of its investment services and activities."*

The list of risks can be particularly emphasised which could lead to failure to comply with the objective sought: misuse of assets, fraud, poor administration, inadequate maintenance of records or negligence, and the descriptive purpose of the Directive in this respect is to be praised[10]. It is also revealing that various general rules have been laid down regarding deposits in third party countries in an attempt to prevent the ownership rights of clients being affected and whose content basically consists of carrying out a type of due diligence of the third party entity. It also requires the agreement of the client for use by the intermediary of securities.

In the case of client funds, apart logically from excluding credit institutions, it appears to pursue the transience of balances as a measure for minimising them, repeatedly mentioning investment in money market funds in which security must be a priority as opposed to the market (short-term investments, rating) along with liquidity. The restrictions on use of investor funds is formulated on this occasion in contrary terms, permitting the client to object to investment in monetary funds.

h) Conflicts of interest (Article 21, 22 and 23)

This is another of the basic pillars of the new Directive and justifies the existence of some of the organisational requirements previously described. It is a question of giving recognition and proposing solutions which are as specific as possible to a situation which increases with the sophistication of products and markets and of firms themselves which provide simultaneous services[11]. The Level 1 Directive clearly states how the risk must be limited that conflicts of interest prejudice client interests, focusing on three actions: identification, management and, in cases difficult to resolve, disclosure. Nevertheless, it makes it very clear that there must be effective management of the conflict, by taking effective organisational and administrative measures[12] and that the action of the firm cannot be restricted to providing transparency, an objective which is way below what is sought.

The Directive requires the creation of a register in which the types of services provided are included in which conflicts have arisen with a substantial risk to clients.

i) Requirements when the firm prepares reports on investments (Articles 24 and 25)

In these articles the Directive highlights a special type of conflict of interest when it discloses reports on investments[13] which can affect investor portfolio decisions. The objective sought is independence of the analyst,

10 Article 16 f).
11 Recital 29 of the Level 1 Directive.
12 Recital 27 of the Level 2 Directive.
13 Defined as "research or other information recommending or suggesting an investment strategy, explicitly or implicitly, concerning one or several financial instruments or the issuers of financial instruments, including any opinion as to the present or future value or price of such instruments, intended for distribution channels or for the public, and in relation to which the following conditions are met:
(a) it is labelled or described as investment research or in similar terms, or is otherwise presented as an objective or independent explanation of the matters contained in the recommendation;
(b) if the recommendation in question were made by an investment firm to a client, it would not constitute the provision of investment advice for the purposes of Directive 2004/39/EC".

imposing restrictions on operating with the instruments subject to analysis and on dealing contrary to their recommendations, not accepting incentives from those who have an interest in the analysis, and not undertaking to prepare favourable reports and restrictions on revising reports.

4 Elements of greater importance and complexity

In this section the implications are examined which adoption of some of these requirements could have on Spanish undertakings, taking into account the prior legislation in force and characteristics of the business in Spain.

4.1 Implementation of the general organisational Requirements

Investment services undertakings in Spain can be divided into two predominant types of intermediary: subsidiaries of credit institutions and of large foreign investment undertakings, and small firms with a low number of employees[14]. In the first case the general organisational structure is highly conditioned by the financial group to which the entity belongs and a large part of the general organisational requirements will be those established by the group itself, which normally provides the human and material resources to its subsidiary as they are required. The chains of command, strategic decision-making and control are not restricted to the entity itself but to the group. In general, it can be divined that the majority of the large financial groups, for different reasons such as banking rules or because in other countries the Directive has been transposed, have already implemented these measures, which may or may not be correct in a specific case but it does not appear that any of the entities in this category will be starting from scratch with the MiFID. In short, adjustments will be necessary in areas such as registration of activities, training or internal communications systems. In the second category, that of small undertakings, there is normally a virtually total coincidence between shareholders, directors and employees and the decision-making structure or information flows involve them all. Adaptation will not therefore be complex.

In any event, both in large and small undertakings the principle of proportionality comes into play and consequently it does not seem foreseeable that adoption of these measures will constitute major challenges for undertakings in Spain. For this reason, the obligations of undertakings in this field can be virtually reduced to drawing up adequately in writing the procedures which they have implemented. This being so, there appears to be no reason preventing undertakings immediately having an organisational structure adapted to the Directive, nor therefore for adaptation to take a long time after it comes into force.

14 At 30 June there were 113 investment undertakings registered in Spain which have an average of 32 employees. A figure which appears stable over the last 4 years in which variations have been minimal. Nevertheless, the breakdown of the 3,621 total employees at July 2007 is very unequal. Just 5 entities have more than 100 employees and absorb a third of employees in the sector.

It is worthwhile emphasising two organisational requirements as a result of their particular characteristics:

- *The obligation of firms to safeguard the security, integrity and confidentiality of information*, in the light of the nature of the information in question. This obligation has a much greater scope than prohibiting disclosure or preventing the use of privileged information. It extends to all information which must be considered confidential, a concept related to professional secrecy which must be extended in a broad sense such that it includes information of other clients and of the undertaking itself and its investment and operating plans.

- *The need to prepare a contingency plan which permits the preservation of data and essential functions or their recovery*. The importance of these plans, the purpose of which is to preserve client assets, has been ratified by the tragic events which have occurred in recent years throughout the world but neither is it a new obligation. The General Code of Conduct of Securities Markets, annexed to Royal Decree 629/1993, already provided that "*both companies and individual entrepreneurs must provide the necessary resources in order that in the event of cessation or interruption of the business the interests of clients do not suffer any prejudice*" , a distinct rule but clearly of similar purpose. In any event, the Directive scarcely mentions the requirements which these plans must fulfil and it appears that this must be an important aspect given that what is intended is that they function well, not just that the entity carries out a reflection in this respect and documents it. It is foreseeable for this reason that in domestic regulation the minimum requirements will be established which these plans must fulfil and therefore full adaptation may be delayed.

As common characteristics of these two requirements it must be indicated that, unlike the remaining obligations under Article 5 of the Level 2 Directive, proportionality is not applicable.

4.2 Importance to firms and supervisors of the compliance function

As already indicated, the Directive makes control one of its principal features with the twin objective, set out in the legislation, of detecting breaches and taking measures to minimise risks and also implicitly improving and reducing exposure to them, advising the rest of the organisation in this respect. The compliance function therefore becomes one of the keys to the proper functioning of firms and also to their survival in a sector which, pursuant to these rules, will have to increasingly comply with legislation.

The concept is not new in Spain, nor in most countries. The figure of the Compliance Manager, or Control Unit in its Spanish denomination, spread through virtually all undertakings in the mid-90s. What is new is the importance which it acquires and the requirements which must be fulfilled. At the present time this concept is considered by undertakings as an ally, a type of financial quality control which anticipates problems before they become aggravated. To supervisors,

without prejudice to the doubts which raised by the debate on the efficacy of the obligation of self-incrimination when there is a breach, it is also a very useful extension of its functions.

It will thus be a key function and a priority element in supervision and therefore must be examined in great detail and with interest by undertakings and also by supervisors. Good control of legislative compliance will be an element very highly assessed by supervisors. It is therefore foreseeable, at least at an initial stage, that part of the supervisory activities of the CNMV after implementation of the MiFID will focus on verifying the effectiveness and adequacy of compliance functions as a measure for the prevention of greater risks.

The requirements merit additional analysis which this function must fulfil in order to be effective. On the one hand, authority to access the necessary documentation and the persons required without restriction, which means that the function be situated outside the operating hierarchy. On the other hand, dedication and independence. Both are highly relevant aspects in practice and, despite the principle of proportionality again being applicable in deciding whether the person responsible can devote part of his time to provision of the services, it seems logical that the application of this principle must be exceptional despite the undertaking being of reduced size. It is so essential that at the present time it is no longer considered a non-productive cost to devote resources to someone repeatedly going over and analysing the risks of the organisation and proposing improvements. For this reason the debate that this concept has aroused regarding the application of proportionality and whether it is necessary that it be a function or a department seems more theoretical than real.

This restrictive application of proportionality opens up a further debate however, regarding the desirability or otherwise of outsourcing this function. Outsourcing, which logically will have to fulfil the general requirements of subcontracting essential functions and which will be examined later, offers independence as its principal advantages when delegating to a person outside the undertaking or group, along with specialisation if this new obligation gives rise to experts in the provision of this service for several undertakings. On the other hand, it has the drawback of being distant and the mistrust which may be generated in an organisation by granting full access to all documentation to third parties who also work with other competitors. This will therefore be a decision carefully considered by each undertaking, and a very important one.

Adaptation of this aspect to the new requirements also does not raise major problems since it has been normal for years. In most firms adaptation will simply consist of relocating the persons who currently carry out this function in accordance with the Directive. There is therefore no reason why its application should be delayed after the Directive comes into force, without prejudice to previously requiring important decisions.

It should finally be indicated that, despite its importance, the Directive scarcely lays down requirements which the holder must fulfil[15]. It seems that this omission is not intentional but will require domestic regulations to specify which requirements as to knowledge and experience must be considered minimum, which supervisors will take very much into account in their actions.

4.3. Proportionality in the functions of risk management and internal auditing

One of the most important doubts which has arisen is how to apply the principle of proportionality[16] to these functions.

In the case of the risk control function, the doubt consists in whether the existence or not of this function is conditioned by the "nature, scale and complexity of the business activity and the nature and range of services..." which is provided. In this manner, if the activity is simple it would not be necessary to create a risk control body. This should not be the interpretation, but rather that with the body in existence it may not be necessary for it to be independent due to the application of proportionality.

Nevertheless, the opposite model has been adopted in respect of internal audit. Its very existence depends on the application of proportionality. If the existence of this function is necessary, the body must be independent.

As occurs with regulatory compliance, control figures are common in our entities and moreover are considered essential by the supervisors who will probably analyse their functioning. For both reasons it is desirable that entities adapt to these requirements as soon as possible since regulatory developments are not essential for the purpose, which will only add minor qualifications in this field.

4.4 Problems of controlling personal transactions

This control raises several problems in application which each entity must resolve in the manner most appropriate to the structure and the objectives sought. These include:

1 *The scope of persons and securities subject to control.* Each entity must specify the persons who may have confidential information or raise conflicts of interest with the firm in order to subject them to control and at all times define the specific types of securities or instruments susceptible to being used for the purpose[17]. Nevertheless, it must be taken into account that any control activity necessarily involves costs. When the control is more extensive, for example by affecting a large number of persons or transactions, the costs will be higher. This cost-benefit problem is particularly manifested in large entities in which analysis of transactions, if they are very numerous, involves a genuine management problem. The same happens when an attempt is made to carry out control which is too rigid of persons affected, making it obligatory to give notice and authorise a high number of transactions or types of securities. Finding a reasonable balance between the efficacy of

15 Although there is a general obligation to "employ personnel with the qualifications knowledge and experience necessary to carry out the functions assigned to them ".

16 Article 7.2 of the Level 2 Directive provides: "Member States shall require investment firms, where appropriate and proportionate in view of the nature, scale and complexity of their business and the nature and range of the investment services and activities undertaken in the course of that business, to establish and maintain a risk management function that operates independently and carries out the following tasks…".

17 What is normally denominated as lists of persons and securities.

the measures and their cost is difficult. Aware of this, the Directive excludes control of collective investment institutions provided that they have asset diversification rules equivalent to those regulated by the European Directive and are not managed by the relevant person. This is a consistent exception, as investment in public debt or other very liquid securities can be in some cases.

2 *The time of control*. Another interesting question in this field is whether the control of personal transactions must take place before or after the event. Obviously, control before the event is clearly better since it reduces the risk, but it is also true that it increases the cost if attempting to analyse transactions rapidly[18]. Proponents of control after the event normally state that the existence of controls already reduces the likelihood that a person has an incentive to engage in illegal transactions and, consequently, the cost-benefit ratio of the control becomes more favourable. Again, each entity must analyse which control or combination of the two, for example by type of product, is more suitable to its individual case.

3 *The need to operate through the entity itself*. This is a strictly Spanish obligation since our regulation[19] requires that at least directors and also other persons designated by the entity, as a result of their access to privileged or confidential information or because they are susceptible to generating conflicts of interest, carry out their transactions through the entity for which they work. The purpose of this old rule is to strengthen control and prevent the entity under an obligation to control from evading responsibility. In some cases this obligation has been shown to be excessive since there are entities which do not operate with retail clients and they need to make exceptions in these cases. Furthermore, carrying out transactions in another entity offers some advantages, such as reducing the capacity of the person affected to influence the handling of the transaction itself (for example obtaining a good price) insofar as if the entity is independent this client will be treated as just another client without the privileges which he may have in his own entity.

4 *Volume of transactions*. This is a conceptual problem with important practical implications when the relevant person has large assets in securities, connected and controlled undertakings, etc. In some cases these large assets and undertakings may operate very actively (for example with large daily volumes in a multiple of instruments and markets) with greater or lesser autonomy in relation to their beneficiary. Establishing a control over all transactions of the undertakings or the holdings of the person can be non-viable and highly costly. Attempting to implement blind trusts, i.e. without involvement of the beneficiary, may be unreal. Consequently, it is one of the most difficult cases to resolve. Only a combination of several of the measures referred to in this section could provide an efficient solution.

18 Entities which opt for control before the event normally analyse the transaction in two or three days.
19 Royal Decree 629/1993.

5 *Identification of suspicious transactions*. Up to now the problems have been referred to which involve establishing a control over transactions. It is more problematic however to fix the content of the control. Identifying whether a transaction is carried out with privileged or confidential information is as complicated as demonstrating it when there is a suspicion and much more so if the control is before the event or shortly after carrying out the transaction. Even more complicated is identifying the direction of a series of transactions not carried out at a single point in time. In other words, it is possible that in a series of transactions each of them individually may easily pass through the filters established, but taken as a whole they are contrary to the objectives set down for control.

6 *The credibility of blind trusts*. Theoretically this is an optimal formula for avoiding transaction control. However, firms which allow this practice must take into account the capacity for influence of the relevant person over his trustee. For this reason the fact that a blind trust exists run by a third party does not exonerate the firm from a certain control, at least in order to ensure that the trust management is independent. Thus, in order to allow this exception from transaction control it is necessary that the trust and the trustee are previously approved and that provisions exist in the contract which permit information to be directly required from the trustee regarding the portfolio when considered appropriate.

In short, the control of personal transactions is manifested as an essential element for avoiding risks, but can also be highly complex and costly despite formulas existing such as those mentioned, and others suggested by current Spanish regulation, such as establishing minimum periods for holding portfolios which could facilitate the control. Taking into account that this obligation has been known and applied by Spanish entities for years and that there is a long experience, in practice it does not constitute a major novelty or additional cost. Adaptation to the MiFID includes reflection on the most effective control system and redefining the persons subject to control, but none of these reviews would justify adaptation which could take particular time after the Directive comes into force.

4.5. The systemic effects of the outsourcing of functions

In recent years a multitude of undertakings have emerged which specialise in the provision of certain services for professionals in the market. In general they cover business areas which require a large burden of fixed capital, principally in IT, and which are scarcely profitable if they need to be tackled individually by each entity. The growing number of entities in this type of business means that competition between them is based on quality of service, taken as the possibility of adapting to each undertaking[20], rather than elements such as cost of provision, which is logical taking into account that the entity which delegates does not free itself from responsibility.

20 One very important and highly-assessed element to undertakings which subcontract and a business objective for subcontractors is having systems which are compatible with different types of entity. As well as accessing a large number of client-entities, this also enables the entity to change its systems without changing subcontractor, which benefits its continuity of business.

Outsourcing nevertheless involves additional risks which are aggravated in some cases by the fact that the entities subcontracted may not be entities supervised by any body. The supervisor must assess, to the extent that outsourcing generally takes place with a single or few service providers, whether a failure in functioning could have an undesirable systemic effect. For this reason it's highly likely that this type of entity will be subject to supervision in the short term in order to verify the capacity of the service provider.

As indicated, outsourcing is growing in Spanish entities. Adapting contracts to the requirements laid down by the Directive does not in principle seem to raise excessive difficulties.

4.6 Conflict of interest characteristics and policy

The new regulation is more complete than that in force in Spain, which is set out in various disparate legislation[21], since the Article relating to conflicts of interest[22] deals exclusively with those which take place between clients and not between undertaking and clients, which are located separately in the other provisions, mainly in that relating to impartiality and good faith[23]. In any event, the objectives pursued are the same:

- The detection of conflicts[24], for example with a register thereof whose contents must be specified in the internal conduct rules, which must include those of directors and employees *"as a result of their family relationships, personal assets or any other reason and maintain the said information updated"* .

- The *handling* of some of them in order to reduce them[25] as far as possible, within the general obligation of resolving them when they occur, with measures such as Chinese walls or the predetermined assignment of transactions in grouped trading.

- That of *disclosing* to clients the economic or other type of links between the entity and others who serve as counterparty or specific provisions in relation to the advisory activity[26].

The Directive makes it obligatory to establish a written conflict policy. In order to prepare this it is necessary to analyse the characteristics of the conflicts of interest it is intended to regulate:

1 *Extension to the whole undertaking.* Unlike the remaining organisational requirements, obligations in relation to conflicts of interest are not limited

21 Many of them in the General Code of Conduct for Securities Markets, annex to Royal Decree 629/93.
22 Section 6 of the General Code of Conduct.
23 Section 1 of the General Code of Conduct.
24 Section 3.1. f) of Royal Decree 629/1993
25 Section 6 of the General Code of Conduct annexed to Royal Decree 629/1993, provides that "Entities must avoid conflicts of interest between clients and, when they cannot be avoided, have the necessary internal mechanisms to resolve them, without privileges in favour of any thereof".
26 Section 5 of the General Code of Conduct.

to the provision of investment or ancillary services in themselves, but extend to the activities of the undertaking as a whole. In other words, in order for conflicts of interest to fall within the scope of the Directive it is necessary that they arise from the provision of investment or ancillary services or a combination of the two, but it is not necessary that they arise in relation to another service or in relation to other clients to whom the same services are provided but in relation to all activities of the undertaking[27].

2 *The type of client is irrelevant*. Unlike other measures, principally transparency, which aims to protect retail clients, conflicts could prejudice any type of client since they are hidden, and therefore the client, even if professional, cannot avoid or anticipate them.

3 *Almost universal extension of the persons who can originate conflicts*: the undertaking itself, connected persons, group entities and clients.

4 *Definition of the conflict is particularly important*. It requires that there is a prejudice, understood in a broad manner, to the client. It does not suffice that the entity or another client may obtain a benefit. This is one of the most important aspects for delineating the concept.

5 *The principle of proportionality is applicable*. It must be made clear that this refers to the policy of managing conflicts of interest which will be moderated depending on the activity and organisation of the undertaking, but not in relation to the obligation to "*establish, apply and maintain*" this policy, which must happen in any event. In reality the principle of proportionality lacks any practical utility since it is clear that if an undertaking has a simple organisation and activity, its conflict of interest policy will be simple since the conflicts will be clear, and vice versa.

In relation to the content of the conflict of interest policy, the Level 2 Directive is very precise and the measures provided are essentially based on establishing information barriers ("Chinese walls"), separate supervision of departments or preventing certain persons being able to influence decisions when the conflict exists. Furthermore, the obligation is established to disclose them, provided that it has not been possible to avoid them, in a permanent manner such that there is evidence thereof.

Finally, the Directive echoes one of the principal types of conflict of interest, being the preparation of investment research reports, and proposes specific and precise measures for persons who prepare them, in order to maintain their independence intact, such as prohibition on personal transactions contrary to recommendations, receiving incentives, undertaking to produce favourable reports, etc. This is certainly a more complete formulation than that in force in Spanish regulation which assigns the responsibility for reports to the entity for which the analyst works, providing that they must be considered to be the opinion of the entity[28]. In any event these are difficult obligations to supervise in practice and therefore the measures to be adopted must necessarily be complex.

27 Recital 27 provides in this respect: *"Investment firms should aim to identify and manage the conflicts of interest arising in relation to their various business lines and their group's activities under a comprehensive conflicts of interest policy".*
28 Section 6 of the General Code of Conduct.

Despite its complexity it does not seem that preparation of a policy and the procedures for controlling it will involve an insuperable difficulty for Spanish entities since virtually all control mechanisms and concepts are known and, in most cases, already adopted. This means that legislative developments or clarifications regarding the work to be carried out are unnecessary and that it can be tackled immediately on entry into force of the Directive, without prejudice to these policies being improved over time in the light of experience. A clear determination is necessary to identify and management conflicts since it is one of the essential pillars of the Directive and therefore the subject of priority supervisory action. It is also important to highlight that many of the conflicts which occur in this market are not exclusive to a few entities. In reality there are similar business structures and similar conflicts within almost all entities, and the fact that some take the Directive obligations more seriously necessarily sets the pace for the others. It is unthinkable, faced with equivalent businesses, that one entity should very stringent measures and another very relaxed measures. This would affect the symmetry of application of the rules, costs and the competence and protection of investors, key elements of the Directive.

5 Conclusions

The MiFID has, in terms of general principles, articulated various minimum organisational requirements for firms which provide investment services. Their purpose is to improve the provision of services to clients and contribute to their protection, within a framework of fair competition between firms. This must in particular generate increases in quality and security in provision of the services. The foregoing with one basic objective: bringing about an integrated European market which is capable of competing at global level, improving the capacity to attract international financial agents.

With respect to application and adaptation of Spanish undertakings to these new requirements, the delay in legislative adaptation in relation to some countries has raised a debate in the sector as to whether application requires a long transitional adaptation period. A detailed analysis highlights the few novelties provided in relation to current regulation in Spain and the criteria which the supervisor has been maintaining. It could almost be said that Spanish legislation in this field is already adapted to a large extent to the MiFID. This may be partly due to the significant contribution of Spanish delegates in its preparation. Moreover, during the long gestation period of the new Directive, major efforts have been made to disseminate its contents and practical implications. Consequently it would not seem venturesome to suggest that the new rules are already known and understood and, consequently, their process of implementation will in general not be traumatic.

In any event, the analysis made has disclosed certain areas of priority action for both undertakings and the supervisor. The compliance function and all those relating to risk control are perhaps the most important examples.

V Statistics Annex

1 Markets

1.1 Equity

Share issues and public offerings[1]

TABLE 1.1

	2004	2005	2006	2006 III	2006 IV	2007 I	2007 II	2007 III[2]
CASH VALUE[3] (Million euro)	21,735.6	2,960.5	5,021.7	1,472.6	941.4	803.9	11,218.1	875.8
Capital increases	18,748.0	2,803.4	2,562.9	1,188.4	497.5	696.1	9,896.5	812.4
Of which, primary offerings	1,101.9	0.0	644.9	0.0	99.7	0.0	334.2	33.3
With Spanish tranche	537.9	0.0	613.6	0.0	99.7	0.0	334.2	33.3
With international tranche	564.0	0.0	31.3	0.0	0.0	0.0	0.0	0.0
Secondary offerings	2,987.6	157.1	2,458.8	284.2	443.9	107.8	1,321.6	63.4
With Spanish tranche	1,664.4	54.7	2,167.5	208.5	443.9	107.8	1,321.6	63.4
With international tranche	1,323.2	102.5	291.3	75.7	0.0	0.0	0.0	0.0
NO. OF FILES[4]	42	27	30	7	7	7	10	5
Capital increases	37	25	23	4	6	6	8	5
Of which, primary offerings	4	0	10	1	2	0	2	2
Of which, bonus issues	15	6	0	0	0	0	0	0
Secondary offerings	7	2	15	4	3	1	1	1
NO. OF ISSUERS[4]	37	24	23	6	6	7	10	5
Capital increases	31	23	18	4	5	6	8	5
Of which, primary offerings	3	0	6	1	1	0	2	2
Secondary offerings	6	1	10	3	2	1	3	1

1 Total files registered with the CNMV (including supplements of initial files).
2 Available data: August 2007.
3 Does not include registered amounts that were not carried out.
4 Includes all registered offerings, including the issues that were not carried out.

Primary and secondary offerings. By type of subscriber

TABLE 1.2

Million euro	2004	2005	2006	2006 III	2006 IV	2007 I	2007 II	2007 III[1]
PRIMARY OFFERINGS	1,101.9	0.0	644.9	0.0	99.7	0.0	334.2	33.3
Spanish tranche	536.4	0.0	613.6	0.0	99.7	0.0	334.2	33.3
Private subscribers	348.1	0.0	0.0	0.0	0.0	0.0	112.0	0.0
Institutional subscribers	188.3	0.0	613.6	0.0	99.7	0.0	222.2	33.3
International tranche	564.0	0.0	31.3	0.0	0.0	0.0	0.0	0.0
Employees	1.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Others	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
SECONDARY OFFERINGS	2,987.6	157.1	2,458.8	284.2	443.9	107.8	1,321.6	63.4
Spanish tranche	1,657.9	54.7	2,164.4	208.5	442.4	107.8	1,311.7	63.4
Private subscribers	657.4	27.3	398.7	31.8	81.7	16.2	289.4	0.0
Institutional subscribers	1,000.5	27.3	1,765.7	176.7	360.7	91.7	1,022.4	63.4
International tranche	1,323.2	102.5	291.3	75.7	0.0	0.0	0.0	0.0
Employees	6.5	0.0	3.1	0.0	1.5	0.0	9.9	0.0
Others	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0

1 Available data: August 2007.

Admission to listing. Files registered with the CNMV

TABLE 1.3

	2004	2005	2006	2006 III	2006 IV	2007 I	2007 II	2007 III[1]
NOMINAL VALUE (Million euro)								
With issuance prospectus	1,909.6	498.0	963.4	620.0	53.5	69.1	91.2	171.8
Capital increases	1,699.3	494.0	575.9	340.9	28.4	69.1	6.6	171.8
Of which, primary offerings	45.4	0.0	145.3	0.0	0.1	0.0	4.5	0.0
Secondary offerings	210.3	4.0	387.5	279.1	25.1	0.0	84.6	0.0
Without issuance prospectus	564.6	167.3	564.7	185.9	118.6	320.4	1,166.4	325.3
NO. OF FILES								
With issuance prospectus	36	26	18	5	4	5	5	4
Capital increases	34	25	13	3	3	5	3	4
Of which, primary offerings	2	0	5	0	1	0	2	0
Secondary offerings	3	1	9	2	2	0	3	0
Without issuance prospectus	16	27	61	17	20	17	19	14

1 Available data: August 2007.

Companies listed[1]

TABLE 1.4

	2004	2005	2006	2006 III	2006 IV	2007 I	2007 II	2007 III[2]
Total electronic market[3]	128	126	135	133	135	135	137	135
Of which, without Nuevo Mercado	115	115	124	122	124	124	127	125
Of which, Nuevo Mercado	13	11	11	11	11	11	10	10
Of which, foreign companies	6	5	6	6	6	6	6	5
Second Market	17	14	12	14	12	12	11	11
Madrid	2	2	2	2	2	2	2	2
Barcelona	12	10	9	10	9	9	8	9
Bilbao	0	0	0	0	0	0	0	0
Valencia	3	2	1	2	1	1	1	0
Open outcry ex SICAV	53	47	38	40	38	34	33	33
Madrid	28	22	16	17	16	15	14	14
Barcelona	31	28	24	24	24	21	20	20
Bilbao	15	14	10	11	10	9	9	9
Valencia	21	18	13	16	13	11	11	11
Open outcry SICAV	3,086	3,111	744	2,642	744	81	23	12
MAB[4]	-	-	2,405	497	2,405	3,096	3,193	3,227
Latibex	30	32	34	34	34	34	34	34

1 Data at the end of period.
2 Available data: August 2007.
3 Without ETF (Exchange Traded Funds).
4 Alternative Stock Market.

Capitalisation[1]

TABLE 1.5

Million euro	2004	2005	2006	2006 III	2006 IV	2007 I	2007 II	2007 III[2]
Total electronic market[3]	525,695.1	616,684.7	813,764.7	735,680.9	813,764.7	885,715.3	895,117.8	826,893.6
Of which, without Nuevo Mercado	511,770.8	607,062.8	800,144.5	724,521.4	800,144.5	870,815.3	884,128.1	815,778.3
Of which, Nuevo Mercado	13,924.3	9,621.9	13,620.2	11,159.5	13,620.2	14,900.0	10,989.7	11,115.3
Of which, foreign companies	54,734.6	64,312.7	105,600.9	96,456.9	105,600.9	137,859.2	137,570.4	93,840.2
Ibex 35	344,240.2	407,797.4	502,828.0	464,171.3	502,828.0	533,589.0	537,038.9	520,590.6
Second Market	292.5	307.4	392.7	828.7	392.7	713.3	610.3	227.8
Madrid	11.0	9.2	18.9	14.6	18.9	32.6	37.3	37.5
Barcelona	184.1	154.4	184.2	649.3	184.2	404.2	234.2	190.3
Bilbao	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Valencia	97.3	143.8	189.6	164.8	189.6	276.4	338.8	0.0
Open outcry ex SICAV	5,311.3	6,142.5	7,905.3	7,184.5	7,905.3	8,989.9	8,713.0	9,628.1
Madrid	2,411.2	2,754.4	2,698.1	3,119.7	2,698.1	3,159.6	3,050.6	2,877.4
Barcelona	2,517.2	3,129.2	4,966.3	3,817.6	4,966.3	5,333.9	5,159.5	5,839.0
Bilbao	317.1	405.9	59.5	28.8	59.5	56.2	137.1	136.7
Valencia	1,556.7	836.1	741.9	699.8	741.9	767.6	777.8	1,195.3
Open outcry SICAV	28,972.7	33,997.6	9,514.9	30,466.0	9,514.9	2,168.0	1,289.6	997.2
MAB[4]	-	-	29,864.4	5,460.6	29,864.4	38,711.9	41,072.2	40,390.9
Latibex	124,754.8	222,384.1	271,641.8	233,979.4	271,641.80	278,554.2	305,994.0	302,106.6

1 Data at the end of period.
2 Available data: August 2007.
3 Without ETF (Exchange Traded Funds).
4 Alternative Stock Market.

Trading

TABLE 1.6

Million euro	2004	2005	2006	2006 III	2006 IV	2007 I	2007 II	2007 III[1]
Total electronic market[2]	636,527.4	847,663.7	1,144,562.9	263,333.6	349,801.5	414,929.6	438,830.9	262,244.2
Of which, without Nuevo Mercado	618,574.3	817,834.7	1,118,546.1	257,271.8	341,252.0	399,828.6	432,131.5	257,912.9
Of which, Nuevo Mercado	17,953.1	29,829.0	26,016.8	6,061.8	8,549.6	10,872.5	5,386.2	3,708.7
Of which, foreign companies	6,165.7	15,115.1	11,550.3	3,664.0	2,378.8	4,228.5	1,313.2	622.5
Second Market	21.3	25.9	49.3	11.4	18.6	121.9	21.4	35.3
Madrid	4.7	1.8	7.2	3.5	1.8	4.7	2.4	0.8
Barcelona	16.1	22.9	41.6	7.8	16.5	116.6	18.7	33.7
Bilbao	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Valencia	0.6	1.3	0.5	0.1	0.2	0.6	0.3	0.7
Open outcry ex SICAV	423.9	860.6	736.3	107.6	267.2	316.4	152.4	45.5
Madrid	122.6	187.8	257.6	45.8	75.9	66.6	55.4	14.9
Barcelona	293.3	667.0	297.8	58.8	174.3	239.2	94.5	28.7
Bilbao	1.7	1.1	159.2	1.4	0.5	0.0	0.0	0.0
Valencia	6.2	4.6	21.8	1.7	16.5	10.6	2.5	1.9
Open outcry SICAV	4,770.0	5,037.9	4,581.9	866.6	1,090.9	257.6	56.4	25.4
MAB[3]	-	-	1,814.2	92.8	1,704.5	1,770.9	1,604.9	932.9
Latibex	366.4	556.7	723.3	160.2	158.0	217.0	226.5	148.4

1 Available data: August 2007.
2 Without ETF (Exchange Traded Funds).
3 Alternative Stock Market.

Trading on the electronic market by type of transaction[1]

TABLE 1.7

Million euro	2004	2005	2006	2006 III	2006 IV	2007 I	2007 II	2007 III[2]
Regular trading	599,874.2	798,934.5	1,080,117.5	238,809.8	331,649.8	401,231.1	423,056.8	256,058.7
Orders	353,532.0	488,416.3	658,839.2	138,709.9	203,310.4	255,425.4	247,466.7	156,678.8
Put-throughs	71,360.1	82,403.1	105,910.7	21,955.4	32,102.3	39,297.4	42,731.3	23,747.4
Block trades	174,982.0	228,115.1	315,367.7	78,144.5	96,237.1	106,508.3	132,858.9	75,632.5
Off-hours	26,037.3	27,863.0	11,651.6	2,587.5	6,847.5	3,644.2	5,191.6	2,906.3
Authorised trades	1,367.2	4,773.4	4,052.0	169.3	2,975.6	1,455.1	1,789.6	274.0
Art. 36.1 SML trades	826.0	1.3	6,439.7	6,439.7	0.0	0.0	0.0	0.0
Tender offers	1,698.8	6,682.8	18,094.6	11,960.2	3,922.5	4,158.7	50.0	1,995.7
Public offerings for sale	3,057.2	226.3	3,264.0	1,102.5	576.8	0.0	5,314.0	0.0
Declared trades	278.5	2,298.9	10,347.9	586.1	215.0	2,280.0	268.3	172.5
Options	3,388.3	5,268.0	8,279.8	1,274.8	3,073.3	1,608.2	2,609.6	96.3
Hedge transactions	-	1,615.4	2,315.7	403.8	541.1	552.3	550.9	740.8

1 Without ETF (Exchange Traded Funds).
2 Available data: August 2007.

Margin trading for sales and securities lending

TABLE 1.8

Million euro	2004	2005	2006	2006 III	2006 IV	2007 I	2007 II	2007 III[1]
TRADING								
Securities lending[2]	306,056.7	393,964.1	550,850.4	116,996.8	162,875.2	196,697.8	245,021.9	143,804.7
Margin trading for sales of securities[3]	139.2	152.2	379.9	96.7	94.2	129.3	123.2	110.3
Margin trading for securities purchases[3]	401.8	465.0	511.9	105.7	152.3	146.1	108.2	51.7
OUTSTANDING BALANCE								
Securities lending[2]	54,518.5	66,737.5	62,058.2	52,604.7	62,058.2	75,199.6	103,293.4	90,391.8
Margin trading for sales of securities[3]	18.2	28.5	73.6	74.2	73.6	103.8	94.6	112.1
Margin trading for securities purchases[3]	46.7	52.3	70.1	60.9	70.1	74.5	64.0	47.8

1 Available data: August 2007.
2 Regulated by Article 36.7 of the Securities Market Law and Order ECO/764/2004.
3 Transactions performed in accordance with Ministerial Order dated 25 March 1991 on the margin system in spot transactions.

1.2 Fixed-income

Gross issues registered[1] at the CNMV

TABLE 1.9

	2004	2005	2006	2006 III	2006 IV	2007 I	2007 II	2007 III[2]
NO. OF ISSUERS	157	155	159	48	69	60	66	43
Mortgage covered bonds	9	9	11	5	6	6	4	6
Territorial covered bonds	2	2	5	2	3	2	1	2
Non-convertible bonds and debentures	50	49	46	20	18	20	18	13
Convertible bonds and debentures	2	4	1	0	0	0	0	0
Backed securities	48	53	61	11	28	13	22	11
Commercial paper	58	68	68	13	20	28	22	13
Of which, asset-backed	3	3	3	1	0	0	2	1
Of which, non-asset-backed	55	65	65	12	20	28	20	12
Other fixed-income issues	4	1	0	0	0	1	3	2
Preference shares	12	6	9	2	6	2	1	2
NO. OF ISSUES	257	264	335	66	98	88	86	61
Mortgage covered bonds	17	21	37	11	7	8	10	9
Territorial covered bonds	2	3	6	2	3	2	1	4
Non-convertible bonds and debentures	95	93	115	27	26	30	23	17
Convertible bonds and debentures	3	4	1	0	0	0	0	0
Backed securities	48	54	82	11	34	17	25	14
Commercial paper	62	81	83	13	20	28	23	13
Of which, asset-backed	3	3	3	1	0	0	2	1
Of which, non-asset-backed	59	78	80	12	20	28	21	12
Other fixed-income issues	5	1	0	0	0	1	3	2
Preference shares	26	7	11	2	8	2	1	2
NOMINAL AMOUNT (Million euro)	329,962.3	414,253.9	523,131.4	121,497.2	146,023.2	173,448.3	156,957.4	103,884.1
Mortgage covered bonds	19,074.0	35,560.0	44,250.0	10,950.0	5,030.0	8,400.0	7,245.5	6,525.0
Territorial covered bonds	1,600.0	1,775.0	5,150.0	1,800.0	3,200.0	1,450.0	1,500.0	2,000.0
Non-convertible bonds and debentures	38,093.6	41,907.1	46,687.5	9,980.0	8,272.0	9,632.0	9,342.0	5,000.0
Convertible bonds and debentures	97.4	162.8	68.1	0.0	0.0	0.0	0.0	0.0
Backed securities	50,524.8	69,044.3	91,607.7	9,772.4	39,766.4	39,392.2	31,517.5	12,841.5
Spanish tranche	38,099.5	63,908.3	85,099.9	9,772.4	34,207.8	39,392.2	31,517.5	12,841.5
International tranche	12,425.3	5,136.0	6,507.8	0.0	5,558.6	0.0	0.0	0.0
Commercial paper[3]	214,602.8	264,359.5	334,457.0	88,897.9	88,970.8	114,144.1	106,967.4	77,022.6
Of which, asset-backed	3,723.6	2,767.5	1,992.7	802.3	137.0	156.0	138.8	37.0
Of which, non-asset-backed	210,879.2	261,592.0	332,464.3	88,095.6	88,833.8	113,988.1	106,828.6	76,985.6
Other fixed-income issues	428.1	89.3	0.0	0.0	0.0	350.0	310.0	425.0
Preference shares	5,541.5	1,356.0	911.0	97.0	784.0	80.0	75.0	70.0
Pro memoria:								
Subordinated issues	8,871.2	11,078.5	27,361.5	4,725.8	13,157.2	14,481.7	3,777.6	4,615.9
Underwritten issues	97,791.9	94,368.0	92,213.5	9,772.4	40,066.4	39,392.2	31,616.5	12,841.5

1 This Includes the volume of issues admitted to trading without register issuance prospectuses.
2 Available data: August 2007.
3 The figures for commercial paper refer to the amount placed in the year.

Issues admitted to trading on AIAF

TABLE 1.10

Nominal amount (million euro)	2004	2005	2006	2006 III	2006 IV	2007 I	2007 II	2007 III[1]
Total	353,772.2	425,137.4	507,525.3	126,312.2	135,910.4	175,388.7	147,084.9	126,581.6
Commercial paper	211,984.5	263,728.9	332,328.4	89,005.7	88,120.0	115,064.7	105,314.5	77,120.1
Bonds and debentures	63,878.7	56,771.5	45,155.4	11,980.0	6,454.0	10,632.0	7,295.0	9,375.0
Mortgage covered bonds	20,550.0	31,600.0	43,720.0	10,100.0	6,500.0	9,550.0	6,495.5	8,575.0
Territorial covered bonds	2,300.0	1,775.0	2,650.0	300.0	2,200.0	2,950.0	1,000.0	1,900.0
Backed securities	50,884.7	67,480.5	83,042.5	14,806.6	32,127.5	36,830.0	26,904.9	29,541.5
Preference shares	4,174.3	3,781.5	629.0	120.0	509.0	362.0	75.0	70.0
Matador bonds	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0

1 Available data: August 2007.

AIAF. Issuers, issues and outstanding balance

TABLE 1.11

	2004	2005	2006	2006 III	2006 IV	2007 I	2007 II	2007 III[1]
NO. OF ISSUERS	324	384	438	416	438	448	457	475
Commercial paper	63	66	69	69	69	68	66	68
Bonds and debentures	76	82	80	91	80	93	92	95
Mortgage covered bonds	10	12	14	14	14	15	15	15
Territorial covered bonds	3	3	5	4	5	7	7	7
Backed securities	163	211	257	236	257	268	280	298
Preference shares	33	42	46	42	46	49	49	50
Matador bonds	20	20	20	20	20	18	17	16
NO. OF ISSUES	2,459	2,836	3,681	3,507	3,681	3,985	4,143	4,249
Commercial paper	1,593	1,724	2,242	2,199	2,242	2,451	2,539	2,508
Bonds and debentures	271	329	398	385	398	423	430	453
Mortgage covered bonds	41	54	83	77	83	90	98	107
Territorial covered bonds	5	8	11	10	11	14	15	17
Backed securities	468	631	856	746	856	916	971	1074
Preference shares	47	58	65	60	65	69	70	71
Matador bonds	34	32	26	30	26	22	20	19
OUTSTANDING BALANCE[2] (million euro)	307,428.8	448,679.3	588,942.3	548,592.0	588,942.3	645,466.6	675,996.4	731,869.9
Commercial paper	45,176.7	57,719.4	70,778.6	67,489.2	70,778.6	77,054.5	81,591.4	96,384.7
Bonds and debentures	68,044.8	103,250.7	131,107.8	128,308.6	131,107.8	138,282.1	136,090.3	143,155.3
Mortgage covered bonds	57,324.5	90,550.0	129,710.0	124,210.0	129,710.0	139,260.0	145,755.5	154,330.5
Territorial covered bonds	5,800.0	7,575.0	9,525.0	8,025.0	9,525.0	12,475.0	13,475.0	14,775.0
Backed securities	109,862.5	164,810.0	222,866.1	195,875.4	222,866.1	253,378.5	274,173.0	298,803.4
Preference shares	18,705.1	22,486.6	23,115.6	22,606.6	23,115.6	23,417.6	23,492.6	23,062.6
Matador bonds	2,515.1	2,287.6	1,839.2	2,077.2	1,839.2	1,598.8	1,418.5	1,358.4

1 Available data: August 2007.
2 Nominal amount.

AIAF. Trading

TABLE 1.12

Nominal amount in million euro	2004	2005	2006	2006 III	2006 IV	2007 I	2007 II	2007 III[1]
BY TYPE OF ASSET. Total	572,030.0	877,812.1	910,493.9	214,330.4	270,334.3	286,592.8	262,799.2	203,233.8
Commercial paper	291,902.6	408,185.0	489,069.5	139,298.9	140,827.7	153,727.0	140,611.4	104,537.6
Bonds and debentures	51,263.3	86,585.7	82,421.1	17,962.7	19,567.1	27,157.8	25,082.6	12,385.0
Mortgage covered bonds	46,014.4	60,060.9	70,113.5	15,466.1	21,803.3	21,036.3	19,535.9	11,865.3
Territorial covered bonds	3,356.9	2,740.1	3,659.1	618.0	2,588.9	1,216.9	568.4	3,212.7
Backed securities	171,724.6	313,778.5	257,628.9	39,549.6	83,470.8	81,489.8	75,463.1	70,343.3
Preference shares	4,139.4	4,046.2	4,647.8	952.2	1,512.0	1,409.7	1,031.7	656.3
Matador bonds	3,628.8	2,415.7	2,954.1	482.8	564.7	555.2	506.2	233.6
BY TYPE OF TRANSACTION. Total	572,030.0	877,812.0	910,493.9	214,330.4	270,334.3	286,592.8	262,799.2	203,233.8
Outright	242,333.0	322,819.0	386,368.8	84,178.3	118,623.9	114,617.8	100,039.0	70,825.7
Repos	197,778.0	284,520.0	330,839.9	91,538.6	98,597.3	120,468.5	117,077.4	80,009.3
Sell-buybacks/Buy-sellbacks	131,919.0	270,473.0	193,285.1	38,613.5	53,113.1	51,506.4	45,682.8	52,398.8

1 Available data: August 2007.

AIAF. Third-party trading. By purchaser sector

TABLE 1.13

Nominal amount in million euro	2004	2005	2006	2006 III	2006 IV	2007 I	2007 II	2007 III[1]
Total	430,127.3	591,837.2	702,608.8	171,695.1	213,205.3	231,736.2	211,982.4	148,081.1
Non-financial companies	176,479.7	218,139.5	260,108.1	74,115.1	78,073.8	88,151.6	102,730.2	65,073.1
Financial institutions	138,401.6	218,381.1	247,876.4	63,569.6	68,679.6	68,858.1	71,023.9	51,824.1
Credit institutions	43,446.8	71,118.9	83,999.1	19,304.5	26,313.7	20,027.7	26,406.4	19,513.1
CIS[2], insurance and pension funds	90,163.8	138,580.4	145,911.5	40,199.8	37,714.5	40,317.3	38,310.3	27,180.4
Other financial institutions	4,790.9	8,681.8	17,965.8	4,065.2	4,651.4	8,513.2	6,307.3	5,130.5
General government	1,695.9	5,629.4	7,058.9	1,311.1	2,317.3	2,514.1	2,195.6	1,551.2
Households and NPISHs[3]	16,100.1	14,433.3	23,675.9	4,445.8	7,080.9	16,310.4	4,427.7	2,580.7
Rest of the world	97,450.1	135,253.9	163,889.4	28,253.5	57,053.7	55,902.0	31,605.1	27,052.1

1 Available data: August 2007.
2 Collective Investment Schemes.
3 Non-profit institutions serving households.

Issues admitted to trading on equity markets. Files registered with the CNMV

TABLE 1.14

	2004	2005	2006	2006 III	2006 IV	2007 I	2007 II	2007 III[1]
NOMINAL AMOUNTS (Million euro)	113.3	1,234.6	68.1	0.0	0.0	0.0	0.0	0.0
Non-convertible bonds and debentures	50.0	1,140.0	0.0	0.0	0.0	0.0	0.0	0.0
Convertible bonds and debentures	63.3	94.6	68.1	0.0	0.0	0.0	0.0	0.0
Others	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
NO. OF FILES	3	6	1	0	0	0	0	0
Non-convertible bonds and debentures	1	3	0	0	0	0	0	0
Convertible bonds and debentures	2	3	1	0	0	0	0	0
Others	0	0	0	0	0	0	0	0

1 Available data: August 2007.

Equity markets. Issuers, issues and outstanding balances

TABLE 1.15

	2004	2005	2006	2006 III	2006 IV	2007 I	2007 II	2007 III[1]
NO. OF ISSUERS	52	56	57	56	57	56	53	52
Private issuers	35	39	40	39	40	40	38	38
Non-financial companies	12	12	10	10	10	10	8	8
Financial institutions	23	27	30	29	30	30	30	30
General government	17	17	17	17	17	16	15	14
Regional governments	3	3	3	3	3	3	3	3
NO. OF ISSUES	264	267	264	261	264	252	247	245
Private issuers	113	122	131	123	131	129	121	121
Non-financial companies	28	22	18	18	18	17	14	14
Financial institutions	85	100	113	105	113	112	107	107
General government	151	145	133	138	133	123	126	124
Regional governments	87	92	89	91	89	87	91	89
OUTSTANDING BALANCES[2] (Million euro)	14,460.0	16,323.0	17,105.4	16,914.7	17,105.4	16,952.6	16,594.7	16,923.0
Private issuers	4,533.2	5,507.3	6,784.3	5,973.3	6,784.3	6,596.0	6,183.0	6,109.2
Non-financial companies	1,244.7	835.4	492.1	491.9	492.1	486.3	454.0	454.0
Financial institutions	3,288.5	4,671.9	6,292.2	5,481.5	6,292.2	6,109.7	5,729.0	5,655.2
General government[3]	9,926.8	10,816.1	10,321.1	10,941.3	10,321.1	10,356.6	10,411.7	10,813.8
Regional governments	7,198.2	8,457.2	8,319.8	8,591.6	8,319.8	8,665.6	8,721.4	8,723.5

1 Available data: August 2007.
2 Nominal amount.
3 Without public book-entry debt.

Trading on equity markets

TABLE 1.16

Nominal amounts in million euro	2004	2005	2006	2006 III	2006 IV	2007 I	2007 II	2007 III[1]
Electronic market	227.0	220.0	257.3	22.8	37.7	87.2	23.5	12.2
Open outcry	490.1	4,538.3	5,009.9	2,641.2	1,899.0	2,067.1	592.6	320.9
Madrid	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Barcelona	50.4	4,404.2	4,879.6	2,616.8	1,867.8	2,033.0	563.6	302.8
Bilbao	309.2	9.2	24.8	1.3	2.6	1.6	2.0	1.2
Valencia	130.5	124.8	105.5	23.1	28.5	32.4	27.0	16.9
Public book-entry debt	40.8	36.1	35.6	7.9	9.9	7.7	10.4	3.7
Regional governments debt	76,258.8	83,204.0	84,443.6	21,182.1	18,365.4	20,980.3	21,295.2	14,795.5

1 Available data: August 2007.

Organised trading systems: SENAF y MTS. Public debt trading by type

TABLE 1.17

Nominal amounts in million euro	2004	2005	2006	2006 III	2006 IV	2007 I	2007 II	2007 III[1]
Total	381.1	219.5	175.1	45.5	36.4	26.1	22.9	8.5
Outright	104.1	71.0	94.3	34.9	19.1	17.3	14.1	7.9
Sell-buybacks/Buy-sellbacks	274.8	148.5	80.2	10.6	17.3	8.8	8.8	0.6
Others	2.2	0.1	0.6	0.0	0.0	0.0	0.0	0.0

1 Available data: August 2007.

1.3 Derivatives and other products

1.3.1 Financial derivatives markets: MEFF

Trading on MEFF CUADRO 1.18

No. of contracts	2004	2005	2006	2006 III	2006 IV	2007 I	2007 II	2007 III[1]
Debt products	98	46	15	4	3	1	4	2
Debt futures[2]	98	46	15	4	3	1	4	2
Ibex 35 products[3,4]	4,767,871	5,490,958	7,119,853	1,677,721	1,998,653	2,246,165	2,443,146	1,620,384
Ibex 35 plus futures	4,354,868	4,935,648	6,408,961	1,545,699	1,755,309	2,056,808	2,235,602	1,495,591
Ibex 35 mini futures	118,250	114,563	159,830	34,313	46,228	62,981	70,034	53,681
Call mini options	148,119	232,825	288,542	48,399	116,334	48,028	53,850	23,581
Put mini options	146,634	207,922	262,521	49,310	80,783	78,348	83,661	47,531
Stock products[5]	20,255,113	29,728,916	33,655,790	6,354,792	8,397,012	6,916,993	6,818,146	2,797,426
Futures	12,054,799	18,813,689	21,229,811	4,294,517	4,888,296	3,777,996	3,773,666	1,032,113
Call options	5,226,872	6,803,863	7,664,125	1,183,228	2,587,277	1,624,490	1,655,261	744,774
Put options	2,973,442	4,111,364	4,761,854	877,047	921,439	1,514,507	1,389,219	1,020,539
Pro-memoria: MEFF trading on Eurex								
Debt products[6]	2,815,703	1,440,370	1,117,956	258,349	222,213	242,092	303,004	191,579
Index products[7]	1,784,965	1,080,801	1,423,441	374,207	287,166	338,709	401,267	246,795

1 Available data: August 2007.
2 Contract size: 100 thousand euros.
3 The number of Ibex 35 mini futures (multiples of 1 euro) was standardised to the size of the Ibex 35 plus futures (multiples of 10 euro).
4 Contract size: Ibex 35 * 10 euros.
5 Contract size: 100 Stocks.
6 Bund, Bobl and Schatz futures.
7 Dax 30, DJ EuroStoxx 50 and DJ Stoxx 50 futures.

1.3.2 Warrants, option buying and selling contracts, and ETF (Exchange Traded Funds)

Issues registered at the CNMV TABLE 1.19

	2004	2005	2006	2006 III	2006 IV	2007 I	2007 II	2007 III[1]
WARRANTS[2]								
Premium amount (Million euro)	1,525.3	1,840.0	5,144.3	642.5	1,713.0	1,942.1	1,492.9	2,712.5
On stocks	929.0	1,180.8	3,697.6	465.8	1,243.1	1,411.9	1,077.8	1,727.9
On indexes	553.8	559.9	1,064.9	135.8	414.2	449.4	380.9	853.4
Other underlyings[3]	42.5	99.3	381.8	40.9	55.6	80.7	34.2	131.2
Number of issues	1,600	1,720	4,063	671	1,652	1,667	1,404	1,506
Number of issuers	7	6	8	7	7	7	6	6
OPTION BUYING AND SELLING CONTRACTS								
Nominal amounts (Million euro)	247.7	112.2	206.8	101.2	42.0	61.0	45.0	25.0
On stocks	195.3	87.8	196.2	101.2	32.0	55.0	45.0	25.0
On indexes	48.7	16.4	0.6	0.0	0.0	0.0	0.0	0.0
Other underlyings[3]	3.8	8.0	10.0	0.0	10.0	6.0	0.0	0.0
Number of issuers	31	13	12	3	4	4	2	1
Number of issues	8	4	4	2	2	3	1	1

1 Available data: August 2007.
2 Includes issues not requiring a prospectus by application of the new regulations.
3 Includes the following underlying: baskets of stocks, exchange rates, interest rates and commodities.

Equity markets. Warrants and ETF trading

TABLE 1.20

	2004	2005	2006	2006 III	2006 IV	2007 I	2007 II	2007 III[1]
WARRANTS								
Trading (Million euro)	1,826.9	2,142.4	2,907.4	554.0	849.9	1,169.4	1,323.8	992.5
On Spanish stocks	1,141.7	1,431.7	1,803.9	341.4	603.3	784.1	823.3	556.4
On foreign stocks	95.1	155.8	294.7	45.0	97.8	120.8	133.6	76.7
On indexes	550.7	516.8	727.4	149.6	119.2	237.8	351.3	345.6
Other underlyings[2]	39.3	38.0	81.4	18.0	29.6	26.8	15.6	13.8
Number of issues[3]	2,207	2,520	4,284	1,991	2,475	3,073	3,440	3,380
Number of issuers[3]	8	8	9	9	9	9	9	9
CERTIFICATES								
Trading (Million euro)	78.6	69.8	58.8	11.4	15.3	14.3	14.7	5.9
Number of issues[3]	16	15	14	11	11	10	12	10
Number of issuers[3]	5	5	5	4	4	3	3	3
ETF								
Trading (Million euro)	-	-	-	609.1	1,218.0	927.2	832.8	679.5
Number of funds	-	-	-	2	5	5	5	12
Assets[4] (Million euro)	-	-	-	204.4	376.8	507.8	521.6	na

1 Available data: August 2007.
2 Includes the following underlying: baskets of stocks, exchange rates, interest rates and commodities.
3 Issues or issuers which were traded in each period.
4 Foreign collective investment schemes including the investment volume marketed in Spain.
na: No available data.

1.3.3 Non- financial derivatives

Trading on MFAO[1]

TABLE 1.21

Number of contracts	2004	2005	2006	2006 III	2006 IV	2007 I	2007 II	2007 III[2]
On olive oil								
Extra – virgin olive oil futures[3]	10,693	21,145	35,079	7,027	6,400	16,679	14,173	3,495

1 Olive oil futures market.
2 Available data: August 2007.
3 Nominal amount of the contract: 1,000 kg.

2 Investment services

Investment services. Spanish firms, branches and agents

TABLE 2.1

	2004	2005	2006	2006 III	2006 IV	2007 I	2007 II	2007 III[1]
Broker – dealers								
Spanish firms	48	46	47	46	47	45	46	46
Branches	90	96	108	107	108	95	97	100
Agents	6,453	6,562	6,610	6,587	6,610	6,466	6,614	6,675
Brokers								
Spanish firms	55	56	57	58	57	55	55	54
Branches	13	11	11	10	11	11	12	12
Agents	363	516	589	585	589	601	644	648
Portfolio management companies								
Spanish firms	21	17	15	15	15	14	13	13
Branches	4	4	4	4	4	4	4	4
Agents	3	14	5	4	5	5	5	6
Credit institutions[2]	207	206	204	205	204	204	202	202

1 Available data: August 2007.
2 Source: Banco de España.

Investment services. Foreign firms

TABLE 2.2

	2004	2005	2006	2006 III	2006 IV	2007 I	2007 II	2007 III[1]
Total	1,107	1,196	1,321	1,296	1,321	1,357	1,386	1,424
European Economic Area investment services firms	801	867	973	950	973	1,005	1,027	1,061
Branches	19	18	22	17	22	24	25	26
Free provision of services	782	849	951	933	951	981	1,002	1,035
Credit institutions[2]	306	329	348	346	348	352	359	363
From EU member states	297	320	339	337	339	344	351	354
Branches	37	38	44	42	44	45	49	51
Free provision of services	259	281	294	294	294	298	301	302
Subsidiaries of free provision of services institutions	1	1	1	1	1	1	1	1
From non-EU states	9	9	9	9	9	8	8	9
Branches	8	8	8	8	8	7	7	8
Free provision of services	1	1	1	1	1	1	1	1

1 Available data: August 2007.
2 Source: Banco de España.

Intermediation of spot transactions

TABLE 2.3

	II 2006				II 2007			
Million euro	Spanish Stock Exchange	Other Spanish Markets	Foreing markets	Total	Spanish Stock Exchange	Other Spanish Markets	Foreing markets	Total
FIXED – INCOME								
Total	4,685	2,364,626	401,144	2,770,455	6,223	2,387,396	386,262	2,779,881
Broker-dealers	3,566	321,527	47,088	372,181	5,888	199,685	50,140	255,713
Brokers	1,119	2,043,099	354,056	2,398,274	335	2,187,711	336,122	2,524,168
EQUITY								
Total	405,397	1,316	27,420	434,133	598,498	1,897	33,250	633,645
Broker-dealers	374,382	636	21,618	396,636	561,947	1,016	30,511	593,474
Brokers	31,015	680	5,802	37,497	36,551	881	2,739	40,171

Intermediation of derivative transactions[1]

TABLE 2.4

	II 2006				II 2007			
Million euro	Spanish organised markets	Foreign organised markets	Non organised market	Total	Spanish organised markets	Foreign organised markets	Non organised market	Total
Total	220,506	1,675,771	916,094	2,812,371	322,937	4,460,817	1,054,768	5,838,522
Broker – dealers	92,352	280,988	2,906	376,246	183,696	339,608	177,805	701,109
Brokers	128,154	1,394,783	913,188	2,436,125	139,241	4,121,209	876,963	5,137,413

1 The amount of the buy and sell transactions of financial assets, financial futures on values and interest rates, and other transactions on interest rates will be the securities nominal or notional value or the principal to which the contract reaches. The amount of the transactions on options will be the strike price of the underlying asset multiplied by the number of instruments committed.

Portfolio management. Number of portfolios and assets under management

TABLE 2.5

	II 2006			II 2007		
	Total	IIC[1]	Other[2]	Total	IIC[1]	Other[2]
NUMBER OF PORTFOLIOS						
Total	17,618	99	17,519	19,737	95	19,642
Broker – dealers	9,690	19	9,671	11,024	25	10,999
Brokers	4,032	47	3,985	4,090	35	4,055
Portfolio management companies	3,896	33	3,863	4,623	35	4,588
ASSETS UNDER MANAGEMENT (thousand euro)						
Total	14,013,785	1,322,545	12,691,240	14,496,725	1,569,471	12,927,254
Broker – dealers	4,833,302	542,171	4,291,131	6,039,778	745,462	5,294,316
Brokers	5,407,466	534,255	4,873,211	3,582,278	526,529	3,055,749
Portfolio management companies	3,773,017	246,119	3,526,898	4,874,669	297,480	4,577,189

1 IIC: Collective investment schemes.
2 Includes the rest of clients, both covered and not covered by the Investment Guarantee Fund, an investor compensation scheme regulated by Royal Decree 948/2001.

Aggregated income statement. Broker – dealers

TABLE 2.6

Thousand euro[1]	2004	2005	2006	2006 III	2006 IV	2007 I	2007 II	2007 III[2]
I. FINANCIAL INCOME	78,435	57,653	17,325	20,034	17,325	8,484	11,025	27
II. NET INCOME FROM SECURITIES TRADING	-44,315	200,360	48,335	138,978	48,335	38,135	-166,565	-199,393
III. NET COMMISSION	539,154	653,273	775,377	548,181	775,377	240,751	485,244	561,804
Commission revenues	700,061	847,524	1,009,089	716,306	1,009,089	312,113	624,257	729,382
Brokering	449,067	526,241	629,952	432,407	629,952	215,607	409,875	476,408
Placement and underwriting	39,904	58,685	73,278	61,443	73,278	9,161	31,775	43,649
Securities deposit and recording	15,237	17,593	22,367	16,322	22,367	5,743	12,455	14,609
Portfolio management	14,141	20,599	23,883	16,119	23,883	6,757	14,570	16,691
Design and advising	35,131	52,180	55,918	42,403	55,918	20,736	40,110	45,240
Stocks search and placement	12	6	0	6	0	9	9	9
Market credit transactions	128	56	33	27	33	5	11	13
IIC subscription and redemption	104,909	118,871	141,312	102,479	141,312	34,771	70,425	82,321
Other	41,532	53,293	62,346	45,100	62,346	19,324	45,027	50,442
Commission expenses	160,907	194,251	233,712	168,125	233,712	71,362	139,013	167,578
IV. TOTAL NET REVENUES	573,274	911,286	841,037	707,193	841,037	287,370	329,704	362,438
V. OPERATING INCOME	207,113	498,362	395,105	383,776	395,105	173,463	98,455	93,453
VII. EARNINGS AFTER TAXES	215,903	266,734	430,651	484,790	430,651	280,510	482,067	560,898

1 Added amounts from the beginning of the year to the last day of every quarter. From 2005 it includes companies removed through out the year.
2 Available data: July 2007.

Results of proprietary trading. Broker – dealers

TABLE 2.7

Thousand euro[1]	Total II 2006	Total II 2007	Financial income II 2006	Financial income II 2007	Securities portfolio II 2006	Securities portfolio II 2007	Other charges II 2006	Other charges II 2007
Total	54,770	-156,263	-8,354	11,025	63,438	-166,565	-314	-723
Money market assets and public debt	2,920	-13,372	5,992	1,959	-3,072	-15,331	0	0
Other fixed – income securities	22,948	39,902	16,937	26,446	6,011	13,456	0	0
Domestic portfolio	21,517	40,358	15,531	23,433	5,986	16,925	0	0
Foreign portfolio	1,431	-456	1,406	3,013	25	-3,469	0	0
Equities	-75,118	189,622	21,020	64,441	-96,138	125,181	0	0
Domestic portfolio	2,553	134,855	4,697	27,559	-2,144	107,296	0	0
Foreign portfolio	-77,671	54,767	16,323	36,882	-93,994	17,885	0	0
Derivatives	162,158	-280,317	0	0	162,158	-280,317	0	0
Repurchase agreements	-8,008	-2,546	-8,008	-2,546	0	0	0	0
Market credit transactions	0	0	0	0	0	0	0	0
Deposits and other transactions with financial Intermediaries	-54,054	-91,887	-54,054	-91,887	0	0	0	0
Other transactions	3,924	2,335	9,759	12,612	-5,521	-9,554	-314	-723

1 Added amounts from the beginning of the year to the last day of every quarter. From 2005 it includes companies removed through out the year.

Aggregated income statement. Brokers

TABLE 2.8

Thousand euro[1]	2004	2005	2006	2006 III	2006 IV	2007 I	2007 II	2007 III[2]
I. FINANCIAL INCOME	7,677	10,665	12,934	10,041	12,934	3,275	6,899	8,084
II. NET INCOME FROM SECURITIES TRADING	622	3,306	3,906	1,796	3,906	437	1,120	991
III. NET COMMISSION	157,362	184,113	233,447	172,783	233,447	62,888	121,309	139,578
Commission revenues	191,091	229,752	297,030	218,924	297,030	81,545	159,573	183,201
Brokering	88,168	97,948	114,111	83,035	114,111	34,088	66,060	75,412
Placement and underwriting	1,355	3,821	3,183	2,074	3,183	465	1,470	2,320
Securities deposit and recording	1,389	1,357	1,520	1,280	1,520	683	1,005	1,065
Portfolio management	13,747	14,868	28,672	22,916	28,672	8,177	14,534	16,216
Design and advising	1,959	2,664	2,360	1,703	2,360	423	1,119	878
Stocks search and placement	0	0	0	0	0	0	0	0
Market credit transactions	0	0	0	0	0	1	1	0
IIC subscription and redemption	26,452	46,171	68,513	49,242	68,513	17,629	37,345	44,076
Other	58,021	62,923	78,671	58,674	78,671	20,079	38,039	43,234
Commission expenses	33,729	45,639	63,583	46,141	63,583	18,657	38,264	43,623
IV. TOTAL NET REVENUES	165,661	198,084	250,287	184,620	250,287	66,600	129,328	148,653
V. OPERATING INCOME	43,424	66,420	95,026	76,220	95,026	28,709	53,410	59,669
VII. EARNINGS AFTER TAXES	20,763	38,264	62,449	74,660	62,449	33,484	64,113	69,413

1 Added amounts from the beginning of the year to the last day of every quarter. From 2005 it includes companies removed through out the year.
2 Available data: July 2007.

Aggregated income statement. Portfolio management companies

TABLE 2.9

Thousand euro[1]	2004	2005	2006	2006 III	2006 IV	2007 I	2007 II	2007 III[2]
I. FINANCIAL INCOME	550	575	895	594	895	338	705	843
II. NET INCOME FROM SECURITIES TRADING	89	65	6	-5	6	-1	-16	-1
III. NET COMMISSION	15,155	17,164	15,195	10,146	15,195	3,875	7,485	8,734
Commission revenues	15,868	25,508	27,625	19,789	27,625	7,435	14,804	17,390
Portfolio management	10,450	18,813	22,068	16,893	22,068	6,028	12,371	14,936
Design and advising	3,265	4,380	4,951	2,252	4,951	898	1,380	1,211
IIC subscription and redemption	320	592	261	228	261	393	820	972
Other	1,833	1,723	345	416	345	116	233	271
Commission expenses	713	8,344	12,430	9,643	12,430	3,560	7,319	8,656
IV. TOTAL NET REVENUES	15,794	17,804	16,096	10,735	16,096	4,212	8,174	9,576
V. OPERATING INCOME	4,528	6,051	6,352	3,496	6,352	1,661	3,171	3,743
VII. EARNINGS AFTER TAXES	1,730	3,465	4,112	2,479	4,112	1,420	2,477	2,796

1 Added amounts from the beginning of the year to the last day of every quarter. From 2005 it includes companies removed through out the year.
2 Available data: July 2007.

Surplus equity over capital adequacy requirements[1]

TABLE 2.10

	Surplus		Number of companies according to its surplus percentage									
Thousand euro	Total amount	%[2]	< 50[3]	<100	<150	<200	<300	<400	<500	<750	<1000	>1000
Total	1,212,029	353.21	14	22	8	11	14	9	8	7	9	12
Broker – dealers	1,076,517	417.26	0	6	3	2	10	4	5	3	6	7
Brokers	124,847	205.42	10	13	4	7	4	4	2	4	2	5
Portfolio management companies	10,665	43.76	4	3	1	2	0	1	1	0	1	0

1 Available data: June 2007.
2 Average percentage is weighted by the required equity of each company. It is an indicator of the number of times, in percentage terms, that the surplus contains the required equity in an average company.
3 Includes all registered companies, even if they have not sent information.

Return on equity (ROE) before taxes[1]

TABLE 2.11

		Number of companies according to its annualized return							
	Average[2]	Losses	0-5%	6-15%	16-30%	31-45%	46-60%	61-75%	76-100%	>100%
Total	68.40	11	12	8	20	14	8	4	13	24
Broker – dealers	71.15	1	2	1	12	6	2	3	7	12
Brokers	59.39	8	8	4	5	8	4	1	6	11
Portfolio management companies	13.85	2	2	3	3	0	2	0	0	1

1 Available data: June 2007.
2 Average weighted by equity, %.

3 Collective investment schemes (IIC)[1]

Number, managements and depositories of collective investment schemes registered with the CNMV

TABLE 3.1

	2004	2005	2006	2006 III	2006 IV	2007 I	2007 II	2007 III[1]
Total financial IIC	5,717	5,841	6,007	5,966	6,006	6,071	6,169	6,212
Mutual funds	2,620	2,723	2,850	2,829	2,850	2,885	2,921	2,931
Investment companies	3,097	3,118	3,150	3,137	3,149	3,178	3,217	3,239
Funds of hedge funds	-	-	2	-	2	2	22	29
Hedge funds	-	-	5	-	5	6	9	13
Total real estate IIC	9	13	17	15	17	17	17	19
Real estate investment funds	7	7	9	9	9	9	9	10
Real estate investment companies	2	6	8	6	8	8	8	9
Total foreign IIC marketed in Spain	238	260	340	312	340	354	362	383
Foreign funds marketed in Spain	93	115	163	144	164	169	171	186
Foreign companies marketed in Spain	145	145	177	168	177	185	191	197
Management companies	116	112	114	113	114	116	116	117
IIC depositories	137	135	132	132	132	129	127	127

1 Available data: August 2007.

1 In this document, neither hedge funds nor funds of hedge funds are included in the figures referred to mutual funds.

Number of IIC investors and shareholder

TABLE 3.2

	2004	2005	2006	2006 III	2006 IV	2007 I	2007 II	2007 III[1]
Total financial IIC	8,261,376	8,869,084	9,048,207	9,348,199	9,048,207	9,156,645	9,180,702	-
Mutual funds	7,880,076	8,450,164	8,637,781	8,924,673	8,637,781	8,740,972	8,755,921	8,760,338
Investment companies	381,300	418,920	410,403	423,526	410,403	415,539	423,142	-
Funds of hedge funds	-	-	2	-	2	26	1,456	2,060
Hedge funds	-	-	21	-	21	108	183	204
Total real estate IIC	86,490	119,113	151,053	140,284	151,053	153,656	154,426	154,860
Real estate investment funds	86,369	118,857	150,304	139,818	150,304	152,902	153,630	154,061
Real estate investment companies	121	256	749	466	749	754	796	799
Total foreign IIC marketed in Spain	321,805	560,555	779,165	806,305	779,165	782,020	825,552	-
Foreign funds marketed in Spain	51,364	104,089	144,139	141,164	144,139	158,900	176,834	-
Foreign companies marketed in Spain	270,441	456,466	635,026	665,141	635,026	623,120	648,718	-

1 Available data: July 2007.

IIC total net assets

TABLE 3.3

Million euro	2004	2005	2006	2006 III	2006 IV	2007 I	2007 II	2007 III[1]
Total financial IIC	261,191.7	289,810.7	300,584.0	300,523.1	300,584.00	305,058.2	310,144.3	307,794.70
Mutual funds	236,088.4	262,200.9	270,406.3	271,361.1	270,406.3	273,412.8	276,600.4	274,269.9
Investment companies	25,103.3	27,609.8	30,152.7	29,162.1	30,152.7	31,516.0	32,791.7	32,645.8
Funds of hedge funds	-	-	0.6	-	0.6	9.5	600.2	698.7
Hedge funds	-	-	24.4	-	24.4	119.9	152.0	180.2
Total real estate IIC	4,434.4	6,690.8	9,052.0	8,450.7	9,052.0	9,240.8	9,416.8	9,503.9
Real estate investment funds	4,377.9	6,476.9	8,595.9	8,072.8	8,595.9	8,781.7	8,929.4	9,003.6
Real estate investment companies	56.4	213.9	456.1	377.9	456.1	459.2	487.4	500.2
Total foreign IIC marketed in Spain	17,785.6	33,668.1	44,102.9	41,595.1	44,102.9	45,113.8	50,040.1	-
Foreign funds marketed in Spain	3,498.1	8,267.3	12,099.3	10,719.6	12,099.3	12,464.3	14,194.5	-
Foreign companies marketed in Spain	14,287.4	25,400.8	32,003.5	30,875.5	32,003.5	32,649.6	35,845.6	-

1 Available data: July 2007.

Mutual funds asset allocation[1]

TABLE 3.4

Million euro	2004	2005	2006	2006 III	2006 IV	2007 I	2007 II	2007 III[2]
Asset	236,088.4	262,200.9	270,406.9	271,361.1	270,406.9	273,422.3	277,200.6	274,968.7
Cash	6,506.5	8,207.5	10,462.9	11,860.2	10,462.9	11,228.2	11,578.9	11,037.4
Portfolio investment	230,212.7	255,273.6	260,002.9	259,249.8	260,002.9	262,034.2	265,596.0	263,796.0
Domestic securities	114,058.9	123,683.6	127,355.4	126,103.1	127,355.4	130,070.3	131,055.2	132,659.0
Shares	9,578.3	11,602.1	13,806.8	13,614.7	13,806.8	14,389.8	14,196.3	13,982.1
Mutual funds units	16,782.6	17,255.9	17,322.8	17,148.5	17,322.8	17,377.4	18,719.4	18,882.9
Public money market assets	4,434.9	4,149.4	2,887.7	3,877.0	2,887.7	3,306.6	2,539.7	2,601.5
Other public fixed-income	11,422.9	10,088.7	9,891.6	9,929.2	9,891.6	10,178.1	9,715.2	9,142.2
Private money market assets	19,735.9	26,850.7	28,483.2	27,931.5	28,483.2	29,522.6	30,711.7	31,994.2
Other private fixed-income	14,235.6	18,835.6	23,105.3	20,985.5	23,105.3	24,646.1	24,879.8	24,900.9
Spanish warrants and options	157.0	483.1	603.3	580.0	603.3	578.1	675,3	637.7
Repos	37,706.7	34,417.8	31,229.4	32,036.3	31,229.4	30,046.1	29,592.5	30,492.2
Unlisted securities	5.0	0.2	25.4	0.2	25.4	25.4	25.4	25.3
Foreign securities	116,153.8	131,590.0	132,647.4	133,146.7	132,647.4	131,963.9	134,540.7	131,137.0
Euros	107,682.4	118,871.5	118,664.1	119,488.4	118,664.1	118,953.6	120,459.4	117,072.7
Shares	7,065.6	8,925.1	11,418.0	10,459.1	11,418.0	12,823.3	14,247.4	13,715.6
Mutual fund units	11,184.8	15,986.0	23,414.2	23,961.8	23,414.2	22,849.5	23,440.2	22,692.4
Fixed-income	86,833.3	90,220.7	78,933.4	80,881.9	78,933.4	78,365.1	77,447.7	75,795.9
Foreign warrants and options	2,598.8	3,739.7	4,898.7	4,185.5	4,898.7	4,915.7	5,324.0	4,868.9
Unlisted securities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	8,471.4	12,718.5	13,983.3	13,658.3	13,983.3	13,010.3	14,081.3	14,064.3
Shares	4,991.0	7,019.5	7,343.0	6,992.1	7,343.0	7,085.0	7,705.1	7,592.8
Mutual fund units	2,576.7	4,395.6	5,491.5	5,441.2	5,491.5	4,812.2	5,343.0	5,454.9
Fixed-income	875.9	1,204.8	1,011.7	1,103.4	1,011.7	978.0	888.4	871.4
Foreign warrants and options	27.7	97.2	136.0	120.3	136.0	134.2	143.7	144.1
Unlisted securities	0.0	1.4	1.2	1.3	1.2	1.0	1.1	1.0
Net balance (Debtors -Creditors)	-630.9	-1,280.3	-58.8	251.1	-58.8	160.0	25.7	135.2

1 Hedge funds are not included in these figures. The information is not available because hedge funds have different accounting regulation.
2 Available data: July 2007.

Investment companies asset allocation

TABLE 3.5

Million euro	2004	2005	2006	2006 III	2006 IV	2007 I	2007 II	2007 III[1]
Asset	25,103.3	27,610.0	30,152.7	29,162.1	30,152.7	31,516.0	32,791.7	32,645.8
Cash	632.6	728.9	802.2	813.7	802.2	870.9	1,004.7	901.5
Portfolio investment	24,338.5	26,884.9	29,294.1	28,258.3	29,294.1	30,407.1	31,692.4	31,557.2
Domestic securities	13,710.4	13,851.1	15,553.8	14,970.1	15,553.8	15,929.3	15,905.8	16,058.9
Shares	4,831.2	5,906.5	6,727.3	6,581.5	6,727.3	7,050.5	7,191.8	7,038.8
Mutual funds units	755.2	941.2	1,095.0	1,093.6	1,095.0	1,143.6	1,309.5	1,328.2
Public money market assets	90.0	128.1	463.4	445.8	463.4	362.7	418.1	462.9
Other public fixed-income	754.8	897.0	678.2	754.8	678.2	737.3	802.0	728.0
Private money market assets	152.0	359.1	555.4	497.5	555.4	623.6	732.9	727.2
Other private fixed-income	339.5	397.3	554.8	540.0	554.8	571.5	534.9	530.4
Spanish warrants and options	7.3	15.3	19.7	12.6	19.7	21.1	23.0	33.2
Repos	6,779.2	5,206.2	5,459.1	5,044.0	5,459.1	5,418.1	4,892.7	5,205.4
Unlisted securities	1.2	0.3	0.8	0.3	0.8	0.8	0.8	4.7
Foreign securities	10,628.1	13,033.8	13,740.3	13,288.3	13,740.3	14,477.8	15,786.6	15,498.2
Euros	7,590.0	9,178.6	9,847.7	9,555.0	9,847.7	10,522.9	11,635.6	11,364.2
Shares	2,315.2	2,885.6	3,379.9	3,064.0	3,379.9	3,676.0	4,414.1	4,257.0
Mutual fund units	2,520.8	3,351.6	4,169.1	4,001.5	4,169.1	4,523.4	5,012.2	4,979.9
Fixed-income	2,642.5	2,755.8	2,041.5	2,236.0	2,041.5	2,061.5	1,984.2	1,892.7
Foreign warrants and options	109.8	185.7	257.2	253.5	257.2	262.0	225.1	234.5
Unlisted securities	1.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	3,038.0	3,855.2	3,892.6	3,733.3	3,892.6	3,954.9	4,151.0	4,134.1
Shares	1,888.0	2,173.9	2,104.7	2,067.3	2,104.7	2,080.2	2,086.3	2,037.2
Mutual fund units	934.1	1,403.7	1,517.7	1,422.5	1,517.7	1,672.9	1,852.7	1,862.7
Fixed-income	214.4	270.0	234.8	235.7	234.8	188.3	199.7	219.1
Foreign warrants and options	1.6	7.5	11.3	7.8	11.3	13.6	12.3	15.1
Unlisted securities	0.0	0.1	24.1	0.0	24.1	0.0	0.0	0.0
Net balance (Debtors - Creditors)	132.2	-3.8	56.4	90.0	56.4	238.0	94.7	187.1

1 Available data: July 2007.

Financial mutual funds: number, investors and total net assets by category[1]

TABLE 3.6

	2004	2005	2006	2006 II	2006 III	2006 IV	2007 I	2007 II
NO. OF FUNDS								
Total financial mutual funds	2,594	2,705	2,822	2,771	2,803	2,822	2,872	2,919
Fixed-income[2]	627	624	606	612	613	606	609	606
Mixed fixed-income[3]	231	217	212	208	210	212	207	211
Mixed equity[4]	232	222	222	222	222	222	215	216
Spanish equity	110	116	118	116	118	118	118	118
Foreign equity[5]	443	454	467	465	461	467	480	488
Guaranteed fixed-income	191	211	220	220	218	220	232	237
Guaranteed equity	474	514	559	535	559	559	577	586
Global funds	286	347	418	393	402	418	434	457
Funds of hedge funds	-	-	2	-	-	2	2	22
Hedge funds	-	-	5	-	-	5	6	9
INVESTORS								
Total financial mutual funds	7,880,076	8,450,164	8,637,781	9,015,250	8,924,673	8,637,781	8,740,972	8,755,921
Fixed-income	2,929,836	3,071,656	2,960,879	3,028,497	3,034,437	2,960,879	2,933,505	2,881,128
Mixed fixed-income	457,701	492,988	524,827	534,893	544,308	524,827	551,786	539,799
Mixed equity	447,452	408,757	357,013	393,214	377,923	357,013	374,508	376,559
National equity	333,020	365,301	317,386	391,990	371,730	317,386	341,396	363,017
Foreign equity	1,091,711	1,199,460	1,258,426	1,340,735	1,284,729	1,258,426	1,274,138	1,263,619
Guaranteed fixed-income	459,047	455,237	497,540	472,703	482,550	497,540	518,940	541,442
Guaranteed equity	1,655,196	1,849,626	1,783,867	1,849,107	1,831,944	1,783,867	1,771,469	1,766,834
Global funds	506,113	607,139	937,843	1,004,111	997,052	937,843	975,230	1,023,523
Funds of hedge funds	-	-	2	-	-	2	26	1,456
Hedge funds	-	-	21	-	-	21	108	183
TOTAL NET ASSETS (Million euro)								
Total financial mutual funds	236,088.4	262,200.9	270,406.3	269,777.9	271,361.1	270,406.3	273,412.8	276,600.4
Fixed-income	120,466.7	123,890.7	116,511.9	119,929.2	118,494.2	116,511.9	116,963.0	116,344.7
Mixed fixed-income	11,795.7	14,625.8	15,314.5	14,833.4	15,103.3	15,314.5	15,755.0	15,329.1
Mixed equity	9,357.3	10,005.6	10,149.2	10,142.9	10,233.6	10,149.2	10,090.7	10,289.1
National equity	8,042.1	9,741.7	10,416.4	9,206.8	10,421.2	10,416.4	11,238.3	9,523.4
Foreign equity	14,623.6	20,925.1	24,799.6	21,377.3	22,361.7	24,799.6	25,759.1	29,428.3
Guaranteed fixed-income	13,803.5	13,442.0	14,484.8	13,398.2	14,139.1	14,484.8	15,179.1	15,810.4
Guaranteed equity	39,658.2	45,839.8	44,796.6	44,818.0	45,642.4	44,796.6	43,998.9	44,140.0
Global funds	18,341.3	23,730.1	33,933.3	36,072.2	34,965.6	33,933.3	34,428.9	35,735.4
Funds of hedge funds	-	-	0.6	-	-	0.6	9.5	600.2
Hedge funds	-	-	24.4	-	-	24.4	119.9	152.0

1 Mutual funds that have sent reports to the CNMV (therefore mutual funds in a process of dissolution or liquidation are not included).
2 This category includes: Short-term fixed income, Long-term fixed income, Foreign fixed-income and Monetary market funds.
3 This category includes: Mixed fixed-income and Foreign mixed fixed-income.
4 This category includes: Mixed equity and Foreign mixed equity .
5 Until 2002 this category includes: Foreign equity and Foreign Equity Euro. From 2002 this category includes: Euro equity, Foreign equity Europe, Foreign equity Japan, Foreign equity USA, Foreign equity emerging countries and Other foreign equity.

Financial mutual funds: Detail of investors and total net assets by type of investors

TABLE 3.7

	2004	2005	2006	2006 III	2006 IV	2007 I	2007 II	2007 III[1]
INVESTORS	7,880,076	8,450,164	8,637,804	8,924,673	8,637,804	8,741,106	8,757,560	8,762,602
Individuals	7,666,310	8,202,638	8,389,315	8,674,470	8,389,315	8,490,813	8,499,831	8,505,519
Residents	7,558,501	8,101,310	8,292,264	8,576,300	8,292,264	8,394,044	8,402,736	8,408,429
Non-residents	107,809	101,328	97,051	98,170	97,051	96,769	97,095	97,090
Legal entities	213,766	247,526	248,489	250,203	248,489	250,293	257,729	257,083
Credit Institutions	1,378	1,634	1,609	1,600	1,609	1,576	1,721	1,270
Other resident Institutions	210,888	244,223	244,980	246,752	244,980	246,819	254,123	253,888
Non-resident Institutions	1,500	1,669	1,900	1,851	1,900	1,898	1,885	1,925
TOTAL NET ASSETS (Million euro)	236,088.4	262,200.9	270,431.3	271,361.1	270,431.3	273,542.2	277,352.6	275,148.9
Individuals	172,068.9	193,948.6	201,411.0	201,607.3	201,411.0	202,506.4	204,173.3	203,329.7
Residents	168,792.7	190,753.2	198,330.5	198,501.3	198,330.5	199,482.9	201,266.3	200,267.6
Non-residents	3,276.2	3,195.4	3,080.5	3,106.0	3,080.5	3,023.5	3,086.8	3,062.1
Legal entities	64,019.5	68,252.3	69,020.3	69,753.7	69,020.3	71,035.8	72,579.1	71,819.2
Credit Institutions	5,128.8	4,253.2	5,318.0	4,992.6	5,318.0	5,569.0	5,422.3	2,868.9
Other resident Institutions	54,271.1	62,749.8	61,646.6	62,863.6	61,646.6	63,305.8	65,248.3	66,604.0
Non-resident Institutions	4,619.6	1,249.4	2,055.70	1,897.6	2,055.70	2,160.9	2,328.8	2,346.3

1 Available data: July 2007.

Subscriptions and redemptions of financial mutual funds by category[1]

TABLE 3.8

Million euro	2004	2005	2006	2006 II	2006 III	2006 IV	2007 I	2007 II
SUBSCRIPTIONS								
Total financial mutual funds	144,489.9	169,807.0	194,787.4	50,177.0	37,435.8	46,864.6	52,761.5	44,063.4
Fixed-income	90,646.7	108,566.1	118,705.9	29,928.1	25,539.0	29,310.1	31,678.8	27,498.6
Mixed fixed-income	4,164.8	6,677.3	8,476.6	1,948.5	1,208.2	1,982.5	2,322.7	1,439.3
Mixed equity	1,513.1	2,065.2	2,783.6	642.6	375.6	708.7	908.8	753.2
Spanish equity	4,031.4	5,588.5	5,590.4	1,216.2	1,500.5	1,406.7	1,984.6	991.9
Foreign equity	8,166.6	14,006.2	17,662.3	4,143.8	2,688.1	4,850.4	5,518.9	4,925.4
Guaranteed fixed-income	7,700.7	6,923.9	6,126.2	1,480.0	1,450.3	1,798.7	2,073.6	1,915.3
Guaranteed equity	11,373.3	13,520.7	8,914.1	2,205.3	1,852.2	2,457.2	1,800.2	1,858.3
Global funds	16,893.3	12,459.2	26,528.3	8,612.5	2,821.7	4,350.2	6,474.0	4,681.2
Funds of hedge funds	-	-	0.6	-	-	0.6	8.9	188.6
Hedge funds	-	-	24.4	-	-	24.4	47.0	28.6
REDEMPTIONS								
Total financial mutual funds	125,168.6	155,304.2	198,600.1	49,106.6	41,714.4	52,565.8	52,566.6	45,164.4
Fixed-income	83,463.6	107,150.9	127,469.1	27,866.4	27,519.7	31,363.9	32,087.4	28,502.6
Mixed fixed-income	4,616.9	4,339.6	7,048.4	2,093.8	1,403.6	2,035.2	1,967.4	1,664.7
Mixed equity	2,581.1	2,602.5	3,644.7	966.6	723.8	1,166.2	1,023.0	893.9
Spanish equity	2,922.1	5,323.3	7,824.6	2,490.3	1,438.9	2,401.9	1,750.2	1,861.3
Foreign equity	7,594.2	11,390.2	16,490.9	6,038.3	2,794.5	3,852.6	4,986.4	4,010.5
Guaranteed fixed-income	5,723.2	7,014.0	5,029.3	1,306.9	695.1	1,444.6	1,452.0	1,369.5
Guaranteed equity	9,411.5	8,931.6	11,830.1	2,901.7	2,486.6	4,130.0	2,785.1	2,238.1
Global funds	8,856.1	8,552.1	19,263.1	5,442.6	4,652.3	6,171.5	6,515.1	4,623.8
Funds of hedge funds	-	-	0.0	-	-	0.0	0.0	1.3
Hedge funds	-	-	0.1	-	-	0.1	0.0	0.1

1 Estimated data.

Financial mutual funds asset change by category: Net subscriptions/redemptions and return on assets

TABLE 3.9

Million euro	2004	2005	2006	2006 II	2006 III	2006 IV	2007 I	2007 II
NET SUBSCRIPTIONS/REDEMPTIONS								
Total financial mutual funds	18,424.3	14,444.3	-4,524.5	1,065.6	-4,292.3	-6,469.2	231.8	-1,114.7
Fixed-income	7,184.0	1,445.5	-9,423.4	2,070.2	-2,107.6	-2,625.5	-415.0	-1,009.7
Mixed fixed-income	-440.8	2,349.6	1,539.2	-166.5	-36.0	-54.4	355.9	-224.7
Mixed equity	-1,109.2	-546.5	-854.7	-319.1	-369.7	-460.0	-112.4	-141.0
Spanish equity	1,130.0	276.0	-2,219.4	-1,300.1	92.4	-986.0	242.4	-871.0
Foreign equity	514.8	2,652.4	1,133.8	-1,831.4	-159.9	928.4	553.5	928.6
Guaranteed fixed-income	1,853.1	-354.4	1,018.9	176.7	694.2	353.5	621.7	623.8
Guaranteed equity	1,222.3	4,693.6	-3,021.1	-754.4	-589.7	-1,817.2	-982.8	-479.7
Global funds	8,070.1	3,928.2	7,302.1	3,190.2	-1,816.0	-1,808.1	-40.6	58.9
Funds of hedge funds	-	-	0.6	-	-	0.6	8.9	588.4
Hedge funds	-	-	24.3	-	-	24.3	47.0	28.5
RETURN ON ASSETS								
Total financial mutual funds	7,038.9	11,670.2	12,733.7	-3,052.0	5,876.3	5,516.1	2,784.2	4,303.9
Fixed-income	1,870.5	1,837.6	2,260.2	426.2	794.8	726.6	831.1	747.3
Mixed fixed-income	444.6	620.3	606.6	-127.8	305.8	238.4	140.9	145.9
Mixed equity	567.8	1,053.4	984.2	-250.3	454.1	378.7	163.0	258.2
Spanish equity	1,182.8	1,623.7	2,882.9	-290.0	1,122.0	981.2	579.5	203.5
Foreign equity	851.9	3,507.1	2,736.1	-1,427.0	1,150.6	1,484.3	420.5	1,678.4
Guaranteed fixed-income	334.0	222.8	112.3	11.4	101.0	34.6	87.2	40.7
Guaranteed equity	1,470.5	1,635.5	1,995.2	-773.0	1,381.3	923.7	242.0	694.2
Global funds	316.8	1,169.8	1,156.2	-621.5	566.5	748.6	320.0	535.8
Funds of hedge funds	-	-	0.0	-	-	0.0	0.0	2.3
Hedge funds	-	-	0.1	-	-	-	0.8	3.6

Financial mutual funds return on assets. Detail by category

TABLE 3.10

% of daily average total net assets[1]	2004	2005	2006	2006 II	2006 III	2006 IV	2007 I	2007 II
MANAGEMENT YIELDS								
Total financial mutual funds	4.31	5.87	5.73	-0.84	2.44	2.15	1.31	1.87
Fixed-income	2.51	2.31	2.51	0.56	0.84	0.67	0.90	0.83
Mixed fixed-income	4.96	6.18	5.30	-0.51	2.39	1.89	1.22	1.27
Mixed equity	7.46	12.96	11.31	-1.99	4.94	4.14	2.03	2.94
Spanish equity	19.40	20.10	30.10	-2.44	11.94	9.65	5.77	2.54
Foreign equity	7.80	22.82	13.82	-5.59	5.80	6.75	2.09	6.42
Guaranteed fixed-income	3.49	2.45	1.67	0.30	0.95	0.44	0.78	0.46
Guaranteed equity	5.47	5.26	5.86	-1.31	3.43	2.39	0.91	1.95
Global funds	3.30	7.41	4.84	-1.46	1.94	2.58	1.28	1.88
Funds of hedge funds	-	-	ns	-	-	ns	-0.31	0.96
Hedge funds	-	-	ns	-	-	ns	1.47	4.50
EXPENSES, MANAGEMENT FEE								
Total financial mutual funds	1.08	1.07	1.04	0.25	0.27	0.26	0.26	0.27
Fixed-income	0.78	0.73	0.63	0.17	0.16	0.14	0.16	0.16
Mixed fixed-income	1.29	1.24	1.21	0.30	0.31	0.31	0.29	0.30
Mixed equity	1.64	1.69	1.63	0.38	0.42	0.42	0.40	0.40
Spanish equity	1.80	1.77	1.83	0.40	0.49	0.47	0.45	0.44
Foreign equity	1.65	1.80	1.78	0.37	0.46	0.49	0.43	0.48
Guaranteed fixed-income	0.84	0.77	0.75	0.19	0.19	0.18	0.17	0.17
Guaranteed equity	1.44	1.38	1.34	0.34	0.34	0.33	0.33	0.33
Global funds	1.26	1.41	1.26	0.24	0.32	0.37	0.32	0.35
Funds of hedge funds	-	-	ns	-	-	ns	0.37	0.29
Hedge funds	-	-	ns	-	-	ns	0.40	0.99
EXPENSES, DEPOSITORY FEE[2]								
Total financial mutual funds	0.10	0.10	0.09	0.02	0.02	0.02	0.02	0.02
Fixed-income	0.10	0.09	0.08	0.02	0.02	0.02	0.02	0.02
Mixed fixed-income	0.12	0.11	0.10	0.03	0.03	0.02	0.02	0.02
Mixed equity	0.11	0.11	0.11	0.03	0.03	0.03	0.03	0.03
Spanish equity	0.11	0.11	0.11	0.03	0.03	0.03	0.03	0.03
Foreign equity	0.12	0.11	0.11	0.03	0.03	0.03	0.03	0.03
Guaranteed fixed-income	0.09	0.09	0.09	0.02	0.02	0.02	0.02	0.02
Guaranteed equity	0.10	0.11	0.11	0.03	0.03	0.03	0.03	0.03
Global funds	0.09	0.09	0.10	0.03	0.03	0.03	0.03	0.03
Funds of hedge funds	-	-	ns	-	-	ns	0.04	0.01
Hedge funds	-	-	ns	-	-	ns	0.04	0.52

1 The % refers to monthly average total net assets for the Hedge fund category.
2 Instead of the depository fee, the figures for the Hedge fund category refers to the financial expenses.
ns: it is not significant.

Mutual fund quaterly returns. Detail by category

TABLE 3.11

In %	2004	2005	2006	2006 II	2006 III	2006 IV	2007 I	2007 II
Total financial mutual funds	3.38	5.00	5.59	-0.97	2.31	2.28	1.11	1.65
Fixed-income	1.65	1.53	1.95	0.38	0.68	0.63	0.72	0.65
Mixed fixed-income	3.79	5.00	4.18	-0.79	2.09	1.58	0.94	0.96
Mixed equity	6.20	11.85	10.34	-2.26	4.61	3.78	1.71	2.57
Spanish equity	19.06	20.60	33.25	-2.34	11.90	9.73	5.78	2.07
Foreign equity	7.55	24.18	14.98	-5.15	5.74	6.60	2.12	6.38
Guaranteed fixed-income	2.62	1.66	0.83	0.10	0.75	0.24	0.59	0.29
Guaranteed equity	4.07	3.95	4.66	-1.64	3.12	2.12	0.56	1.62
Global funds	2.17	6.16	4.01	-1.60	1.61	2.21	0.99	1.57
Funds of hedge funds	-	-	ns	-	-	ns	-0.55	1.08
Hedge funds	-	-	ns	-	-	ns	1.26	3.18

ns: it is not significative.

Management companies. Number of portfolios and assets under

TABLE 3.12

	2004	2005	2006	2006 III	2006 IV	2007 I	2007 II	2007 III[1]
NUMBER OF PORTFOLIOS								
Mutual funds	2,620	2,723	2,850	2,829	2,850	2,885	2,921	2,940
Investment companies	2,962	2,989	3,049	3,025	3,049	3,073	3,112	3,126
Funds of hedge funds	-	-	2	-	2	2	22	29
Hedge funds	-	-	5	-	5	6	9	13
Real estate investment fund	7	7	9	9	9	9	9	10
Real estate investment companies	2	6	8	6	8	8	8	9
ASSETS under management (Million euro)								
Mutual funds	236,088.4	262,200.9	270,406.3	271,361.1	270,406.3	273,412.8	276,600.4	274,269.9
Investment companies	22,923.8	25,486.0	28,992.7	27,959.5	28,992.7	30,293.3	31,523.9	31,386.9
Funds of hedge funds	-	-	0.6	-	0.6	9.5	600.2	698.7
Hedge funds	-	-	24.4	-	24.4	119.9	152.0	180.2
Real estate investment fund	4,377.9	6,476.9	8,595.9	8,072.8	8,595.9	8,781.7	8,929.4	9,003.6
Real estate investment companies	56.4	213.9	456.1	377.9	456.1	459.2	487.4	500.2

1 Available data: July 2007.

Foreign Collective Investment schemes marketed in Spain

TABLE 3.13

	2004	2005	2006	2006 II	2006 III	2006 IV	2007 I	2007 II
INVESTMENT VOLUME[1] (million euro)	17,785.6	33,614.7	44,102.9	41,655.8	41,595.1	44,102.9	45,113.8	50,040.1
Mutual funds	3,498.1	8,267.2	12,099.3	10,687.5	10,719.6	12,099.3	12,464.3	14,194.5
Investment companies	14,287.4	25,347.4	32,003.5	30,968.3	30,875.5	32,003.5	32,649.6	35,845.6
INVESTORS/SHAREHOLDERS	321,805	560,555	779,165	753,416	806,305	779,165	782,020	825,552
Mutual funds	51,364	104,089	144,139	140,263	141,164	144,139	158,900	176,834
Investment companies	270,441	456,466	635,026	613,153	665,141	635,026	623,120	648,718
NUMBER OF SCHEMES	238	260	340	280	312	340	354	362
Mutual funds	93	115	163	122	144	163	169	171
Investment companies	145	145	177	158	168	177	185	191
COUNTRY								
Luxembourg	164	161	189	175	183	189	190	196
France	25	47	83	48	68	83	90	92
Ireland	34	35	46	42	44	46	48	48
Germany	11	11	12	11	12	12	12	12
UK	3	5	6	3	3	6	9	9
The Netherlands	1	1	1	1	1	1	1	1
Austria	-	-	1	-	1	1	1	1
Belgium	-	-	1	-	-	1	2	2
Malta	-	-	1	-	-	1	1	1

1 Investment volume: participations or shares owned by the investors/shareholders at the end of the period valued at that moment of time.

Real estate investment schemes

TABLE 3.14

	2004	2005	2006	2006 III	2006 IV	2007 I	2007 II	2007 III[1]
REAL ESTATE MUTUAL FUNDS								
Number	7	7	9	9	9	9	9	10
Investors	86,369	118,857	150,304	139,818	150,304	152,902	153,630	154,061
Asset (Million euro)	4,377.9	6,476.9	8,595.9	8,072.8	8,595.9	8,781.7	8,929.4	9,003.6
Return on assets (%)	6.65	5.35	6.12	1.52	0.80	1.31	1.1	0.42
REAL ESTATE INVESTMENT COMPANIES								
Number	2	6	8	6	8	8	8	9
Shareholders	121	256	749	466	749	754	769	799
Asset (Million euro)	56.4	213.9	456.1	377.9	456.1	459.2	487.4	500.2

1 Available data: July 2007. In this case, the return on assets is monthly.

VI Legislative Annex (*)

(*) This annex has been prepared by the Studies and Statistics Department of the CNMV.

Legislative novelties of national scope approved in the third quarter of 2007 were as follows:

- **Act 16/2007**, of 4 July, on the reform and adaptation of commercial legislation in the accounting field for international harmonisation based on European Union legislation.

  The purpose of this reform is to adapt commercial legislation in the accounting field to the criteria included in European Union Regulations in which the International Financial Reporting Standards are adopted in substantial mandatory aspects.

  In order to achieve this objective, the Act delineates the basic structure of the accounting model, setting out the new documents which must be submitted together with balance sheet, profit and loss account and notes to the accounts. These are a statement which sets out changes in net worth (NWCS) and a cash flow statement solely for those undertakings which cannot draw up abbreviated balance sheet, NWCS and notes to accounts. The NWCS will record certain income deriving from variations in value resulting from applying the reasonable value principle which, in certain circumstances, will be included in the profit and loss account.

  Another modification to be emphasised is the requirement for including qualitative information which is significant for making a comparison with the previous financial year in the notes to annual financial statements.

  Other substantial aspects of these reforms are:

  (i) incorporation into the Commercial Code of definitions of the elements included in annual financial statements (assets, liabilities, net worth, income and expenses);

  (ii) qualification of the content of some of the accounting principles, such as the scope of the principle of prudent valuation. Specifically, the valuation rule of cost price or historic cost for liabilities is developed, and an obligation is laid down in any event to use the functional currency or currencies with which the undertaking operates;

  (iii) the inclusion of a further valuation principle contemplated by international standards, the principle of reasonable value, in principle applicable to certain financial instruments.

- **Act 22/2007**, of 11 July, on the remote marketing of financial services aimed at consumers.

  The Act completes incorporation into the Spanish legal system of Directive 2002/65/EC on the distance marketing of consumer financial services. The general purpose is to provide suitable protection for consumers based on the special characteristics of financial services. A rigorous regime is established of information to be received by consumers before entering into contracts. A

right of withdrawal is regulated which enables the contract to be rescinded within a particular period by simply stating a desire to do so. The Act also provides supplementary guarantees for protection against fraudulent use of cards in use for the payment of financial services. Furthermore, it ensures legal defence of consumers and promotes the use of extra-judicial claims.

- **Resolution of 11 July 2007**, of the Council of the Spanish Securities Market Commission [*Comisión Nacional del Mercado de Valores*] on delegation of powers and functions to the Chairman, Deputy Chairmen, and Executive Committee.

  The delegation of powers and functions covers several aspects: verification of requirements for admission of securities to listing, notification of significant holdings, exclusion of securities from trading, collective investment institutions, investment services undertakings, public offerings, takeover bids, etc.

- **Decision of 13 June 2007**, of the Spanish Securities Market Commission classifying certain modifications of the regulations on management, formation plans and bylaws of Collective Investment Institutions as of minor relevance.

- **Circular 1/2007**, of 11 July of the Spanish Securities Market Commission on statistical information requirements of European Union Collective Investment Institutions, which partially modifies Circular 2/1998, of 27 July, on statistical information requirements of European Monetary Union Collective Investment Institutions.

  The Circular lays down the requirements for statistical information which CII which are at any time considered a Monetary Financial Institution must send to the CNMV, in order that the said information can be used by the Central European Bank for monitoring monetary policy within the Economic and Monetary Union.

- **Royal Decree 1066/2007**, of 27 July on the regime of public takeover bids.

  This completes the substantial modifications made by Act 6/2007[1] to the regime of public takeover bids and the transparency of issuers. It contains exhaustive regulation of all stages of making a takeover bid [*oferta pública de adquisición - opa*] for shares of a listed company.

  Aspects set out in the Royal Decree include the following:

  The specific rules applicable to mandatory takeover bids when achieving control of a listed company, both directly and on an intervening basis. We should recall that Act 6/2007 meant replacing the regime of the total or partial mandatory takeover bid prior to obtaining certain significant holdings with a system of full mandatory bid after obtaining control.

1 Act 6/2007, of 12 April on reform of the Securities Market Act, 24/1988, of 28 July For further details on the new takeover legislation you can consult the article "The New Spanish Legislation on Takeover Bids" in the CNMV Bulletin for the second quarter of 2007.

A controlling holding in a company is deemed to be acquired when: (i) over 30% of voting rights are held (the earlier thresholds of 25% and 50% are eliminated), or (ii) with a percentage of voting rights less than the foregoing, in the 24 months following the date of acquisition of the lower percentage more than half of the members of the Board of Directors are appointed. If any of these circumstances arise a takeover bid must be launched in full at an equitable price.

It deals with a further two cases of mandatory bids: (i) on the exclusion of securities from listing, and (ii) when a company wishes to reduce its capital by purchasing its own shares for subsequent redemption.

Regarding equitable price, it specifies that this must not be less than the highest price which the offeror or persons acting in concert therewith have paid or agreed for the same securities during the 12 months prior to announcement of the bid.

Regarding voluntary bids, it specifies the exceptions applicable to the general regime of takeover bids. These bids are those in which a person wishes to acquire a large block of shares by appealing to all shareholders. They may be made for the whole of the capital or part. Neither need they be made at an equitable price.

It develops the rules applicable in the field of defence against takeover bids. Regarding the obligatory duty of passivity of the Board of Directors, specific measures are listed which require authorisation of the General Meeting. Furthermore, and also with reference to the optional regime of neutralisation of other defences, the necessary precautions are established in order that the General Meeting can decide on the proposals made with full knowledge.

With respect to competing bids, it is provided that the initial offeror may modify its conditions provided that the difference between the initial bid and that of the highest bid does not exceed 2%. An improvement of bid conditions is deemed to take place when the offeror increases the price offered by at least 1% or when it extends the initial bid to a higher number of securities by at least 5% with respect to the best of the competitors.

It implements the procedure applicable to the novel figure of forced sale and purchase rights (squeeze-out and sell-out) after making a bid. These rights may be exercised when the bid has been accepted by at least 90% of voting rights.