

COUNTRY REPORT SPAIN 2008

1. ECONOMIC AND FINANCIAL BACKGROUND.

The Spanish economy has been affected by international environment prompted by further slowdown in the US economy, the rising course of oil prices and the prolongation of the financial turbulence. The Spanish economy ended the year 2007 with a GDP growth rate (of 3,5%) but it began to show signs of undergoing a change in cycle, following an upturn that had lasted for fourteen.

The interest rates rise by ECB from end 2005 to June 2007 and the increasingly subdued rises in house prices began to temper consumption and residential investment decisions as early as 2006. Enhanced competition from banking deposits and structured products against the background of rising interest rates continued to be felt strongly throughout Europe, with Spain being one of the most severely hit countries.

The pace of employment generation adapted to the gradual slowing of activity in the second half of 2007, ending the year at a growth rate of 2,5%. This path has continued, somewhat more sharply, in the opening first part of 2008. It has particularly affected to employment in the construction industry. With a view to the immediate future, the macroeconomic projections recently published by the Banco de España suggest that national demand will continue to lose steam, in both its consumption and capital investment components.

In 2007, the Spanish UCITS industry's assets suffered a decrease of 15% totalling to EUR 269 billions, because of net redemptions and financial and credit crunch crisis which affected the positive market performances on the second half of 2007. Throughout the whole year 2007, Ibex-35 index registered a 7,3% rise, which reflected the reduction of the strength of the national economy on the past years, specially based on internal demand. Therefore this can be seen as a positive performance in the context of the actual financial markets.

On the other hand, Money Market Funds and Bond Funds experienced net redemptions although the increases on interest rates approved by European Central Bank (ECB), due to investors preferences to deposits as these products have been highly marketed by banks and saving banks in order to balance their assets and liabilities as to compensate the great amount of mortgages (20% annual increase in the last 5 years) sold out by them. In order to cope with this objective, advertising campaigns have been focused on highlighting future returns in contrast with Money Market Funds past performances (Funds are not allowed to market future performances).

2. KEY TRENDS IN FLOWS AND ASSETS UNDER MANAGEMENT.

The assets of Collective Investment Schemes (Investment Funds and SICAV) decreased to 269 billion euros at the end of December.

Investors preference radically change from global funds which, as a result of their flexible strategy could obtain higher returns while taking on greater risk, and focused on guaranteed bond funds.

EVOLUTION BY CATEGORIES

Assets and net sales (Billion Euros)	Dec-05	Dic-06	Dic-07	Jun-08	% VARIATION		NET SALES	
					2007	2008 Jan-Jun	2007	2008 Jan-Jun
MONEY MARKET FUNDS	54,5	0,1	37,3	38,1	33809%	2%	-	-2,6
BOND FUNDS	73,8	121,5	79,5	76,6	-35%	-4%	-3,0	-1,7
Domestic	54,5	103,2	60,9	55,9	-41%	-8%	-6,5	-3,8
International	2,6	1,6	1,0	0,8	-38%	-20%	-3,0	-0,2
Guaranteed	16,7	16,7	17,6	19,9	5%	13%	6,5	2,3
BALANCED	46,9	50,6	52,7	43,7	4%	-17%	0,3	-4,8
Domestic	16,2	15,8	14,1	9,6	-11%	-32%	-1,5	-3,0
International	30,7	34,8	38,6	34,1	11%	-12%	1,8	-1,8
EQUITY FUNDS	93,4	107,6	99,9	72,0	-7%	-28%	-13,4	-20,9
Domestic	9,9	11,4	6,4	4,5	-44%	-30%	-2,1	-1,9
International	39,2	52,1	51,3	31,8	-2%	-38%	-7,6	-14,3
Guaranteed	44,3	44,1	42,2	35,7	-4%	-15%	-3,7	-4,7

a) EQUITY FUNDS:

- At 31 December 2007, the assets amounted Euro 99,9 Billion, compared with Euro 107,6 Billion at the end of 2006. This high decrease was basically based on negative performance of domestic equity markets and outflows in domestic Equity Funds.
- First semester 2008: these Funds have reduced their assets by 28%, mainly due to credit crunch crisis which affected into strong outflows, bad performances due to an uncertain and unestable equity market among other different reasons.

b) BOND FUNDS:

- During 2007: the assets decreased from Euro 121,5 Billion to Euro 79,5 Billion, mainly based on transfers to Money Market Funds due to a reclassification in statistics introduced by Spanish Stock Exchange Commission (CNMV).
- First semester 2008: these Funds have lightly decreased their assets in 4%, up to Euro 76,6 Billion, due to inflows of Guaranteed Funds.

c) MONEY MARKET FUNDS:

- At 31 December 2007, the assets amounted Euro 37,3 Billion, compared with Euro 0,1 Billion at the beginning of the year, due to the reasons mentioned above.
- First semester 2008: these Funds have increased their assets up to Euro 38,1. This 2% increase is mainly based on positive market performances as net sales stood on 2,6 billions.

d) BALANCED FUNDS:

- During 2007, the assets increased from Euro 50,6 Billion to Euro 52,7 Billion, that is to say an increase of 4% mainly due to net subscriptions.
- First semester 2008: these Funds have decreased their assets up to Euro 43,7 Billion. This is mainly based on returns of this kind of Funds, and net outflows of 4,8 Billion.

3. RECENT REGULATORY AND SELF REGULATORY DEVELOPMENTS

Spanish regulation has been implemented in several issues since the previous IIFA Conference, held in 2007. The main legislation, adopted during this period, is referred to the following items:

• MIFID

European regulation on markets in financial instruments was adopted and developed in Spanish legal system by Law 47/2007 of 19 December¹ and Royal Decree 217/2008 of 15 February².

According to regulation, depending on the type of services provided, investment firms must obtain different information about clients or potential clients:

- o When providing *investment advice or portfolio management*, the investment firm must obtain the necessary information regarding the client's or potential client's knowledge and experience in the investment field relevant to the specific type of product or service, his/her financial situation and his/her investment objectives so as to enable the firm to recommend to the client or potential client the investment services and financial instruments that are suitable for him (suitability test).
- o When providing *investment services other than those referred to in the previous paragraph*, investment firms must ask the client or potential client to provide information regarding his/her knowledge and experience in the investment field relevant to the specific type of product or service offered or demanded so as to enable the investment firm to assess whether the investment service or product envisaged is appropriate for the client (appropriateness test).

Nevertheless, investment firms are not required to apply appropriateness test, when providing investment services that only consist of *execution and/or the reception and transmission of client orders with or without ancillary services* and the following requirements are fulfilled:

- o the service is related to non-complex financial instruments,
- o the service is provided at the initiative of the client or potential client,
- o the client or potential client has been clearly informed that in the provision of this service the investment firm is not required to assess the suitability of the instrument or service provided or offered and that therefore he does not benefit from the corresponding protection of the relevant conduct of business rules;
- o the investment firm complies with its obligations to avoid conflicts of interest.

In this regard, it is important to emphasize that:

- UCITS (collective investment schemes that comply with Council Directive 85/611/EEC of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating

¹ Law 47/2007 of 19 December amending Securities Market Law 24/1988 of 28 July.

² Royal Decree 217/2008, of 15 February, on the legal regime of investment firms and of other investment services entities and partially amending the Regulation implementing Law 35/2003 of 4 November on collective investment undertakings, as approved by Royal Decree 1309/2005 of 4 November.

to undertakings for collective investment in transferable securities) are considered non-complex financial instruments.

- Other collective investment schemes (no UCITS), that have been authorised for marketing to the public, need to be analysed to determine if they should be considered as non-complex. For this purpose, the circumstances in which valuation systems will be independent of the issuer should include where they are overseen by a depositary that is regulated as a provider of depositary services in a Member State.

Legislation establishes differences between investment services and marketing. When developing an activity that only consist of marketing, there is not an obligation to obtain information about clients or potential clients.

Irrespective of the activity developed, information addressed by investment firms to clients or potential clients must comply with certain requirements. This information, including marketing communications, must be fair, clear and not misleading.

Spanish supervisor (CNMV) made an important effort by developing a consultation process with industry and providing guidelines and information related to MIFID. CNMV has promoted a number of meetings with the representative national associations of financial institutions (investment firms, banks, saving banks, cooperative banks and collective investment schemes) and Bank of Spain, to evaluate the impact of MIFID on the institutions represented. Additionally, CNMV has published a document, that answers *frequently asked questions about MIFID* and a *consumer's guide to MIFID*, in order to explain investors how MIFID affects them when dealing with firms that provide investment services in Europe.

- **ACCOUNTING, DETERMINATION OF TOTAL ASSETS, RISK DIVERSIFICATION RATIOS AND REGULATION OF CERTAIN CIS.**

Order EHA/35/2008 of 14 January 2008 implements certain aspects on accounting for Collective Investment Schemes (CIS) and determination of their total assets; the calculation of risk diversification ratios; the CIS whose investment policy consists of reproducing, replicating or taking as a reference a stock market or fixed-income index and the requirements of the internal control and risk management and control systems of CIS management companies.

Basically, the Order establishes very general rules and empowers the CNMV to issue the necessary provisions on the majority of the mentioned aspects³.

- **TRANSACTIONS IN DERIVATIVE FINANCIAL INSTRUMENTS**

During the present year, Order EHA/888/2008⁴ has been adopted. This regulation enlarges the range of derivative financial instruments in which financial Collective Investment Schemes can invest (for

³ More specifically, the Order refers to the following aspects to be developed by CNMV, such as:

- *Specific CIS' accounting rules*: annual accounts, valuation methods, assets classification, determination of total assets and results, determination of supplementary confidential returns to be submitted by CIS, and the detail of and frequency with which the data must be supplied to the CNMV.
- *CIS whose investment policy consists of replicating or reproducing a specific stock market or fixed-income index*: establishment of the maximum deviation permitted in the returns of this CIS with respect to the benchmark index.

⁴ Order EHA/888/2008 of 27 March on transactions of financial collective investment schemes in derivative financial instruments and clarification of certain definitions of Royal Decree 1309/2005 of 4 November.

example, increasing the range of eligible underlying for a derivative instrument). With regard to transactions of financial Collective Investment Schemes in derivative financial instruments, it establishes rules about:

- Suitable derivative financial instruments
- Requirements that certain derivative financial instruments must comply with
- Objectives pursued by this transactions
- Limits to risk taken
- Valuation
- Internal control mechanisms
- Supervision
- Information to disclose

Order's scope excludes Hedge Funds, because they have specific rules that are more flexible.

• DEPOSITARY

Order EHA/596/2008 of 5 March regulates certain aspects referred to CIS' depositaries and certificates of unit-holders' investment. With regard to depositaries of collective investment scheme assets, it specifies the functions to be carried out by them and makes them to draw up rules of procedure.

• RELEVANT EVENTS

CNMV has adopted Circular 5/2007 of 27 December on CIS' relevant events. This regulation pursues a triple objective, so it tries:

- o to systematize cases that are considered CIS' relevant events,
- o to speed up disclosures of CIS' relevant events and
- o to clarify foreign CIS' obligations on the matter.

• REAL ESTATE INVESTMENT FUNDS

Different rules related to Real Estate Investment Funds have been modified recently⁵. These modifications tend to implement technical and formal improvements with regard to appraisal of real estate assets, information related to property appraisal reports and financing limits.

⁵ Regulations that modifies Real Estate Investment Funds rules are:

- Order EHA/3011/2007 of 4 October amending Order ECO/805/2003 of 27 March on rules for the appraisal of real estate assets and of certain rights for financial purposes.
- Royal Decree 215/2008 of 15 February amending article 59 of the regulation implementing Law 35/2003 of 4 November on collective investment undertakings, as approved by Royal Decree 1309/2005 of 4 November.
- Circular 2/2008, of 26 March, partially amending Circular 4/1994 of 14 December on accounting, reporting, establishment of net asset value, operative and investment coefficients and property appraisal reports of Real Estate Investment Funds.

4. PLANNED REGULATORY AND SELF REGULATORY DEVELOPMENTS

Spanish regulation on Collective Investment Schemes, included in Law 35/2003 and Royal Decree 1309/2005, has required additional rules to implement that regulation and bring the previous regulation up to date.

Ministry of Economy and Finance and CNMV have planned to implement a wide range of aspects related to Collective Investment Schemes by adopting the necessary Orders and Circulars respectively. The table shows subjects whose regulation is expected to be implemented in 2008 and the status, indicating if there is a Draft regulation available or not.

Law 35/2003 on collective investment undertakings	
Royal Decree 1309/2005 implementing Law 35/2003 on collective investment undertakings	
Subject	Order / Circular
Securities lending	Draft Order (expected October 2008)
CIS Accounting	Circular (approved September 2008)
Net asset value, coefficients and CIS whose investment policy consists of reproducing, replicating or taking as a reference a stock market or fixed-income index	Draft Circular (expected October 2008)
Public periodic reports	Circular (approved September 2008)
Derivative Financial Instruments	Circular planned for 2008. Not available yet.
Depositary	Circular planned for 2008. Not available yet.
CIS management Company	Draft Circular (expected November 2008)
Investment policy	Circular planned for 2008. Not available yet.
Internal control of CIS management companies	Circular planned for 2008. Not available yet.

Considering European Regulation, the European Commission has proposed an important revision of the EU framework for UCITS. The proposed changes to the UCITS Directive will remove administrative barriers to the cross-border distribution of UCITS funds; create a framework for mergers between UCITS funds and allow the use of master-feeder structures; replace the Simplified Prospectus by a new concept of Key Investor Information and improve cooperation mechanisms between national supervisors. Management company Passport has not been included in the proposal.

5. OTHER MAJOR ISSUES AND DEVELOPMENTS

• LIQUID ASSETS AND VALUATION

Due to the special market situation caused by subprime crisis, occurred in August 2007, Spanish Supervisor (CNMV) has reminded CIS management companies the importance of maintaining an accurate liquidity control system and has developed a monitoring in order to verify that valuation of CIS' assets was correct.

Additionally, INVERCO set up a working group in order to identify the best practices with regard to asset valuation.

• PRIVATE PENSION REGULATION

At the end of December 2007, Royal Decree 1684/2007 amended the pension scheme and pension fund regulations approved by Royal Decree 304/2004 of 20 February 2004.

The Royal Decree makes changes in various areas such as:

- actuarial aspects of pension schemes,
- obligations to provide information to participants and beneficiaries,
- the list of eligible assets and rights, updated to include credit derivatives, non-financial derivatives and non-harmonised collective investment institutions, among others.
- rules on internal control of management companies, rules of conduct and on separation of depositories, and
- rules on administrative registers, particularly those relating to cross-border activities.

Amendments aimed, on the one hand, to adapt the legal framework of the Pension Scheme and Pension Fund Regulations to the changes in pension funds in particular, and in the financial sector in general, owing to the appearance of new investment alternatives for pension funds, and, on the other, to adapt it to the existing trends in the rest of the financial sector in relation to internal control procedures.

Provisions of Royal Decree 1684/2007 were developed by Order EHA/407/2008, of 7 February.