Financial regulation: fourth quarter of 1999

1. INTRODUCTION

In the fourth quarter of 1999, the output of new provisions of a financial nature was relatively larger than in previous periods.

As regards the Banco de España (BE), first, the amendment to the general clauses applicable to monetary policy operations to specify certain cases of breach of the obligations arising under such general clauses is highlighted. Second, the rules for payment of the profits of the BE to the Treasury have been published. These maintain the same criteria as laid down in previous legislation, although the rules on the allocation of monetary income of national central banks in the Statute of the European System of Central Banks (ESCB) and of the European Central Bank (ECB) are taken into account.

In relation to credit institutions, first, the accounting standards have been amended to introduce new criteria for the coverage of credit risk in order to provide for levels of solvency risk that will become apparent in the next economic downturn. In this respect, the establishment of a provision for the statistical coverage of insolvency, based on the statistical modelling of the level of risk of each institution based on its historical experience, should be noted. Second, the legislation on capital has been amended to adjust its content to the characteristics and operation of such provision.

Turning to the securities markets, five financial provisions are discussed: first, the incorporation into Spanish law of Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems is highlighted due to its importance. Second, certain amendments have been introduced into the legislation on tender offers in order to eliminate certain regulatory costs, without thereby reducing investor protection. Third, a number of rules have been established on the transparency of transactions on official securities markets, in accordance with the minimum requirements laid down in Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field. Fourth the requirements for admission to listing on stock markets have been made more flexible and a special segment has been created for trading the securities of innovative high-technology firms on stock markets. Lastly, the general code and rules of conduct of the securities market have been adapted to the particularities of the portfolio investment management.

The procedures and documents for obtaining authorisation of the incorporation plans for

new venture capital companies and their management companies have been regulated.

In the insurance field, certain provisions of the pension scheme and fund regulations have been updated. The existing limit on annual contributions has been raised, new situations that may be assimilated to retirement have been determined and jointly promoted pension schemes under the employment system regulated. Also, the regulation on the application of firms' pension commitments to employees and beneficiaries, known as the "externalisation regime", has been approved.

As regards the taxation of financial assets, two provisions are mentioned. These, among other things, modify the system of withholdings and payments on account for public debt issued by OECD countries and they simplify the procedure for repayment of the withholding on the interest paid on assets held by tax-exempt persons.

Finally, as usual in this period, the State budget for the year 2000 is discussed. The requirements for stability and budgetary rigour arising from Spain's membership of the Euro area are reflected in the budget. As in previous years, a number of fiscal, administrative and social measures have been published along with the budget law, in order to facilitate the fulfilment of economic policy objectives set out in the budget.

2. BANCO DE ESPAÑA: MONETARY POLICY OPERATIONS

The Resolution of 11 December 1998 (1) of the Executive Commission of the Banco de España, partially amended by the Resolution of 23 July 1999 (2), specified the general clauses applicable to the monetary policy operations carried out by the BE from 1 January 1999, in accordance with the guidelines laid down by the ECB.

Recently, this Resolution has been amended by the Resolution of 26 October 1999 of the Executive Commission of the BE (BOE (Official State Gazette) of 7 December 1999), to revise the cases and effects of breach, by the institutions, of the obligations arising under these general clauses.

The Resolution of 26 October updates and clarifies certain cases of breach and, in particular, those relating to the use of collateral.

3. MODIFICATION OF THE RULES FOR PAYMENT OF THE PROFITS OF THE BE TO THE TREASURY

The rules for payment of the profits of the BE to the Treasury were laid down in the second additional provision to the 1988 Budget Law 33/1987 of 23 December 1987 (since repealed), which was subsequently incorporated into the Internal Rules of this institution approved by a resolution of the Governing Council of the BE of 14 November 1996 (3).

Later, Law 12/1998 of 28 April 1998, which amends the Law of Autonomy of the BE 13/1994 of 1 June 1994, provided in its second additional provision that the rules for payment to the Treasury of the profits of this institution would be laid down in regulations. This has now been done by the publication of Royal Decree 1746/1999 of 19 November 1999 (BOE of 20 November 1999). This maintains the same rules for payment as in the previous legislation, the convenience and appropriateness of which has long been confirmed, although the rules on the allocation of monetary income of national central banks in the Statute of the ESBC and of the ECB are taken into account.

The BE shall pay to the Treasury the profits earned and recorded in its accounts that are attributable to the latter on the following dates and in the following percentages:

a) On the first business day of November each year, 70 % of the profits earned and recorded to 30 September of that year.

b) On the first business day of the following February, 90 % of the profits earned and recorded to 1 December of the previous year, having deducted the payment mentioned in (a) above.

c) The rest of the profits earned shall be paid when the balance sheet and profit and loss accounts of the BE have been approved by the government upon a proposal from the Ministry of Economy and Finance.

The payments established in (a) and (b) shall be resolved by the Governing Council of

(1) See "Financial regulation: fourth quarter of 1998", in *Economic bulletin,* Banco de España, January 1999, pp. 78-82.

(2) See "Financial regulation" third quarter of 1999", in *Economic bulletin,* Banco de España, October 1999, pp. 73-74.

(3) See "Regulación financiera: cuarto trimestre de 1996", in *Boletín económico,* Banco de España, January 1997, pp. 104-106.

the BE, after approval of the relevant profit and loss account. In such resolutions account shall be taken of the possible obligations of the BE to the ESCB under article 32 of the Statute of the ESCB, and in the case of (a) the foreseeable path of the results to the end of the year.

The payment rules established are temporary in nature, being applied, with a criterion of maximum prudence, to the years 1999, 2000 and 2001, until such time as the ESCB takes a new decision under its Statute. Also, the format of the BE's balance sheets and profit and loss accounts shall follow any guidelines and instructions of the ECB that may be applicable.

4. CREDIT INSTITUTIONS: AMENDMENT OF ACCOUNTING STANDARDS

BE Circular 4/1991 of 14 June 1991 (4), which sets out the accounting standards and the formats for the financial statements of credit institutions, has been frequently amended to adapt its content to the changes affecting the credit system in recent years.

Credit institutions are currently enjoying an economic boom, in which a significant role is being played by the minimal weight of the provisions for solvency risk that they must charge to their profit and loss accounts, given the low default rate characteristic of economic upturns. However, as shown by past experience, the loan portfolio may contain hidden potential default risks that will probably be revealed when the business cycle turns down.

As a preventive measure, the Banco de España has, by means of *BE Circular 9/1999 of 17 December 1999* (BOE of 23 December 1999), introduced certain new coverage criteria into the accounting rules to recognise and forestall such risks in the medium and long-term. A *provision for the statistical coverage of insolvency* ("statistical provision for insolvency") has been created and the current treatment of the general provision for insolvency, to cover the total risk, has been redrafted to make it clearer.

This statistical provision for insolvency shall be created by charging to the profit and loss account each year an estimate of the total latent bad debts in the various portfolios classified by level of risk. In this respect, the institutions will estimate the provisions needed using calculation methods based on their own experience of default and on the expected losses for each category of uniform credit risk, taking into account the quality of the different types of counterparties, the security given and its recoverable value, the life of the transaction, if relevant, and the future outlook for the risk based on the foreseeable medium- and long-term changes in the economic situation. An amount shall be set aside quarterly to the provision from the profit and loss account, in accordance with the accounting procedure established in the Circular. If it is wished to make transfers to this provision monthly, similar criteria shall apply, with the appropriate adjustments to the calculations.

The calculation methods shall form part of an appropriate system to measure and manage credit risk, using an historical base spanning a complete business cycle, and must be checked by the Banco de España. As an alternative, BE Circular 9/1999 establishes a system for calculating the transfers to be made to the statistical provision for insolvency which consists in classifying the various loans into six categories or risk groups (no appreciable risk, low risk, medium-low risk, medium risk, medium-high risk and high risk) to which a specific coefficient shall be applied, ranging from 0 % for loans with no appreciable risk to 1.5 % for high-risk loans. Where institutions have their own calculation methods approved by the Banco de España, they may use them, in which case the method specified in the Circular shall only be applied to those risks not covered by the own method.

Transfers shall be made to this provision from the profit and loss account equal to the statistical estimate of the total latent bad debts in the various uniform-risk portfolios (credit risk multiplied by the relevant coefficients) less the net provisions for insolvency made during the quarter. If this amount is negative, it shall be credited to the profit and loss account and debited to the provision, insofar as the available balance of the latter is sufficient.

The Circular also updates the accounting treatment for doubtful assets and the specific coverage of credit risk. As regards single risks, in addition to those specified in BE Circular 4/1991, amounts that have not fallen due under a personal loan with monthly payments shall be classified as doubtful if any payment is more than six months overdue. In all other cases, assets shall be classified as doubtful when payments are more than one year overdue.

The situations in which assets classified as doubtful are reclassified as normal investments are specified and widened. Such reclassification shall take place not only when effective security is provided, but also when it is reasonably

(4) See "Regulación financiera: segundo trimestre de 1991", in *Boletín económico,* Banco de España, July-August 1991, pp. 58-60.

certain that the customer will be able to pay on time and, in both cases, at least the outstanding ordinary interest has been received, without taking into account the default interest. BE Circular 9/1999 also adds that claims on creditors subject to a suspension of payments order shall be reclassified as normal investments when the borrower has paid at least 25 % of the claims affected by the suspension of payments (having deducted any reduction agreed) or two years have elapsed since registration at the Mercantile Registry of the order approving the agreement between the borrower and its creditors, provided that such agreement is being faithfully performed and the trend in the financial and net-worth situation of the firm dispels any doubts regarding full repayment of its debts. The amounts of transactions reclassified as normal investment shall be recorded in the balance sheet for official supervisory purposes until they have been eliminated in a memorandum item known as *"restructured credit".*

As regards credit-risk cover, the requirements have been tightened slightly with the inclusion in the *general scale* of a 3-6 month tranche for assets classified as doubtful, according to the time elapsed from when the first overdue payment in a particular transaction became due. The general scale is thus defined as follows:

Period of default on first overdue payment	Percentage cover
Over 3 and up to 6 months	10
Over 6 and up to 12 months	25
Over 12 and up to 18 months	50
Over 18 and up to 21 months	75
Over 21 months up to write off	100

The coverage percentages and tranches of the reduced scale established in BE Circular 4/1991 are maintained for mortgage loans and financial leasing transactions, in both cases relating to completed residential property, excluding multi-purpose premises and country estates. However, if the amount of the outstanding exposure exceeds 80 % of the appraised value of the residence, the general scale shall apply to the whole transaction. For these purposes, the original appraisal value shall be used if the institution does not have a more recent one available.

The current treatment of the general provision for insolvency, intended to cover the total risks, has been redrafted to make it clearer.

Certain changes have been introduced into the current regulation of country risk that are intended to maintain or strengthen its prudential levels and to provide various technical improvements. The Circular clarifies its scope of application. It now covers, in addition to sovereign risk and transfer risk, the other risks arising from international financial activity which include the other risks that may be covered by export credit insurance (5). There are hardly any changes to the coverage of country risk, although its content is specified, stressing the specific treatment for financial, money or off-balance-sheet support to branches and subsidiary and multi-group institutions resident in countries classified as very doubtful, doubtful or in temporary difficulty.

The Circular has also been used to adapt the current criteria for valuing unlisted shares and other equity to the general provisions of the Chart of Accounts.

Lastly, it should be noted that the BE Circular will enter into force on 1 July 2000 and will thus be fully operative in the second half of the year, although immediate application of its criteria is recommended, in particular, in relation to the statistical provision for insolvency. However, the amendment relating to the valuation of unlisted shares entered into force on 1 December 1999.

5. CREDIT INSTITUTIONS: CHANGES IN THE DETERMINATION AND CONTROL OF THE MINIMUM LEVELS OF CAPITAL

BE Circular 5/1993 of 26 March 1993 (6) represents the final development of the legislation on the capital and supervision on a consolidated basis of financial institutions. Its content has been changed during the years since to adapt it to the new circumstances that have arisen.

For the purposes of calculation of the solvency coefficient, a number of items are deducted from the elements which make up the capital of a credit institution, including the shortfalls in the mandatory specific provisions, with respect to the levels required by accounting standards.

As mentioned in the previous section, BE Circular 9/1999 has established the obligation to create the new statistical provision for insolvency.

(5) Such risks are set out in the Ministerial Order of 12 February 1998 on the State coverage of risks arising from foreign and international trade.

(6) See "Regulación financiera: primer trimestre de 1993", in *Boletín económico,* Banco de España, April 1993, pp. 88 and 89.

Given the characteristics of this provision and the way in which it operates, it was considered desirable to amend BE Circular 5/1993, by means of BE Circular 10/1999 of 17 December 1999 (BOE of 23 December 1999), in order to clarify that any shortfall in this provision should not be included as a deduction from the capital.

Finally, it is necessary to take into account the amount of the statistical provision for insolvency to calculate the net book value of the assets and off-balance-sheet items on the basis of which the insolvency coefficient is calculated. For this purpose it is established that these provisions shall be deducted in proportion to the risks on which their calculation is based, in accordance with the contribution of each to the provision based on its risk profile.

6. PAYMENT AND SECURITIES SETTLEMENT SYSTEMS

The significant increase in the transfers of money funds and securities between the financial institutions of the European Union (EU) and the rest of the world has intensified the concern of the supervisory authorities to establish payment and securities settlement systems which guarantee and ensure the stability of the financial systems in question. Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems was intended to contribute to the efficient operation of cross-border payment and securities settlement arrangements in the EU, by offering a harmonised legal solution. Its main objectives were as follows:

1. To reduce the legal risks associated with participation in payment and securities settlement systems, especially in relation to the finality of settlement, the legal validity of netting agreements and the legal enforceability of collateral security supplied by the participants to cover their obligations.

2. To contribute, through the acceptance of collateral security provided in connection with monetary policy operations, to greater financial stability and to developing the necessary legal framework for the ESCB and the ECB to conduct their monetary policy.

3. To ensure that payments can be made in the internal market without any hindrance whatsoever.

4. To promote greater integration of Community credit institutions in the internal payment systems of other EU Member States, thereby supporting the freedom of movement of capital and the freedom to provide services.

Law 41/1999 of 12 November 1999 (BOE of 13 November 1999) on payment and securities settlement systems, with the same objectives, has been published, in order to incorporate the provisions of the above-mentioned Directive into Spanish law.

Chapter one of the Law establishes its scope, defining the payment and securities clearing and settlement systems *("the systems"),* and *the participants* therein, as well as the collateral security used to ensure the proper functioning of the payment and securities settlement arrangements. The special mention given to the monetary policy operations that have to be conducted by the ECB and the central banks of the EU Member States should be noted here. As regards the participants, these may be credit institutions and investment services companies that are accepted as members of a system and which are liable thereto in respect of financial obligations deriving from its operation. The ECB, the BE, the central banks of the Member States, the international financial organisations of which Spain is a member and the managers and settlement agents of other systems are also entitled to participate in the systems.

Chapter two sets out the rules that apply to Spanish systems and their participants. Systems must be recognised by means of a declaration in a resolution adopted by the government at the request of the institutions participating therein or upon a request by the BE, the CNMV (National Securities Market Commission) or the appropriate regional supervisory body. The requirements that Spanish systems must comply with in order to be recognised are set out. The following are notable:

a) Their purpose shall be the execution and, where appropriate, netting of orders to transfer funds or securities.

b) At least three financial institutions must participate in them. These shall be Spanish credit institutions or investment services companies or financial institutions authorised to operate in Spain, provided that at least one of them has its central administration in Spain.

c) Their general requirements for membership and rules of operation shall have been approved by the relevant supervisory authority (the BE, the CNMV or the relevant body of the Regional (Autonomous) Government) and published in the BOE. Such

rules shall determine, inter alia, the time at which a transfer order shall be considered accepted by the system, as well as the establishment of adequate instruments for the control and management of risks.

d) Orders to transfer funds shall be settled through a cash account held with the BE.

e) They shall be managed by the BE or by an entity subject to its supervision or to that of the CNMV or of the competent body of the Regional (Autonomous) Government.

The systems currently existing in Spain are recognised as being subject to this Law, as it is considered that they comply with the requirements laid down thereby, without prejudice to their adaptation thereto within six months. These include: the *SLBE* (the BE Settlement Service), together with the other systems (in other countries) that make up the payment interconnection and settlement system managed by the ESCB; the *Servicio de Compensación y Liquidación de Valores* (Securities Clearing and Settlement Service), managed by the company with the same name and regulated by Securities Market Law 24/1988 and its implementing provisions; the *Stock Market Clearing and Settlement Services* managed by their respective regulatory companies; the public-debt market *Book-Entry System* managed by the BE; the clearing and settlement arrangements for contracts traded on the *MEFF* (financial futures and options) *equity and fixed-income* markets; and the clearing and settlement system of the *AIAF* (Association of Securities Dealers) *fixed-income market.*

Chapter three regulates netting and orders to transfer funds and securities. For these purposes, orders to transfer funds and securities are the instructions given by a participant for the purpose of:

a) Placing an amount of money at the disposal of a final consignee, or assuming or discharging a payment obligation as defined in the rules of a system, provided that the instructions for its execution are given by means of an entry in the books of a participant, central bank or credit institution.

b) Transferring title or any other right over one or more securities or derivative instruments, by means of an entry in a register or some other means that evidences the transfer.

The most important aspect of this chapter is the validity and finality of trance for marauders and netting, which, where applicable, will take place between them, they for the participants and third parties. In this way, the transfer orders shall be sent to a system by its participants, when they have been received and accepted, in accordance with the system operating rules, shall be irrevocable. There is no possibility of opposing such transactions, which greatly reduces the possibility of systemic risk.

Chapter four regulates the consequences of finality of settlement in relation to insolvency proceedings that may be brought against a participant. Provided that such proceedings are commenced after the transfer orders have been received and accepted by a system, the shall have no affect whatever on such orders (i.e. the orders shall be clear and settled). The same rules should apply to the collateral security constituted by a participant in favour of the system or of other participants in the event of insolvency proceedings. The beneficiaries of the security, including the monetary authorities, shall be entitled to enforce their security outside the insolvency proceedings (7).

Lastly, Chapter five creates the Interbank Payments Service (SEPI), which will replace the Madrid Clearing House, giving it corporate status and a structure that will enable it to operate with maximum certainty and flexibility. SEPI shall have the sole object of facilitating the exchange, clearing and settlement of orders to transfer funds between credit institutions, been a complementary to the SLBE. Under its corporate objects SEPI may establish such relations with other bodies or entities engaged in a similar activity is, within or outside Spain, as it considers desirable to better performed its functions and assume the management of other systems all services are with similar objects, other than the SEPI.

Supervision of the company shall be carried out by the BE. The latter shall be responsible for authorising, prior to the adoption by the relevant bodies of the company, the company statutes and the amendments, as well as the basic rules of operation of the systems and services that it manages and all other instructions regulating its operations.

7. CHANGES TO THE RULES GOVERNING TENDER OFFERS

The law governing tender offers used to be contained in Royal Decree 279/1984 of 25 Jan-

(7) These exceptions to insolvency law are justified by their main objective, namely to establish the legal and technical instruments considered essential to avoid systemic risk and to ensure the stability of the financial system.

uary 1984, which has been repealed. After various changes a new general framework for tender offers was implemented by Royal Decree 1197/1991 of 26 July 1991 (8), which adapted the previous law to the requirements of legal practice.

Subsequent experience has shown the advisability of making some changes to this Royal Decree to eliminate certain regulatory costs, without thereby reducing the protection of investors in companies subject to tender offers. These changes have been introduced by means of *Royal Decree 1676/1999 of 29 October 1999* (BOE of 30 October 1999),

The percentage or threshold for making a tender offer in cases of indirect acquisition of a significant holding in another company or entity has been changed in order to bring them into line with those established for the same cases in the event of merger (9). As a result, a tender offer must now be made whenever, as a consequence of the acquisition, the holding in the company concerned reaches 50 %, or more, of its capital. The tender offer shall be made within six months following the date of acquisition and shall be for a number of shares enabling the purchaser to obtain at least 75 % of the capital of the company and, in any event, representing at least 10 % of the capital of the company concerned.

With regard to competing bids (10), certain requirements have been changed in order to overcome the excessive rigidity in their regulation and to widen the possibilities for reacting to a tender offer. First, the consideration of a competing bid can be that established in the general legislation (cash, securities, or both). Previously only cash consideration was permitted. Second, in the event that the consideration of the competing bid consists (wholly or partly) of securities to be issued by the bidding company, the acceptance period shall be lengthened in accordance with the general legislation, i.e. it shall be extended, in all cases, to fifteen days from the general meeting of the bidding company at which the increase in capital is approved (11) and, in the event that the acceptance period for the preceding bid terminates on a later date, to such later date.

8. RULES ON TRANSPARENCY IN TRANSACTIONS ON OFFICIAL SECURITIES MARKETS

Royal Decree 629/1993 of 3 May 1993 (12) on rules of conduct for the securities markets and compulsory registrations, implemented by the Ministerial Order of 25 October 1995 (13) and CNMV Circular 1/1996 de 27 March 1996 (14), laid down certain minimum standards of conduct for all persons operating on securities markets, based on EU recommendations and directives, which involved a significant step towards securing the transparency of all participants in such markets.

Subsequently, Law 37/1998 of 16 November 1998, which amended the Securities Market Law 24/1988 of 28 July 1988, established that, in order to increase market transparency, the National Securities Market Commission (CNMV), the BE or the market regulatory bodies should determine, within such limits as may be established by regulations, the information of a public nature on market transactions that it shall be compulsory to disclose.

Pending its implementation through regulations, the CNMV has issued *CNMV Circular 3/1999 of 22 September 1999* on the transparency of transactions on official securities markets (BOE of 1 October 1999), since it is essential to determine the minimum information that must be published on transactions performed on official securities markets (15), in accordance with the minimum requirements laid down in the regulation of securities markets.

The Circular regulates the information of a public nature that stock markets, official futures and options markets and the AIAF fixed-income market must disclose on (both ordinary and extraordinary) market transactions, as well as, where applicable, the orders made on the same.

(8) See "Regulación financiera: tercer trimestre de 1991", in *Boletín económico,* Banco de España, October 1991, pp. 57 and 58.

(9) In the case of merger, a tender offer must be made when, as a consequence of the merger, the holding in the capital of the company concerned reaches 50 % or more.

(10) Tender offers for securities that have been wholly or partly the subject of a previous bid submitted to the CNMV whose acceptance period has not expired shall be considered competing bids, providing that they fulfil certain requirements.

(11) Previously, as the consideration could only be in the form of cash, the acceptance period was one month.

(12) See "Regulación financiera: segundo trimestre de 1993", in *Boletín económico,* Banco de España, July-August 1993, pp. 105-106.

(13) See "Regulación financiera: cuarto trimestre de 1995", in *Boletín económico,* Banco de España, January 1996, pp. 85-86.

(14) See "Regulación financiera: primer trimestre de 1996", in *Boletín económico,* Banco de España, April 1996, pp. 130-131.

(15) This Circular is not applicable to operations in the government-debt market.

The *stock market regulatory companies* shall publish, in daily turnover bulletins or through other appropriate media, certain information that is set out in the Circular, according to the type of transaction to be performed. The Circular thus regulates the information which must be published on ordinary transactions, both on orders made (or quotations) and on transactions executed; on equity transactions carried out through floor trading; on transactions carried out on the electronic fixed-income market; on special stock market transactions and on extraordinary transactions.

The *regulatory companies of official futures and options markets* shall publish, in real time and for each contract and open maturity and series, where applicable, the cumulative volume for each of the three best bid and offer proposals. As regards transactions executed, the price, volume and time of execution of all transactions carried out during the session shall be indicated and, as regards open positions, the volume thereof.

Finally, with regard to transactions executed on the AIAF fixed-income market, the volume contracted in each issue traded, the latest price and IRR shall be reported in real time, except for short-term assets (promissory notes) for which only the latest volume contracted and IRR shall be published.

9. STOCK MARKETS: CHANGES TO THE REQUIREMENTS FOR ADMISSION TO LISTING

Decree 1506/1967 of 30 June 1967, which approved the Stock Market Regulation currently in force, established that the Ministry of Economy and Finance may change the minimum requirements for the admission of securities to listing on a stock market provided there are circumstances warranting such changes.

Given the increasing tendency of investors to channel their funds into the equity market in recent years, and in order to stimulate the financing of Spanish firms through the securities market, the economic authorities, by means of a Ministerial Order of 19 June 1997 (16), have lifted the requirement for firms wishing to obtain a stock-market listing to have obtained, either in the last two years or in three of the last five years, sufficient profits to have enabled a dividend of at least 6 % of capital to have been paid. The Order requires instead that one of the following circumstances be met: the issuing entity can justify profits in future years on the basis of its business and financial prospects, irrespective of the period elapsed since its incorporation; the issuing entity has been formed as a consequence of merger, spin-off or contribution of a business; or the issuer is in the process of economic realignment or restructuring or privatisation by a public entity.

Recently, with the object of opening up for certain Spanish firms a new channel for obtaining funds in the securities markets, the *Ministerial Order of 22 December 1999* (BOE of 30 December 1999) has made the provisions of the Ministerial Order of 19 June 1997 even more flexible. The justification of future profits has been replaced by a report that the issuing entity must submit to the CNMV on its business and financial prospects, and on its future results.

The two other main requirements for a firm to be admitted to listing remain unchanged, namely a capital of at least ESP 200 million and a minimum level of diffusion of its capital (at least 100 shareholders each holding less than 25 % of the share capital).

10. STOCK MARKETS: CREATION OF A SPECIAL TRADING SEGMENT

A certain type of firm has become particularly prominent on the current economic scene. Such firms belong to sectors at the cutting edge of technology. They are exposed to higher risks, but also have great growth potential. The levels of information and investor protection in these markets need to be increased and adapted to their particular characteristics, as the current legal framework governing the Spanish Securities markets is clearly insufficient.

As a result the *Ministerial Order of 22 December 1999* (BOE 30 December 1999) has been published. This creates a special trading segment called the *"New Market",* in which the securities of firms belonging to innovative high-technology sectors and other sectors offering great potential for future growth will be traded.

The CNMV shall be responsible for establishing the general criteria to determine which firms' securities should be traded on the New Market. It will also establish the listing requirements that these firms will have to fulfil. The stock market will establish the rules for trading and operation of the New Market and will appropriately publish the general and specific information required from the issuing entities belonging to this market segment.

(16) See "Regulación financiera: segundo trimestre de 1997", in *Boletín económico,* Banco de España, July-August 1997, p. 113.

The issuing entities shall report, at least once a year, on the progress and developments in their business, as well as the prospects for the same. Finally, they must mention, in the various information prospectuses and in the periodic public information and in the annual accounts that their securities will be traded on the New Market.

11. GENERAL CODE AND RULES OF CONDUCT IN PORTFOLIO INVESTMENT MANAGEMENT

The preamble to Law 24/1988 of 28 July 1988 on the securities market addressed the need for Spanish legislation to ensure minimum rules of conduct for all persons operating on securities market. The priority aim of these rules was to safeguard investor interests and ensure market transparency at all times. These principles were implemented by means of Royal Decree 629/1993 of 3 May 1993 on rules of conduct in securities markets and compulsory registrations, the objective of which was to contribute to market transparency and to investor safeguards, establishing a general code of conduct to govern relations between institutions operating in the markets and their customers.

However, the considerable growth of portfolio management in Spain in recent years has scarcely been accompanied by the implementation of specific rules for this activity.

In order to adapt the general code of conduct and the associated rules of Royal Decree 629/1993 to the particularities of portfolio investment management, the Ministerial Order dated 7 October 1999 (BOE of 16 October 1999) was promulgated to institute a body of rules of conduct specifically geared to governing relations between portfolio managers and their customers.

Its scope covers investment services companies (17) and Spanish and foreign credit institutions alike (hereafter, institutions) which engage in national territory in activities relating to the discretionary and personalised management of investment portfolios in conformity with the mandate conferred upon them by investors resident in Spain.

In the portfolio management business, institutions must observe certain principles and obligations that are specified in the Order, including most notably: to offer professional advice to their customers; to engage in their business in accordance with the criteria agreed upon in writing with the customer (general investment criteria) under the related contract; to refrain from transacting unnecessary operations aimed at augmenting commissions and without any benefit to the customer; and, in the event of a conflict of interest, to give priority to customers' interests over their own. In this respect, institutions shall inform customers of conflicts of interest that arise in the performance of their business, duly identifying, in the information they regularly send to their customers, the operations, investments or actions where such conflicts arise. They should also inform them expressly of any relationship or self-serving link between the manager or its group and any of the companies in which the customer has an interest in respect of representation for the exercise of the voting rights derived from the shares belonging to said customer.

Relations between customers and their portfolio manager shall be formalised by means of a standard portfolio management contract, as stipulated in the Ministerial Order dated 25 October 1998 (18). These contracts, the standardised model for which shall be approved by the CNMV (National Securities Market Commission), shall be drafted in a clear and readily understandable way. Their content will cover aspects specified in the Order, including most notably the following: a detailed description of the general investment criteria agreed upon by the customer and the institution; a specific, detailed list of the different types of operations that may be conducted, in which, at a minimum, those involving equity and fixed-income securities, other spot financial instruments, derivatives and structured and financed products will all be categorised; an undertaking by the manager to manage the portfolio provided by the customer in a discretionary, personalised manner; and express mention of the Investment Guarantee Fund or of the alternative guarantee arrangements of which the management institution should avail itself if it is a non-resident entity.

(17) Law 37/1998 of 16 November 1998 amending Securities Market Law 24/1988 of 28 July 1988, which transposed Directive 93/22/EEC of 10 May 1993 on investment services in the securities field into Spanish law, introduced the term "investment services companies", similar to that used by Directive 93/22/EEC, to include securities-dealer companies and securities agencies, and portfolio management companies.

(18) This Ministerial Order partially implemented Royal Decree 629/1993 of 3 May 1993 on rules of conduct for the securities market and compulsory registrations, establishing the system of rates which the institutions apply to their customers, the rules they must respect on making available to their customers securities and funds corresponding to the transactions performed, as well as on the delivery of the relevant contractual documents.

Moreover, and irrespective of the causes that may legally or conventionally give rise to the termination of the portfolio management contract, customers shall retain the power at all times to terminate it unilaterally, without prejudice to the institution's entitlement to receive the commissions unpaid on operations performed as of the time of the contract's termination and other contractually agreed expenses. Once the contract has been terminated, portfolio managers shall have fifteen days at most to report the management accounts.

Lastly, once the contract has been terminated, the portfolio managers shall make the assets available to their customers in the form contractually envisaged, after having deducted the amounts due.

12. VENTURE CAPITAL COMPANIES: ADMINISTRATIVE PROCEDURES AND STANDARDISED FORMS

Law 1/1999 of 5 January 1999 (19) established a full, stable legal framework for venture capital companies *(entidades de capital riesgo,* hereafter, ECRs) and their management companies *(sociedades gestoras de las ECR,* hereafter, SGECRs). This provided a foundation for these companies to continue promoting or fostering small and medium-sized non-financial companies so that they should continue engaging in activities relating to technological innovation or other areas through the acquisition of temporary holdings in their capital.

The aforementioned Law empowered the Ministry of Economy and Finance (MEH) to determine, for each type of ECR and having regard to their specialities, the requirements and standardised application forms for authorisation along with the standardised documents that should accompany said application. With this prerogative the MEH issued the Ministerial Order dated 17 June 1999 (20), thereby partially implementing Law 1/1999, it expressly commissioned the CNMV to determine both the requirements and standardised forms, and it stipulated that such documentation should be submitted directly to the CNMV.

By virtue of this authorisation, CNMV Circular 4/1999 of 22 September 1999 (BOE of 16 October 1999) was issued. This Circular regulates the procedures and documentary forms applicable for obtaining authorisation to set up the new ECRs and SGECRs and to amend the management regulations and articles of association of pre-existing companies.

The processing of ECR and SGECR incorporation plans shall be initiated by means of the presentation before the CNMV of an authorisation application, using the forms set out in the annexes to this Circular.

The ECR application shall specify: the data identifying the applicant; an explanatory report of the ECR plan, so as to allow a proper assessment of the purpose and goals of the new entity; a draft prospectus containing the legal and financial elements that will allow investors to form a balanced opinion of the investment proposed; a draft of the management regulation or the articles of association; the career record of the members of the ECR's Board of Directors and of its senior managers, and a questionnaire on standards of integrity to be completed by the aforementioned members. All these data shall be provided and set out in accordance with the forms stipulated by the CNMV and included in the annexes to this Circular.

The application for authorisation for SGECRs is similar to that for ECRs. Presentation before the CNMV of the same documents is required, with the exception of the draft prospectus.

13. AMENDMENT OF PENSION SCHEME AND FUND REGULATIONS

Law 30/1995 of 8 November 1995 (21) on the regulation and supervision of private insurance, and Law 66/1997 of 30 December 1997 (22) on fiscal, administrative and social measures, introduced a series of amendments to Law 8/1987 of 8 June 1987 (23) on the regulation of pension schemes and funds. The amendments related to the legal regime for pension schemes and the financial and actuarial arrangements to which their workings should adapt. Likewise, these regulations provided for the regulatory implementation of certain matters, particularly in relation to capitalisation arrangements, to the calculation of capitalisation

(19) See "Financial regulation: fourth quarter of 1998", in *Economic bulletin,* Banco de España, January 1999, pp. 100-101.

(20) See "Financial regulation: second quarter of 1999", in *Economic bulletin,* Banco de España, July 1999, pp. 69-70.

(21) See "Regulación financiera: cuarto trimestre de 1995", in *Boletín económico,* Banco de España, January 1996, pp. 86-91.

(22) See "Financial regulation: fourth quarter of 1997", in *Economic bulletin,* Banco de España, January 1998, pp. 90-91.

(23) See "Regulación financiera: segundo trimestre de 1987", in *Boletín económico,* Banco de España, July 1987, pp. 49-51.

funds and technical provisions, and to other limits and aspects of pension schemes.

To address this regulatory implementation, Royal Decree 1589/1999 of 15 October 1999 (BOE of 26 October 1999) has been issued. It updates certain provisions of the regulations governing pension schemes and plans that were approved by Royal Decree 1307/1988 of 30 September 1988.

With regard to funded systems, only the use of financial and actuarial systems of individual funding will be acceptable, excluding the group schemes envisaged in the regulations to date. Hence, the annual cost of each of the contingencies in which the benefit is defined shall be calculated individually for each participant, not permitting the annual amount of the contribution attributable to each participant for these items to differ from the attributed tax borne by said participant.

With regard to the limitation on annual contributions, the ceiling is raised from ESP 1,000,000 to ESP 1,100,000, and may be raised to ESP 2,200,000 for participants aged 52 and over. Likewise, the MEF may update these additional limits as and when the maximum contribution ceiling is altered (i.e. the collection or liquidity of the assets).

Regarding the arrangements for benefits, new situations that may be assimilated to retirement have been determined and the means of collection and recognition of benefit entitlements have been updated. Regarding situations assimilated to retirement, both the termination and suspension of the working relationship of a participant aged at least 52 and entailing a move to unemployment status shall be considered as such provided said participant is registered as unemployed with INEM (National Employment Office) or is in this situation as from that age. In employment schemes, the establishment of such benefits and their recognition may be envisaged for limited periods of time or circumstantially, by virtue of the assumptions stipulated in the Workers' Statute or on the basis of what should have been specified in a group programme of contractual termination or suspension and accepted under collective bargaining.

Further, retirees may only make contributions to pension schemes for the contingency of dying. Nonetheless, retirees that resume work, re-registering with the Social Security system, may contribute to pension schemes with a view to their subsequent retirement.

As to the means of collection and recognition of benefit entitlements, benefits may, as under the previous arrangements, be in the form of capital, income or mixed (combining capital and income).

Mention should be made of the addition of a new section in Royal Decree 1307/1988 to regulate *jointly promoted pension schemes under the employment system (hereafter, joint schemes).* These schemes have to be applied by several companies, whether in a single group or one of companies with fewer than 250 employees.

Regarding joint schemes of a single group, these may be made up of corporations that belong to the group and meet the following conditions:

a) What are involved are companies incorporated in conformity with Spanish legislation and headquartered in national territory.

b) They shall have pension commitments to their employees for retirement contingencies that are susceptible to integration into a pension scheme.

Nonetheless, credit institutions, insurance companies, and securities-dealer companies and securities agencies that should have opted to maintain their commitments in in-house funds will not have to participate in the scheme. And nor will group companies which, as of the date of the group pension scheme being legalised, are promoters of other, previously legalised pension schemes. Once the group pension scheme is legalised, new companies or institutions that subsequently become part of the group may join it.

As regards joint schemes promoted by companies with fewer than 250 employees, the legalisation of these schemes will require that at least two companies be initially involved, with any others with fewer than 250 employees being allowed to participate subsequently, should the specifications limiting the number and characteristics of potential promoters so permit it.

Other noteworthy aspects are the rules common to jointly promoted pension schemes, the composition and working of the control board, the separation of the promoting institutions and the causes of cessation of the schemes.

Lastly, the additional provision of the regulation updates the financial and actuarial hypotheses of relevance for pension schemes, and the transitional provision presents the elements and terms necessary to proceed to the adaptation of pre-existing pension schemes to what is laid down in this Royal Decree.

14. APPLICATION OF COMPANIES' PENSION COMMITMENTS TO EMPLOYEES AND BENEFICIARIES

Law 30/1995 of 8 November 1995 on the regulation and supervision of private insurance crafted the regime governing the application of companies' pension commitments to employees, retirees and beneficiaries (the so-called *externalisation regime),* including the benefits occasioned. At the same time, it amended Law 8/1987 of 8 June 1987 on the regulation of pension schemes and funds along these lines. This regime is of a permanent nature, as it stipulates that the firm's commitments to employees, retirees and beneficiaries should be applied through pension schemes or insurance contracts, and that the coverage of such commitments through in-house funds or similar instruments involving the firm retaining title to the funds set aside shall not be admissible.

Recently, this regime has been implemented by means of RD 1588/1999 of 15 October 1999 (BOE of 27 October 1999). As a result, the Regulation on the application of firms' pension commitments to employees and beneficiaries (also known as the externalisation regime) has been approved.

This regime allows two ends to be met. First, it safeguards firms' pension commitments to employees and beneficiaries in the event of insolvency or financial difficulties for firms. And second, the externalisation of pension commitments off firms' balance sheets allows firms to free resources and focus on their particular business, which will ultimately make for greater national and international competitiveness. Likewise, this process involves transferring the management of pension resources to institutions specialising in financial management and investment, whether pension fund management companies or insurance companies.

Nonetheless, the regime retains an exception – albeit a transitory one – for entities in the financial sector, namely credit institutions, insurance companies and securities-dealer companies and securities agencies (hereafter, financial institutions), since they are engaged in sectors regulated and overseen by a control body, which results in the solvency pursued by the regulation being safeguarded. Furthermore, the habitual business of these institutions does indeed focus on the administration and management of funds and, where appropriate, on the assessment and coverage of risks.

The regulation has four sections.

The first section specifies the scope of the application of firms' pension commitments and the obligation to apply and, where appropriate, adapt firms' pension commitments whether by means of pension schemes, group insurance contracts or both.

The second section sets out the transitional regime for the adaptation of pension commitments by means of pension schemes. Among others, this regime must include the following elements:

a) A rebalancing plan covering the rights in respect of past service corresponding to pension commitments to existing staff and, where applicable, obligations to retirees and beneficiaries.

b) The transfer of existing funds, which shall be carried out within 10 years from the execution or modification of the specifications of the pension scheme, as the case may be, to incorporate the commitments included in the rebalancing plan.

c) Payment of the deficit, within 15 years from execution of the pension scheme or, as the case may be, from amendment of the scheme to incorporate the rebalancing plan.

d) The legal rules, the valuation and quantification of the rights in respect of past service and the obligations to retirees and beneficiaries.

The third section refers to the application of pension commitments by means of insurance contracts, either in the form of a group insurance policy or through the relevant benefit regulations.

Finally, the fourth section implements an exceptional regime for financial institutions. It should be stressed that the regulation maintains a regime of exception for financial institutions that have their pension commitments assumed prior to 10 May 1996 in an internal fund. The following conditions must be met:

a) The pension commitments must arise under a collective agreement or equivalent instrument prior to that date.

b) The financial institution shall have assumed the commitment by that date or, if subsequently, by subrogation as a result of corporate operations.

c) The commitments, as at the entry into force of this regulation, shall be applied by the financial institution through the relevant provisions or book entries, with the responsibility

for management of the funds to cover them corresponding to either the financial institution itself or to other financial institutions under insurance transactions or the like.

Also, this transitional regime may be extended to employees from other financial institutions, when the latter assumed pension commitments to the former which they are authorised to cover by means of internal funds. In these cases, if the institution is subrogated to or assumes such commitments, it may in turn cover them with an internal fund, provided that the latter has been authorised to cover its commitments with an internal fund.

Likewise, institutions seeking to come under this transitional regime shall make an application to the Ministry of Economy and Finance before 1 January 2001, submitting the documentation specified in the Royal Decree and fulfilling the conditions laid down here and in the said Regulation.

Finally, they must adjust the fresh pension commitments assumed since 9 May 1996, the pension commitments to staff joining the company after the entry into force of this regulation and the insurance contracts which apply pension commitments to the first additional provision of Law 8/1987 of 8 June 1987 on the regulation of pension schemes and funds.

15. TAXATION OF FINANCIAL ASSETS

The publication of two tax provisions aiming to promote the development and greater liberalisation of markets for financial assets, in line with the other industrialised countries, should be noted:

First, *Royal Decree 2060/1999 of 30 December 1999* (BOE of 31 December 1999) has been published, amending certain provisions of the corporate income tax regulations approved by Royal Decree 537/1997 of 14 April 1997 (24). The following three points should be noted: (i) income from debt issued by the governments of OECD countries and financial assets traded on organised markets in such countries, as well as income obtained from funds of funds and master-feeder funds and the amounts paid by insurance companies to pension funds as a consequence of the insurance of pension schemes are exempted from withholdings; (ii) the obligation on the depositories of open-end investment companies to make withholdings is abolished, and as a result, in the case of the transfer or redemption of their shares, the shareholder shall be obliged to make a payment on account; (iii) the withholding rate generally applicable under the corporate income tax has been lowered from 25 % to 18 %, in line with personal income tax provisions.

Second, the *Ministerial Order of 22 December 1999* (BOE of 29 December 1999) has been published, establishing a new simpler procedure for the refunding of withholdings. In particular, this Order systematises and unifies the withholding procedure applied to the interest on financial assets in the form of book entries that are traded on an official secondary market and held by taxpayers exempt from corporate income tax or the tax on the income of non-residents where income is obtained in Spanish territory through a permanent establishment. This new procedure shall not apply to income from government securities, except for those issued by a local government.

16. STATE BUDGET FOR THE YEAR 2000

As usual in December, the State Budget for the year 2000 has been approved by *Law 54/1999 of 29 December 1999* (BOE of 30 December 1999).

This Budget contains no significant changes from the previous year's, continuing the line of austerity, control of the deficit and budgetary discipline initiated in previous years.

Owing to their importance or novelty, the following aspects should be highlighted:

With respect to financial regulation, the legal interest rate and the delay interest rate for tax purposes are held at 4.25 % and 5.5 %, respectively. Also, the ceiling for the increase in the outstanding stock of State debt during the year is set at ESP 1.71 trillion. This ceiling, which may be revised if certain circumstances envisaged in the Law arise, shall apply to the increase as at the end of the year, and may be exceeded, upon authorisation from the Ministry of the Economy and Finance, in a limited number of cases.

In the fiscal sphere, with regard to personal income tax, the relevant general and regional tax brackets are adjusted and the coefficients to correct acquisition values are updated to 2 % (percentage inflation rate forecast for the coming year). Also, mechanisms are established to compensate those taxpayers for whom the new regulation is less advantageous than the deductions previously enjoyed for investment and rental of their habitual residence.

(24) See "Regulación financiera: segundo trimestre de 1997", in *Boletín económico,* Banco de España, July-August 1997, pp. 115 and 116.

In relation to corporate income tax, the coefficients to allow for inflation since 1983 are updated, and the amount of the payments on account that entities subject to this tax are required to make is determined. There are no other amendments to the legislation in force in 1999, other than the introduction of an obligation on look-through companies to make advance payments of the tax and, as in the case of personal income tax, the possibility of deducting from the tax base expenditure on the patronage of priority activities and programmes. As regards the wealth tax, the exempt amount (ESP 18 million) and the rate schedule applicable in the event that the Regional (Autonomous) Governments do not approve specific amounts or have not assumed responsibilities in this area are updated.

As regards public spending, the suspension of the possibility of making appropriations, except in certain specific cases, and the prohibition on transferring appropriations from capital to current operations are both maintained, with the same qualifications as last year.

In relation to the Regional (Autonomous) Governments, their percentage shares in State revenue for the five-year period 1997-2001, applicable on 1 January 2000, are fixed, distinguishing between the final percentage shares in the State's territorial revenue under personal income tax and those of the Regional (Autonomous) Governments in general State revenue. Also, as regards the year-2000 financing through shares in State revenue, those Regional (Autonomous) Government's to which the financing arrangements for the five-year period are applicable are distinguished from those that have not adopted the agreement on the financing arrangements.

17. FISCAL, ADMINISTRATIVE AND SOCIAL MEASURES

As usual in recent years, to facilitate the achievement of the economic policy objectives set out in the State Budget for the year 2000, a number of fiscal, administrative and social measures have been adopted. These are contained in *Law 55/1999 of 29 December 1999* (BOE of 30 December 1999).

The Law introduces certain amendments in the area of taxation and to the provisions regulating general government employees, and responds to specific needs in relation to management, organisation and activities of government.

In the fiscal sphere, certain parts of the current personal income tax provisions contained in Law 40/1998 of 9 December 1999 are amended (25). First, compensation paid by general government for personal injury (physical or psychological) suffered as a consequence of the operation of public services is now included under exempt income. Second, the cases in which deductions may be made for investment in habitual residences have been extended to include cases in which taxpayers carry out work and installations to refurbish the same, including the common parts of the building and areas through which passage is necessary to obtain access to the building (previously only the disabled were entitled to these deductions). As regards the calculation of net earned income received at irregular intervals, the Law establishes that the amount of the income to which the 30 % reduction shall be applied may not exceed the amount obtained by multiplying the annual average wage of all personal income tax payers by the number of years over which the income is generated. For this purpose, where the income is clearly obtained irregularly, a period of five years shall be taken.

In general, the net earned income obtained in the year 2000 under the personal income tax self-assessment arrangements may be reduced by 7 %, and by as much as 12 % if the level of staff has been increased during the year 2000.

Certain incentives have been introduced into the corporate income tax, such as the new rules for the deduction for scientific research and technological innovation activities.

With regard to VAT, as from 1 January 2000, the special arrangements for the retail trade whereby tax bases are determined proportionately and their impact on other special VAT arrangements are abolished and the special arrangements for investment in gold are established.

Finally, among the additional provisions, the amendments to Securities Market Law 24/1988 of 28 July 1988 (26) and to Royal Legislative Decree 1564/1989 of 22 March 1989 approving the consolidated text of the Public Limited Companies Law are notable. These amendments regulate *"stock options"* for the first time.

As regards Law 24/1988, the directors of listed companies shall notify the company concerned, the stock markets on which their shares are traded and the CNMV of any acquisition or disposal of stock options over their company's

(25) See "Financial regulation: fourth quarter of 1998", in *Economic bulletin,* Banco de España, January 1999, pp. 105-107.

(26) See "Regulación financiera: tercer trimestre de 1988", in *Boletín económico,* Banco de España, October 1988, pp. 61 and 62.

shares, by whatever means. Also, in addition to the existing requirements, the listing of a company's shares and the appointment of new directors shall require the directors to give details of any stock options they may hold over their company's shares. Finally, the managers of listed companies shall notify the CNMV of any stock options received by way of remuneration. Such notification shall be subject to the rules on the publication of relevant facts (27).

As regards the Public Limited Companies Law, remuneration consisting of shares or stock options or tied to the share price must be expressly envisaged in the articles of association, and shall require a resolution of the shareholders in general meeting. Also, the exercise and disposal by the directors of a listed company of stock options granted before 1 January 2000 (where this is not envisaged in the articles of association) shall also require approval by the shareholders in general meeting. In the case of general managers and the like, approval by the shareholders in general meeting shall be necessary in all cases for the exercise or disposal of stock options granted prior to 1 January 2000.

20.1.2000.

(27) Contained in article 82 of Securities Market Law 24/1988 of 28 July 1988. Issuers of securities are required to inform the public, as soon as possible, of any fact or decision that may significantly affect their prices, although the CNMV may grant exemptions from this obligation should it deem this necessary.