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Regulation development and MiFID impact on collective investment in Spain

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Abstract

Purpose – The objective of this paper is to review Spanish regulatory evolution in the collective investment area, which is very recent in its principal aspects.

Design/methodology/approach – The paper assesses the way investment funds are impacted by the Markets in Financial Instruments Directive (MiFID) and the Spanish legislation.

Findings – The legal aspect of the Collective investment institutions (CII) in Spain has experienced a major renovation over the past four years. There were three basic principles: increased flexibility of the CIIs' regime, reinforced protection for investors, and improved administrative intervention regime. Although MiFID focuses its attention on financial markets and investment firms, it also implies an important change for collective investment institutions. New conditions arising after the introduction of this norm are imposing major challenges for financial entities, supervisory authorities and financial markets.

Research limitations/implications – The unified regulatory system, even after the implementation of MiFID, remains fragmented, and the way in which it will apply to investment funds is not easy to disentangle.

Practical implications – As a result of this process, it is hoped that levels of competitiveness will increase and transaction costs fall, which will ultimately result in improved conditions for investors and more efficient companies.

Originality/value – The paper establishes the implications of the MiFID and the UCITS Directives for the investment fund industry in Spain.

Keywords Investment funds, Regulation, Spain

Paper type Research paper

1. Introduction

As in all other developed countries, collective investment in Spain is a very important industry with high-growth expectations. It has two roles within the financial system: on the one hand it is a way of financial disintermediation and on the other it is a savings instrument that enables small investors to access capital markets under achievable conditions, through diversified investments with professional management.

The objective of this paper is to review Spanish regulatory evolution in this area, which is very recent in its principal aspects. Major developments are also still to be resolved, especially concerning hedge funds and other non-UCITS assets. These instruments have great developmental potential if compared with the preceding evolution in other EU countries.

Furthermore, it would be impossible to tackle this subject without taking into account the fact that Markets in Financial Instruments Directive (MiFID), which plays an important role in regulating European financial markets, came into effect on 1 November.

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The original objective of this Directive was to increase levels of competition and make a higher level of integration possible, with supervisory authorities also making the necessary effort to protect the small investor. Spain, although experiencing some delay due to the fact that it is still in a phase of completing procedures before Parliament, has transposed the Directive by modifying the Stock Market Reform Act, with this subject playing a very prominent role in all scopes of Spanish financial industry.

2. Evolution of collective investment regulation in Spain

Collective investment institutions (CII) in Spain currently hold assets worth €251,953 million with over 8.7 million investors. These figures are the result of major growth over recent years: more than 37 per cent in assets and over 13 per cent in the number of investors since the year 2000. At this time, Spain is ranked seventh in Europe in terms of managed assets, with assets managed by CII representing more than 25 per cent of Gross Domestic Product. In addition, more than 350 foreign CIIs are traded in Spain, representing over €45,000 million.

The legal aspect of the CII in Spain has experienced a major renovation over the past four years, due to Ley 35/2003 (2003), from 4 November, on CII. This law was a landmark in this sector as it abolished an act that had been in force almost 20 years, Ley 46/1984 (1984). After many controversies, the collective investment industry was modernised, giving it the necessary flexibility to adapt to the changes demanded by the market.

Within the framework of a financial system like the one that existed in Spain at that time, Ley 46/1984 (1984) established a legal system aimed at facilitating complete development of collective investment in Spain, initiating its definitive reform and modernisation process. It must not be forgotten that over those 20 years profound changes took place within our macroeconomic environment, from our entering the EEC to the introduction of the euro.

Furthermore, Ley 35/2003 (2003) was a necessary step for transposing the Directives that completed the introduction of collective investment in the single financial services market: Directive 85/611/EEC (1985, UCITS), Directive 2001/107/EC (2002), amending the previous law regarding management companies and simplified brochures, and Directive 2001/108/EC (2002), amending Directive UCITS with regards to new categories of assets and procedures for cross-border trade.

There were three basic principles of the Law:

(1) *Increased flexibility of the CIIs' regime.* In order to adapt collective investment structures to meet the aspirations of an increasingly demanding and diverse group of investors.

(2) *Reinforced protection for investors.* In other words, strengthening transparency obligations and norms of conduct to prevent conflicts of interest is more effective for investor protection than imposing restrictions on the CIIs' behaviour.

(3) *Improved administrative intervention regime.* Striving to streamline the procedure and reduce terms of authorisations, without reducing legal security for investors.

It took a further two years for the new points introduced by the Law to become reality with the passing of the CII Regulations, the result of Real Decreto 1309/2005 (2005), of 4 November. Through this Regulations, and in compliance the three principles

established, a series of measures were adopted in order to avoid restrictions or unnecessary obstacles that affect the investment and performance possibilities of Spanish CII.

Therefore, in accordance with the first of these three principles (increased flexibility of the CIIs' regime), the new regulations enable investors to select from a wider range of products, authorising new CIIs. New figures in the market include exchange traded funds (ETF) (article 49), hedge funds (article 43) and funds of hedge funds (article 44), real estate investment trust (REITs) were also developed (article 56).

It must also be highlighted that assets that are suitable for investment with regard to previous possibilities (article 36), basically shares and obligations, were also extended.

As far as the second principle (reinforced protection for investors) is concerned, the obligations of due diligence of the management companies and the obligation of monitoring the performance of these companies by the depositary are finalised. Furthermore, the management companies, depositaries, distributors and investment companies are subjected to comply with a series of norms with the objective of preventing conflicts of interest.

Finally, with regards to the third principle (improved administrative intervention regime), it must be highlighted that CIIs could be made up of compartments. In other words, the minimum assets and number of investors required for each type of CII are maintained but then compartments with less assets or a fewer number of investors can be established under a single constituent contract and management regulations (article 15).

Today, the new legislative framework has been in force for just two years, introducing profound changes. Therefore, 2006 and 2007 have been fundamental years in the progress of some of these changes and as a consequence in the progress of legislative development.

Therefore, during 2006, one of the most significant new aspects of the CII Regulations was the regulation of hedge funds and funds of hedge funds for the first time ever in Spain. In this sense, it is Order EHA 1199/2006 of 25 April that tackles this important question. This Order deals with different aspects: the investment regime and indebtedness policy, general criteria regarding calculation of the net asset value and other aspects of the management companies and depositaries in this matter.

Also, the aforementioned Order empowers the Spanish market's supervisory body, the "Comisión Nacional del Mercado de Valores" (CNMV), to determine necessary provisions, especially of a technical nature, that make it possible to make this Order more efficient. These matters are established in "Circular" 1/2006 of the CNMV.

The most significant aspect of the year 2007 is the Royal Decree 362/2007, of 16 March, which amends the CII Regulations of 2005 in which, in accordance with the requests of the investment funds industry, different amendments are established. On the one hand, the redemption regime of hedge funds and funds of hedge funds is made more flexible. On the other hand, article 45 of the aforementioned regulation, regarding the master-feeder, is amended, including hedge funds and funds of hedge funds as suitable assets.

The first hedge fund was registered in Spain on 8 November 2006 and at present 18 hedge funds and 30 funds of hedge funds are in operation with 1,950 investors. Deposits in these funds up until September 2007 have totalled €501 million, an amount that represents just 0.2 per cent of the assets managed by investment funds in Spain.

While these products have been available internationally for 50 years, they have taken off slowly in Spain, which might come down to two factors: first to the delay in regulation; and second to the supervisory authority's desire to protect small investors. Therefore, in the case of hedge funds, access is only possible with a minimum investment of €50,000. Funds of hedge funds are those funds designed for small investors without minimum issuance limits as they do not directly invest in securities but rather in other hedge funds.

Therefore, there are several important challenges that are still to be tackled in terms of regulations. The most important and the most highly demanded by the market refers to regulating the use of derivatives. In fact, foreign hedge funds currently cannot be traded because the regulations previous to the CII Regulations are still in force (order of 10 June 1997 and "Circular" 3/1997). Therefore, it is necessary to adapt Spanish regulations to the real operation of international hedge fund markets.

Other questions still to be resolved are currently in progress or are at least being studied. In this sense, the CNMV is making a great effort and has recently published, for the first time ever, its Plan of Action for 2007-2008. Besides, the regulations on derivatives mentioned above, this Plan highlights the following proposals on collective investment:

- Proposal for regulatory adaptation of REITS. In this sense, the fiscal modification that these products have in Spain becomes necessary if their development is to be promoted. This is a product with a high-growth potential, as reflected by its evolution in neighbouring countries and the moment of real estate shock that international financial markets are experiencing.
- Proposal for regulatory adaptation of Risk Capital, which allows private equity funds to be developed. Law 25/2005 granted the creation of management companies and efficient investment vehicles to access this type of product.
- Proposal for regulatory adaptation of ETF. This product was first traded on the Spanish market in 2006 in an attempt by the "Bolsas y Mercados Españoles" to adapt to the new financial niches of demand. In this sense, and unlike conventional funds, money cannot be transferred from a traditional fund to a ETF without creating capital gain. Therefore, Spain has what is known as a "fiscal toll".

With regards to Spain's more immediate regulatory future, the country is awaiting the approval of the Stock Market Law Reform bill, foreseen for the end of November, to transpose the MiFID. We will look at this in more detail in the next section.

3. Impact of MiFID on the investment fund industry

The new community directive regarding markets in financial instruments, known more widely as MiFID (Directive 2004/39/EC (2004), Directive 2006/73/EC (2006) and Regulation 1287/2006 (2006)) replaces Directive 93/22/EC (1993) on investment services. The purpose of the new legal framework established by MiFID is to adapt community regulation in view of the increased complexity of financial markets and the appearance of new financial instruments available to the investor. Likewise, MiFID hopes to increase harmonisation of the regulation on this matter, thereby creating a truly integrated financial market.

MiFID implies a significant change in the understanding of financial markets. This is due to the fact that MiFID, besides establishing the operating conditions of the regulated

markets, allows multilateral trading facilities to appear. Furthermore, the new Directive aims to improve protection for the investor. To do this, it imposes demanding organisational requirements, conduct of business rules and transparency on investment firms. Advisory activities are also separated from all other activities and the principle of best execution for investors is established. MiFID also expands on the principle of freedom of establishment and freedom to provide services of investment firms authorised in a member state. MiFID also clarifies the principles of mutual recognition and of home Member State supervision.

Although MiFID focuses its attention on financial markets and investment firms, it also implies an important change for CII. Firstly, MiFID has a direct impact on the CIIs themselves or on their units. Second, MiFID also affects the marketing of the CII' units.

3.1 Direct impact

CII, and their management companies and depositaries, are excluded from MiFID according to article 2, section h) of Directive 2004/39/EC (2004). However, the management companies of CIIs shall be directly affected by MiFID when certain additional activities are performed that are different to those considered as their own. Such additional activities are covered by article 5 of Directive 85/611/EEC and are as follows[1]:

- discretionary management of portfolios of investments;
- investment advice; and
- safekeeping and administration in relation to units of investment funds and, if applicable, of shares of investment firms.

Management companies that perform such activities shall continue to be subject to Directive 85/611/EEC (1985, UCITS) but should also comply with certain norms established by MiFID. More specifically, they must comply with matters regarding organisation and norms of conduct for the provision of investment services to clients[2]. Nevertheless, they shall not, in principle, be subject to the other norms of MiFID.

In terms of information that must be obtained and provided to investors for their better protection, MiFID takes into account whether the client is a retail client or a professional client[3]. CII and their management companies are included in the professional client category. This implies that investment firms will have less rigorous information obligations with regards to them. This is due to the fact that MiFID supposes that professional clients will be in conditions to identify information that is necessary to adopt their decisions for themselves[4]. On the other hand, MiFID also specifies the information that investment firms must provide to their clients on units in collective investment undertakings. In this sense, article 34 of Directive 2006/73/EC (2006) considers that a simplified prospectus that complies with article 28 of Directive 85/611/EEC must be considered appropriate information.

Finally, article 36 of Regulation 1287/2006 (2006) establishes the requirements so that units of CII are admitted to trading on regulated markets. This paper establishes that such instruments must comply with requirements of registration, notification or other procedures, as necessary for marketing the CII. However, Member States may provide that the aforementioned requirements are not a necessary pre-condition[5].

3.2 Impact on marketing

Along with the direct impact, MiFID also has consequences on the marketing of units of CIIs. Marketing is an internal activity of CII management and therefore shall not be subject

to MiFID when performed by management companies. However, if marketing is performed through investment firms, this activity shall be subject to MiFID. It is necessary to explain that, in the case of collective investment in transferable securities, article 19, section 6 of Directive 2004/39/EEC empowers investment firms to provide certain investment services with fewer information requirements than usual. The services referred to are those consisting of the execution or reception and transmission of client orders, with or without ancillary services, provided that three requirements are met:

(1) the service is provided at the initiative of the client;

(2) the client is informed that the investment firm is not required to assess the suitability of the instrument offered or the service provided; and

(3) article 18 of Directive 2004/39/EEC regarding conflicts of interest is complied with.

So that other types of CIIs can benefit from these lesser information requirements, they should comply with the conditions established in article 38 of Directive 2006/73/EC (2006)[6].

One fundamental aspect of marketing is the compensation of companies in charge of such a task. MiFID allows such compensation provided that they comply with the requirements established in article 26 of Directive 2006/73/EC (2006). In other words, the client must be clearly informed of such commission prior to providing the service and such commission must imply an increased quality of the service provided to the client. One controversial aspect regarding compensation is based on retrocession of commissions received by management companies of CIIs from their marketing company. Generally speaking, such commissions have generated a conflict of interest in detriment of the client. In fact, clients are often even unaware of their existence. Within the new framework of MiFID, retrocession of commissions shall only be allowed if they comply with article 26 of Directive 2006/73/EC (2006), i.e. if they improve the service to the investor and are clearly explained.

The new MiFID is being transposed to Spanish legislation by amending the Stock Market Law (Ley 24/1988, 1988). With this amendment, Directive 2004/39/EC (2004) and specific aspects of Directive 2006/73/EC (2006) and Regulation 1287/2006 (2006) are incorporated into Spanish legal code. These latter two norms shall be transposed in the future through the corresponding regulatory developments of the Stock Market Law (Ley 24/1988, 1988).

As far as direct effects are concerned, Spanish regulations abide by the aspects contemplated by MiFID on this subject. First, it is established that management companies and depositaries of CIIs are not subject to MiFID except for certain activities, as has been stated above[7]. Second, CII are considered professional clients according to article 78bis of the new law and according to article 79bis they shall be subject to lesser information requirements. Finally, units of CII are considered financial instruments within the scope of the Stock Market Law (article 2, section 1).

Regarding the marketing of units of CII, the new Spanish law establishes the same considerations as MiFID[8]. However, inducements are not yet included in the new Spanish legislation and therefore are pending future regulatory developments. Nevertheless, the CNMV has already started to consider retrocession of commissions as being inappropriate. In fact, two fund management companies have been forced to pay certain retrocessions into investment funds they were administering.

4. Conclusions

This paper analyses the development of regulation for the collective investment sector in Spain. Over the last decades, this sector has grown in importance, both in Spain and in neighbouring countries. In fact, it currently represents a fundamental part of our financial system, both from a savings and funding perspective.

In Spain, evolution of collective investment responds to the general trend that our country has followed over recent decades since it joined the EEC. In this sense, successive European Directives regarding both collective investment and financial markets and institutions have been transposed. This implies a clear commitment to integrating European financial markets. As a result of this process, it is hoped that levels of competitiveness shall increase and transaction costs shall fall, which will ultimately result in improved conditions for investors and more efficient companies.

The final challenge for CIIs is MiFID, which came into effect on 1 November. In Spain, MiFID has been transposed through the Stock Market Law Reform. New conditions arising after the introduction of this norm are imposing major challenges for financial entities, supervisory authorities and financial markets. All of these should make every effort to adapt to the changes brought by MiFID, not only during this start-up phase but also throughout future development and compliance.

However, CII shall have to face a new challenge as the European Commission is preparing the amendment to the UCITS Directive for next year, 2008.

Notes

1. With regards to this matter, article 5 of Directive 85/611/EEC was amended by article 66 of 2004/39/EC.
2. Directive 85/611/EEC (amended by MiFID) establishes that management companies performing these additional activities shall be subject to section 2 of article 2 and to articles 12, 13 and 19 of Directive 2004/39/EC (they should also comply with the development of such articles in Directive 2006/73/EC and Regulation 1287/2006).
3. Such information requirements are covered by article 19, section 3 of Directive 2004/39/EC and in its development in Directive 2006/73/EC (articles 27-34).
4. These clients may request non-professional treatment and investment firms may agree to provide a higher level of protection. This higher level of protection will be provided when a client who is considered to be a professional enters into a written agreement with the investment firm to the effect that it shall not be treated as a professional for the purposes of the applicable conduct of business regime. Such agreement should specify the services, transactions or types of products or transactions it applies to.
5. Article 36 of Regulation 1287/2006 establishes certain aspects that regulated markets must consider so that units in a collective investment undertaking can be traded on such markets.
6. These requirements are: (1) it does not fall within article 4(1)(18)(c) of, or points (4) to (10) of section C of Annex I to Directive 2004/39/EC; (2) there are frequent opportunities to dispose of, redeem, or otherwise realise that instrument at prices that are publicly available to market participants and that are either market prices or prices made available, or validated, by valuation systems independent of the issuer; (3) it does not involve any actual or potential liability for the client that exceeds the cost of acquiring the instrument; (4) adequately comprehensive information on its characteristics is publicly available and is likely to be readily understood so as to enable the average retail client to make an informed judgment as to whether to enter into a transaction in that instrument.

7. In fact, article 65 of the new Spanish legislation states that with regard to these activities, management companies of collective investment institutions shall be affected by articles 70ter, 70quater, 78, 78bis, 79, 79bis, 79ter and 79quater.
8. Article 79bis, section 8 includes relevant points from article 18 of Directive 2004/39/EEC and article 38 of Directive 2006/73/EC.

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