# 6 Supervision of entities

## 6.1 Investment firms

2018 was marked by the incorporation into Spanish law of MiFID II,[1] MiFIR[2] and the PRIIPs[3] Regulation, all of which apply as from January 2018.

Similarly, the process of approving a European directive and regulation on the solvency regime applicable to investment firms whose size and activity is not comparable to those of credit institutions is at a very advanced stage.

Table 6.1.1 shows that, as a result of these supervisory actions, the CNMV sent out a total of 865 deficiency letters to supervised entities, 659 of which originated from off-site supervision.

**Supervision of investment firms and credit institutions: deficiency letters sent by the CNMV in 2018** TABLE 6.1.1

| Type of deficiency letter | Off-site | On-site | Total |
|---|---|---|---|
| For late filing of information | 149 | 12 | 161 |
| Requests for information | 319 | 118 | 437 |
| Corrective measures or recommendations | 98 | 22 | 120 |
| Other notifications | 93 | 54 | 147 |
| **Total** | **659** | **206** | **865** |

Source: CNMV.

### Conduct of business rules and organisational requirements

The CNMV has carried out communication work with entities that provide investment services with the aim of resolving the various issues that have emerged with regard to the new legislation. In order to disseminate these issues as widely as possible, the CNMV has updated the various questions and answers on legislation published on its website.

In the field of supervision, the CNMV performed two horizontal reviews in which it conducted an early review of compliance with the new obligations that are considered particularly relevant by a representative sample of entities providing investment services. Specifically, it conducted a review on the level of adaptation of

1 Directive 2014/65/EU, on Markets in Financial Instruments.
2 Regulation (EU) No. 600/2014, on Markets in Financial Instruments.
3 Regulation (EU) No. 1286/2014, on key information documents for packaged retail and insurance-based investment products.

investment firms to the new reporting obligations relating to inducements and costs established in MiFID II (see detail in Exhibit 7) and the obligations established in the PRIIPs Regulation (see detail in Exhibit 6).

In the framework of the horizontal supervision activities, the CNMV also performed an analysis of the distribution of ETFs and CIS registered in the United States. This has resulted in a number of entities being reminded of the legal regime applicable to the distribution of these products in Spain. Specifically, the CNMV indicated that these CIS do not have a passport and that, among other requirements, it is necessary for them to be expressly authorised and registered by the CNMV. They have also been reminded that they cannot make recommendations or sales to a retail investor without first providing them with a key information document in line with the provisions contained in the PRIIPs Regulation.

In addition, in 2018 the CNMV worked in coordination with ESMA in order to adopt two decisions that, respectively, prohibit or restrict the marketing of binary options and Contracts For Differences (CFDs). In particular, exercises were conducted to gather information on the activities with these types of products and work was carried out on possible measures to be adopted by the CNMV upon the expiry of the aforementioned ESMA decisions.

Furthermore, the CNMV continues to perform both on-site inspections and off-site supervision, in which it analyses compliance with aspects of supervisory interest by entities that provide investment services. The actions are determined by taking into account the information that firms periodically report to the CNMV. During 2018, the CNMV has taken into account, for the first time, the whistleblowing received according to the new procedure established in the recast text of the Securities Market Act.

**Obligation of entities to take measures aimed at ensuring the reliability of the information obtained from clients to assess the appropriateness or suitability of their investments**

EXHIBIT 13

The CNMV believes it important, as it has highlighted in recent years in its inspection work, for entities to adopt measures and undertake actions aimed at ensuring that the information that they obtain from retail clients to assess the appropriateness and suitability of their transactions in accordance with the provisions of Articles 212, 213 and 214 of the Securities Market Act is consistent, in line with reality and up-to-date.

An inadequate assessment of the appropriateness or suitability of the transactions as a result of deficiencies or errors in the information obtained may result in selling or recommending products that are inappropriate for clients or failing to make or comply with the legally required warnings or handwritten texts in which the client acknowledges that he/she has been informed that a certain product is not appropriate for him/her. This, logically, may improperly make it easier for the entity to place its own securities and financial instruments, as well as those of third parties.

Article 54.7 of Commission Delegated Regulation (EU) 2017/565, of 25 April, which refers to the appropriateness and suitability evaluation, establishes that investment firms must take reasonable steps to ensure that the information collected about their clients or potential clients is reliable. It indicates that these include, but are not limited to, "taking steps, as appropriate, to ensure the consistency of client information, such as by considering whether there are obvious inaccuracies in the information provided" and "ensuring clients are aware of the importance of providing accurate and up-to-date information". Article 55 of the same Regulation establishes that firms shall be entitled to rely on the information provided by their clients for the purposes of assessing appropriateness and suitability except in the case that they are "aware or ought to be aware that the information is manifestly out-of-date, inaccurate or incomplete".

Although appropriateness and suitability assessments must be performed on a case-by-case basis, firms must also adopt measures and take reasonable steps to ensure that the information collected on clients is reliable in general terms.

In this regard, it is recommendable to analyse whether there are situations that *a priori* are atypical, which could be expected not to arise, or only to arise on a purely occasional or isolated basis. For this purpose, the following aspects or indications may be considered:

– Whether the overall data on the level of academic education of the retail clients, bearing in mind their sociological characteristics, are reasonable.

– Whether overall data for clients with a high degree of financial literacy are reasonable, in particular for groups of clients who do not have previous professional or investment experience or a commensurate level of academic training.

– Whether the overall data on retail clients with prior investment experience in complex instruments that are infrequently distributed to the retail public are reasonable, in particular where the experience of the clients does not correspond to their transactions carried out in the entity.

For the adequate detection and correction of situations such as those mentioned above, entities must have adequate procedures in place:

– Procedures applied during acquisition of the product. It is appropriate to establish mechanisms that allow the staff collecting information to detect situations that are atypical *a priori*. The inclusion of automatic alerts in the computer software used during the process of obtaining information may be very useful for these purposes.[1]

– Procedures for reviewing information aimed at periodically analysing whether the information is generally correct and consistent or whether, on the contrary, there are groups of clients in which it may not adequately reflect their general level of academic training, financial literacy or experience, regardless of whether these data are derived from the formalised appropriateness and suitability questionnaires.

– Procedures for the correction of incidents. In the event of inconsistencies, discrepancies or a high volume of atypical situations (situations that may arise for different reasons, one of which may be that the information has not been gathered correctly from the client), appropriate work should be carried out to check and validate the data, using alternative means to merely verifying that the information corresponds to that recorded in the formalised questionnaires.

1 In this regard, see also the Guidelines on certain aspects of the MiFID II suitability requirements of 6 November 2018, ESMA ref. 35-43-1163 (in particular, General Guideline No. 2 and its supplements) of which paragraph 32 states that: "Firms should design their questionnaires so that they are able to gather the necessary information about their client. This may be particularly relevant for firms providing robo-advice services given the limited human interaction. In order to ensure their compliance with the requirements concerning that assessment, firms should take into account factors such as: […] whether steps have been taken to address inconsistent client responses (such as incorporating in the questionnaire design features to alert clients when their responses appear internally inconsistent and suggest they reconsider such responses; or implementing systems to automatically flag apparently inconsistent information provided by a client for review or follow-up by the firm)".

The following incidents and weaknesses that were detected in the course of these actions are considered to be of particular interest:

Cases were identified in which the information obtained by the entities providing investment services in order to assess the appropriateness and suitability of their retail clients' transactions significantly overestimates their education, financial literacy and investment experience. In some cases, this incident affects a large number of clients.

Several inspections have revealed difficulties in obtaining the information requested by the CNMV during the procedure and weaknesses in entities' registration systems, which should be remedied. With regard to this issue, it should be noted that requests were sent to several entities to adopt additional enhancement measures for proper reporting of some specific aspects of the periodic information submitted to the CNMV in the confidential statements.

The CNMV detected occasional cases of failures to comply with the duty to behave diligently and transparently in the interest of the client. In addition, in the field of advice, the CNMV noted inadequate management of the conflicts of interest in placing structured products issued by the group with retail clients and their subsequent repurchase prior to maturity at prices seemingly far from their fair value (with significant spreads which, in the case of repurchases, the firms did not disclose to their clients). This fact was particularly significant in cases in which the repurchase before maturity is the result of a recommendation from the entity providing the service itself, in which it proposes to the client the sale of the structured bond that he/she holds in the portfolio and the investment in a new issue of structured bonds issued by group entities at a placement price higher than the fair value (of which, in this case, the client is informed).

In the case of one entity which had been inspected in previous years, the monitoring conducted revealed the existence of very significant deficiencies that affect several

areas of its activity. In particular, these deficiencies relate to its organisational structure and to the provision of its advisory service, and they have generated proposals for additional administrative actions.

Particularly noteworthy are the facts identified in one entity as a result of the existence of improperly managed conflicts of interest resulting from management and advice in relation to securities registered on the Alternative Stock Market (MAB), securities that have a low level of liquidity.

In an inspection of one entity, it was observed that some of the agents had their own website in which, in addition to informing about the agency's products and services, they included information on other services for which the entity, and therefore the agent, was not authorised.

The CNMV also paid close attention to the preparation of the branches of UK entities that provide investment services in Spain with regard to the different scenarios in which the Brexit negotiations may conclude. For this purpose, the CNMV requested information on the plans of the aforementioned branches for this contingency, with particular emphasis on the duty to appropriately inform their clients about the corresponding effects. The specific supervision of one branch concluded with its removal from the CNMV's register.

With regard to crowdfunding platforms, which, despite not providing investment services, are supervised by the same CNMV department, supervision has continued to focus on a review of the diverse documents that they are required to submit on an annual basis. From the information obtained, it may be concluded that although this sector is small, it is recording high levels of growth. The CNMV has also performed specific case-by-case actions and some on-site inspections relating to crowdfunding platforms where deemed appropriate. The most significant incidents detected referred to significant defects in the information offered to clients and to the performance of activities not included in their corporate purpose.

### Prudential requirements

The prudential supervision of investment firms is carried out, firstly, by analysing their economic-financial situation and net worth viability and, secondly, by verifying that they comply with the solvency requirements laid down in the specific legislation. The ultimate aim is to ensure that these firms have sufficient own funds to take on the risks associated with the activity that they perform. The bulk of this supervision is based on an analysis of the information sent periodically to the CNMV, which is complemented by on-site inspections.

In 2018, the sector as a whole had ample own funds in relative terms (see Chapter 3.2.2.1). As part of its supervisory tasks, the CNMV closely monitored the firms that had revealed net worth or solvency incidents.

The common procedures and methodologies for the Supervisory Review and Evaluation Process (SREP), on which some calibration adjustments were performed, were once again applied during 2018. In accordance with these procedures, supervisory authorities must give different scores to each entity, which will serve as a reference not only for the purposes of supervising the entities, but also in order to set the time

at which the recovery measures planned by the entities should be initiated where necessary.

With the technical support of the Bank of Spain, work began in 2018 on reviewing the internal models for determining the own-fund requirements of a large firm which, as a result of a likely Brexit, decided to transfer a significant part of its business in the United Kingdom to Spain. In addition, for that same firm, the CNMV assessed the appropriateness of applying certain exemptions provided for large exposures. The conclusions of this assessment were reported to the European Banking Authority.

Similarly, the CNMV has continued reviewing the risk profile of all entities, and reporting to the FROB those that fall within the scope of Directive 2014/59/EU of the European Parliament of the Council, of 15 May 2014, establishing a framework for the restructuring and resolution of credit institutions and investment firms.

## 6.2 Collective investment schemes and closed-end investment undertakings

As in previous years, the CNMV focused the bulk of its supervision of mutual funds and SICAV on preventive analysis to ensure that CIS management companies adequately comply with their obligations, that conflicts of interest are solved appropriately and that unit-holders and shareholders receive sufficient information about their investments.

In any event, the two categories of supervision of CIS and their management companies performed by the CNMV continue to be reciprocal and complementary. On the one hand, off-site supervision based on analysing the statements of the CIS submitted to the CNMV on a monthly basis, which include a list of individual positions of the portfolio assets and derivatives of all registered CIS. On the other hand, on-site inspections are basically focused on verifying less standardised or more specific aspects of the CIS that do not appear in the standardised reporting.

Off-site supervision is basically conducted on two levels. The first level consists of performing general periodic analyses for ongoing control of aspects such as adequacy of resources and the internal controls of CIS management companies, the prevention of conflicts of interest and compliance with legally established ratios and the suitability of investments. The other level includes non-recurring analyses, whether general or specific, of issues which arise or are detected during the supervision.

The main periodic controls performed in 2018 are summarised below:

– Control of CIS legality. The aim is to supervise appropriate compliance with the limits established in CIS legislation, including: structural limits (of assets and minimum number of unit-holders and shareholders), limits on diversification by issuer, and counterparty risk and exposure in trading with derivatives.

– Analysis of returns and price comparison. This aims to detect atypical changes in net asset values based on a regression analysis of the daily performance of the market compared with the performance of the CIS. The CNMV also performs comparative analyses to identify discrepancies in the valuation applied by entities to the same asset.

These analyses allow the CNMV to detect incidents and deficiencies in the asset valuation procedures and in the controls implemented by management companies, as well as any other incorrect recording of transactions and allocation of expenses and fees.

– Trading of assets. By means of automated processes, the CNMV identifies transactions that might reveal conflicts of interest, including: asset applications (transactions in which one or several CIS acquire a fixed-income or equity asset and other CIS from the same management company sell it), purchases of structured products, placements in the primary market and secondary market transactions in assets with low liquidity.

  In all these cases, the CNMV, where appropriate, must verify proper compliance with the rules on related-party transactions established in current legislation. Specifically, the CNMV must verify that the entity has a formal authorisation procedure which demonstrates that such trading is performed in the interest of both CIS and at arm's length.

– Analysis of CIS audits. CIS regulations require firms to send audit reports and annual accounts electronically to the CNMV. This information must be delivered to investors as part of the annual report. No significant incidents were detected in the CIS audit reports in 2018, with only one of them containing any qualification.

### Legislative changes in CIS and venture capital undertakings and relevant criteria

EXHIBIT 14

Following the significant legislative changes in 2016 resulting from transposition of the Alternative Investment Fund Managers Directive and UCITS V, the regulation of collective investment and venture capital is currently at a stage of consolidation. However, a series of rules modifying the specific and individual aspects of these vehicles has recently been published. The most noteworthy changes are as follows:

– Law 35/2003 on CIS has been amended with regard to the regulation of omnibus accounts for the distribution of national funds with the aim of allowing such accounts to also be used to hold positions of pre-existing unit-holders and not only new unit-holders, as provided for in the previous legislation. In addition, a two-tier omnibus account scheme is allowed, as a mediating entity may be placed between the manager and the distributor, with the scheme of **manager-mediating entity-distributor-final investor being valid**.[1]

– The regulation of the expenses corresponding to the financial analysis service that may be borne by investment funds and SICAVs is amended in the CIS Regulation so that they may be regulated independently and separated from brokerage costs. CIS will therefore be able to bear the analysis costs provided that they do not depend on the volume of brokerage transactions, they appear in the prospectus, they entail original thought, they are related to the investment category of the CIS and they contribute to improving investment decision-making.[2]

– In the area of transparency, the Law on CIS has been amended to allow the yearly and half-yearly reports of CIS to be submitted to investors electronically (unless the investor does not provide the necessary data for this purpose or declares a preference to receive the reports physically). This constitutes a full change with regard to the previous obligations whereby the information had to be submitted on paper by default. Similarly, in the case of renewals of funds with a specific target return, it will not be necessary to deliver the half-yearly report prior to subscription and only the Key Investor Information Document (KIID) must be delivered.[3]

– Another more technical amendment was the updating of the disciplinary regime provided for in the Law on CIS to align it with that provided for in the UCITS V Directive, with a significant increase in the maximum amount of the penalties. Similarly – and in line with the provisions of the Securities Market Act for investment firms – management companies must enable an internal channel so that employees may report the commission of infringements and therefore guarantee both their protection with regard to reprisals and the confidentiality of the person reporting the alleged infringement (internal whistleblowing).[4] Infringements classified in Regulation (EU) 2017/1131 on money market funds[5] are also incorporated.

– In the area of systemic risk control, amendments are made to the Law on CIS and Law 22/2014 on venture capital undertakings and other closed-ended collective investment undertakings, in order to grant powers to the CNMV to require management companies to strengthen the level of liquidity of the portfolios of CIS, venture capital undertakings and other closed-ended collective investment vehicles and, in particular, to increase the percentage of investment in particularly liquid assets. This has been done taking into account the recommendations made by international bodies relating to the introduction in the short term of the macroprudential tools necessary to address possible vulnerabilities for the financial system.[6]

In addition to these regulatory amendments, in November 2018 the CNMV published an update of its Questions and Answers on CIS legislation that aim to disseminate clarifications with regard to this legislation as well as criteria resulting from its supervisory practice. The most significant new aspects of this update are as follows:

– As an exception to the general principle of valuation at market prices, it is clarified that the amortised cost method may be used to measure all short-term public debt constant net asset value money market funds, as well as assets with a residual maturity of 75 days in short-term low volatility net asset value money market funds, providing the limits set by European legislation on such funds are not exceeded.

– It is considered to be allowed and in line with the regulations that CIS may apply the anti-dilution mechanism known as "swing pricing" in order to preserve equity among CIS investors. Swing pricing entails

making an adjustment to the net asset value so that the trading costs of the buy and sell transactions necessary as a result of movements in subscriptions and redemptions may be passed on to the unit-holders that give rise to them (protecting the other investors) on those days in which certain thresholds are exceeded. Managers who wish to apply it must inform about this in the fund's prospectus and initially by publishing price sensitive information.

– It is communicated that it is not possible to allocate fees to CIS for managing the collection of interest and amortisation of securities, the transfer of securities, the collection of dividends and coupons and other financial transactions given that the collection of dividends and coupons is already remunerated by the deposit fee as these procedures are associated with the custody of the assets in the portfolio of the CIS and are part of the depository's obligations.

– Lastly, it is clarified that it is possible to allocate to the fund the non-usual expenses (legal defence, advice, consulting, etc.) incurred for extraordinary claims for withholdings made in foreign securities that have formed part of the portfolio, providing certain conditions are met.

1 First Final Provision of Law 11/2018, of 28 December, amending the Code of Commerce, the recast text of the Capital Companies Act and the Auditing Act.
2 Second Final Provision of Royal Decree 1464/2018, of 21 December, which transposes level 2 of MiFID II by amending Royal Decree 217/2008 on investment firms.
3 Idem note 1.
4 Idem note 1.
5 Second Final Provision of Royal Decree-Law 19/2018, of 23 November, on payment services and other urgent financial measures.
6 Article 1 of Royal Decree Law 22/2018, establishing macroprudential tools.

With regard to one-off or non-recurring supervisory analyses, which are normally the result of the special circumstances of entities or markets, the CNMV continued the general analyses of the sector for certain issues or aspects in 2018, which included the following:

– In accordance with its 2018 Activity Plan, the CNMV performed a review of intermediaries' selection procedures. This analysis covered a total of 28 management companies in which there might be a group entity (bank or investment firm) through which they operate. For this purpose, the CNMV requested information not only on their procedures, but also on the list of intermediaries and the volumes and fees applied with each of them.

– In accordance with its 2018 Activity Plan, the CNMV also conducted a review of compliance with the requirements established in the Technical Guide on non-recurring related-party transactions (published in January 2017). This review was carried out by means of an analysis of a sample of transactions performed by each entity in order to verify that there is sufficient documentary support showing that they were performed in the exclusive interest of the CIS and on an arm's length, or better, basis.

– Following publication of a statement[4] on the need to enhance the transparency of the information provided in the Key Investor Information Document (KIID) of CIS and in the periodic public reporting on the type of management carried out,[5] the CNMV sent a letter to 17 managers for them to send, in the case of 43 investment funds, the commitment to modify the KIIDs before the end of the year and inform in the periodic public reporting of the second half of the year about the new requirements established in this statement.

– With regard to the liquidity of CIS portfolios, as a preventive measure, the CNMV performed an analysis of investment funds that hold significant exposures (over 25% of assets managed) to subordinate/preferred debt assets, securitisations and other assets with lower levels of liquidity, so as to verify that they have internal liquidity management controls and appropriate procedures to protect the interests of unit-holders and avoid conflicts of interest. Noteworthy among these mechanisms for liquidity control and conflict prevention is the creation in a series of CIS of so-called "side pockets" which contain certain low liquidity assets.

– In the area of eligible assets, the CNMV conducted an analysis to quantify the exposure of CIS to funds of the GAM family, which, due to a series of circumstances linked to their manager, were closed to redemptions and placed in liquidation. With regard to eligible assets, the CNMV also conducted an analysis to check whether Spanish CIS are investing in cryptocurrencies, such as trackers linked to bitcoin and other virtual currencies. Hardly any investments were found in these assets.

– With regard to CIS expenses, an analysis was conducted on the TERs (Total Expense Ratios, percentage of total annual expenses over the fund's assets) of investment funds to ensure, on the one hand, their reasonableness and, on the other, that the funds are not incurring in ineligible expenses or are exceeding fee limits.

In addition to these sector-wide analyses of specific issues, the CNMV performed other analyses of specific issues affecting individual entities, such as asset valuation, investments in non-eligible assets or liquidity, conflicts of interest, etc.

4 Published on the CNMV's website on 8 October.

5 Specifically, that in cases in which information on a benchmark is included, it must be specified whether such benchmark is used in merely informative or comparative terms or whether, on the contrary, to a greater or lesser extent management is linked to the benchmark.

## Prior review of the marketing material of investment funds

EXHIBIT 15

The CNMV included in the horizontal reviews of its 2018 Activity Plan an analysis of the advertising used by investment fund management companies, covering the registration of new funds and the renewal of funds with a target return.

For this purpose, managers were asked to provide all the advertising that they were going to use and the CNMV checked compliance with Order EHA/1717/2010, of 11 June, on the regulation and control of the marketing material of investment products and services and Article 60 of Royal Decree 217/2008, of 15 February.

It was agreed that this review would only be carried out for a limited period of time, as the final objective was to set criteria that may serve as guidance for the market.

The review performed by the CNMV in this regard covered the 126 new funds and renewals of structured funds registered between 31 October 2017 and 30 November 2018, promoted by 41 different management companies. Of the total registrations, marketing material was used for the launch or distribution of 69 funds (54.76% of the cases), promoted by 18 management companies (43.9%).

From the results of the review, it is worth highlighting that so-called "commercial factsheets" are the main material used by financial institutions for the marketing of new investment funds. These factsheets often consist of a modified version of the Key Investor Information Document (KIID). In addition, some products were also advertised through banners, mass e-mails and social networks, and only in a minority were mass media (press or radio) used.

In the case of some management companies, the commercial factsheets exclusively show objective data on returns, net asset value, fees, etc., without reflecting any opinion or advertising message (they are rather a modified version of the periodic public reporting). In some cases, it is not the management company that prepared this factsheet, but an external entity.

**Incidents detected: criteria transmitted to the sector**

As a consequence of the incidents detected during this review, the following guidelines have been passed on to the 18 management companies that used marketing material:

– Marketing material must make reference to the KIID and the prospectus and indicate where these documents may be obtained. In addition, expressions that might lead investors to believe that the KIID is less important than any other information used as advertising for the fund must be avoided.

- The information in the advertising message must be consistent with that presented in the KIID. It is necessary to include essential information on the product's risks and conditions, in addition to any warning that may be required, in a format (size and letter type) that is easily legible and which is at least equal to the predominant font size in the information provided.

- Any mention of avoidance of liability of the management company or distributor with regard to the content of the advertising must be avoided.

- The relevant information must appear in the body of the message, ensuring that it does not appear in footnotes.

- Past performance may not be the most prominent element of the communication and may not be presented in a larger or highlighted font size.

- Expressions relating to the existence of advantages or a pre-eminent position or establishment of comparisons without any objective basis, with expressions such as "market leader" or "return higher than that of other financial products", must be avoided.

- In the case of guaranteed funds or structured funds with a non-guaranteed target return:

  i) The reference to the returns must always be linked to the period of the guarantee or structure, as well as to its maturity date. Information must also be provided on the consequences of redemptions before maturity.

  ii) The return scenarios, together with a graph that presents the historic performance of the Annual Equivalent Rate (AER), must be included. Similarly, entities must include the warnings required in the Technical Guide on the strengthening of the transparency of investment funds with a specific long-term target return, published by the CNMV on 19 March 2017.

  iii) The yield to maturity must be expressed in terms of the AER. The figure must be included in a sufficiently visible manner, which will allow investors to make comparisons with other investment alternatives.

  iv) The period during which the structure is open for the entry of investors must be specified.

- Information on charges and fees must be adequate. In some cases, the CNMV has noted that the information provided was deficient as entities omitted the subscription and redemption fees or the indirect fees in those funds which make their investments through other CIS.

In funds with mandatory redemptions, entities may not use expressions such as "annual return", "quarterly payment", "payment every three months", etc., which may lead investors to believe that they are receiving income, when neither the return nor the initial investment are guaranteed, for which an express warning must be made.

The number of **venture capital vehicles** analysed rose by 9.1% on the previous year, which entailed an increase of 2.4% of total sector assets. The general periodic analyses performed revealed a slight improvement in the coverage of the mandatory investment ratios.

The analyses performed through the confidential information received on compliance both with the mandatory investment ratio and the mandatory diversification ratio have included SME venture capital vehicles and European venture capital funds, although these vehicles are still in the period of exemption from compliance provided for in the law.

A sectoral classification of investments was performed in accordance with the information analysed. The CNMV concluded that 39% of investments are made in firms classified within the services sector, followed by other venture capital vehicles, with 22%, and firms from the manufacturing sector, with 18%.

In addition, the CNMV studied the audit reports received, as well as the special reports provided for in Rule 20 of Circular 11/2008 on the additional information provided to auditors by the entities whose initial reports contained an auditor's opinion with qualifications due to scope limitations.

In its supervisory work, the CNMV, in specific cases, paid particular attention to the information provided in the reports on the valuation method used in the different portfolio investments, as well as the explanations in the cases in which the valuation method had been modified or in situations where there have been sharp falls in specific investments. The aim of this analysis was to check compliance with accounting standards applicable to venture capital undertakings.

In 2017 – the last year for which these data are available – there was a sharp increase in the number of investors in the venture capital sector (18.5% up on 2016 to stand at 13,000). This is a sector largely reserved for professional investors.

As a consequence of the aforementioned increase in the number of investors in venture capital undertakings and closed-ended collective investment undertakings, which is in addition to the even greater increase of the previous year (up 48.1%, from 7,411 to 10,973), and also the requirements of the CNMV's Activity Plan, an analysis was performed on the content of the delivery of the KIID in accordance with PRIIPs legislation where distributed to retail investors. In this regard, it should be noted that the PRIIPs Regulation entered into force on 1 January 2018 and closed-ended vehicles do not enjoy the temporary exemption until 2020 (extended by two more years) of CIS. The deficiencies detected in the information contained in the KIID (performance scenarios, cost data and qualitative information) were subject to the appropriate deficiency letters.

In 2018, as a result of these supervisory actions, the CNMV sent out 1,321 deficiency letters to supervised entities.

Of the total number of letters, 511 were for late filing of information, mostly audit reports of CIS.

In addition, 121 letters were sent requesting information necessary for supervision (other than that available on a general basis) from the entities subject to supervision.

A total of 610 letters were also sent requesting undertakings to adopt specific measures, improvements or recommendations to solve the incidents detected in the supervision performed and, finally, 79 letters corresponding to other notifications (basically responding to enquiries).

**Supervision of CIS and venture capital undertakings: deficiency letters sent by the CNMV in 2018** TABLE 6.2.1

| Type of deficiency letter | Off-site | On-site | Total |
|---|---|---|---|
| For late filing of information | 511 | 0 | 511 |
| Requests for information | 81 | 40 | 121 |
| Corrective measures or recommendations | 571 | 39 | 610 |
| Other notifications | 36 | 43 | 79 |
| **Total** | **1,199** | **122** | **1,321** |

Source: CNMV.

## 6.3 Management companies: CIS management companies, management companies of closed-end collective investment undertakings and securitisation fund management companies

The general supervisory tasks carried out by the CNMV with regard to management companies remain geared towards prevention or, as the case may be, solving possible scenarios of capital deficits that might endanger their solvency.

In this regard, it should be noted that management companies as a whole have a high surplus of own funds. In the case of CIS management companies, eligible capital amounted to 980 million euros (6.9 times the required capital). The eligible capital of management companies of collective investment undertakings stood at 105.7 million euros (3.1 times the required capital). Finally, securitisation fund management companies are a different case as almost all of them hold the maximum required capital provided for in the law and adapt the eligible capital to said maximum. The sector's surplus is therefore very limited.

The assets under management of CIS management companies rose by 13% on 2017. The assets under management of management companies of collective investment undertakings rose by 8%, while the assets managed by securitisation fund management companies fell by nearly 6%.

The recurring supervisory tasks focused on analysing the confidential information received on a half-yearly basis, which allows the CNMV to monitor entities' level of

solvency, the annual audited reports, the reports by entities' internal audit unit and a review of certain mandatory legal requirements.

The following aspects may be highlighted with regard to the specific or non-recurring supervisory analyses conducted with regard to CIS management companies:

– With regard to conduct of business rules, work was carried out over the year on **corporate governance**. This report was divided into two lines of work: the first analyses the legislative obligations relating to the existence of an audit committee, a remuneration committee, the independence of the members of the board of directors, etc., in all management companies. The second line of work involves an in-depth review of the organisational structure of recently-created management companies. The incidents found (directors that could not be considered independent, failure to comply with audit committee requirements, etc.) resulted in the corresponding deficiency letters.

– In the area of transparency, the CNMV analysed a sample of management companies to verify whether they included the mandatory information on the exercise of voting rights in the periodic public reports.

– With regard to **branches of European management companies** operating in Spain, a Circular was approved at the end of the year to obtain information on their activity and thus supervise application of conduct of business rules. An *ad hoc* request for quantitative data on their level of activity was made prior to approval of the Circular.

In the area of **management companies of collective investment undertakings**, the specific non-recurring supervisory analyses remain focused on improving the information received by conducting checks on the quality of the confidential information.

With regard to **securitisation fund management companies**, it is important to note the Draft Circular that included, in application of Law 5/2015, 27 April, on promoting business financing, the submission of confidential information statements by securitisation fund management companies to the CNMV, as a consequence of the entry into force on 1 January 2019 of Regulation (EU) 2017/2402 of the European Parliament and of the Council, of 12 December 2017, laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation and amending Directives 2009/65/EC, 2009/138/EC and 2011/61/EU and Regulations (EC) No. 1060/2009 and (EU) No. 648/2012. However, it was deemed appropriate to postpone said request for information from securitisation fund management companies pending definitive adaptation of Spanish law to this European regulation.

Finally, it is important to note the increase in the number of management companies over 2018: 11 new CIS management companies, 8 management companies of collective investment undertakings and 1 securitisation fund management company, and the greater general effort in the CNMV's general supervisory tasks.

## 6.4 Depositories

Following the analysis performed in 2017 to supervise the adaptation of depositories to the requirements of Circular 4/2016 on CIS depositories – which specifies

and details how depositories should perform their custody, registration and supervision functions and oversight of the activities of management companies – supervision in 2018 focused on analysing the half-yearly reports on the supervision and oversight function that must be submitted to the CNMV. In these reports, depositories must include all the failures to comply with legislation or anomalies that have been detected in the management and administration of CIS. Within these, special attention has been paid to those prepared by the depositories of venture capital undertakings and closed-ended collective investment undertakings, given the new requirement for these investment vehicles to have a depository.

The above controls were supplemented by off-site supervision of the compliance of the depository function in two credit institutions, in its two aspects: the function of custody of the assets owned by the CIS and the function of supervision and oversight of the activity of the management companies. It also analysed the structure, resources and independence of this function within the organisation.

## 6.5 Cooperation in the prevention of money laundering

The Executive Service of the Commission for the Prevention of Money Laundering and Monetary Offences (Spanish acronym: SEPBLAC) and the CNMV have applied the cooperation agreement entered into between the two entities, which takes into account both the CNMV's supervision plan and the priorities set by SEPBLAC in its analyses of money-laundering risks. In application of said agreement, in 2018 the CNMV submitted notifications to SEPBLAC with the conclusions reached on the level of compliance with the obligations in the prevention of money laundering by six investment firms and collective investment scheme management companies included in the reviews previously agreed between both bodies.

Similarly, the CNMV sent SEPBLAC relevant information relating to incidents of money laundering prevention identified in the review of the internal audit reports prepared by reporting entities.

## 6.6 Benchmarks

Benchmarks are regulated under Regulation (EU) 2016/1011 of the European Parliament and of the Council, which was published on 29 June 2016 and applies as from 1 January 2018. Some of its provisions, such as those relating to critical benchmarks and the colleges of supervisors, apply as from 30 June 2016.

This Regulation is the result of the cases of manipulation of benchmarks that took place in the past and it establishes mechanisms to reduce the vulnerability to similar scenarios. That is why in practically every European jurisdiction the securities regulator (in the case of Spain, the CNMV) has been the competent authority designated to apply the new rules.[6]

6 The regulation also confers on the Bank of Spain oversight, inspection and disciplinary functions relating to compliance with the obligations of supervised entities that are contributors of input data to benchmarks prepared by the Bank of Spain and compliance with obligations relating to the use of benchmarks in financial contracts applicable to entities subject to Bank of Spain supervision in the area of transparency and customer protection.

This legislation establishes new obligations for administrators and contributors of input data, as well as for supervised entities that use benchmarks. The CNMV, as the competent authority designated to apply the new regulation, also takes on additional powers relating to: i) the authorisation and registration of administrators of benchmarks located in Spain and ii) the supervision of administrators, contributors and any persons involved in the provision of these benchmarks.

Consequently, in 2018 the CNMV continued working on defining the scope of application of Regulation 2016/1011 and on performing actions to facilitate and promote implementation of the new rules, which include the following:

– The creation of a **section on the CNMV website** dedicated to benchmarks that allows access to all relevant national and international legislation and information.

– Publication of a **statement addressed to the sector** to inform about the new obligations contained in the Regulation and the CNMV's criteria in applying its supervision policy, which is proportionate to the nature and risks inherent to each case.

– The holding of a **seminar-workshop** for the dissemination and discussion of the new Benchmarks Regulation among, and with, the supervised entities. When holding this seminar, the CNMV was assisted by representatives from IOSCO and ESMA, as well as from associations and supervised entities, who participated in several roundtables.

– Publication of **Questions and Answers** that solve practical issues and which supplement the Questions and Answers prepared by ESMA.

In 2018 the CNMV continued to perform its activity as a member of the Euribor and Eonia colleges, as well as the Libor Supervisory College. One of the objectives of the college is to coordinate the supervisory policy and actions of the member authorities and in 2018, it discussed the supervision policy applicable to contributors to critical benchmarks.

In this context, in 2018 the CNMV initiated the review of compliance with the corresponding requirements of the new regulation of entities that participate in the panels of the critical benchmarks: Euribor and Eonia.

Last year, the CNMV continued paying particular attention to the reform of interest rate benchmarks, which follows the recommendations of the G20 and the FSB so as to evolve towards improved benchmarks that are less susceptible to manipulation and more representative of the economic reality that they aim to measure, as well as towards alternative risk-free rates, which will reduce the excessive concentration in the current benchmarks (see Exhibit 16).

## Status of the reform of interest-rate benchmarks

EXHIBIT 16

The reduction in activity in money markets since the financial crisis, together with the cases of manipulation of interbank reference rates, led to the G20 and the FSB promoting reforms with the aim of evolving towards enhanced benchmarks (less susceptible to manipulation and more representative of the economic reality that they attempt to measure) as well as towards alternative risk-free reference rates, which will reduce excessive concentration in the current benchmarks.

Interest rate benchmarks perform a crucial economic function in the pricing of numerous instruments and contracts, in risk management and in the implementation and monitoring of monetary policy. This makes it necessary to strengthen the robustness and ensure the sustainability of these benchmarks with the aim of maintaining financial stability.

In Europe, these reforms have led to approval of Regulation (EU) 2016/1011 – which requires existing benchmarks to adapt their governance and calculation methodology – and to the creation of a working group – promoted by the ECB, the European Commission, ESMA and the Belgian FSMA (in its capacity as supervisor of the Euribor and the Eonia), with the participation of members of the industry – entrusted with: i) identify risk-free rates that may be used as an alternative to the current benchmarks, ii) defining paths for an orderly transition and iii) strengthening the robustness of current and future contracts.

Since 2013, EMMI – administrator of the euro area benchmarks (Euribor and Eonia) – has been working to strengthen its governance structure and transparency and to implement a methodology in line with the requirements of Regulation (EU) 2016/1011. The aim of the administrator over 2019 (without a continuity solution) is for the Euribor to change from being calculated based on the quotes of a group of banks to being calculated based on the real transactions of these banks and other sources of data when there are insufficient transactions. EMMI is working on implementing the new methodology with a view to being in a position to receive authorisation under the European regulation before the end of 2019.

As EMMI has made public, the Euribor must adapt its calculation methodology to the requirements of the new regulation, but it will continue to reflect the same underlying interest: the rate at which wholesale funds in the euro area could be obtained in the unsecured money market.

In the euro area, the ECB has decided to develop a short-term euro interest rate (€STR, Euro Short Term Rate) as from October 2019 which will reflect the wholesale euro unsecured overnight borrowing costs of euro area banks. This benchmark has been recommended by the working group as the euro risk-free rate to replace the Eonia. The group has also published a proposal for transition based on a methodological modification of the Eonia, which would be calculated as a fixed spread over the €STR for the time necessary to complete the transition.

The €STR will also act as a fallback rate for Euribor-linked contracts, which must include fallback clauses with provisions in the event of a disappearance of the benchmark. On the possible use of €STR as an alternative to Euribor, the working group is developing a methodology based on derivatives markets to build an €STR-based term structure.

With regard to contractual robustness, the group has concluded that the clauses in current contracts are inadequate or insufficient. In order to facilitate adaptation, it has published guidance on the introduction of robust fallbacks in the new contracts (as required by the European regulation as from 1 January 2018) and plans to publish recommendations relating to current contracts.

In the United Kingdom, the Bank of England has already introduced SONIA (Sterling Overnight Index Average) to replace the Libor, which is not expected to survive beyond 2021, the date on which the UK authorities announced they will no longer support the benchmark and they will allow the contributor panel banks to pull out if they so wish.

Other jurisdictions, such as the United States, Switzerland and Japan, have also initiated a process towards alternative benchmarks and work is being conducted to facilitate the transition to an environment of greater diversification in interest rate benchmarks and lower dependence on the current ones.

## 6.7 Resolution authority (preventive stage) of investment firms

Spanish legislation on recovery and resolution opted for a model that distinguishes between resolution functions in the preventive stage, which are entrusted to the CNMV with regard to investment firms and to the Bank of Spain with regard to credit institutions, and in the enforcement stage, which are assigned to the Fund for Orderly Bank Restructuring (Spanish acronym: FROB) for both types of entity.

The resolution framework comprises three phases: i) the preventive phase, in which the entity's ordinary activity includes an analysis of its capacity to address its own crisis and to be resolved in an orderly manner if it fails; ii) the early intervention phase, in which the supervisor may exercise new powers to act on entities when they start to weaken but are still viable; and iii) the resolution phase if, in the end, despite the preventive measures, the entity's failure cannot be avoided.

As preventive resolution authority, the CNMV must draw up and approve – following a report from the FROB and from the competent supervisor – the resolution plan of each investment firm or group subject to supervision on a consolidated basis, and thus identify the best strategy in the event of failure. On drawing up the resolution plan, the CNMV performs an assessment of the entity's resolvability in order to determine whether, in the event that it fails, the resolution or liquidation can be carried out in a credible and feasible manner, without undermining the continuity of the critical functions performed by the entity. This plan also identifies and, where appropriate, eliminates, any obstacles that may hinder or prevent the entity's resolution or liquidation.

The first planning cycle was completed in 2018 and nine resolution plans were drawn up. Table 6.7.1 shows the number of plans implemented since 2016.

**Investment firm resolution plans** TABLE 6.7.1

| | 2016 | | 2017 | | 2018 | | Total | |
|---|---|---|---|---|---|---|---|---|
| Type | No. of plans drawn up | Plans with possible obstacles | No. of plans drawn up | Plans with possible obstacles | No. of plans drawn up | Plans with possible obstacles | No. of plans drawn up | Plans with possible obstacles |
| Individual | 5 | - | 5 | 4 | - | - | 10 | 4 |
| Group | 2 | 2 | 9 | 4 | 9 | 4 | 20 | 10 |
| Update | - | - | 1 | - | - | - | 1 | - |
| **Total** | **7** | **2** | **15** | **8** | **9** | **4** | **31** | **14** |

Source: CNMV.

In the resolution plans of investment firms, it is considered that the most appropriate strategy, in the event of failure, is liquidation in accordance with an ordinary insolvency procedure. This is deemed to be a credible and feasible procedure to the extent that it would make it reasonably possible to achieve, and at least to the same extent as a resolution process, the resolution objectives established by the Law on recovery and resolution in this area.

In the assessment of **resolvability**, some firms hold significant client assets (cash and financial instruments) and, therefore, in the event of failure, said resolvability may be affected by difficulties and delays in the restitution and transfer of these assets to other entities in the course of a liquidation through ordinary insolvency proceedings. The CNMV has proposed preventive measures to these entities, such as entering into agreements with third entities when certain early warning thresholds are reached. Consequently, in the event of failure, the transfer and redemption of client assets is assured, whether on a provisional or final basis, without incidents and in the shortest time possible.[7]

During the drafting of the resolution plan, the CNMV also assesses the possible **minimum requirements for own funds and eligible liabilities** (MREL), i.e., whether the entity has sufficient minimum own funds and eligible liabilities to absorb losses and to carry out the chosen (resolution or liquidation) strategy. In the cases analysed, no additional amount was considered necessary to recapitalise the firms, given that the strategy proposed was liquidation through ordinary insolvency proceedings, considering that the amount necessary to guarantee absorption of losses must match the minimum capital required at any time by the competent supervisor.

7 The recent modification of Royal Decree 217/2008, of 15 February, on the legal regime of investment firms and other entities that provide investment services by means of Royal Decree 1464/2018, of 21 December, sets out significant changes with regard to the internal organisation measures of investment firms in relation to asset management with effect as from 17 April 2019. In particular, it establishes the requirement for investment firms to reach agreements with entities outside the group so that, at the CNMV's request, in the event that they undergo financial difficulties or reasonable doubts emerge as to their viability or adequate investor protection, they may agree on the block transfer of the safeguarded financial instruments and cash of their clients to one or several entities.

The legislation allows the CNMV to establish **simplified obligations** in drawing up recovery and resolution plans. These will be based on a series of indicators of size, type of activity, risk, interconnections and impact of the firm or group on markets and the economy. In view of the specific characteristics of investment firms, the plans that have been drawn up are simplified resolution plans that must be updated at least annually.[8]

In 2018 all investment firms falling within the scope of application of resolution legislation submitted the update of their **recovery plans**. These plans have been reviewed independently by the supervision and resolution functional areas of the CNMV, as well as by the FROB – in its capacity as resolution authority at the enforcement stage – and it has been concluded that in no case did their content have a negative effect on the resolvability of the entities.

**Coordination between Spanish resolution authorities** is guaranteed institutionally as the CNMV, through its Vice-chairperson, and the Bank of Spain are members of the governing commission of the FROB since entry into force, in July 2015, of Law 11/2015.

With the aim of strengthening existing institutional cooperation and of specifying the obligations for cooperation and sharing information provided for in Law 11/2015, the CNMV and the FROB signed a cooperation agreement in 2018 in relation to the resolution and recovery of investment firms. Similarly, the FROB also signed an equivalent agreement with the Bank of Spain.

The CNMV, in the exercise of its resolution powers, has remained extremely active in the different forums and working groups worldwide. At an EU level, the CNMV is a member of the Resolution Committee (ResCo) of the European Banking Authority (EBA), which is responsible for developing standards, reports and guidelines relating to the Directive on the recovery and resolution of credit institutions and investment firms. The noteworthy work performed in 2018 includes the following: i) approval of a handbook on independent valuation for purposes of resolution, ii) monitoring the impact of MREL decisions, iii) work on sharing of information in the event of resolution, and iv) coordination of the preparatory measures for Brexit.

At an international level, the CNMV participated in 2018 in the Resolution Steering Group (ReSG) of the Financial Stability Board (FSB), which, in addition to analysing the resolution of banks, also works on coordinating and promoting the resolution of financial market infrastructures at an international level. The CNMV participates in the cross-border crisis management group for financial market infrastructures (fmiCBCM), which reports to the ReSG. This group has published the Guidance on Central Counterparty Resolution and Resolution Planning and, at the end of 2018, presented a discussion paper on financial resources to support CCP resolution and the treatment of CCP equity in resolution for public consultation.

8 Resolution legislation makes it possible to modify the frequency with which resolution plans are updated. It is the CNMV's intention to consider that the resolution plans should now be updated every two years, without prejudice to the fact that changes in the entity's legal or organisational structure might significantly affect the plan's effectiveness or require that it be changed. It must also be changed whenever the CNMV, as preventive resolution authority, at its own initiative or that of the FROB (Fund for Orderly Bank Restructuring), deems it advisable to update the plan within a shorter timeframe.

Centralised clearing of OTC derivatives – one of the G20 commitments to strengthen markets in response to the global financial crisis – has increased the criticality of CCPs with regard to the overall safety and robustness of the financial system. Similarly, this has led to the need to have appropriate tools and measures both to ensure continuity of the critical clearing services and to ensure that incidents may be resolved in an orderly manner, minimising the risks for financial stability and at no cost to the taxpayer.

Pending completion at an EU level of a regulatory framework on the recovery and resolution of CCPs, the member jurisdictions of the FSB have taken the commitment to promote resolution planning and to organise crisis management committees for systemic CCPs. In Spain, there is only one single CCP for the derivatives and spot market, both for fixed income and for equity, that the FSB considers to be systemic in Spain and in other jurisdictions due to the interconnections it has through its participants. In this context, the CNMV has been working on the analysis of the resolvability of the Spanish CCP in accordance with the international standards of the FSB and the resolution legislation in progress.

## 6.8 Investment Guarantee Fund (FOGAIN)

The Investment Guarantee Fund (FOGAIN) compensates customers who are unable to recover the money or securities entrusted to investment firms, except financial advisory firms, in the event of bankruptcy proceedings or a declaration of insolvency by the CNMV. The fund's coverage also extends to customers of CIS management companies and of management companies of closed-end collective investment undertakings in relation to the provision of investment and ancillary services to individual clients, and under the same insolvency situations as for investment firms. The maximum amount of the compensation following verification of the investor's net position stands at 100,000 euros.

At year-end 2018, FOGAIN had a total of 167 member entities, 7 up on the previous year. Table 6.8.1 shows the breakdown by type of entity.

**Trend in number of member entities** TABLE 6.8.1

| Type of firm | 2015 | 2016 | 2017 | 2018 |
|---|---|---|---|---|
| Broker-dealers/brokers | 77 | 81 | 89 | 91 |
| Portfolio management companies | 3 | 2 | 1 | 1 |
| CIS management companies | 56 | 58 | 68 | 73 |
| Venture capital undertaking management companies | | 1 | 2 | 2 |
| **Total** | **136** | **142** | **160** | **167** |

Source: CNMV.

As indicated, the customers of financial advisory firms are not covered by the fund. Neither are customers of foreign entities operating in Spain covered by FOGAIN unless these operate through a branch and they have decided to join up to FOGAIN. There are currently no entities in this situation. Foreign entities are therefore attached to the guarantee funds of their home State, whose coverage may not be the same as that offered in Spain.

FOGAIN has continued to provide support and assistance to its member entities in all matters relating to their relationship with the fund and its coverage.

Following the security and liquidity criteria set out in its regulations, the fund continued to invest its assets in public debt with different maturities over the year and in bank deposits.

The FOGAIN's assets totalled 100.6 million euros at year-end, an increase of 13.8% on 2017. The rise was the result of the contributions of the member entities and the return on investments, as well as the amounts recovered by the fund over the year. The fund recovered 5.44 million euros in the bankruptcy proceedings of Interdín Bolsa, SV, S.A. in 2018, which means that to date it has recovered approximately 88% of the total amount paid by FOGAIN to the customers of said entity.

With regard to managing the recovery of the amounts paid out, FOGAIN remains party to several open legal proceedings relating to the claims which it has covered and it initiates all the actions available to it in order to achieve said objective.

During the year, FOGAIN operated different working groups of member entities on issues of common interest, and it was also present on the CNMV's Advisory Committee.

Finally, FOGAIN continues informing investors of its coverage, the entities that are covered and the procedures to request, as the case may be, compensation. This investor information service is another of the functions that are legally assigned to the fund and it is provided by telephone and through its website (www.fogain.com).