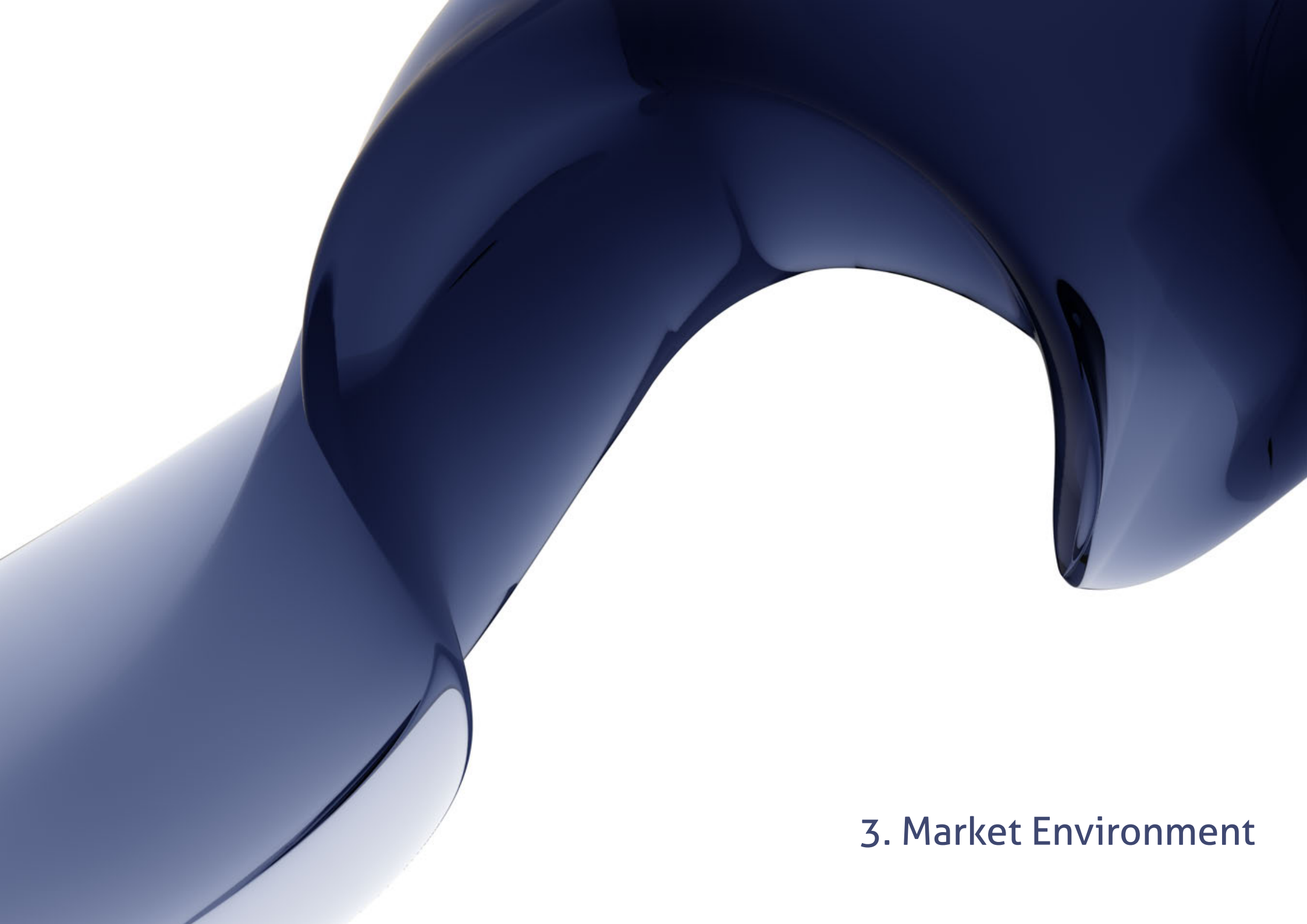
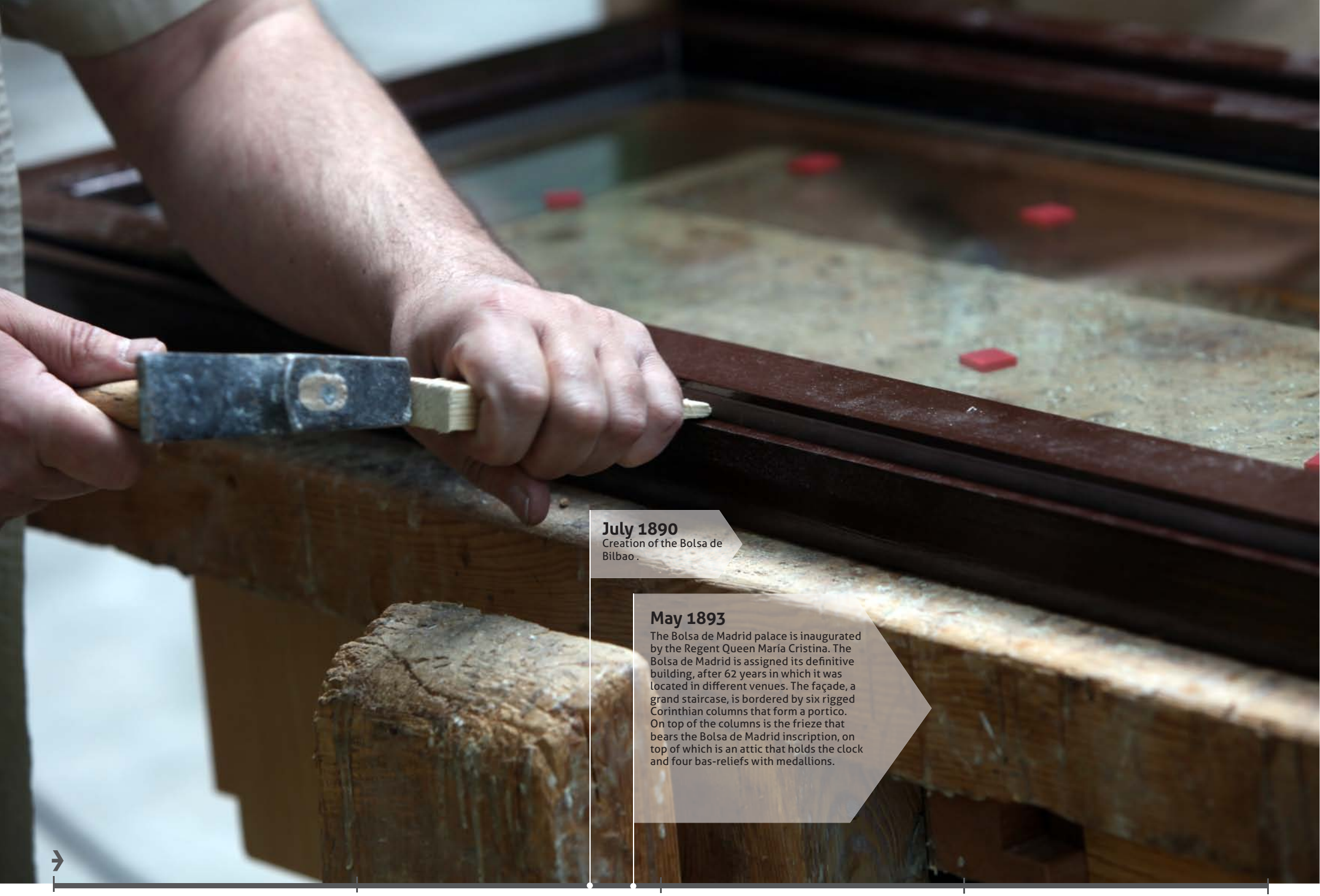


3. Market Environment



July 1890
Creation of the Bolsa de Bilbao .

May 1893
The Bolsa de Madrid palace is inaugurated by the Regent Queen María Cristina. The Bolsa de Madrid is assigned its definitive building, after 62 years in which it was located in different venues. The façade, a grand staircase, is bordered by six rigged Corinthian columns that form a portico. On top of the columns is the frieze that bears the Bolsa de Madrid inscription, on top of which is an attic that holds the clock and four bas-reliefs with medallions.

1800 1850 1900 1950 2012

3

Market Environment

The unstable environment had a major, mostly negative, impact on stock market prices and volumes in 2011, and caused high volatility.

Economic activity

Data in 2010 appeared to signal a beginning of the end of the economic crisis, but this misplaced optimism disappeared in 2011 due to the lack of economic and policy tools to enable developed nations to start on a new economic growth path. Capital markets, which act as a bellwether for confidence in political and institutional measures, punished the lack of resolve to overcome imbalances and frictions, which will make global economic recovery a much more drawn out process if not addressed.

The lack of agreement between parties was clearly evident in Europe in 2011, especially in the second half of the year. The euro zone sovereign debt crisis was and is the powder keg that led to a dramatic worsening in the economic outlook in 2011. The catalyst that caused markets to reverse the positive trend apparent until spring 2011 was the increasing probability that the euro, which contributes to almost 20% of world GDP (around $12.2 trillion out of a total of $62 trillion) could cease to exist. This risk has diminished somewhat in recent months after the German and French governments took control of the situation. In relative terms, the euro zone has a larger capital market than the United States, equivalent to 484% of its GDP (according to IMF figures, 24% of the $250 trillion in bonds, shares and bank assets at the end of 2010). It is also directly responsible for 22% of all Public Debt and 30% of Private Debt issued.

As such, it comes as no surprise that the sovereign debt crisis was the decisive factor behind the general reduction in economic activity in 2011 compared to initial expectations. Another factor was the steady worsening of the short-term world economic outlook, especially for developed nations but also, to a lesser degree, for emerging markets, which until now had been unscathed.

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Market Environment

Growth forecasts lowered successively for 2011 and 2012

Throughout 2011, the world's leading economic institutions successively lowered their GDP growth forecasts (in some cases by more than 50% of their initial forecasts made in the first quarter of the year). The most recent IMF projections point to a slowdown in world growth from 5.2% in 2010 to rates of 3.8% in 2011 and 3.3% in 2012. These figures indicate a cut in world growth forecasts of 1 and 1.1 points respectively, compared to forecasts made in June 2011. Emerging markets will continue to lead world growth, with an aggregate rise of 6.2% estimated in 2011 and 5.4% in 2012, much higher than the combined estimate for developed nations (1.6% in 2011 and 1.2% in 2012). We would highlight the downward revisions of 2012 growth forecasts for the US economy (-0.9 points to 1.8%) and for Germany (-1.7 points to 0.3%). The lower growth in world trade volumes that the IMF forecasts for the coming years are highly significant (from 12.7% in 2010 to 6.9% in 2011 and 3.8% in 2012).

As such, the generalised fall in share prices and high market volatility in 2011 played a key role in curbing economic recovery and this has been reflected in the financial statements of leading listed companies, especially in the financial sector, which is unable to return to its normal activities. The harsh fiscal adjustment programme that most developed countries are undergoing is hindering short term growth plans and has had to be carried out without time to give aid to a private sector that is having to deleverage and finding it difficult to get credit. The reality is that a recovery in business activity and employment will be very difficult to achieve in the next two or three years.

At the same time, the lack of effective global governance policies and economic measures have laid bare the difficulties of being able to act effectively to counter the trend marked by global capital markets in the midst of what some describe as the greatest financial crisis in modern economic history.

IMF Economic forecasts (September/October 2011)[1]

GDP growth (%)	Actual		Forecast	
	2009	2010	2011	2012
Gross world product	-0.7	5.2	3.8	3.3
Developed economies	-3.7	3.2	1.6	1.2
U.S.	-3.5	3.0	1.8	1.8
Japan	-6.3	4.4	-0.9	1.7
U.K.	-4.9	2.1	0.9	0.6
Euro zone	-4.3	1.9	1.6	-0.5
Germany	-5.1	3.6	3.0	0.3
Spain	-3.7	-0.1	0.7	-1.7
Recently industrialised Asian economies	-0.7	8.4	4.2	3.3
Emerging and developing economies	2.8	7.3	6.2	5.4
Latin America and Caribbean	-1.7	6.1	4.6	3.6
China	9.2	10.4	9.2	8.2
India	6.8	9.9	7.4	7.0
TRADE volume (annual %)	**-10.7**	**12.7**	**6.9**	**3.8**
Imports				
Developed economies	-12.4	11.5	4.8	2.0
Emerging and developing economies	-8.0	15.0	11.3	7.1
Exports				
Developed economies	-11.9	12.2	5.5	2.4
Emerging and developing economies	-7.7	13.8	9.0	6.1

(1) Revision of GDP and Trade Data forecasts in January 2012

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Consumer prices (% annual)	Actual		Forecast	
	2009	2010	2011	2012
Developed economies	0.1	1.6	2.7	1.6
U.S.	-0.3	1.6	3.0	1.2
Japan	-1.4	-0.7	-0.4	-0.5
U.K.	2.1	3.3	4.5	2.4
Euro zone	**0.3**	**1.6**	**2.5**	**1.5**
Germany	0.2	1.2	2.2	1.3
Spain	**-0.2**	**2.0**	**2.9**	**1.5**
Recently industrialised Asian economies	1.3	2.3	3.7	3.1
Emerging and developing economies	**5.2**	**6.1**	**7.2**	**6.2**

Unemployment rate (% of active workforce) [2]				
EU	**9.0**	**9.7**	**9.7**	**9.8**
Euro zone	9.6	10.1	10.0	10.1
Germany	7.8	7.1	6.1	5.9
Spain	18.0	20.1	20.9	20.9
U.K.	7.6	7.8	7.9	8.6
U.S.	**9.3**	**9.6**	**9.0**	**9.0**
Japan	**5.1**	**5.1**	**4.9**	**4.8**

(2) European Commission Autumn forecasts

Current account balance (% of GDP)				
Developed economies	**-0.2**	**-0.2**	**-0.3**	**0.1**
U.S.	-2.7	-3.2	-3.1	-2.1
Japan	2.8	3.6	2.5	2.8
U.K.	-1.7	-3.2	-2.7	-2.3
Euro zone	**0.1**	**0.3**	**0.1**	**0.4**
Germany	5.6	5.7	5.0	4.9
Spain	**-5.2**	**-4.6**	**-3.8**	**-3.1**
Recently industrialised Asian economies	8.0	7.0	6.4	6.1

Lack of confidence, a certain degree of confusion, a lack of agreement about which policies to adopt first and social unrest can be described as the predominant features in 2011.

BANKIA is listed on the stock exchange

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Market Environment

Doubts about the Euro, the sovereign debt crisis and risks for the international economy

The ongoing sovereign debt crisis in 2011 threatened the sustainability of the current form of the EMU, highlighting the risks to the balance sheets of a large number of "systemic" financial entities that are evidently having encountering difficulties in re-establishing a sufficiently healthy balance sheet to continue their financing and credit operations normally.

2011 saw bank recapitalisations and country bailouts, especially that of Greece, and these clashed with the lack of political willingness to give up sovereignty in favour of economic and monetary stability in the euro zone. This struggle led to enforced changes of government in Portugal, Greece, and Italy. Throughout the year, the G-20 showed itself to be completely ineffective due to governments' lack of credibility. Finally, Germany and France took the helm in Europe, "imposing" their budget austerity programme even at the cost of this impacting on their own growth prospects. The size and speed of the proposed adjustment to conform to the new requirements greatly reduces the room for manoeuvre for those economies with the biggest problems (essentially the peripherals, Spain included) and increases the likelihood of these countries entering recession. At the same time, the difficulties in changing the remit, objectives and the way the ECB operates within the EMU is provoking debate, as is the monetary policy easing that the new president of the ECB,

Impact on stock prices of Eurozone crisis

Euro STOXX 50 vs. MSCI The World Index. Trend Comparison 2010 - 2011 with same baseline

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Market Environment

Mario Draghi, adopted in November when he lowered the intervention rate (from 1.5% to 1%), which had questionable benefits in the minds of some investors.

Even today nothing seems able to calm the turbulent waters in the sovereign debt markets, and the risk premiums of certain European countries are still being punished. However, in the last few weeks of 2011, pressure on debt financing costs of countries like Italy and Spain abated (falling by two or three percentage points) following Angela Merkel's statement that the EU was not contemplating any form of private sector participation in the necessary adjustment programmes (i.e. there will be no enforced haircuts). This action seemed to partially restore the credibility of long term sovereign debt interest rates as a risk free investment and led to a rally in both the debt and stock markets towards the end of last year.

This is the picture for the euro zone at the end of 2011. With internal markets frankly depressed, euro zone economies are looking at a short term future of little or no growth. As this outlook is shared by many euro zone countries with close commercial ties, the implication is that the export market, which helped growth during the crisis, is unlikely to be able to make up for domestic weakness. The depreciation in the euro/dollar exchange rate (to around $1.30 after reaching $1.50 in the course of 2011) is, perhaps, the most promising reading that can be taken for euro economies at the moment given that it helps exports which are also threatened by economic slowdown in several key emerging markets.

Budget deficit (% of GDP)	**Actual**		**Forecast**	
	2009	**2010**	**2011**	**2012**
Developed economies	**-9.9**	**-8.5**	**-7.9**	**-6.5**
U.S.	-12.8	-10.3	-9.6	-7.9
Japan	-10.3	-9.2	-10.3	-9.1
U.K.	-10.3	-10.2	-8.5	-7.0
Euro zone	**-6.3**	**-6.0**	**-4.1**	**-3.1**
Germany	-3.1	-3.3	-1.7	-1.1
Spain	**-11.1**	**-9.2**	**-6.1**	**-5.2**
Gross public debt (% of GDP)				
U.S.	85.2	94.4	100.0	105.0
Japan	216.3	220.0	233.0	238.4
U.K.	68.3	75.5	80.8	84.8
Euro zone	**79.9**	**85.8**	**88.6**	**90.0**
Germany	74.1	84.0	82.6	81.9
Spain	**53.3**	**60.1**	**67.4**	**70.2**

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Budget deficit (% of GDP)

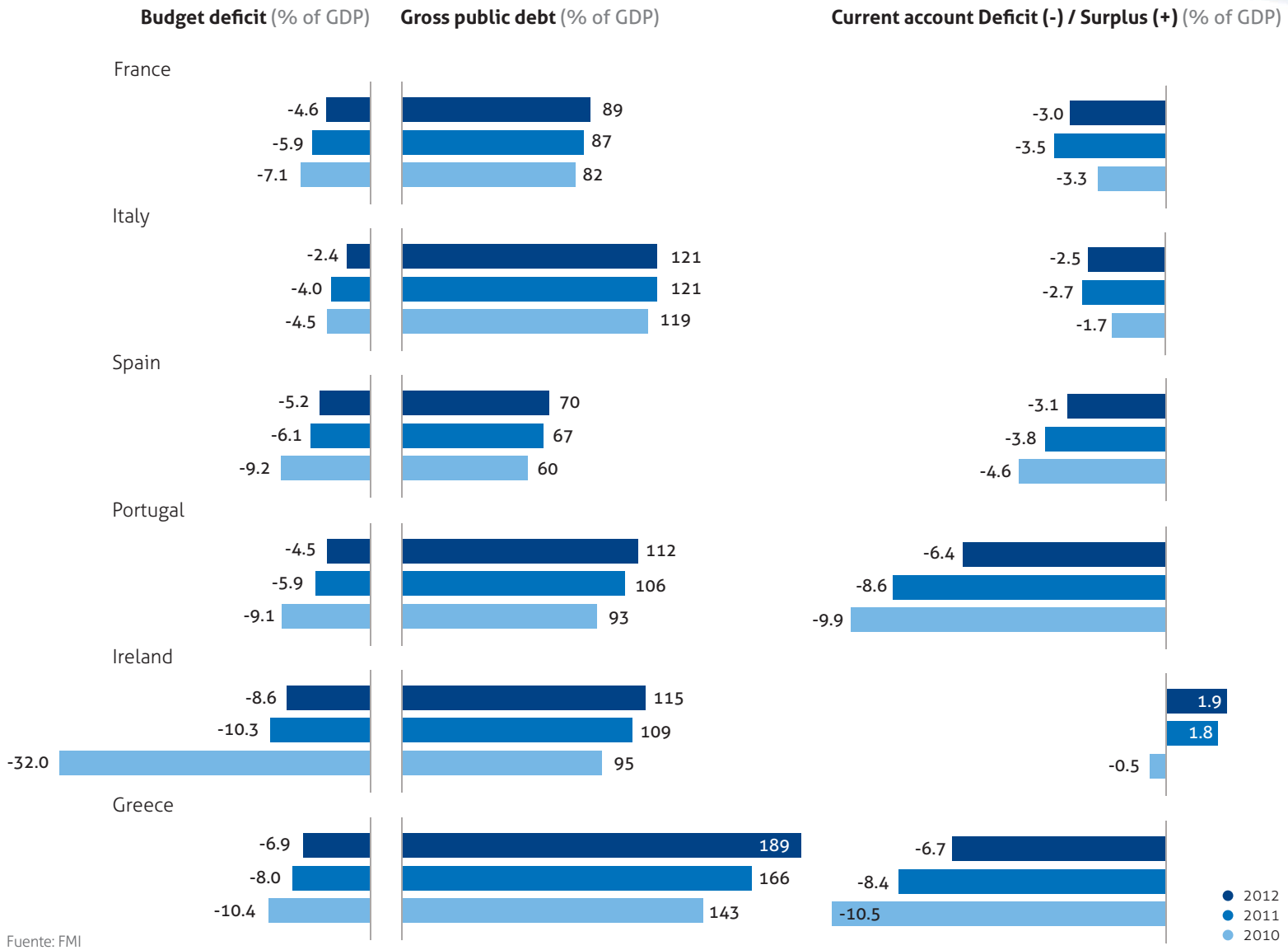
	2010	2011	2012
Greece	-10.4	-8.0	-6.9
Ireland	-32.0	-10.3	-8.6
Portugal	-9.1	-5.9	-4.5
Spain	-9.2	-6.1	-5.2
Italy	-4.5	-4.0	-2.4
France	-7.1	-5.9	-4.6

Gross public debt (% of GDP)

	2010	2011	2012
Greece	143	166	189
Ireland	95	109	115
Portugal	93	106	112
Spain	60	67	70
Italy	119	121	121
France	82	87	89

Current account Deficit (-) / Surplus (+) (% GDP)

	2010	2011	2012
Greece	-10.5	-8.4	-6.7
Ireland	-0.5	1.8	1.9
Portugal	-9.9	-8.6	-6.4
Spain	-4.6	-3.8	-3.1
Italy	-1.7	-2.7	-2.5
France	-3.3	-3.5	-3.0



Fuente: FMI

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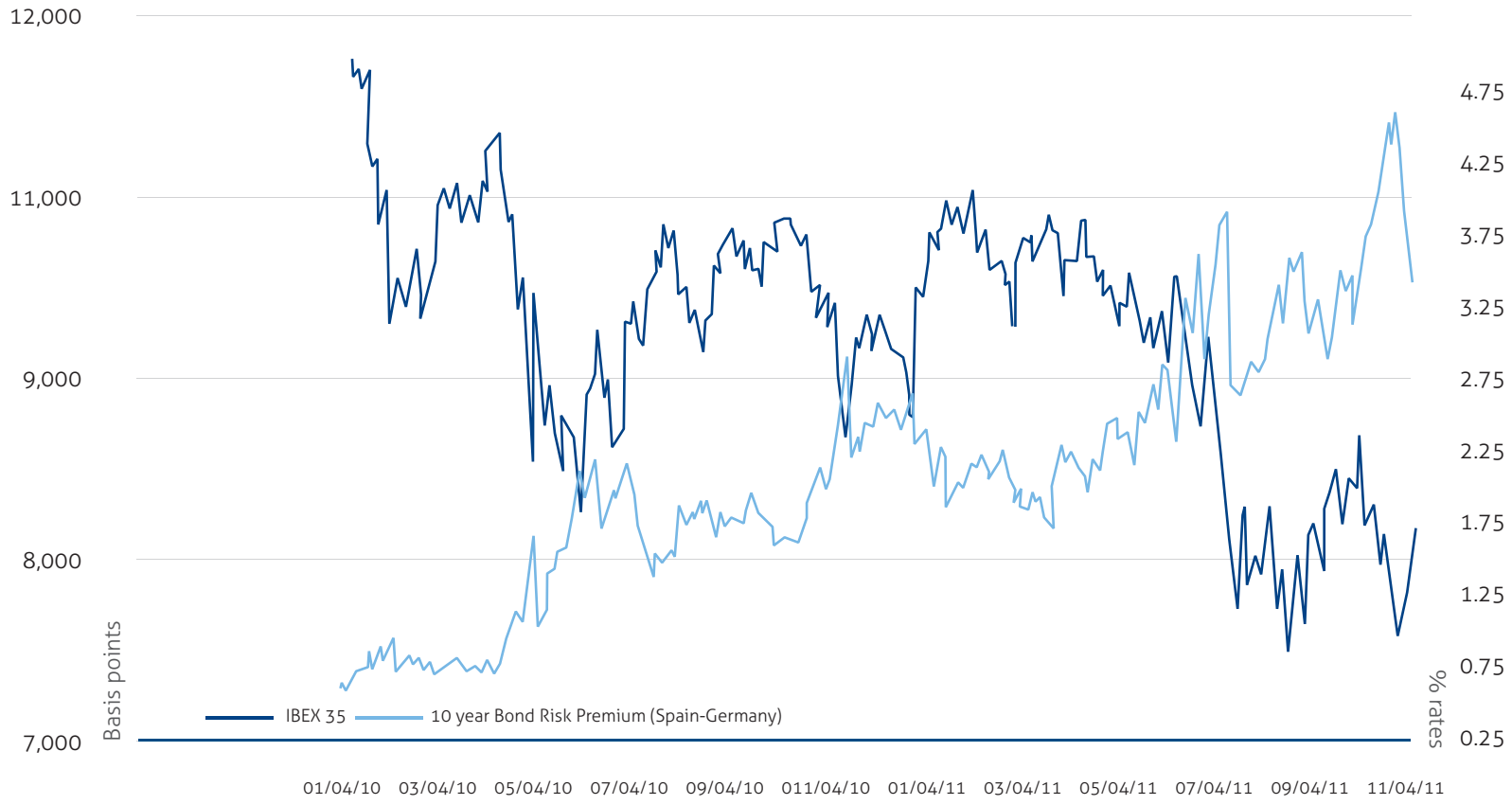
Market Environment

Spain: a difficult balance between economic growth and deleveraging

In Spain during 2011, only a certain dynamism in the foreign sector was able to slightly offset a domestic market depressed by unemployment and the subsequent weakness in consumption and the lack of public and private sector investor stimulus. GDP grew a mere 0.7% in 2011, having contracted 0.3% in the last quarter and forecasts for 2012 are not promising. The IMF expects GDP to contract around 1.7%, the EU -1% and the Bank of Spain -1.5%, with falls in all domestic consumption and investment components making up National Product (NP) as well as a slowdown in export activity.

The Spanish economy is trying to redress the situation through ongoing reforms and large-scale adjustments that began in 2009 and were most evident in 2011 through public spending cuts (including a change in the constitution), as well as restructuring the financial sector to ensure its viability (which has still to be completed). The main obstacles facing the Spanish economy in the short and medium term are the high unemployment rate, the strong fall in tax revenues and the high levels of household and bank debt.

IBEX 35 and Spanish Debt Risk Premium 2010- 2011
(Coef. Correlation of levels in 2011= -0.87)



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The Spanish economy has to face a period of Private Debt reduction and the recapitalisation of financial institutions is an unavoidable process. The effects of deleveraging on the recovery of GDP would certainly be more noticeable if accompanied by a depreciation in our currency exchange rate. A weaker euro would be positive for Spain and Europe as a whole. Likewise, the necessary budgetary austerity would also have a more positive effect on the economy if accompanied by deleveraging by the major economic agents, especially those in the financial sector.

All the procedures and reforms put into action in 2012 are long term processes, therefore, the short term outlook is bleak. If we put the unemployment rate to one side, the real Achilles heel of the Spanish economy is the relative size of the deleveraging that needs to be carried out following the effects of the real estate bubble built up over years.

According to the IMF, the fiscal adjustment that Spain needs to undergo between 2010 and 2030 is equivalent to about 11% of GDP. In some neighbouring countries these requirements are appreciably higher: United Kingdom, Ireland, Portugal and Japan between 13% and 15%, US around 17%, and Greece nearly 20%.

Plans to improve banks' equity levels (recapitalisation) are not an exclusively Spanish phenomenon. The European Banking Authority (EBA) has determined that European banks need additional capital of €118 billion. Of that sum, Greek banks need the most with €30 billion, Spanish banks require €26 billion and German banks €13 billion. These requirements must be covered before the summer of 2012 even if public funds have to be accessed to do so. The restructuring of the financial sector and the measures being implemented means that Spanish banks are on the way to complying with the new target of Tier 1 capital equivalent to 9% of balance sheet assets.

The concentration of "Spanish Public Debt" risk on the balance sheets of domestic banks is one of the highest in the world. The five largest Spanish banks have exposure of some €165 billion to Spanish debt (87% of their public debt portfolio). According to the latest official data, the Spanish financial sector has commitments of around €175 billion in operations tied to real estate assets.

Spain has to strike a difficult equilibrium between deleveraging and economic growth which may have a pernicious effect on the normal circulation of credit flows. Between 1995 and 2006 Spanish Public Debt fell by more than 30%, whilst Private Debt in the system rose by around 140%. Over the last 20 years, Spanish household debt has risen by 4.4 times (1.5 times since 2001) and today, it is equivalent to 92% of GDP. Over the same period, Spanish financial institutions have increased their debt 31 times (almost 11 times since 2001) and have debt equivalent to 104% of GDP. A large part of this sum (around €1.1 trillion) is owed to non resident lenders and when they reduce their exposure to Spain, national agents are obliged to reduce their debt with these lenders more rapidly than is in their interest to do so. These figures give a fairly clear idea of the scale of the programme that is being implemented; a programme that involves reducing liabilities, selling assets and increasing equity. A task where the role of the stock markets could prove decisive. In 2011, the Spanish stock market was tapped by companies to raise financing of more than €37 billion, the third highest amount in all the world's stock markets.

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Market Environment

In this context, despite tensions and some rather unsuitable restrictive measures imposed by regulators for operations involving certain types of shares, the Spanish stock market registered a reasonable level of aggregate activity and made an effective contribution in helping many companies meet their financing requirements, and channelled investors' funds in the process of cleaning up and restructuring Spanish banks and savings banks.

As can be seen in the activity data of BME's different areas of business, the tools that support stock market investment (liquidity, transparency, valuations, guarantees, etc) helped to counteract the negativity caused by the troubled environment.

At the same time, the prompt and efficient service offered by the BME Group allowed it to maintain a solid business position despite the slowdown in economic activity and the capital markets. The company's strength is based on its diverse income base, competitive products and services offered and cost control.

Spain - macroeconomic scenario 2011-2012
% yoy change except where stated

	2011		2012	
	Bank of Spain (January 2012)	**Funcas (21 November 2011)**	**Bank of Spain (January 2012)**	**Funcas (21 November 2011)**
Macroeconomic figures				
GDP	0.7	0.7	-1.5	-0.5
Household consumption	0.0	0.0	-1.2	-0.4
Public consumption	-1.2	-1.7	-6.3	-4.0
GFCF	-4.7	-4.9	-9.2	-5.8
Capital goods	2.2	1.2	-7.0	-1.4
Construction	-7.8	-7.8	-10.6	-8.2
Domestic demand	-1.3	-1.4	-4.0	-2.4
Exports	8.8	9.2	3.5	4.1
Imports	1.4	1.5	-4.8	-2.2
Foreign balance (contrib. GDP)	2.0	2.0	2.5	1.9
Other indicators				
Employment	-1.7	-1.6	-3.0	-2.0
Unemployment rate (% total workforce)	21.5	21.5	23.4	23.0
Unit labour costs	-1.8	-1.8	-0.8	-1.0
Household savings rate (% of GDI)	11.8	11.9	11.7	10.4
Balance of payments (% GDP)		-4.0		-2.4
Financing Capacity or requirement (% GDP)	-3.7	-3.5	-1.4	-1.9
Pub Admin balance (% GDP)	**-8.1**	**-7.5**	**-4.4**	**-4.4**
Gross public debt (% of GDP)		**68.1**		**72.3**

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Regulation

The dominant theme in 2011 was once again the raft of new regulations. The flood of regulations unleashed by the financial crisis has been so forceful and widespread that we find ourselves at the start of a true revolution in financial market legislation.

Over two years ago the international financial community embarked on a far-reaching regulatory review process (that is still ongoing) which affects all areas identified as causes of the crisis: systemic risk, supervisory failings, insufficient transparency. The European Union aspired to playing a leading role in the development of the G-20 action plan (London and Pittsburgh) to respond to the financial crisis, and many of the measures adopted in 2011 were done so with the aim of implementing this plan.

Anti-crisis measures

The most important Spanish legislation in 2011 was faithful to the criteria and aims of the EU directive: to mitigate the effects of the crisis, strengthen and give credence to the financial system, and, in the case of Spain, curb unemployment.

Of the whole range of exceptional measures that were approved to combat the crisis, two are particularly significant. Firstly, the amendment to article 135 of the Spanish Constitution. This amendment aims to guarantee budgetary stability, reinforcing Spain's commitment to the European Union and ensuring Spanish economic and social sustainability.

The second key regulation approved in 2011 was the plan to strengthen the Spanish financial sector. This regulation, which supplements other measures taken in 2010, has two main parts. It will strengthen the capital base of Spanish financial institutions and tailor the FROB as a public tool to facilitate compliance with the new capital requirement rules that financial entities are obliged to meet.

In relation to strengthening solvency levels, the new international standards for capital requirements established by Basel II have been adopted. The minimum capital required to cover risk weighted assets is 8%, 10% for those entities whose risk weighted assets exceed 20% and that have not placed at least 20% of their shares with third parties. The FROB reform aims to provide the necessary tools to help entities secure adequate capitalisation (Royal Decree-Law 2/2011).

In June, as part of the European reform process, motivated by the need to supervise credit entities, investment services companies and rating agencies and with the aim of ensuring the stability of the whole financial system, two key directives related to capital requirements and implementing a standardised regulation for credit rating agencies were transposed into Spanish legislation. These regulations strengthened financial institutions' capital management (Royal Decree 771/2011) and made changes to the supervision and operation of credit rating agencies (Law 15/2011).

New regulations to complete the recapitalisation and restructuring of the Spanish financial system were approved in the last quarter of 2011 (Royal Decree-Law 14/2011 and 19/2011).

The new government completed its programme of exceptional legislation on 31 December when it passed a series of urgent budgetary, tax and financial measures aimed at reducing the public deficit (Royal Decree-Law 20/2011).

These new fiscal and tax measures included an increase in the VAT rate and the tax on savings income through the creation of supplementary levies which will be applicable in 2012-2013. The withholding on income tax was also increased to 21%.

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Market Environment

MiFID and MiFIR: New regulations to make European financial markets more efficient and transparent

The G-20 statements issued in both London and Pittsburgh in 2009 highlighted the urgent need to strengthen the financial markets by improving transparency and stepping up the monitoring of less regulated markets such as the derivatives market. The statements also stressed the need to tackle the problem of excessive volatility in the commodities derivatives market.

In response to this, in October 2011 the European Commission submitted several proposals to amend the MiFID Directive, through a new Directive called MiFID II, along with a Regulation (MiFIR).

The Markets in Financial Instruments Directive (MiFID), in force since November 2007, regulates the provision of investment services using financial instruments (such as broking, advisory services, trading, portfolio management, insurance, etc) by banks and investment banks, as well as the management of traditional markets and alternative trading platforms (denominated Multilateral Trading Facilities). Although MiFID encouraged competition between these services, which provided investors with alternatives and more competitive pricing, the financial crisis exposed failings in the system in areas such as transparency, market oversight and competition.

The aim of the 2011 proposals is to make markets more efficient, solid and transparent, and increase investor protection. The new framework, which is scheduled to come into force in 2013, will give regulators greater oversight powers and introduce new operating rules covering all trading activities. Discussions of a similar nature are taking place in the United States with the Dodd-Frank Act and in other important international financial centres.

Main features of the proposed revisions

- A more solid and efficient market structure.
  The revision to MiFID presented in October 2011 introduces a new kind of trading centre: Organised Trading Facilities (OTFs), that will be subject to the same transparency and reporting requirements, code of business conduct, best execution and client order handling as those of regulated markets, multilateral trading facilities and investment services companies.

  However, OTFs will not be subject to the same obligations in the execution of orders. Whereas Regulated Markets and Multilateral Trading Facilities are subject to set order execution rules, operators in Organised Trading Facilities will have a certain amount of discretion as to how they execute their orders.

  The Federation of European Stock Exchanges (FESE) in a letter about the MiFID reform addressed to Commissioner Barnier on 8 April 2011 pointed out the possible competition problems that OTF regulations could bring about, exacerbating inequality between trading centres which could lead to regulatory arbitrage opportunities for execution service providers.

- Technological innovations
  Algorithmic and high frequency trading, and the much debated impact that these activities have on orderly markets, has led MiFID II to establish that companies dedicated to this type of trading should be subject to financial regulation. The new regulation will force them to establish risk controls, provide national regulators with information on their strategies and business parameters on a yearly basis and also disclose the algorithms used to execute orders. They must also make firm and constant price quotes to provide sustained liquidity no matter the market conditions.

- Transparency
  Transparency will be regulated by the MiFIR. Structured finance products, issuance fees and derivatives will be subject to the same transparency rules as bonds and debentures . The Commission believes this to be necessary to increase transparency levels in these products, as for the most part they are traded OTC.

  In addition, the Commission proposes to limit pre-transparency exemptions, which will be granted depending on the market model and the type and volume of the orders involved. Exemptions will only be granted through applying to the competent national authorities, under the aegis of the European Securities and Markets Authority (ESMA).

  As regards post-transparency, trades must be reported in the shortest time technically possible.

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- Greater oversight capacity and a stricter framework for commodity derivatives markets

The new European supervisory authority, created by Regulation 1095/2010 of the European Parliament and Council, has been in place since January 2011. This new entity comprises the European System of Financial Supervision (ESFS), which includes the European Securities and Markets Authority (ESMA), the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA), the European Systemic Risk Board (ESRB) and the competent authorities in each Member State. In coordination with the European Securities and Markets Authority, supervisors, under certain circumstances, will be able to ban specific products and services when they are deemed to present a threat to investor protection and financial stability or prevent markets from functioning in an orderly manner.

The proposals also require increased oversight of the commodity derivatives markets and establish information requirements for traders positions by category. This will allow both regulators and market participants to better evaluate the role speculation plays in these markets.

The concerns that the European Commission and the European Parliament have about regulating the derivatives business is shared by the G-20. In the final communiqué released at the Cannes Summit in November 2011, the organisation declared that, in order to build a stronger financial system, it was crucial that the OTC derivatives market be reformed.

- Investor protections

The new MiFID lays down stricter regulations on portfolio management, investment advice and the offering of complex financial instruments, regulating items that were previously exempt.

It also has tightened up established rules for eligible counterparties, imposing stricter standards on dealings between these counterparties and member states.

In order to avoid possible conflicts of interest, it will be forbidden for independent advisors and portfolio managers to receive incentives from third parties, to an even greater degree than originally established by MiFID. Lastly, corporate governance and management responsibilities guidelines have been established for all investment companies.