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Country Report: Voluntary Corporate Governance Code in Spain

The OECD asked several consultants, regulators, corporate governance institutes and other relevant stakeholders to elaborate reports regarding the development and implementation of voluntary corporate governance codes in each of their countries. The country reports as well as a synthesis report elaborated by the OECD Secretariat based upon them are provided to the Roundtable participants as background for the meeting's discussion.

The Spanish country report was jointly elaborated by the OECD Secretariat and the Spanish **Securities Market National Commission (CNMV)** based upon documents produced by the latter.

Further information regarding the code as well as its integral text can be found at: www.cnmv.es

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Organisation for Economic Co-operation and Development
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REPORT OF THE SPANISH UNIFIED GOOD GOVERNANCE CODE ISSUED BY THE CNMV

I. Introduction

Section one f) of Order ECO/3722/2003 of 26 December called on the Spanish Securities Markets Commission (Comisión Nacional del Mercado de Valores, **CNMV**) to publish “a single text with existing corporate governance recommendations”, for listed companies to use as a benchmark when reporting their compliance or otherwise with corporate governance recommendations in their Annual Corporate Governance Reports, as mandated by article 116 of the Securities Market Law (which makes it a mandatory “comply or explain” code).

In order to fulfill the latter, the Spanish Government agreed on 29 July 2005 to set up a Special Working Group to advise the CNMV with regard to the harmonization and update of the Olivencia and Aldama Report recommendations for the good governance of listed companies –the present code’s direct precedents- and to make any supplementary recommendations that it considered to be warranted.

The Special Working Group was officially constituted on 16 September 2005. Its membership was approved by the State Secretary for the Economy at the proposal of the Chairman of the CNMV. The five private-sector experts originally invited onto the Group were later joined by advisors to the European Commission in the areas of corporate governance and the reform of company law. The Group was integrated as follows:

Members from the public administration

- Manuel Conthe, Chairman (CNMV)
- Joaquín de Fuentes, State Advocate General
- Pilar Blanco-Morales, Director General of Registries and Notaries
- Soledad Núñez, Director General of the Treasury and Financial Policy
- Carmen Tejera, Director Legal Advisor to the State Secretary for the Economy
- José Manuel Gómez de Miguel, Head of Regulation, Banco de España

Members from the private sector

- Jesús Caínzos
- Ana María Llopis
- Aldo Olcese
- Cándido Paz-Ares
- Vicente Salas

Advisors to the European Commission on corporate governance matters:

- José María Garrido
- Enrique Piñel

Secretary

- Javier Rodríguez Pellitero, Director of the CNMV Legal Department

II. The Unified Code

On May 19, 2006 the Special Working Group unanimously approved:

- 1) The proposal for a Unified Good Governance Code; and
- 2) Supplementary Recommendations to the Government, CNMV and Spanish financial institutions

The Final Contents of the Report of the Special Working Group on the Good Governance of Listed Companies –detailed further in the present report- were the following:

ANNEX I - Unified Good Governance Code

I. Core Principles

II. Recommendations

III. Definitions

Appendix 1. Legal provisions relating to the Unified Code Recommendations

Appendix 2. Basic agreements between the Unified Code and other Recommendations

Appendix 3. Membership of the Special Working Group

ANNEX II – Supplementary Recommendations to the Government, CNMV and Financial Institutions

In drawing up its best corporate practices recommendations, the Group elected to confine itself to:

- Good governance recommendations for companies whose shares are traded on the stock exchange, although work may subsequently turn to the issuers of fixed-income securities.
- The internal governance of listed companies, i.e. without venturing too far into the terrain of “corporate social responsibility”, which mainly refers to companies’ dealings with stakeholders other than shareholders, is not circumscribed to listed companies and is being dealt with independently by a parliamentary sub-commission.
- Recommendations whose fulfillment is voluntary, rather than mixing them in with legal duties or binding rules. This is a point to remember when analyzing the Recommendations of the Unified Code, especially when comparing them with the good governance codes of other countries. Thus, readers less familiar with Spanish company law should be aware that what they may see as obvious omissions are in fact already written into current legislation. In this respect, Appendix 1 of the Code lists the most important Spanish legal texts governing the issues addressed by the Unified Code.

In its update of Olivencia and Aldama Report recommendations, the Group has borne in mind a number of international recommendations issued since the publication of the Aldama Report. These include the latest version of the OECD's Principles of Corporate Governance, along with:

- Recommendations and proposals of the European Commission such as:
 - a) Recommendation of 15 February 2005 (2005/162/EC) on the role of non-executive or supervisory directors and the committees of the (supervisory) board.
 - b) Recommendation of 14 December 2004 (2004/913/EC) on the remuneration of directors of listed companies.
 - c) Proposal for a Directive on the exercise of voting rights by listed company shareholders (COM (2005) 685 final), approved by the Commission on 5 January 2006.

- The recommendations on corporate governance for banking organizations approved by the Basel Committee on Banking Supervision¹.

The main points which the Unified Code has in common with the Olivencia and Aldama Reports and the above international recommendations are summarized in Appendix 2 of the Unified Code.

After several months of work in 2005 and a brief consultation round with market experts in early 2006, the Group submitted its Proposal for a Unified Code and Supplementary Recommendations to public consultation on 18 January 2006, appending a list of questions for consideration and comment. The consultation process involved two distinct stages: a series of presentation events at the four Spanish stock exchanges, at which a large number of suggestions were taken from the floor; and the reception of written comments, up to 28 February, which with the authors' consent were then posted on the CNMV website.

The Group looked carefully at all the comments and criticisms received, and as a result made numerous changes in the final version of the Unified Code that we can summarize as follows:

II.1 Changes in form

- The recommendations have been couched in terms of "should" rather than "will", to avoid any impression of a legal requirement.
- Reference is made to the fact that the "comply or explain" principle traces to article 116 of the Securities Market Law, and is not an innovation of the Code itself.
- Many recommendations have had a preamble added to clarify their content.
- The number of recommendations has been reduced and a separate section included with definitions of the main concepts used.

II.2 Changes in content

- The case where a dominant and subsidiary company are separately listed is no longer described as exceptional. And as the Code's control measures for related-party transactions are deemed sufficient as they stand, the recommendation that where related-party transactions between a dominant firm and listed subsidiary can be presumed to be frequent, the former should not hold a majority on the latter's board has been dropped from the final version.
- Also removed is the 50% limit recommended in the Proposal for the board places held by proprietary directors when their combined ownership interest is no greater than 50%.
- And the reference to a minimum number of board meetings.
- The reference to an independent Deputy Chairman as a check to the power of Executive Chairman has been replaced by the proposal that a lead independent director be appointed to coordinate the activity of external members.
- The recommendation that board secretaries should not be directors has been dropped from the Code, which now refrains from expressing an opinion either way.
- Likewise no mention is made of a 12-year limit as a defining condition for directorial independence, though the text retains the recommendation that independent directors should not hold their office beyond this term.

1. *Enhancing corporate governance for banking organisations*, Basel Committee on Banking Supervision, January 2006.

- The Code now explicitly states that the owner of a non significant shareholding (i.e., less than 5%) can be an independent director. In other words, it acknowledges that the receipt of dividends does not disqualify from independence.
- It is accepted that the remuneration report need not be published separately, but can be inserted in some other document like the Annual Corporate Governance Report, Annual Report or Directors' Report, whichever companies prefer. Individual directors' remuneration details are to be included in the notes to the annual accounts.
- The rules on the make-up of the Audit and Remuneration committees have been relaxed to some degree. These need no longer be formed by a majority of independents but simply appoint all their members from among external directors, with an independent in the chair.

A number of recommendations have been retained, at times with small adjustments or clarifications, despite attracting a degree of criticism. In particular:

- The imperative or binding nature of the minimum conditions for a director to qualify as "independent", as stipulated in clause 1.b) of Order ECO/3722/2003, of 26 December. In other words, companies may not call any director "independent" who does not meet the said requirements.
- The recommendation that company bylaws should not contain limitations on voting rights or any other defense mechanisms against takeover bids.
- The recommendation that executive directors be as few as is reasonably possible, though the text now allows for their equity ownership to be taken into account, along with the complexity of the corporate group.
- The recommendation that independent directors should occupy at least one third of board places, while allowing that the actual number resulting may be lower than 3 in very small boards.
- The recommendation on gender diversity, admitting that it may become redundant if Parliament passes new sex equality legislation.
- The recommendation that the board should decide on the wisdom of a director staying on if he or she is tried – not just charged – for any of the offences listed in article 124 of the Public Limited Companies Act as being an automatic cause for removal in the event of conviction.
- The recommendation that the remuneration report should be put to the advisory vote of the General Shareholders' Meeting.
- The recommendation – now separately formulated in the Code - that remuneration reports set out the individual payments made to board members, including those made to executive directors (among them, as a logical consequence, their remuneration as managers).
- The recommendation that companies establish a "whistle blowing" procedure under the supervision of the Audit Committee, so employees can confidentially or, where appropriate, even anonymously report any irregularities they observe in the company's conduct. The Working Group understands that the cases dealt with will mainly refer to financial or accounting matters, and that companies establishing such mechanisms will do so in strict adherence with the terms of data protection legislation.

Given that listed companies deciding to voluntarily subscribe to the Code may need to submit certain matters to their General Shareholders' Meetings (for instance, amendment of the General Meeting and board regulations or in some cases the company bylaws), the Working Group has urged the CNMV not to

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oblige them to specify fulfillment or otherwise of its corporate governance recommendations until the publication of the Annual Corporate Governance Reports corresponding to 2007. The Working Group wishes to extend a special thanks to the many professionals and experts who took the time to participate in its sessions; to all those citizens, institutions and Spanish and foreign firms who submitted their comments on the Draft Code; and, finally, to the professionals and support staff of the CNMV, whose dedication and collaborative spirit made the work of the Group considerably lighter.

III. Core Principles

Characteristics of the Code

a) *Voluntariness*, subject to the “comply or explain” principle

Article 116 of the Securities Market Law cites the principle known internationally as “comply or explain” in requiring listed Spanish firms to specify their “*degree of compliance with corporate governance recommendations, justifying any failure to comply*” in their Annual Corporate Governance Reports. The present Code sets out the recommendations to be borne in mind by listed companies when fulfilling their disclosure requirements under the said law.

In other words, Spanish legislation leaves it up to companies to decide whether or not to follow corporate governance recommendations, but requires them to give a reasoned explanation for any deviation, so that shareholders, investors and the markets in general can arrive at an informed judgement.

In keeping with this “voluntariness” principle, this Code does not replicate legally binding precepts among its recommendations. It therefore omits certain recommendations that are necessary in other countries or advocated by the European Commission, on the grounds that they are already written into Spanish law (see Appendix 1 for the Spanish provisions of most bearing in this connection).

b) *Binding definitions*

Listed companies can freely decide to comply or not with the Code's good governance recommendations, but their reporting on the same must invariably respect the underlying concepts used. So, for instance, it is up to companies whether they follow Recommendation 13 on independent directors, but what they cannot do is call a director “independent”, for the purposes of disclosure requirements, if that person does not meet the minimum conditions stated in point 5 of Section II (Definitions).

c) *Evaluation by the market*

It will be left to shareholders, investors and the markets in general to evaluate the explanations companies give of their degree of compliance with Code recommendations. In other words, the extent of compliance or the quality of explanations will not give rise to any actions by the CNMV, as this would directly invalidate the voluntary nature of the Code.

This affirmation is understood to be without prejudice to the monitoring powers assigned to the CNMV with regard to the Annual Corporate Governance Report of listed companies in article 116 of the Securities Market Law and Order ECO/3722/2003 of 26 December, whereby the regulator may order companies to make good any omissions or false or misleading data.

d) *Generality*

This Code is directed at all listed companies, whatever their size and market capitalization. This is not to deny that some recommendations may be unsuitable or excessively burdensome for smaller sized firms. In such cases, however, all firms need do is state their reasons for non fulfillment and any alternatives chosen, i.e. their freedom of decision and organizational autonomy are entirely guaranteed.

IV. Recommendations

Fifty eight (58) recommendation-style best practices were included in the Unified Code along with their respective briefing texts to better-explain their context. The specific subjects of the recommendations are the following:

a) Bylaws and general shareholders' meeting

- Bylaw restrictions
- Listed companies from the same group
- Competences of the General Shareholders' Meeting
- Prior circulation of board proposals to the General Shareholders' Meeting
- Separate votes on General Meeting items
- Split votes

b) Board of Directors

- The corporate interest
- Competences of the board
- Size
- Functional structure
- Other directors
- Proportion between proprietary and independent directors
- Sufficient number of independent directors
- Explaining the nature of directors
- Gender diversity
- The Chairman
- The Secretary
- Board meetings
- Regular evaluation
- Information to directors
- Dedication

c) On directors

- Selection, appointment and renewal
- Disclosure of director particulars
- Rotation of independent directors
- Removal and resignation
- Remuneration
- The advisory vote of the General Shareholders' Meeting
- Disclosure of individual remuneration

d) On committees

- Executive Committee
- Supervision and Control committees
- Audit Committee
- Nomination and Remuneration committees

V. Definitions

The following definitions were included in this section; (i) senior officer; (ii) significant shareholdings; (iii) executive directors; (iv) proprietary directors and (v) independent director. The definition of the latter is mandatory for companies in order to classify their directors to fulfill the legally-provided quota. Please find the definition of independent directors of the Unified Code attached to the present report as **“Annex 1”**.

VI– Supplementary Recommendations to the Government, CNMV and Financial Institutions

Supplementary recommendations regarding corporate governance framework and implementation strategies overall were included at ANNEX II of the Special Working Group Report. Please find said recommendations attached to the present report as **“Annex 2”**.

“ANNEX 1”**DEFINITION OF INDEPENDENT DIRECTORS AS PROVIDED IN THE UNIFIED CODE**

Directors appointed for their personal or professional qualities who are in a position to perform their duties without being influenced by any connection with the company, its shareholders or its management.

As such, the following shall in no circumstances qualify as independent directors:

- a) Past employees or executive directors of group companies, unless 3 or 5 years have elapsed, respectively, from the end of the relation.
- b) Those who have received some payment or other form of compensation from the company or its group on top of their directors' fees, unless the amount involved is not significant.

Dividends or pension supplements received by a director for prior employment or professional services shall not count for the purposes of this section, provided such supplements are non contingent, i.e. the paying company has no discretionary power to suspend, modify or revoke their payment, and by doing so would be in breach of its obligations.

- c) Partners, now or on the past 3 years, in the external auditor or the firm responsible for the audit report, during the said period, of the listed company or any other within its group.
- d) Executive directors or senior officers of another company where an executive director or senior officer of the company is an external director.
- e) Those having material business dealings with the company or some other in its group or who have had such dealings in the preceding year, either on their own account or as the significant shareholder, director or senior officer of a company that has or has had such dealings.

Business dealings will include the provision of goods or services, including financial services, as well as advisory or consultancy relationships.

- f) Significant shareholders, executive directors or senior officers of an entity that receives significant donations from the company or its group, or has done so in the past 3 years.

This provision will not apply to those who are merely trustees of a Foundation receiving donations.

- g) Spouses, or partners maintaining an analogous affective relationship, or close relatives of one of the company's executive directors or senior officers.
- h) Any person not proposed for appointment or renewal by the Nomination Committee.
- i) Those standing in some of the situations listed in a), e), f) or g) above in relation to a significant shareholder or a shareholder with board representation. In the case of the family relations set out in letter g), the limitation shall apply not only in connection with the shareholder but also with his or her proprietary directors in the investee company.

Proprietary directors disqualified as such and obliged to resign due to the disposal of shares by the shareholder they represent may only be re-elected as independents once the said shareholder has sold all remaining shares in the company.

A director with shares in the company may qualify as independent, provided he or she meets all the conditions stated in this Recommendation and the holding in question is not significant.

“ANNEX 2”**RECOMMENDATIONS TO THE GOVERNMENT, CNMV AND FINANCIAL INSTITUTIONS (ANNEX II OF THE UNIFIED CODE)****I. RECOMMENDATIONS TO THE GOVERNMENT****1. Rationalization of disclosure requirements.**

The Government is urged to review the reporting requirements applying to listed companies in order to eliminate unnecessary repetitions and duplications and, in particular, to unify and standardize the information they must disclose in connection with related-party transactions.

2. Extension of the maximum tenure of the chairmen of listed company Audit Committees.

The importance and complexity of the matters entrusted to the Audit Committee mean members in general and the chairman particularly must unite knowledge and capabilities that are not always easy to find. This being so, the current requirement to change chairman every four years can occasionally cause problems. The Government is therefore recommended to amend the eighteenth additional provision of the Securities Market Law in order to relax the requirement that the chairman of the Audit Committee of listed companies must be replaced at four-year intervals.

3. Coordination among small shareholders in defense of the corporate interest

The Government should look at ways to foster coordination among the small shareholders of listed companies, so they have a bigger say in the General Shareholders' Meeting and can better exercise the “minority rights” they are accorded under current law, while ensuring that any such mechanisms are used in good faith, and to defend the corporate interest.

Among the coordination mechanisms worth considering, singly or in combination, would be:

1. Creation of an Electronic Shareholder Forum so individual shareholders and shareholder groups can seek others' backing or proxy for proposals to be put to the General Shareholders' Meeting.
2. Creation by the CNMV of a Voluntary Register of Shareholder Associations.
3. Promotion of independent institutions and associations to analyze and assess the quality of listed company corporate governance.
4. Review of the regulations on proxy request forms with a view to their greater transparency and neutrality.

4. Shareholder lists and attendance cards

The Government is called on to amend Royal Decree 116/1992 in order that listed companies' entitlement to know their shareholders, as enshrined in the first additional provision of the Public Limited Companies Law is available to all – and not only to those companies whose shares must be registered under legal mandate.

This would mean attendance cards could be issued by the listed company itself, and not by the multiplicity of financial intermediaries acting as share custodians, ensuring their more uniform content at company level while facilitating the organization of General Meetings.

5. Challenging of shareholder resolutions

The Government is urged to study the necessary legal amendments to prevent the excessive, improper or abusive use of the powers to challenge General Shareholders' Meeting resolutions provided by article 117 of the Public Limited Companies Law.

6. Directors' liability for breach of trust

The Government is urged to tighten up and toughen the civil liability regime for breaches of trust by company directors. Some measures that might be considered are:

- a) A better typification of the duties of loyalty and the procedures to follow in the event of conflicts of interest;
- b) The extension of duties of loyalty, and the associated liability, to controlling shareholders, as well as to de facto directors, including shadow directors.
- c) Direct empowerment of shareholders to file a derivative suit for breach of trust, to be typified perhaps as a "minority right";
- d) Establishment of a leave to proceed filter so the judge can reject any cases constituting abuse of process;
- e) Imposing of heavier penalties, to include at least the return of sums corresponding to unjust enrichment. This Recommendation refers solely to breach of trust, and not to actions taken for negligence or breach of care.

II. RECOMMENDATIONS TO THE CNMV

7. Change of auditor

As a means to safeguard auditor independence, the CNMV should procure the following information whenever a listed company changes auditor:

- a) From the company: the corresponding significant event notice should state whether discrepancies arose with the outgoing auditor and, if so, explain their nature.
- b) From the outgoing auditor: a declaration of conformity or dissent regarding the above statement by the listed company;
- c) From the incoming auditor: confirmation that it had no conversations with the company, prior to its services being engaged, regarding the accounting or audit principles it would apply.

8. Use of Unified Code recommendations

Listed companies voluntarily subscribing to Unified Code recommendations may need to submit certain changes to their Shareholders' Meetings; for instance, the amendment of General Meeting and board regulations and, in some cases, the company's bylaws. It seems advisable, therefore, for the CNMV to wait until the Annual Corporate Governance Reports for the year 2007 (i.e. those published in 2008) before obliging firms to specify fulfillment or otherwise of the Code's corporate governance recommendations, pursuant to article 116 of the Securities Market Law.

III. RECOMMENDATIONS TO FINANCIAL INSTITUTIONS

9. Exercise of voting rights by institutional investors

Collective investment schemes, pension funds and plans and other institutional investors are urged to actively exercise the voting rights conferred by their ownership of listed companies' shares, and to inform their members or final investors of the general criteria used, if any, for the exercise of such rights.

10. Exercise of voting rights through intermediaries and custodians

Financial intermediaries belonging to the Sociedad de Sistemas (central depository company) and acting as depositories or custodians of listed company shares are urged to be scrupulous in passing the details of General Shareholders' Meetings onto their principals, and procuring their instructions on how to vote.