

# Annual Corporate Governance Report for Listed Companies

## A. Ownership structure

### A.1 Complete the following table on the company's share capital:

Date of last modification	Share capital (€)	Number of shares	Number of voting rights
2017/09/20	5,192,131,686.00	5,192,131,686	5,192,131,686

Indicate whether different types of shares exist with different associated rights:

No

### A.2 List the direct and indirect holders of significant ownership interests in your company at year-end, excluding directors:

Name or corporate name of shareholder	Number of direct voting rights	Number of indirect voting rights	% of total voting rights
Banco Bilbao Vizcaya Argentaria, S.A.	268,230,302	0	5.17%
CaixaBank, S.A.	259,611,788	342,072	5.01%
BlackRock, Inc.	0	344,259,683	6.63%

Name or corporate name of indirect holder	Through: Name or corporate name of direct holder	Number of voting rights
CaixaBank, S.A.	VidaCaixa, S.A. de Seguros y Reaseguros	342,072
BlackRock, Inc.	BlackRock Group	344,259,683

Indicate the most significant movements in the shareholding structure during the year.

Name or corporate name of shareholder	Date of transaction	Description of transaction
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### A.3 Complete the following tables on company directors holding voting rights through company shares.

Name or corporate name of director	Number of direct voting rights	Number of indirect voting rights	% of total voting rights
Mr. José María Álvarez-Pallete López	1,351,958	0	0.03%
Mr. Isidro Fainé Casas	595,382	0	0.01%
Mr. José María Abril Pérez	157,077	158,211	0.01%
Mr. Ángel Vilá Boix	333,463	0	0.01%
Ms. Eva Castillo Sanz	113,594	0	0.00%
Mr. José Javier Echenique Landiribar	31,850	75,712	0.00%
Mr. Peter Erskine	42,733	0	0.00%
Mr. Luiz Fernando Furlán	38,423	0	0.00%
Ms. Carmen García de Andrés	704	0	0.00%
Mr. Ignacio Moreno Martínez	18,311	0	0.00%
Mr. Francisco Javier de Paz Mancho	64,862	0	0.00%
Mr. Francisco José Riberas Mera	0	49,173	0.00%

Name or corporate name of indirect shareholder	Through: Name or corporate name of direct shareholder	Number of voting rights
Mr. José María Abril Pérez	Other company shareholders	158,211
Mr. José Javier Echenique Landiribar	Other company shareholders	75,712
Mr. Francisco José Riberas Mera	Other company shareholders	49,173
% of total voting rights held by the Board of Directors		0.06%

Complete the following tables on share options held by directors:

Name or corporate name of director	Number of direct voting rights	Number of indirect voting rights	Equivalent number of shares	% of total voting rights
Mr. José María Álvarez-Pallete López	192,000	0	300,000	0.00%
Mr. Ángel Vilá Boix	120,000	0	187,500	0.00%

**A.4** Indicate, as applicable, any family, commercial, contractual or corporate relationships between owners of significant shareholdings, insofar as these are known by the company, unless they are of little relevance or arise from ordinary trading or exchange activities.

**A.5** Indicate, as applicable, any commercial, contractual or corporate relationships between owners of significant shareholdings, and the company and/or its group, unless they are of little relevance or arise from ordinary trading or exchange activities.

Name or company name of related party	Type of relationship	Brief description
Banco Bilbao Vizcaya Argentaria, S.A.	Corporate	Shareholding of Banco Bilbao Vizcaya Argentaria, S.A. (or any of the companies of its Group), together with Telefónica, S.A. and with Caixabank, S.A., in Telefónica Factoring España, S.A., Telefónica Factoring Perú, S.A.C. (TFP Perú), Telefónica Factoring Colombia, S.A., Telefónica Factoring do Brasil, Ltda., Telefónica Factoring México, S.A. de C.V., SOFOM, E.N.R., and Telefónica Factoring Chile, S.A.
Banco Bilbao Vizcaya Argentaria, S.A.	Corporate	Shareholding of Ciérvana, S.L. (a company which belongs to Grupo BBVA), together with Telefónica Compras Electrónicas, S.A.U., in Adquira España, S.A.
Banco Bilbao Vizcaya Argentaria, S.A.	Corporate	Shareholding of BBVA Bancomer, Institución de Banca Múltiple, Grupo Financiero Bancomer (subsidiary of Banco Bilbao Vizcaya Argentaria, S.A.) together with Telefónica Móviles Mexico, S.A. de C.V. (subsidiary of Telefónica, S.A.) in Adquira de México, S.A. de C.V.
CaixaBank, S.A.	Corporate	Shareholding of Caixabank, S.A., with Telefónica, S.A. and with Banco Bilbao Vizcaya Argentaria, S.A. (or with any of the companies of its Group), in Telefónica Factoring España, S.A., Telefónica Factoring Perú, S.A.C. (TFP Perú), Telefónica Factoring Colombia, S.A., Telefónica Factoring do Brasil, Ltda., Telefónica Factoring México, S.A. de C.V., SOFOM, E.N.R., and Telefónica Factoring Chile, S.A.
CaixaBank, S.A.	Corporate	Shareholding of Caixabank Consumer Finance, E.F.C., S.A. (subsidiary of Caixabank, S.A.) together with Telefónica, S.A., in Telefónica Consumer Finance, E.F.C., S.A.

**A.6 Indicate whether any shareholders' agreements have been notified to the company pursuant to Articles 530 and 531 of the Spanish Corporations Act (Ley de Sociedades de Capital, hereinafter "LSC" in Spanish). Provide a brief description and list the shareholders bound by the agreement, as applicable.**

Yes

Parties to the shareholders' agreement
Vivendi, S.A.
Telefónica, S.A.
% of share capital affected
0.95%

**Brief description of the agreement:**

See heading H “Other information of interest”, Note 5 to Section A.6.

<b>Parties to the shareholders’ agreement</b>	
Telefónica, S.A.	
China Unicom (Hong Kong) Limited	
<b>% of share capital affected</b>	
	1.24%

**Brief description of the agreement:**

See heading H “Other information of interest”, Note 5 to Section A.6.

<b>Parties to the shareholders’ agreement</b>	
Telefónica, S.A.	
Koninklijke KPN NV	
<b>% of share capital affected</b>	
	1.43%

**Brief description of the agreement:**

See heading H “Other information of interest”, Note 5 to Section A.6.

**Indicate whether the company is aware of the existence of any concerted actions among its shareholders. Give a brief description as applicable.**

No

**Expressly indicate any amendments to or termination of such agreements or concerted actions during the year.**

See heading H “Other information of interest”, Note 5 to Section A.6.

**A.7 Indicate whether any individuals or bodies corporate currently exercise control or could exercise control over the company in accordance with Article 5 of the Spanish Securities’ Market Act (Ley del Mercado de Valores). If so, identify.**

No

#### A.8 Complete the following tables on the company's treasury shares.

At year end:

Number of shares held directly	Number of shares held indirectly (*)	% of total share capital
65,687,859	0	1.27%

(\*) Through:

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**Detail any significant changes during the year, in accordance with Royal Decree 1362/2007.**

#### Explain any significant changes

On September 26, 2017 all of the treasury stock movements made by the Company from the last notification were communicated to the Spanish National Securities Market Commission (effective December 9, 2016) in order to modify the number of voting rights of Telefónica, S.A. This was derived from an increase in capital with the issue of 154,326,696 new shares in response to the expiration of some convertible bonds (whose issuance was disclosed to the market via press releases of Significant Event on September 10 and 11, 2014, with register number 210598 and 210620, respectively). Among the treasury stock movements communicated, the most relevant corresponds to the transmission, of 72,007,507 Company shares, dated March 14, 2017, which represented 1.387% of the share capital, as a consequence of the share swap carried out with Koninklijke KPN NV (KPN) that was notified to the Spanish National Securities Market Commission through Significant Event on March 13, 2017, with register number 249449.

The transmissions on August 2 and September 21, 2017 correspond to the conversion of the previously mentioned Bonds. For these purposes, the minimum value of the share was set at 9.7174 euros.

The rest of the transmissions correspond to the execution of different incentive plans for employees. Considering all the transactions made by the Company from December 9, 2016 to September 26, 2017, a total of 75,359,265 shares were directly transmitted, which represented 1.451% of the share capital.

#### A.9 Give details of the applicable conditions and time periods governing any resolutions of the General Shareholders Meeting authorizing the Board of Directors to repurchase or transfer the treasury shares.

At Telefónica's Ordinary General Shareholders Meeting held on May 30, 2014, the shareholders resolved to renew the authorisation granted at the General Shareholders Meeting of June 2, 2010, for the derivative acquisition of treasury stock, either directly or through Group companies, in the terms literally transcribed below:

"A) Authorise, pursuant to articles 144 and the articles thereunder of the Spanish Corporations Act, the derivative acquisition, at any point and as many times as it might be deemed necessary, by Telefónica, S.A. – either directly, or through any of its subsidiaries – of treasury stock, fully-paid, by purchase and sale, by exchange or by any other legal transaction.

The minimum acquisition price or minimum value of the consideration shall be equal to the par value of the shares of its own stock acquired, and the maximum acquisition price or maximum consideration value shall be

equal to the listing price of the shares of its own stock acquired by the Company on an official secondary market at the time of the acquisition.

Such authorization is granted for a period of 5 years as from the date of this General Shareholders' Meeting and is expressly subject to the limitation that the par value of the Company's own shares acquired directly or indirectly pursuant to this authorization added to those already held by Telefónica, S.A. and all its controlled subsidiaries shall at no time exceed the maximum amount permitted by the Law at any time, and the limitations on the acquisition of the Company's own shares established by the regulatory Authorities of the markets on which the shares of Telefónica, S.A. are traded shall also be observed.

It is expressly stated for the record that the authorization granted to acquire shares of its own stock may be used in whole or in part to acquire shares of Telefónica, S.A. that it must deliver or transfer to directors or employees of the Company or of companies of its Group, directly or as a result of the exercise by them of option rights owned by them, all within the framework of duly approved compensation systems referencing the listing price of the Company's shares.

B) To authorize the Board of Directors, as broadly as possible, to exercise the authorization granted by this resolution and to implement the other provisions contained therein; such powers may be delegated by the Board of Directors to the Executive Commission, the Executive Chairman of the Board of Directors, the Chief Operating Officer or any other person expressly authorized by the Board of Directors for such purpose.

C) To deprive of effect, to the extent of the unused amount, the authorization granted under Item III on the Agenda by the Ordinary General Shareholders Meeting of the Company on June 2, 2010."

#### A.9.bis. Estimated free-float capital:

Estimated free-float capital	%
	80.94

**A.10** Indicate, as applicable, any restrictions on the transfer of securities and/or any restrictions on voting rights. In particular, indicate any type of restrictions that could impose obstacles to the takeover of the company by means of share purchases on the market.

Yes

Description of the restrictions
See heading H "Other information of interest", Note 7 to Section A.10.

**A.11** Indicate whether the General Shareholders' Meeting has agreed to take neutralization measures to prevent a public takeover bid by virtue of the provisions of Act 6/2007.

No

If applicable, explain the measures adopted and the terms under which these restrictions may be lifted.

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**A.12** Indicate whether the company has issued securities not traded in a regulated market of the European Union.

**Yes**

If so, identify the various classes of shares and, for each class of shares, the rights and obligations they confer.

Shares of Telefónica, S.A. are traded on the Spanish electronic trading system (the “Continuous Markets”), and also on the stock exchanges of New York, London, Lima and Buenos Aires, and they all have the same characteristics, rights and obligations.

On the New York and Lima stock exchanges, Telefónica, S.A. shares are traded through American Depositary Shares (ADSs), where each ADS represents a Company share.



## B. General Shareholders Meeting

**B.1** Indicate and, as applicable, describe any difference between the system of minimum quorums for constitution of the General Shareholders Meeting established in the Spanish Corporations Act (Ley de Sociedades de Capital, hereinafter "LSC" in Spanish).

No

**B.2** Indicate and, as applicable, describe any differences between the company's system of adopting corporate resolutions and the framework established in the LSC:

No

Describe how they differ from the rules established in the LSC.

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**B.3** Indicate the rules governing amendments to the company's Bylaws. In particular, indicate the majorities required to amend the Bylaws and, if applicable, the rules for protecting shareholders' rights when changing the Bylaws.

The Bylaws and Regulations for the General Shareholders Meeting of Telefónica confer upon the General Shareholders Meeting the power to agree to amend the Corporate By-laws (articles 15 and 5, respectively), being subject to legal provisions applicable for all other matters.

The procedure for amending the Bylaws is governed by Articles 285 and following articles of the revised text of the Spanish Corporations Act, and needs to be approved at the General Shareholders Meeting with the majorities stated in Articles 194 and 201 of the same law. In particular, if the Shareholders Meeting is convened to deliberate on Bylaw amendments, including capital increases or decreases, on eliminating or restricting the preferential acquisition right for new shares, and the transformation, merger, spin-off, or the global assignment of assets and liabilities and the relocation of the registered offices abroad, then shareholders which own at least fifty per cent of the subscribed capital with voting rights will have to be present or be represented by proxy on first call. If there is no sufficient quorum, then the Shareholders' Meeting will be held on second call, on this occasion at least twenty-five per cent of the subscribed capital with voting rights will need to be present, either in person or by proxy. When shareholders which represent less than fifty per cent of the subscribed capital with voting rights are present at the Shareholders Meeting, either in person or by proxy, the resolutions referred to above can only be approved when two thirds of the capital, present or represented by proxy at the Shareholders Meeting, vote in favour of the resolution.

Pursuant to article 286 of the Spanish Corporations Act, if the Bylaws are amended, then the Directors, or, if applicable, the shareholders who have made the proposal, will have to draw up in full the text of their proposed amendment, and a written report in which they justify the amendment, which will have to be submitted to the shareholders which are taking part in the Shareholders' Meeting to deliberate on that amendment.

Furthermore, pursuant to article 287 of the Spanish Corporations Act, the announcement calling the General Shareholders Meeting will have to clearly state the questions which might have to be amended, and note that all the shareholders are entitled to analyse the full text of the proposed amendment and the report on such an amendment at the registered offices, and also to request that such documents be delivered to them or sent free of charge.

According to article 291 of the Spanish Corporations Act, when new obligations are established for shareholders due to amendment of the Bylaws, the resolution will have to be passed with the approval of the affected shareholders. Furthermore, if the amendment directly or indirectly affects a type of shares, or part of them, then the provisions of article 293 of that Act will be applicable.

The procedure for voting on proposed resolutions by the Shareholders' Meeting is also regulated in Article 197 bis of the Spanish Corporations Act, in the internal regulations of Telefónica (in particular, in Article 23 of the Regulations of the General Shareholders Meeting). This Article states that, when amendments are made to the Bylaws, each article or group of articles which are materially different will be voted for separately.

#### B.4 Indicate the attendance figures for the General Shareholders' Meetings held during the year:

Date of general meeting	Attendance data				
	% attending in person	% by proxy	% remote voting		Total
			Electronic means	Other	
2016/05/12	0.21%	55.34%	0.03%	0.55%	56.13%
2017/06/09	0.27%	55.71%	0.03%	0.49%	56.50%

#### B.5 Indicate whether the Bylaws impose any minimum requirement on the number of shares required to attend the General Shareholders Meetings.

Yes

Number of shares required to attend the General Shareholders Meetings
300

#### B.6 Section eliminated.

#### B.7 Indicate the address and mode of accessing corporate governance content on your company's website as well as other information on General Meetings which must be made available to shareholders on the website.

Telefónica complies with applicable legislation and best practices in terms of the content of its website concerning Corporate Governance. In this respect, it fulfils both the technical requirements for access and for content for the Company website, including information on General Shareholders Meetings, through direct access from the homepage of Telefónica, S.A. ([www.telefonica.com](http://www.telefonica.com)) in the section "Shareholders and Investors" ([www.telefonica.com/accionistaseinversores](http://www.telefonica.com/accionistaseinversores)), which includes not only all of the information that is legally required, but also information that the Company considers to be of interest.

All the available information included on the Company website, except for certain specific documents, is available in two languages: Spanish and English.

## C. Company management structure

### C.1 Board of Directors

C.1.1 List the maximum and minimum number of directors included in the Bylaws:

Maximum number of directors	20
Minimum number of directors	5

C.1.2 Complete the following table with board members' details.

Name or corporate name of director	Representative	Type of director	Position on the Board	Date of first appointment	Date of last appointment	Election procedure
Mr. José María Álvarez-Pallete López	-	Executive	Chairman	2006/07/26	2017/06/09	Resolution of General Shareholders' Meeting
Mr. Isidro Fainé Casas	-	Proprietary	Vice Chairman	1994/01/26	2016/05/12	Resolution of General Shareholders' Meeting
Mr. José María Abril Pérez	-	Proprietary	Vice Chairman	2007/07/25	2013/05/31	Resolution of General Shareholders' Meeting
Mr. Ángel Vilá Boix	-	Executive	Chief Operating Officer (C.O.O.)	2017/07/26	2017/07/26	Co-opting
Ms. Eva Castillo Sanz	-	Other external Directors	Director	2008/01/23	2013/05/31	Resolution of General Shareholders' Meeting
Mr. Juan Ignacio Cirac Sasturain	-	Independent	Director	2016/04/08	2016/05/12	Resolution of General Shareholders' Meeting
Mr. José Javier Echenique Landiribar	-	Independent	Director	2016/04/08	2016/05/12	Resolution of General Shareholders' Meeting
Mr. Peter Erskine	-	Independent	Director	2006/01/25	2016/05/12	Resolution of General Shareholders' Meeting
Ms. Sabina Fluxà Thienemann	-	Independent	Director	2016/04/08	2016/05/12	Resolution of General Shareholders' Meeting
Mr. Luiz Fernando Furlán	-	Independent	Director	2008/01/23	2013/05/31	Resolution of General Shareholders' Meeting
Ms. Carmen García de Andrés	-	Independent	Director	2017/05/04	2017/06/09	Resolution of General Shareholders' Meeting
Mr. Peter Löscher	-	Independent	Director	2016/04/08	2016/05/12	Resolution of General Shareholders' Meeting
Mr. Ignacio Moreno Martínez	-	Proprietary	Director	2011/12/14	2017/06/09	Resolution of General Shareholders' Meeting
Mr. Francisco Javier de Paz Mancho	-	Independent	Director	2007/12/19	2013/05/31	Resolution of General Shareholders' Meeting
Mr. Francisco José Riberas Mera	-	Independent	Director	2017/05/04	2017/06/09	Resolution of General Shareholders' Meeting
Mr. Wang Xiaochu	-	Proprietary	Director	2015/09/30	2016/05/12	Resolution of General Shareholders' Meeting

<b>Total number of directors</b>	16
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Indicate any board members who left during this period:

<b>Name or corporate name of director</b>	<b>Type of directorship at time of leaving</b>	<b>Leaving date</b>
Mr. César Alierta Izuel	Other external Director	2017/05/04
Mr. Gonzalo Hinojosa Fernández de Angulo	Independent	2017/05/04
Mr. Pablo Isla Álvarez de Tejera	Independent	2017/05/04
Mr. Julio Linares López	Other external Director	2017/07/26
Mr. Antonio Massanell Lavilla	Proprietary	2017/12/21

C.1.3 Complete the following tables on board members and their respective categories:

#### EXECUTIVE DIRECTORS

<b>Name or corporate name of director</b>	<b>Post held in the company</b>
Mr. José María Álvarez-Pallete López	Executive Chairman
Mr. Ángel Vilá Boix	Chief Operating Officer (C.O.O.)
<b>Total number of executive directors</b>	2
<b>% of the Board</b>	12.50%

#### EXTERNAL PROPRIETARY DIRECTORS

<b>Name or corporate name of director</b>	<b>Name or corporate name of significant shareholder represented or proposing appointment</b>
Mr. José María Abril Pérez	Banco Bilbao Vizcaya Argentaria, S.A.
Mr. Ignacio Moreno Martínez	Banco Bilbao Vizcaya Argentaria, S.A.
Mr. Isidro Fainé Casas	CaixaBank, S.A.
Mr. Wang Xiaochu	China Unicom (Hong Kong) Limited
<b>Total number of proprietary directors</b>	4
<b>% of the Board</b>	25.00%

## INDEPENDENT EXTERNAL DIRECTORS

Name or corporate name of director	Profile
Mr. Juan Ignacio Cirac Sasturain	Graduated in Theoretical Physics. Ph. D. in Physics. Fields of Specialization in Quantum Optics, Quantum Computation, Atomic Physics.
Mr. José Javier Echenique Landiribar	Economic and Actuarial Sciences Graduate. Vice-Chairman of Banco Sabadell, S.A.
Mr. Peter Erskine	Psychology Graduate. Was General manager of Telefónica Europe until December 2007. Was Chairman of Ladbrokes, Plc until December 2015.
Ms. Sabina Fluxà Thienemann	Business Management and Administration graduate. MBA from ESADE. High Business Management Program at IESE. Co-Vice Executive President and CEO of Iberostar Group.
Mr. Luiz Fernando Furlán	Degrees in chemical engineering and business administration, specialising in financial administration. From 2003 to 2007 he was Minister of Development, Industry and Foreign Trade of Brazil.
Ms. Carmen García de Andrés	Degree in Economic and Business Sciences. Chairwoman of Tomillo Foundation.
Mr. Peter Löscher	Degree in Economics and Business. MBA at Vienna University of Economics. Advanced Management Program at Harvard Business School. Chairman of the Supervisory Board of OMV Aktiengesellschaft and Sulzer AG.
Mr. Francisco Javier de Paz Mancho	Graduate in Information and Advertising. Law Studies. IESE Business Management Program. Formerly Chairman of the State-owned company MERCASA.
Mr. Francisco José Riberas Mera	Degree in Law and in Economics and Business Administration. Chief Executive Officer of Gestamp Automoción, S.A.
<b>Total number of independent directors</b>	<b>9</b>
<b>% of the Board</b>	<b>56.25%</b>

List any independent directors who receive from the company or group any amount or payment other than standard director remuneration or who maintain or have maintained during the period in question a business relationship with the company or any group company, either in their own name or as a significant shareholder, director or senior manager of an entity which maintains or has maintained the said relationship.

**No**

If applicable, include a statement from the board detailing the reasons why the said director may carry on their duties as an independent director.

## OTHER EXTERNAL DIRECTORS

Identify the other external directors and list the reasons why these cannot be considered proprietary or independent directors and detail their relationships with the company, its executives or shareholders.

Name or corporate name of director	Reasons	Company, executive or shareholder with whom the relationship is maintained
Ms. Eva Castillo Sanz	On February 26, 2014, Ms. Eva Castillo Sanz resigned as Chairwoman of Telefónica Europa, and was therefore included in the "Other external Directors" category.	Telefónica, S.A.
<b>Total number of other external directors</b>		1
<b>% of the Board</b>		6.25%

List any changes in the category of each director which have occurred during the year.

Name or corporate name of director	Date of change	Former category	Current category
-	-	-	-

C.1.4 Complete the following table on the number of female directors over the past four years and their category.

	Number of female directors				% of total directors of each type			
	Year 2017	Year 2016	Year 2015	Year 2014	Year 2017	Year 2016	Year 2015	Year 2014
Executive	0	0	0	0	0.00%	0.00%	0.00%	0.00%
Proprietary	0	0	0	0	0.00%	0.00%	0.00%	0.00%
Independent	2	1	0	0	22.22%	11.11%	0.00%	0.00%
Other External	1	1	1	1	100.00%	33.33%	33.33%	50.00%
<b>Total:</b>	3	2	1	1	18.75%	11.11%	5.56%	5.56%

C.1.5 Explain the measures, if applicable, which have been adopted to ensure that there is a sufficient number of female directors on the board to guarantee an even balance between men and women.

Explanation of measures

See heading H "Other information of interest". Note 9 to Section C.1.5.

C.1.6 Explain the measures taken, if applicable, by the Nominating Committee to ensure that the selection processes are not subject to implicit bias that would make it difficult to select female directors, and whether the company makes a conscious effort to search for female candidates who have the required profile.

Explanation of measures

In accordance with Article 10.3 of the Board Regulations, the Board of Directors and the Nominating, Compensation and Corporate Governance Committee shall ensure, within the scope of their respective powers, that the candidates chosen are persons of recognized calibre, qualifications and experience, who are willing to devote a sufficient portion of their time to the Company, and shall take extreme care in the selection of the persons to be appointed as Independent Directors.

In this context, the Nominating, Compensation and Corporate Governance Committee analyzed and favorably reported the update of the Board Member Selection Policy (approved, in its first version, on November 25, 2015), which included the Diversity Policy applicable to the Telefónica, S.A. Board of Directors. It was thus renamed the Diversity Policy related to the Telefónica, S.A. Board of Directors and Board Member Selection, approved by the Board of Directors at their meeting held on December 13, 2017.

Furthermore, subject to Article 10.4 of the Regulations of the Board of Directors, the results of the preliminary analysis of the needs of the Board of Directors will be set out in the report of the Nominating, Compensation and Corporate Governance Committee, which will be published on calling the General Shareholders Meeting at which each Director will be submitted for ratification, appointment or re-election.

When, despite the measures taken, there are few or no female directors, explain the reasons.

Explanation of the reasons.

As shown in Table C.1.4, the selection procedures do not suffer from implicit biases that hinder the selection of Directors and in fact the Company has deliberately sought women who meet the professional profile sought. In this sense, regarding the percentage that female Directors represent with respect to the total number of members of the Board of Directors, in Table C.1.4, it observes the qualitative leap that the Company has made in this area, having gone from 5.56% in 2015, to 11.11% in 2016 and, finally, to 18.75% in 2017.

All the measures and processes agreed and adopted by the Board of Directors and the Nominating, Compensation and Corporate Governance Committee to ensure the number of female directors on the Board guarantee an even balance and to ensure that the selection processes are not subject to implicit bias that would make it difficult to select female directors have been implemented and initiated by the Company.

Thus, in the amendment carried out during the year 2016 in the composition of the Company's Board of Directors, Ms. Sabina Fluxà Thienemann was appointed unanimously by the Board of Directors, at the proposal of the Nominating, Compensation and Corporate Governance Committee, as Independent Director of Telefónica. This appointment was ratified by the Telefónica General Shareholder's Meeting held on May 12, 2016.

Likewise, in the amendment brought into effect in 2017 on the composition of the Board of Directors of the Company, the Board of Directors unanimously appointed Ms. Carmen García de Andrés as Independent Board Member of Telefónica, at the proposal of the Nominating, Compensation and Corporate Governance Committee. This appointment was ratified by the Telefónica General Shareholder's Meeting held on June 9, 2017.

In both proposals to appoint (Ms. Sabina Fluxà Thienemann and Ms. Carmen García de Andrés), the Nominating, Compensation and Corporate Governance Committee considered the solvency, competency, experience, professional merits and availability of Ms. Fluxà and Ms. García de Andrés for their effective performance of the duties, exclusively considering their individual and professional characteristics. All of this was included in the framework of the then valid Board Member Selection Policy, which, with respect to the promotion of the presence of Board Members in the Board of Directors, already expressly imposed the obligation to favor gender diversity in Board Member selection procedures, and prohibited any type of implicit bias that could entail any discrimination.

C.1.6.bis Explain the conclusions of the Nominating Committee regarding verification of compliance with Director selection policy. And, in particular, how this policy is being used towards the target that at least 30% of the total members of the Board of Directors should be female directors by 2020.

## Explanation of conclusions.

Telefónica S.A. has a Board Member Selection Policy as of November 25, 2015. This policy was updated on December 13, 2017 to include the Diversity Policy applicable to the Board of Directors and, as a consequence, was renamed the Diversity Policy in relation to the Telefónica S.A. Board of Directors and the Selection of Board Members. This Policy is concrete and verifiable, and as of November 25, 2015 (before its update of December 13, 2017), assures that the proposals for appointments or re-election of Board Members is based on a prior analysis of the Board of Director's needs, and favours the diversity of knowledge, experience, and gender without incurring in any implicit bias that may imply any discrimination whatsoever.

Said Diversity Policy in relation to the Telefónica S.A. Board of Directors and the Selection of Board Members is public and may be viewed on the corporate web page ([www.telefonica.com](http://www.telefonica.com)).

Within the framework of the Selection of Board Members Policy (valid before the approval, on December 13, 2017 of the Policy of Diversity in relation to the Telefónica S.A. Board of Directors and the Selection of Board Members), during the 2017 fiscal year, the Nominating, Compensation and Corporate Governance Committee proposed and/or informed, as the case may be, the appointment of Telefónica S.A. Board Members in accordance to the aforementioned criteria, considering the solvency, competency, experience, professional merits, and disposition of the candidates to dedicate the time and effort necessary for the efficient performance of their duties, exclusively considering their personal and professional characteristics, all of this to favour the diversity of knowledge, experience, and gender, without incurring in any implicit bias that may imply any discrimination whatsoever.

Thus, in its meeting celebrated on May 3, 2017 the Committee proposed to the Company's Board of Directors the appointment by co-option as Independent Board Members Ms. Carmen García de Andrés and Mr. Francisco José Riberas Mera, after the voluntary resignation from their positions as Board Members presented by Mr. César Alierta Izuel, Mr. Gonzalo Hinojosa Fernández de Angulo, and Mr. Pablo Isla Álvarez de Tejera. And, similarly, in its meeting celebrated on July 25, 2017 the Committee favourably informed the appointment by co-option of Mr. Ángel Vilá Boix as Executive Board Member in replacement of Mr. Julio Linares López.

Likewise, within the framework of the Selection of Board Members Policy (valid before the approval, on December 13, 2017 of the Policy of Diversity in relation to the Telefónica S.A. Board of Directors and the Selection of Board Members), the Committee favourably informed and/or proposed, as the case may be, the re-election and ratification of the Telefónica S.A. Board Members by the Company's Ordinary General Shareholders Meeting, considering and assessing the duties performed and the dedication of the Board Members, basing all of the proposals on a prior analysis of the Board of Director's needs, and favouring the diversity of knowledge, experiences, and gender.

Thus, the Ordinary General Meeting of Shareholders celebrated on June 9, 2017 approved, at the proposal of the Company's Board of Directors, the re-election of Mr. José María Álvarez-Pallete López and of Mr. Ignacio Moreno Martínez, as well as the ratification of the appointments of Ms. Carmen García de Andrés and Mr. Francisco José Riberas Mera.

In this sense, it must be noted that the Nominating, Compensation and Corporate Governance Committee verified the compliance of the Selection of Board Members Policy (valid before the approval, on December 13, 2017 of the Policy of Diversity in relation to the Telefónica S.A. Board of Directors and the Selection of Board Members), on the occasion of the preparation of the proposals for appointment, re-election, and/or ratification of the Board Members presented to the General Meeting of Shareholders celebrated on June 9, 2017.

As for the percentage that the female Board Members represent with respect to the total number of members of the Board of Directors, a qualitative leap that the Company has taken in this field can be observed in figure C.1.4, passing from 5.56% in 2015 to 11.11% in 2016, and finally to 18.75% in 2017.

### C.1.7 Explain how shareholders with significant holdings are represented on the board.



As stated in section C.1.3 of this Annual Corporate Governance Report, at December 31, 2017, the group of external Directors of Telefónica, S.A. was composed of 14 members (out of a total of 16 Members), of whom 4 are proprietary Directors, 9 are independent and 1 falls under the "Other external Directors" category.

Of the four proprietary Directors, at December 31, 2017, one acts in representation of CaixaBank, S.A. which holds 5.01% of the capital stock of Telefónica, S.A., and two act in representation of Banco Bilbao Vizcaya Argentaria, S.A. (BBVA), which holds 5.17% of the capital; and one in representation of China Unicom (Hong Kong) Limited (China Unicom), which owns 1.24% of the capital stock. The percentages mentioned above refer to December 31, 2017.

It is noted that until December 21, 2017, there were two Directors who acts in representation of CaixaBank, S.A.

C.1.8 Explain, when applicable, the reasons why proprietary directors have been appointed upon the request of shareholders who hold less than 3% of the share capital:

Name or corporate name of shareholder	Reasons
	As explained in Section H "Other information of interest", Note 5 to Section A.6 of this report, on January 23, 2011, expanding on their existing strategic alliance, Telefónica, S.A. and China Unicom (Hong Kong) Limited ("China Unicom") signed an extension to their Strategic Partnership Agreement, in which both companies agreed to strengthen and deepen their Strategic Partnership in certain business areas, and committed to investing the equivalent of 500 million US dollars in ordinary shares of the other party. Telefónica also agreed to propose the appointment of a board member nominated by China Unicom, in accordance with prevailing legislation and the Company's Bylaws. Mr. Wang Xiaochu, Chairman and Chief Executive Officer of China Unicom (Hong Kong Limited) is now member of the Board of Directors of Telefónica, S.A.
China Unicom (Hong Kong) Limited	

Provide details of any rejections of formal requests for board representation from shareholders whose equity interest is equal to or greater than that of other shareholders who have successfully requested the appointment of proprietary directors. If so, explain why these requests have not been entertained.

No

C.1.9 Indicate whether any director has resigned from office before their term of office has expired, whether that Director has given the board his/her reasons and through which channel. If made in writing to the whole board, list below the reasons given by that director.

Name of director	Reasons for resignation
Mr. César Alierta Izuel	The Director Mr. César Alierta Izuel, in order to refresh the Board of Directors of the Company, formally stated his voluntary resignation to the Board of Directors, at its meeting held on May 4, 2017, effective as of that date, from its position as Director of Telefónica, S.A., and thus from all of his position within the Board of Directors and within the Executive Commission of such Board.

Name of director	Reasons for resignation
Mr. Gonzalo Hinojosa Fernández de Angulo	The Director Mr. Gonzalo Hinojosa Fernández de Angulo, in order to refresh the Board of Directors, formally stated his voluntary resignation to the Board of Directors, at its meeting held on May 4, 2017, effective as of that date, from its position as Director of Telefónica, S.A., and thus from all of his position within the Board of Directors and within the Committees of such Board (member of the Executive Commission, of the Audit and Control Committee, of the Nominating, Compensation and Corporate Governance Committee, of the Service Quality and Customer Service Committee, of the Regulation and Institutional Affairs Committee, and of the Strategy and Innovation Committee).

Name of director	Reasons for resignation
Mr. Pablo Isla Álvarez de Tejera	The Director Mr. Pablo Isla Álvarez de Tejera, in order to refresh the Board of Directors, formally stated his voluntary resignation to the Board of Directors, at its meeting held on May 4, 2017, effective as of that date, from its position as Director of Telefónica, S.A., and thus from all of his position within the Board of Directors and within the Committees of such Board (member of the Nominating, Compensation and Corporate Governance Committee).

	Reasons for resignation
Mr. Julio Linares López	The Director Mr. Julio Linares López, in order to facilitate the transformation process of the company and of its Board of Directors, formally stated his voluntary resignation to the Board of Directors, at its meeting held on July 26, 2017, effective as of that date, from its position as Director of Telefónica, S.A., and thus from all of his position within the Board of Directors and within the Committees of such Board (Chairman of the Regulation and Institutional Affairs Committee, member of the Service Quality and Customer Service Committee, and of the Strategy and Innovation Committee).

Name of director	Reasons for resignation
Mr. Antonio Massanell Lavilla	The Director Mr. Antonio Massanell Lavilla presented, by means of a written document dated December 21, 2017, and effective as of that date, his voluntary resignation, for personal reasons (retirement), from its position as Director of Telefónica, S.A., and thus from all of his position within the Board of Directors and within the Committees of such Board (Chairman of the Service Quality and Customer Service Committee, member of the Audit and Control Committee, of the Regulation and Institutional Affairs Committee, and of the Strategy and Innovation Committee).

C.1.10 Indicate what powers, if any, have been delegated to the Chief Operating Officer:

Name or corporate name of director	Brief description
Mr. José María Álvarez-Pallete López – Executive Chairman (Chief Executive Officer)	The Chairman of the Company, as the Executive Chairman (Chief Executive Officer), has been expressly delegated all the powers of the Board of Directors, except those that cannot be delegated by Law, by the Corporate Bylaws, or by the Regulations of the Board of Directors which establishes, in Article 5.4, the powers that the Board of Directors reserves itself, and may not delegate.

Name or corporate name of director	Brief description
D. Ángel Vilá Boix - Chief Operating Officer (C.O.O.)	The Chief Operating Officer (C.O.O) has been delegated those powers of the Board of Directors related to the management of the business and the performance of the highest executive functions over all the Company's business areas, except those which cannot be delegated by Law, under the Corporate By-laws or according to the Regulations of the Board of Directors.

C.1.11 List the directors, if any, who hold office as directors or executives in other companies belonging to the listed company's group:

Name or corporate name of director	Corporate name of the group company	Position	Does he or she have executive functions?
Ms. Eva Castillo Sanz	Telefónica Deutschland Holding, AG	Chairwoman of Supervisory Board	No
Mr. Peter Erskine	Telefónica Deutschland Holding, AG	Member of Supervisory Board	No
Mr. Luiz Fernando Furlán	Telefónica Brasil, S.A.	Director	No
	Telefónica de Argentina, S.A.	Director	No
	Telefónica Brasil, S.A.	Director	No
	Telefónica Móviles de México, S.A. de C.V.	Director	No
Mr. Francisco Javier de Paz Mancho	Telefónica Ingeniería de Seguridad, S.A.	Chairman	No

- C.1.12 List any company board members who sit on the boards of directors of other non-group companies that are listed on official securities markets in Spain, insofar as these have been disclosed to the company:

Name or corporate name of director	Name of listed company	Position
Ms. Eva Castillo Sanz	Bankia, S.A.	Director
	Banco Sabadell, S.A.	Vice Chairman
	ACS, Actividades de Construcción y Servicios, S.A.	Director
Mr. José Javier Echenique Landiribar	Ence, Energía y Celulosa, S.A.	Director
	Gas Natural SDG, S.A.	Chairman
	The Bank of East Asia	Director
Mr. Isidro Fainé Casas	Suez Environnement Company	Director
Mr. Luiz Fernando Furlán	Brasil Food, S.A. (BRF)	Director
	Sulzer AG	Chairman
Mr. Peter Löscher	OMV Aktiengesellschaft	Chairman
Mr. Ignacio Moreno Martínez	Obrascón Huarte Lain (OHL), S.A.	Director
	Gestamp Automoción, S.A.	Chairman
	CIE Automotive, S.A.	Director
Mr. Francisco José Riberas Mera	Global Dominion Access, S.A.	Director
	China United Network Communications Limited	Chairman
Mr. Wang Xiaochu	China Unicom (Hong Kong) Limited	Chairman - CEO

- C.1.13 Indicate and, where appropriate, explain whether the Board Regulations establish rules about the maximum number of company boards on which its directors may sit:

Yes

#### Explanation of rules

As set forth in Article 28.2 of the Regulations of the Board of Directors, the Directors will devote the time and efforts required to perform their duties and, to such end, shall report to the Nominating, Compensation and Corporate Governance Committee on their other professional obligations if they might interfere with the performance of their duties as Directors.

In this regard, persons who belong to over five Board of Directors of other corporations other than Telefónica, S.A. and its Group companies cannot be appointed as Directors.

For these purposes, a) all the Boards of companies which form part of the same Group will be counted as a single Board; and b) Boards of asset-holding companies or companies which are vehicles or complements for the Director's own professional activity, of his/her spouse or person with an analogous affective relationship, or his/her closest relatives, will not be counted. On an exceptional basis, for justified reasons, the Board will be able to exempt the Director from this prohibition.

- C.1.14 Section eliminated.

## C.1.15 List the total remuneration paid to the Board of Directors in the year:

Board remuneration (thousands of euros)	10,829
Amount of total remuneration by current directors in accumulated pension rights (thousands of euros)	78,789
Amount of total remuneration by former directors in accumulated pension rights (thousands of euros)	473

## C.1.16 List any members of senior management who are not executive directors and indicate total remuneration paid to them during the year:

Name or corporate name	Position(s)
Mr. Ramiro Sánchez de Lerín García-Ovies	General Secretary and of the Board of Directors
Ms. Laura Abasolo García de Baquedano	Chief Finance and Control Officer
Mr. Guillermo Ansaldo Lutz	Chief Global Resources Officer
Mr. Mariano de Beer	Chief Commercial Digital Officer (CCDO)
Mr. Juan Francisco Gallego Arrechea	General Manager of Internal Audit
Total remuneration received by senior management (in thousands of euros)	
	8,814

## C.1.17 List, if applicable, the identity of those directors who are likewise members of the boards of directors of companies that own significant holdings and/or group companies:

Name or corporate name of director	Name or corporate name of significant shareholder	Position
-	-	-

List, if appropriate, any relevant relationships, other than those included under the previous heading, that link members of the Board of Directors with significant shareholders and/or their group companies:

Name or company name of director with relationship	Name or company name of significant shareholder with relationship	Description of relationship
Mr. José María Abril Pérez	Banco Bilbao Vizcaya Argentaria, S.A.	Early retirement. Formerly General manager of Wholesale and Investment Banking
Ms. Sabina Fluxà Thienemann	Banco Bilbao Vizcaya Argentaria, S.A.	Member of Regional Advisory Board
Mr. Ignacio Moreno Martínez	Banco Bilbao Vizcaya Argentaria, S.A.	Formerly General Manager of Chairman's Office

## C.1.18 Indicate whether any changes have been made to the board regulations during the year:

No

C.1.19 Indicate the procedures for appointing, re-electing, appraising and removing directors. List the competent bodies and the processes and criteria to be followed for each procedure.

See heading H “Other information of interest”, Note 15 to Section C.1.19.

C.1.20 Explain, if applicable, to what extent this annual evaluation of the Board has prompted significant changes in its internal organization and the procedures applicable to its activities:

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**Outline of changes**

In a meeting on February 21, 2017, the Nominating, Compensation and Corporate Governance Committee revised and analysed the results of the Directors of Telefónica, S.A.'s evaluation in 2016 of the Board of Directors and its Committees and of the Company's General Meeting, concluding that, on the whole, they were highly satisfied with the organisation and activities of these governing bodies.

Furthermore, and as a result of this Evaluation, certain improvement points were identified. In view of this and after an exhaustive examination and analysis of the results obtained, the Board followed the Nominating, Compensation and Corporate Governance Committee's proposal and approved the suggested improvements described hereon in order to optimize the operation of the Company's governing bodies:

- i. Continue with the implementation of measures and actions that allow for an optimum performance of the General Shareholder's Meeting.
  - ii. Evaluate the inclusion of more presentations on the agenda of the Board of Directors and of the Executive Commission related to the strategy, products and commercial services of the Company, so that they can be subject to debate by the Board Members.
- 

C.1.20.bis Describe the evaluation process and the evaluated areas performed by the Board of Directors, assisted, if applicable, by an external advisor, with regard to diversity in the Board's composition and skills, in the functioning and composition of its Committees, the performance of the Chairman of the Board of Directors and the company CEO, and each Director's performance and contribution.

With respect to the Board of Directors assessment corresponding to 2017, the Company Board of Directors, based on the favorable report of the Nominating, Compensation and Corporate Governance Committee, agreed to entrust this evaluation to an external consultant, Villafañe & Asociados Consultores.

The aim of this work has been to help the Telefónica, S.A. Board of Directors make their corporate governance assessment by identifying measures for improvement in the governance with possible action plans, under the terms established in the Good Governance Code of the listed companies, approved by the Spanish National Securities Market Commission.

The assessment has been carried out from the review of the Company's Annual Reports corresponding to the 2016 fiscal year, and the Company's corporate documentation, as well as interviews to Independent Board Members, and to the Secretary of the Board of Directors and the Deputy Secretary of the Board of Directors.

The work has been done in two parts; the first, related to the regulatory compliance of the law, review incorporated in the Good Governance Reputation Index (IRBG for its Spanish original), and the “Synthetic IRBG”, or comparative analysis of Telefónica with benchmark corporations in good governance.

The Good Governance Reputation Index (IRBG) is an empirical model of assessment and corporate government improvement that, based on Spanish legal regulations together with the legal regulations of the main western countries, makes it possible to quantify the degree of compliance of the indicators that make up this index. Specifically, 37 corporate governance indicators have been assessed; these indicators are grouped into the following nine variables: (i) Breakdown of the Board of Directors; (ii) Functioning of the Board of Directors; (iii) Committees of the Board of Directors; (iv) Remunerations and Performance; (v) Participation in the General Meeting of Shareholders; (vi) Transparency; (vii) Anti-corruption and Fraud; (viii) Self-regulation and Corporate Social Responsibility; and (ix) Prevention and Treatment of Conflicts of Interest.

Likewise, some recommendations were reflected in this evaluation to optimize the corporate governance system of the Company, related, among others, to:

- The operation of the Board of Directors, recommending the establishment of measures in order to have the documentation related to the issues to be discussed at Board and Committee meetings as far in advance as possible.
- The organization and the operation of the General Shareholder's Meeting, proposing to analyze the possibility of implementing opportune measures for its retransmission, provided that the circumstances thus permit this.
- The composition of the Board of Directors, proposing to continue advancing towards a percentage of 30% of female Board Members in its breakdown by 2020, as well as to continue to reduce the total number of Board Members.

C.1.20.ter Details, if applicable, of the business relations which the consulting firm or any Group company has with the company or any company in its group.

The external consultant has maintained business relationships for a total amount of 119,003.5 Euro for the execution of other work to Telefónica Group Companies.

C.1.21 Indicate the cases in which directors must resign.

In accordance with Article 12 of the Regulations of the Board of Directors, Directors must tender their resignation to the Board of Directors and formalize such resignation in the following cases:

- a) When they cease to hold the executive positions to which their appointment as Directors is linked, or when the reasons for which they were appointed no longer exist.
- b) When they are affected by any of the cases of incompatibility or prohibition established by Law.
- c) When they are severely reprimanded by the Nominating, Compensation and Corporate Governance Committee for having failed to fulfil any of their obligations as Directors.
- d) When their remaining on the Board might affect the Company's credit or reputation in the market or otherwise jeopardise its interests.

The conditions listed above under Recommendation C.1.19 ("Removal") above must also be taken into consideration.

C.1.22 Section eliminated.

C.1.23 Are qualified majorities, other than legal majorities, required for any type of decisions?

**No**

If applicable, describe the differences.

C.1.24 Indicate whether there are any specific requirements, apart from those relating to the directors, to be appointed Chairman of the Board of Directors.

**Yes**

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**Description of requirements**


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In accordance with Article 31.4 of the Corporate Bylaws, in order for a Director to be appointed Chairman, such Director must have served on the Board for at least three years prior to any such appointment. However, such length of service shall not be required if the appointment is made with the favourable vote of at least 85 percent of the members of the Board of Directors.

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C.1.25 Indicate whether the Chairman has the casting vote:

**No**

C.1.26 Indicate whether the Bylaws or the regulations of the Board of Directors set any age limit for directors:

**No**

C.1.27 Indicate whether the Bylaws or the regulations of the Board of Directors set a limited term of office for independent directors:

**No**

C.1.28 Indicate whether the Bylaws or board regulations stipulate specific rules on appointing a proxy to the board, the procedures thereof and, in particular, the maximum number of proxy appointments a director may hold. Also provide details if any restriction in the categories in which a proxy may be delegated has been established, beyond the restrictions imposed by applicable legislation. If so, give brief details.

In accordance with Article 19 of the Regulations of the Board of Directors, Directors must attend meetings of the Board in person, and when unable to do so in exceptional cases, they shall endeavour to ensure that the proxy they grant to another member of the Board includes, as far as is practicable, appropriate instructions. Non-executive Directors may only delegate their proxy in another non-executive Director. Such proxies may be granted by letter or any other means that, in the Chairman's opinion, ensures the certainty and validity of the proxy granted.

Article 34.4 of the Bylaws also establishes that all Directors who are absent may grant a proxy in writing to another Director who is in attendance, with the right to speak and to vote, at the meeting or session to which the proxy refers. The Director granting the proxy shall endeavour, to the extent possible, to include voting instructions in the proxy document.

C.1.29 Indicate the number of Board meetings held during the year and how many times the board has met without the Chairman's attendance. Attendance will also include proxies appointed with specific instructions.

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<b>Number of Board meetings</b>	<b>13</b>
<b>Number of Board meetings held without the Chairman's attendance</b>	<b>0</b>

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If the Chairman is a non-executive Director, indicate the number of meetings held, without attendance or proxy of any executive Director and under the Chairmanship of the Lead Independent Director.



Number of meetings	0
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Indicate the number of meetings of the various board committees held during the year.

Executive Commission	16
Audit and Control Committee	12
Nominating, Compensation and Corporate Governance Committee	11
Service Quality and Customer Service Committee	5
Regulation and Institutional Affairs Committee	11
Strategy and Innovation Committee	11

C.1.30 Indicate the number of board meetings held during the year with all members in attendance. Attendance will also include proxies appointed with specific instructions.

Directors' attendance	13
% of attendances of the total votes cast during the year	100.00%

C.1.31 Indicate whether the consolidated and individual financial statements submitted for authorization by the board are certified previously:

No

Identify, where applicable, the person(s) who certified the company's individual and consolidated financial statements prior to their authorization for issue by the board.

C.1.32 Explain the mechanisms, if any, established by the Board of Directors to prevent the individual and consolidated financial statements it prepares from being submitted to the General Shareholders Meeting with a qualified Audit Report.

Through the Audit and Control Committee, the Board of Directors plays an essential role in supervising the preparation of the Company's financial information, controlling and coordinating the various players that participate in this process.

To achieve this objective, the Audit and Control Committee's work addresses the following basic issues:

A. Supervise internal audit and, in particular:

- a) Safeguard the independence and efficiency of the internal audit function;
- b) Propose the selection, appointment and removal of the person responsible for internal audit;
- c) Propose the budget for such service;
- d) Review the internal audit work plan and its annual activities report;
- e) Receive regular information on its activities; and
- f) Verify that the senior executive officers take into account the conclusions and recommendations of its reports.

- B. Oversee the process of preparing and presenting mandatory financial reporting and submitting recommendations of proposals to the administrative body aimed at safeguarding its integrity. With respect thereto, it shall be responsible for supervising the process of preparation and the completeness of the financial information relating to the Company and the Group, reviewing compliance with regulatory requirements, the proper determination of the scope of consolidation, and the correct application of accounting standards, informing the Board of Directors thereof.
- C. Monitoring the effectiveness of the Company's internal control, internal audit and risk management systems, including fiscal risks, and discuss with the auditors significant weaknesses in the internal control system detected during the audit, without compromising their independence at any time. For that purposes, if deemed necessary, it can submit recommendations or proposals to the Board of Directors and an appropriate monitoring period. With respect thereto, it shall be responsible for proposing to the Board of Directors a risk control and management policy, which shall identify at least the following:
  - a) The types of risk (operational, technological, financial, legal and reputational) facing the Company;
  - b) The risk level that the Company deems acceptable; the measures to mitigate the impact of the identified risks, should they materialise; and
  - c) The control and information systems to be used to control and manage these risks.
- D. Establish and maintain appropriate relations with the Auditor in order to receive, for review by the Committee, information on all matters that could jeopardize the Auditor's independence, and, when applicable, the authorization of permitted services, according to current legislation, and such other communications as may be provided for in auditing legislation and in technical auditing regulations.

In any event, the Audit and Control Committee must receive, on an annual basis, written confirmation from the Auditor of its independence vis-à-vis the entity or entities directly or indirectly related thereto, as well as in-depth and individualized information regarding additional services of any kind provided as well as the fees received to such entities by the Auditor or by the persons or entities related thereto pursuant to the provisions of prevailing legislation.
- E. Issue on an annual basis, prior to the issuance of the audit report, a report stating an opinion on whether the independence of the Auditor is compromised. This report will focus on the assessment of the provision of each and every one of the additional services referred to in the section above, considered individually and as a whole, other than legal audit and in relation to the regime of independence or laws regulating auditing activities.
- F. Analyze and report on economic conditions, the accounting impact, and, if applicable, the proposed exchange ratio in structural and corporative modification transactions which the Company intends to perform, before being submitted to the Board of Directors.
- G. Preliminary reporting to the Board of Directors regarding all matters set out in prevailing legislation and in the Bylaws, and, in particular, concerning:
  1. The financial information that the Company must periodically disclose;
  2. The creation or acquisition of shareholdings in special purpose entities or companies with registered addresses in countries or territories considered to be tax havens; and
  3. Related party transactions.

The Audit and Control Committee verifies both the periodical financial information and the Annual Financial Statements, ensuring that all financial information is drawn up according to the same professional principles and practices. Likewise, the Committee has reviewed the non-financial and diversity information prepared by the Company in accordance to what is established by Royal Decree 18/2017 of 24 November which modifies

the Code of Commerce, the consolidated text of the Corporate Enterprises Act, and the Accounts Auditing Act in terms of non-financial and diversity information. To this effect, the Audit and Control Committee meets whenever appropriate, having held twelve (12) meetings in the course of 2017.

Different members of the Telefónica Group management group attend the Audit and Control Committee meetings, with supportive and assistance duties to the Committee members on the issues that are subject to be analyzed at each of the meetings. In particular, by invitation from the Chairman of the Committee, and when considered necessary, representatives of the General Secretary and the Board, Finance and Control, Internal Auditing, Intervention and Inspection, and Compliance attend the Committee meetings.

In addition to the aforementioned, and as a requirement of its own Committee, other managers from the Company and its subsidiary companies participate to present specific issues that affect their respective businesses or their assigned duties.

The meetings held with the Account Auditor and the Internal Auditor comply with that established in article 7 of the regulations of the Audit and Control Committee of the Company, which establishes that, for the appropriate performance of their supervisory duty, the Committee must know and understand the decisions of Management regarding the application of the most significant criteria and results of the revisions made by Internal Auditing, staying in constant communication with the Account Auditor. In fact, the External Auditor has intervened in meetings of the Audit and Control Committee to explain the work done, as well as to clarify, at the Committee's request, any issues that may have arisen related to the functions assigned to said External Auditor.

The members of the Committee have held meetings separately with each of these interlocutors when it has been deemed necessary, in order to carry out a rigorous follow-up of the preparation of the Company's financial information.

The above notwithstanding, Article 40 of the Regulations of the Board of Directors establishes that the Audit and Control Committee shall ensure that the Board of Directors prepares the final financial statements in a manner that will give no reason for the Auditor to issue a qualified or reserved opinion. However, whenever the Board considers that it should maintain its standards, the Chairman of the Audit and Control Committee shall publicly explain the contents and scope of the discrepancies.

C.1.33 Is the Secretary of the Board also a Director?

**No**

If the Secretary is not a member of the Board, fill in the following table:

Name or corporate name of Secretary	Representative
Mr. Ramiro Sánchez de Lerín García-Ovies	—

C. 1.34 Section eliminated.

C.1.35 Indicate, where applicable, the specific mechanisms implemented by the company to preserve the independence of the auditor, financial analysts, investment banks and rating agencies.

With regards to the independence of the External Auditor of the Company, Article 40 of the Regulations of the Board of Directors establishes that the Board shall, through the Audit and Control Committee, establish a stable and professional relationship with the Company's Auditor, strictly respecting the independence thereof.

The Audit and Control Committee has a fundamental responsibility, as specified in Article 22 of the Regulations of the Board, to establish and maintain appropriate relations with the Auditor in order to receive, for review by the Committee, information on all matters that could jeopardise the Auditor's independence, and, when applicable, the authorisation of permitted services, according to current legislation, and such other communications as may be provided for in auditing legislation and in technical auditing regulations.

In any event, the Audit and Control Committee must receive, on an annual basis, written confirmation from the Auditor of its independence vis-à-vis the entity or entities directly or indirectly related thereto, as well as in-depth and individualised information regarding additional services of any kind provided as well as the fees received to such entities by the Auditor or by the persons or entities related thereto pursuant to the provisions of prevailing legislation.

The Committee must also issue on an annual basis, prior to the issuance of the audit report, a report stating an opinion as to whether the independence of the Auditor is compromised. This report will focus on the assessment of the provision of each and every one of the additional services referred to in the section above, considered individually and as a whole, other than legal audit and in relation to the regime of independence or laws regulating auditing activities.

Article 22 of the Regulations of the Board of Directors stipulates that the Audit and Control Committee submits proposals for the selection, appointment, re-election and replacement of the external auditor to the Board of Directors, and that it shall be held responsible for the selection process in accordance with prevailing laws, and also the conditions for recruiting the external auditor, regularly gathering information about the audit plan and its execution from the auditor, as well as safeguarding its independence in exercising its functions.

Furthermore, the External Auditor has direct access to the Audit and Control Committee and participates regularly in its meetings, in the absence of the Company's management team when this is deemed necessary. To this effect, and in keeping with US legislation on this matter, the External Auditor must inform the Audit and Control Committee at least once a year on the most significant generally accepted auditing policies and practices followed in the preparation of the Company's financial and accounting information affecting key elements in the financial statements which may have been discussed with the management team, and of all relevant communications between the Auditor and the Company's management team. Likewise, as established in Article 40 of the Regulations of the Board of Directors, every year the Auditor will have a meeting with the Board of Directors in plenary session to inform it of the work conducted and about the pattern of the Company's accounting and risks situation.

In accordance with internal company regulations and in line with the requirements imposed by US legislation, the engagement of any service from the Company's External Auditors must always have the prior approval of the Audit and Control Committee. Moreover, the engagement of non-audit services must be done in strict compliance with the Auditing Act (Ley de Auditoría de Cuentas) and the Sarbanes-Oxley Act published in the United States and subsequent regulations. For this purpose, and prior to the engagement of the Auditors, the Audit and Control Committee studies the content of the work to be performed, evaluating any situations that may compromise the External Auditor's independence, and specifically supervises the percentage the fees paid for such services represent in the total revenue of the auditing firm. In this respect, the Company reports the fees paid to the External Auditor, including those paid for non-audit services, in its Notes to the Financial Statements, in accordance with prevailing legislation.

C.1.36 Indicate whether the company has changed its external audit firm during the year. If so, identify the incoming audit firm and the outgoing auditor:

**Yes**

**Outgoing auditor:** Ernst & Young, S.L. (from now on, Ernst & Young).

**Incoming auditor:** PricewaterhouseCoopers Auditores, S.L. (from now on, PwC).

Explain any disagreements with the outgoing auditor and the reasons for the same:

No

C.1.37 Indicate whether the audit firm performs other non-audit work for the company and/or its group. If so, state the amount of fees received for such work and the percentage they represent of the fees billed to the company and/or its group:

Yes

	Company	Group	Total
Non audit services (Thousands of euros)	236	726	962
	Company	Group	Total
Non audit services / Amount total services (%)	6.60	4.50	4.90

C.1.38 Indicate whether the audit report on the previous year's financial statements is qualified or includes reservations. Indicate the reasons given by the Chairman of the Audit Committee to explain the content and scope of those reservations or qualifications.

No

C.1.39 Indicate the number of consecutive years during which the current audit firm has been auditing the financial statements of the company and/or its group. Likewise, indicate how many years the current firm has been auditing the accounts as a percentage of the total number of years over which the financial statements have been audited:

	Company	Group
Number of consecutive years	1	1
	Company	Group
Number of years audited by current audit firm/ Number of years the company's financial statements have been audited (%)	2.90	3.70

C.1.40 Indicate and give details of any procedures through which directors may receive external advice:

Yes

#### Procedures

Article 27 of the Regulations of the Board of Directors stipulates that in order to receive assistance in the performance of their duties, the Directors or any of the Committees of the Board may request that legal, accounting, financial or other experts be retained at the Company's expense. The engagement must necessarily be related to specific problems of a certain significance and complexity that arise in the performance of their duties.

The decision to retain such services must be communicated to the Chairman of the Board of Directors and shall be formalised through the Secretary to the Board, unless the Board of Directors does not consider such engagement to be necessary or appropriate.

C.1.41 Indicate whether there are procedures for directors to receive the information they need in sufficient time to prepare for meetings of the governing bodies:

Yes

#### Procedures

The Company adopts the measures necessary, whenever possible, that the Directors receive the necessary information, specially drawn up and geared to preparing the meetings of the Board and its Committees, sufficiently in advance. Under no circumstances shall such a requirement not be fulfilled, on the grounds of the importance or the confidential nature of the information, apart from in absolutely exceptional cases.

In this regard, and in accordance with Articles 18 and 20 of the Regulation of the Board of Directors, at the beginning of each year the Board of Directors and its Committees set the calendar of ordinary meetings to be held during the year. The calendar may be amended by resolution of the Board itself, or by decision of the Chairman, in which case the Directors shall be made aware of the amendment as soon as practicable. Likewise, the Regulations of the Audit and Control Committee detail the operating regime of this Committee.

Also, at the beginning of the year the Board and its Committees shall prepare an Action Plan detailing the actions to be carried out and their timing for each year, as per their assigned powers and duties.

Likewise, all the meetings of the Board and the Board Committees have a pre-established agenda, which is communicated at least three days prior to the date scheduled for the meeting together with the call for the session. The Agenda for each meeting will clearly state points on which the Board of Directors, or the Executive Committee, have to adopt a decision or resolution.

For the same purpose, in general, the Directors are sent the documentation related to the agenda of the meetings sufficiently in advance. In accordance with Article 19 of the Regulations of the Board of Directors, the Chairman of the Board of Directors organises the debates, promoting and encouraging all Directors to play an active role in the deliberations, safeguarding their right to freely adopt their own position on all matters. Moreover, with the assistance of the Secretary, he shall ensure that the Directors are sent sufficient information to discuss the points set out in the agenda sufficiently in advance of the meeting. He also ensures that sufficient time is given over to discussing strategic matters, and shall encourage debate during meetings, safeguarding the Directors' right to adopt their positions freely on all points discussed.

To provide all the information and clarifications necessary in relation to certain points deliberated, the Group's senior executive officers attend nearly all the Board and Committee meetings to explain the matters within their powers.

Furthermore, and as a general rule, the Regulations of the Board of Directors (Article 26) expressly establish that Directors are granted the broadest powers to obtain information about all aspects of the Company, to examine its books, records, documents and other data regarding corporate transactions. Exercising of this right to receive information shall be channelled through the Chairman or Secretary to the Board of Directors, who shall respond to the requests made by the Directors, providing them with the requested information directly or offering them the proper contacts at the appropriate level of the organisation.

C.1.42 Indicate and, where appropriate, give details of whether the company has established rules obliging directors to inform the board of any circumstances that might harm the organization's name or reputation, tendering their resignation as the case may be:

Yes

## Details of rules

In accordance with Article 12 of the Regulations of the Board of Directors, Directors must tender their resignation to the Board of Directors and formalise such resignation when their remaining on the Board might affect the Company's credit or reputation in the market or otherwise jeopardises its interests.

Likewise, Article 30.h) of the Regulations establishes that Directors must report to the Board any circumstances related to them that might damage the credit or reputation of the Company as soon as possible.

C.1.43 Indicate whether any member of the Board of Directors has notified the company that they have been indicted or tried for any of the offences stated in Article 213 of the Spanish Corporations Act:

**No**

Indicate whether the Board of Directors has examined this matter. If so, provide a justified explanation of the decision taken as to whether or not the director should continue to hold office or, if applicable, detail the actions taken or to be taken by the board.

C.1.44 List the significant agreements entered into by the company which come into force, are amended or terminate in the event of a change of control of the company due to a takeover bid, and their effects.

1. On April 29, 2013, Telefónica, S.A. and TLK Investment, CV (which belongs to Corporación Multi-Inversiones, or "CMI", a Business Group domiciled in Guatemala) signed an agreement whereby Telefónica and CMI incorporated a joint business venture called Telefónica Centroamérica Inversiones, S.L.U. ("TCI"), in which Telefónica contributed its assets in Central America (except for its Costa Rica assets) and CMI made a monetary contribution of USD 500,000,000. As a result of these contributions, Telefónica owns a 60% interest in the share capital of TCI, while CMI's stake is 40%. This arrangement was completed on August 2, 2013.

Telefónica and CMI also entered into a Shareholders' Pact in TCI, which includes a change of control clause stipulating that if there was a change of control of CMI or Telefónica, the other party would be fully entitled to: (i) exercise the right to acquire (call option) the entire stake held in TCI by the shareholder over which control has changed at the date control changed; or (ii) exercise the right to sell (put option) the entire stake the former held in TCI to the latter. In both cases, the purchase price of the stake shall be TCI's market value calculated by an independent expert.

For the purposes of the Shareholders' Pact, a change of control shall be: (i) in the case of CMI, when the last natural person or corporate body controlling CMI ceases to do so; and (ii) for Telefónica, when a natural person or corporate body not controlling Telefónica assumes control. In both instances, "control" shall be as specified in the International Financial Reporting Standards (IFRS).

2. - Financing agreements:

On February 19, 2015, Telefónica, S.A., as borrower, and a group of credit entities, as original lenders, with Citibank International Limited as the agent bank, entered into a syndicated loan amounting up to EUR 2,500 million. On the same date, Telefónica, S.A. executed a novation of another syndicated loan of up to EUR 3,000 million, formalized on February 18, 2014, with The Royal Bank of Scotland, PLC as the agent bank.

Likewise, on November 17, 2015, Telefónica, S.A. as borrower and a group of credit entities as original lenders, with Banco Bilbao Vizcaya Argentaria, S.A. as the agent bank, formalized a syndicated loan of up to EUR 3,000 million, which was modified on November 15, 2016 to reflect certain agreements reached between the parties with respect to its economic terms, including a reduction in its amount up to EUR 1,500 million.

On December 11, 2015, Telefónica, S.A., as borrower, and Banco Bilbao Vizcaya Argentaria, S.A. Niederlassung Deutschland, the Bank of Tokyo-Mitsubishi UFJ, Ltd., sucursal en España, Mizuho Bank Ltd, AB Svensk Exportkredit and Société Générale S.A., as original lenders, and with the support of Exportkreditnämnden,



signed a financing agreement amounting up to USD 750 million. Also on that same date, Telefónica, S.A., as borrower, and Banco Santander, S.A. and Cr dit Agricole Corporate and Investment Bank as original lenders, with the support of Finnvera Plc, entered into a financing agreement amounting up to EUR 500 million.

On March 8, 2016, Telef nica, S.A., as borrower, Export Development Canada and AB Svensk Exportkredit, as original lenders, and Banco Bilbao Vizcaya Argentaria, S.A. Niederlassung Deutschland, as the agent, entered into a financing agreement amounting up to EUR 300 million.

As provided for in all of the aforementioned contracts, in the event of a change of control in Telef nica, S.A., lenders may, under certain circumstances, require the early termination of these financing agreements.

The financing contracts consider the usual criteria in these types of agreement to determine if there has effectively been a change of control, such as obtaining control of the majority of voting rights, on the appointment of the majority of members of the board of directors, or on the Company's financial and operational policies.

- C.1.45 Identify, in aggregate form and provide detailed information on agreements between the company and its officers, executives and employees that provide indemnities for the event of resignation, unfair dismissal or termination as a result of a takeover bid or other.

<b>Number of beneficiaries</b>	31
<b>Type of beneficiary</b>	
Executive Directors, Senior Managers and other Employees	

#### Description of the resolution

With regards to the conditions applicable to termination of contracts, the Executive Chairman, Mr. Jos  Mar a  lvarez-Pallete L pez, and the Chief Operating Officer (C.O.O.), Mr.  ngel Vil  Boix, maintain the conditions of his previous contract which provided for agreed economic compensation for the termination of the employment relationship, where applicable, that can amount to four years' of remuneration at the most. Annual remuneration on which the indemnity is based is the last fixed remuneration and the arithmetic mean of the last two variable remuneration payments received by contract.

Regarding the contracts of members of Senior Management, in general, they are contractually entitled the right to receive the economic compensation indicated below in the event that their employment relationship is ended for reasons attributable to the Company or, in some instances, is due to objective reasons such as a change of control in the Company. However, if the employment relationship is terminated because of a breach attributable to the Executive, he/she will not be entitled to any compensation whatsoever. That notwithstanding, in certain cases the severance benefit to be received by the member of Senior Management according to their contract is not calculated as per these general criteria, but rather is based on other circumstances of a personal or professional nature or on the time when the contract was signed. The agreed economic compensation for the termination of the employment relationship, where applicable, consists of a maximum of three times annual remuneration plus another year based on length of service at the Company. Annual remuneration on which the indemnity is based is the last fixed remuneration and the arithmetic mean of the last two variable remuneration payments received by contract.

Meanwhile, contracts that tie employees to the Company under a common employment relationship do not include indemnity clauses for the termination of their employment. In these cases, the employee is entitled to any indemnity set forth in prevailing labour legislation. However, contracts of some company employees, depending on their level and seniority, as well as their personal or professional circumstances or when they signed their contracts, establish their right to receive compensation in the same cases as in the preceding paragraph, generally consisting of a year and a half of salary. The annual salary on which the indemnity is based is the last fixed salary and the average amount of the last two variable payments received by contract.

Indicate whether these agreements must be reported to and/or authorized by the governing bodies of the company or its group:



	Board of Directors	General Shareholders Meeting
Body authorizing clauses	Yes	No
Is the General Shareholders' Meeting informed of such clauses?		Yes

## C.2. Board committees

C.2.1 Give details of all the Committees of the Board of Directors, their members and the proportion of executive, proprietary, independent and other external directors:

### EXECUTIVE COMMISSION

Name	Position	Professional category
Mr. José María Álvarez-Pallete López	Chairman	Executive
Mr. Isidro Fainé Casas	Vice Chairman	Proprietary
Mr. José María Abril Pérez	Vice Chairman	Proprietary
Mr. Ángel Vilá Boix	Member	Executive
Mr. José Javier Echenique Landiríbar	Member	Independent
Mr. Peter Erskine	Member	Independent
Mr. Francisco Javier de Paz Mancho	Member	Independent
% of Executive Directors		28.57%
% of Proprietary Directors		28.57%
% of Independent Directors		42.86%
% of Other External Directors		0.00%

Explain the functions attributed to this committee, outline the procedures and rules for its organisation and working and summarise the most significant actions taken over the course of the year.

The Board of Directors, always subject to the legal provisions in force, delegates all its powers to an Executive Commission, except those that cannot be delegated by Law, by the Corporate Bylaws, or by the Regulations of the Board of Directors.

The Executive Commission provides the Board of Directors with a greater efficiency and effectiveness in the execution of its tasks, since it meets more often.

Pursuant to the provisions of Article 38 of the Corporate Bylaws of Telefónica, S.A., Article 21 of the Regulations of the Board of Directors regulates the Executive Commission in the following terms:

a) Composition.

The Executive Commission shall consist of the Chairman of the Board of Directors, once appointed as a member of the Executive Commission, and not less than three or more than ten Directors appointed by the Board of Directors.

The Board of Directors shall seek to have External Directors constitute a majority over the Executive Directors.

In all cases, the affirmative vote of at least two-thirds of the members of the Board of Directors shall be required in order for the appointment or re-appointment of the members of the Executive Commission to be valid.

b) Operation.

The Executive Commission shall meet whenever called by the Chairman, and shall normally meet every fifteen days.

The Chairman and Secretary to the Board of Directors shall act as the Chairman and Secretary to the Executive Commission. One or more Vice Chairmen and a Deputy Secretary may also be appointed.

A valid quorum of the Executive Commission shall exist with the presence, in person or by proxy, of more than one-half of its members.

Resolutions shall be adopted by a majority of the Directors attending the meeting (in person or by proxy), and in the case of a tie, the Chairman shall cast the deciding vote.

c) Relationship with the Board of Directors.

The Executive Commission shall report to the Board in a timely manner on the matters dealt with and the decisions adopted at the meetings thereof, with a copy of the minutes of such meetings made available to the members of the Board (Article 21.C) of the Regulations of the Board of Directors).

Most significant actions during the year.

During the 2017 year, the Executive Commission of the Board of Directors of Telefónica, S.A. has analysed, reviewed, deliberated upon and adopted resolutions on a range of matters concerning, inter alia:

- The business activity performed by the Telefónica Group: i) products and services (E2E Digitalization, Internet of Things, Security B2B, Network, Terminals, Business Intelligence, Big Data, voice and data, video services, etc.), ii) business performance in the countries in which the Telefónica Group operates, and iii) operational trends.
- Status of regulations in the telecommunications sector (such as regulatory amendments and spectrum auctions).
- Corporate and financing transactions of the Telefónica Group.

Indicate whether the composition of the Executive Commission reflects the participation within the board of the different types of directors:

**Yes**

#### AUDIT AND CONTROL COMMITTEE

Name	Position	Professional category
Mr. José Javier Echenique Landiribar	Chairman	Independent
Ms. Carmen García de Andrés	Member	Independent
Mr. Ignacio Moreno Martínez	Member	Proprietary
Mr. Francisco Javier de Paz Mancho	Member	Independent
% of Proprietary Directors		25.00%
% of Independent Directors		75.00%
% of Other External Directors		0,00%

Explain the functions attributed to this committee, outline the procedures and rules for its organisation and working and summarise the most significant actions taken over the course of the year.

See heading H “Other information of interest”, Note 19 to Section C.2.1.

Indicate the Director who sits on the Audit Committee who has been appointed, taking into account his/her knowledge and experience in accounting, auditing or in both, and state how many years the Chairman of this Committee has held this position.

<b>Name or Director with experience</b>
Mr. José Javier Echenique Landiribar
<b>No. years Chairman has held this position</b>
2

## NOMINATING, COMPENSATION AND CORPORATE GOVERNANCE COMMITTEE

<b>Name</b>	<b>Position</b>	<b>Professional category</b>
Mr. Francisco Javier de Paz Mancho	Chairman	Independent
Mr. José Javier Echenique Landiribar	Member	Independent
Mr. Peter Erskine	Member	Independent
Ms. Sabina Fluxà Thienemann	Member	Independent
Mr. Luiz Fernando Furlán	Member	Independent
<b>% of Proprietary Directors</b>		0.00%
<b>% of Independent Directors</b>		100.00%
<b>% of Other External Directors</b>		0.00%

Explain the functions attributed to this committee, outline the procedures and rules for its organisation and working and summarise the most significant actions taken over the course of the year.

See heading H “Other information of interest”, Note 20 to Section C.2.1.

## SERVICE QUALITY AND CUSTOMER SERVICE COMMITTEE

<b>Name</b>	<b>Position</b>	<b>Type</b>
Ms. Eva Castillo Sanz	Member	Other External
Ms. Carmen García de Andrés	Member	Independent
Mr. Ignacio Moreno Martínez	Member	Proprietary
<b>% of Proprietary Directors</b>		33.33%
<b>% of Independent Directors</b>		33.33%
<b>% of Other External Directors</b>		33.33%

Explain the functions attributed to this committee, outline the procedures and rules for its organisation and working and summarise the most significant actions taken over the course of the year.

See heading H “Other information of interest”, Note 21 to Section C.2.1.

**REGULATION AND INSTITUTIONAL AFFAIRS COMMITTEE**

Name	Position	Professional category
Mr. Ignacio Moreno Martínez	Chairman	Proprietary
Ms. Eva Castillo Sanz	Member	Other External
Mr. Francisco Javier de Paz Mancho	Member	Independent
<b>% of Proprietary Directors</b>		33.33%
<b>% of Independent Directors</b>		33.33%
<b>% of Other External Directors</b>		33.33%

Explain the functions attributed to this committee, outline the procedures and rules for its organisation and working and summarise the most significant actions taken over the course of the year.

See heading H “Other information of interest”, Note 22 to Section C.2.1.

**STRATEGY AND INNOVATION COMMITTEE**

Name	Position	Professional category
Mr. Peter Erskine	Chairman	Independent
Mr. José María Abril Pérez	Member	Proprietary
Ms. Eva Castillo Sanz	Member	Other External
Mr. Juan Ignacio Cirac Sasurain	Member	Independent
Mr. Peter Löscher	Member	Independent
<b>% of Proprietary Directors</b>		20.00%
<b>% of Independent Directors</b>		60.00%
<b>% of Other External Directors</b>		20.00%

Explain the functions attributed to this committee, outline the procedures and rules for its organisation and working and summarise the most significant actions taken over the course of the year.

See heading H “Other information of interest”, Note 23 to Section C.2.1.

**Action Plan and Report.**

As for the Board itself, at the beginning of each year and in accordance with Article 20 b) 3. of the Regulations of the Board of Directors, all Committees shall prepare an Action Plan detailing the actions to be taken and their timing for each year in each of their fields of action.

All Committees shall also draw up an internal Activities Report summarizing the main activities and actions taken during the previous year, detailing the issues discussed at its meetings and highlighting certain aspects regarding its powers and duties, composition and operation.

As per Article 20 b) 3. of the Regulations of the Board of Directors, in order that it may properly exercise its duties, the Board of Directors is kept fully informed of the issues addressed by the Committees.

C.2.2 Complete the following table on the number of female directors on the various board committees over the past four years:

	Number of female directors			
	2017 Number %	2016 Number %	2015 Number %	2014 Number %
Executive Commission	0	0	0	0
Audit and Control Committee	1 (25.00%)	0	0	0
Nominating, Compensation and Corporate Governance Committee	1 (20.00%)	1 (20.00%)	0	0
Service Quality and Customer Service Committee	2 (66.67%)	1 (20.00%)	1 (14.29%)	1 (14.29%)
Regulation and Institutional Affairs Committee	1 (33.33%)	1 (16.67%)	0	0
Strategy and Innovation Committee	1 (20.00%)	1 (14.29%)	0	0

C.2.3 Section eliminated.

C.2.4 Section eliminated.

C.2.5 Indicate, as appropriate, whether there are any regulations governing the board committees. If so, indicate where they can be consulted, and whether any amendments have been made during the year. Also indicate whether an annual report on the activities of each committee has been prepared voluntarily.

The organization and operation of the Board of Directors Committees is governed under the regulations of the Board of Directors. Additionally and in particular, the Executive Commission is regulated under article 38 of the corporate bylaws; the Audit and Control Committee under article 39 of the corporate bylaws and the regulations of the Audit and Control Committee (approved by the Company Board of Directors at its meeting held on December 13, 2017, based on the recommendation of the Audit and Control Committee); and the Nominating, Compensation and Corporate Governance Committee under article 40 of the aforementioned bylaws. These documents are available for perusal on the Company website.

As mentioned in Section C.2.1 above, the Board Committees draw up an internal Activities Report summarising the main activities and actions taken during the year detailing the issues discussed at their meetings and highlighting certain aspects regarding their powers and duties, composition and operation.

Specifically, and with respect to the Nominating, Compensation and Corporate Governance Committee (in accordance with that established in Recommendation 6 of the Good Governance Code of the listed companies), and the Audit and Control Committee (in accordance with that established in Recommendation 6 of the Good Governance Code of the listed companies, in Section 79 of Technical Guide 3/2017 of the Spanish National Securities Market Commission regarding Audit Committees of Public Interest Companies, and in Article 9 of the

regulations of the Audit and Control Committee of Telefónica, S.A.), an Operation Report is prepared annually. This report is published on the Company website well before the General Shareholder's Meeting is held.

C.2.6 Section eliminated.

## D. Related-party and intragroup transactions

### D.1 Explain, if applicable, the procedures for approving related-party or intragroup transactions.

#### Procedure for reporting on approval of related-party transactions.

Article 5 of the Regulations of the Board of Directors includes a number of powers of the Board which cannot be delegated, including the following:

The approval, based on a favourable report by the Audit and Control Committee, of the transactions which the company carries out with directors, significant shareholders or representatives on the board, or related parties.

Also, as set forth in Article 30.f) of the Regulations of the Board of Directors, Directors shall not directly or indirectly enter into professional or commercial transactions with the Company or with any of the companies of the Group, if such transactions are unrelated to the ordinary course of business of the Company or not performed on an arm's length basis, unless the Board of Directors is informed thereof in advance and, on the recommendation of the Audit and Control Committee, it approves the transaction upon the affirmative vote of at least 90% of the Directors (present in person or by proxy).

Also, Article 38 of the Regulations of the Board of Directors specifically regulates transactions performed with significant shareholders, and establishes that the Board of Directors, based on a favourable report by the Audit and Control Committee, will approve the transactions which the Company or its Group perform with directors, individual or together with others, of a significant shareholding, including shareholders represented in the Board of Directors of the Company or other Group companies or with persons related to them, unless this power is attributable by law to the General Shareholders Meeting.

Directors affected or which represent or which are related to affected shareholders will have to refrain from taking part in the deliberation and voting on the resolution in question.

This approval does not include transactions which, according to prevailing laws, do not require such approval or exemption, i.e. according to Article 529 ter of the Spanish Corporations Act, the transactions which simultaneously fulfil the three following requirements:

- 1.º they are performed by virtue of contracts whose conditions are standardised and are applied on an across-the-board basis to a large number of clients,
- 2.º they are performed at prices or tariffs generally set by the person supplying the goods or services, and
- 3.º their amount is not more than one per cent of the company's annual revenues.

The transactions referred to above shall be assessed from the point of view of equal treatment of shareholders and the arm's-length basis of the transaction, and shall be included in the Annual Corporate Governance Report and in the periodic public information of the Company upon the terms provided by law.

For the transaction to be approved, it will be necessary to ensure that the transaction does not compromise the capital, or, if applicable, that it is performed on an arm's-length basis and that the process is transparent.

Only where there are imperative grounds of urgency, duly justified, decisions mentioned above could be adopted by delegated bodies or persons, and subsequently ratified by the Board of Directors (article 5.5 of the Regulations of the Board of Directors).



## D.2 List any relevant transactions, by virtue of their amount or importance, between the company or its group of companies and the company's significant shareholders.

Name or corporate name of significant shareholder	Name or corporate name of the company or its group company	Nature of the relationship	Type of transaction	Amount (Thousands of euros)
Banco Bilbao Vizcaya Argentaria, S.A.	Telefónica, S.A.	Contractual	Interest paid	8,584
Banco Bilbao Vizcaya Argentaria, S.A.	Telefónica, S.A.	Contractual	Receipt of services	1,600
Banco Bilbao Vizcaya Argentaria, S.A.	Telefónica, S.A.	Contractual	Interest charged	19
Banco Bilbao Vizcaya Argentaria, S.A.	Telefónica, S.A.	Contractual	Others	11,371
Banco Bilbao Vizcaya Argentaria, S.A.	Telefónica, S.A.	Contractual	Finance arrangements: loans	995,109
Banco Bilbao Vizcaya Argentaria, S.A.	Telefónica, S.A.	Contractual	Guarantees	313
Banco Bilbao Vizcaya Argentaria, S.A.	Telefónica, S.A.	Contractual	Finance arrangements: other	1,208,971
Banco Bilbao Vizcaya Argentaria, S.A.	Telefónica, S.A.	Contractual	Dividends and other distributed earning	127,782
Banco Bilbao Vizcaya Argentaria, S.A.	Rest of Telefónica Group	Contractual	Interest paid	26,041
Banco Bilbao Vizcaya Argentaria, S.A.	Rest of Telefónica Group	Contractual	Operating lease contracts	210
Banco Bilbao Vizcaya Argentaria, S.A.	Rest of Telefónica Group	Contractual	Receipt of services	225
Banco Bilbao Vizcaya Argentaria, S.A.	Rest of Telefónica Group	Contractual	Interest charged	28,474
Banco Bilbao Vizcaya Argentaria, S.A.	Rest of Telefónica Group	Contractual	Management contracts	586
Banco Bilbao Vizcaya Argentaria, S.A.	Rest of Telefónica Group	Contractual	Services rendered	37,562
Banco Bilbao Vizcaya Argentaria, S.A.	Rest of Telefónica Group	Contractual	Sale of goods (finished or in progress)	4,440
Banco Bilbao Vizcaya Argentaria, S.A.	Rest of Telefónica Group	Contractual	Others	6,525
Banco Bilbao Vizcaya Argentaria, S.A.	Rest of Telefónica Group	Contractual	Finance arrangements: loans	42,402
Banco Bilbao Vizcaya Argentaria, S.A.	Rest of Telefónica Group	Contractual	Guarantees	221,548
Banco Bilbao Vizcaya Argentaria, S.A.	Rest of Telefónica Group	Contractual	Purchase options commitments	217
Banco Bilbao Vizcaya Argentaria, S.A.	Rest of Telefónica Group	Contractual	Operating lease contracts	15
CaixaBank, S.A.	Telefónica, S.A.	Contractual	Interest paid	3,974
CaixaBank, S.A.	Telefónica, S.A.	Contractual	Receipt of services	1,522
CaixaBank, S.A.	Telefónica, S.A.	Contractual	Finance arrangements: loans	291,813

CaixaBank, S.A.	Telefónica, S.A.	Contractual	Guarantees	8,230
CaixaBank, S.A.	Telefónica, S.A.	Contractual	Finance arrangements: other	413,580
CaixaBank, S.A.	Telefónica, S.A.	Contractual	Dividends and other distributed earnings	104,350
CaixaBank, S.A.	Rest of Telefónica Group	Contractual	Interest paid	779
CaixaBank, S.A.	Rest of Telefónica Group	Contractual	Receipt of services	7,027
CaixaBank, S.A.	Rest of Telefónica Group	Contractual	Services rendered	70,685
CaixaBank, S.A.	Rest of Telefónica Group	Contractual	Sale of goods (finished or in progress)	43,248
CaixaBank, S.A.	Rest of Telefónica Group	Contractual	Operating lease contracts	14,432
CaixaBank, S.A.	Rest of Telefónica Group	Contractual	Guarantees	42,736
CaixaBank, S.A.	Rest of Telefónica Group	Contractual	Purchase options commitments	85,427
CaixaBank, S.A.	Rest of Telefónica Group	Contractual	Other	250,012
CaixaBank, S.A.	Rest of Telefónica Group	Contractual	Purchase of goods (finished or in progress)	55,647

**D.3 List any relevant transactions, by virtue of their amount or importance, between the company or its group of companies and the company's managers or directors.**

**D.4 List any relevant transactions undertaken by the company with other companies in its group that are not eliminated in the process of drawing up the consolidated financial statements and whose subject matter and terms set them apart from the company's ordinary trading activities.**

**In any case, list any intragroup transactions carried out with entities in countries or territories considered to be tax havens.**

**D.5 Indicate the amount from other related-party transactions:**

23,000 thousands euros

**D.6 List the mechanisms established to detect, determine and resolve any possible conflicts of interest between the company and/or its group, and its directors, management or significant shareholders.**

Company policy establishes the following principles governing possible conflicts of interest that may affect Directors, senior executives or significant shareholders:

- With respect to Directors, Article 30 of the Regulations of the Board of Directors establishes that Directors shall inform the Board of Directors of any situation of direct or indirect conflict they may have with the interest

of the company. In the event of conflict, the Director affected shall refrain from participating in the deliberation to which the conflict refers.

Moreover, and in accordance with the provisions set out in the Regulations of the Board, Directors shall refrain from participating in votes that affect matters in which they or persons related to them have a direct or indirect interest.

Likewise, the aforementioned Regulations establish that Directors shall not directly or indirectly enter into professional or commercial transactions with the Company or with any of the companies of the Group, if such transactions are unrelated to the ordinary course of business of the Company or not performed on an arm's length basis, unless the Board of Directors is informed thereof in advance and, on the recommendation of the Nominating, Compensation and Corporate Governance Committee, it approves the transaction upon the affirmative vote of at least 90% of the Directors (present in person or by proxy).

Directors must also report with respect to themselves as well as the persons related thereto (a) the direct or indirect interests held by them and (b) the offices held or duties performed at any company that is in a situation of actual competition with the Company.

For purposes of the provisions of this paragraph, the following shall not be deemed to be in a situation of actual competition with the Company, even if they have the same or a similar or complementary corporate purpose: (i) companies controlled thereby (within the meaning of Article 42 of the Commercial Code); and (ii) companies with which Telefónica, S.A. has established a strategic alliance. Likewise, for purposes of the provisions hereof, proprietary directors of competitor companies appointed at the request of the Company or in consideration of the Company's interest in the capital thereof shall not be deemed to be in a situation of prohibition of competition.

Transactions arising from the duty of loyalty and its exemption regime shall also be subject to prevailing laws.

- Also, Article 38 of the Regulations of the Board of Directors specifically regulates transactions performed with significant shareholders, and establishes that the Board of Directors, based on a favourable report by the Audit and Control Committee, will approve the transactions which the Company or its Group perform with directors, individual or together with others, of a significant shareholding, including shareholders represented in the Board of Directors of the Company or other Group companies or with persons related to them, unless this power is attributable by law to the General Shareholders Meeting.

This approval does not include transactions which, according to prevailing laws, do not require such approval or exemption, i.e. according to Article 529 ter of the Spanish Corporations Act, the transactions which simultaneously fulfil the three following requirements:

- 1.º they are performed by virtue of contracts whose conditions are standardised and are applied on an across-the-board basis to a large number of clients,
- 2.º they are performed at prices or tariffs generally set by the person supplying the goods or services, and
- 3.º their amount is not more than one per cent of the company's annual revenues.

The transactions referred to above shall be assessed from the point of view of equal treatment of shareholders and the arm's-length basis of the transaction, and shall be included in the Annual Corporate Governance Report and in the periodic public information of the Company upon the terms provided by law.

For the transaction to be approved, it will be necessary to ensure that the transaction does not compromise the capital, or, if applicable, that it is performed on an arm's-length basis and that the process is transparent.

- With respect to senior executives, the Internal Code of Conduct for Securities Markets Issues sets out the general principles of conduct for the persons subject to the said regulations who are involved in a conflict of interest. The aforementioned Code includes all the Company's management personnel within the concept of affected persons.

In accordance with that established in this regulation, the people with management responsibilities, their administrative personnel and the managers or employees of Telefónica Group who have privileged information, or participate or have access to or knowledge of a confidential operation (as defined in the previous terms of the internal conduct regulations regarding Stock Markets) have the obligation to (a) remain loyal to the Group and its shareholders at all times, regardless of his/her own or other's interests; (b) refrain from intervening in or influencing decision making that could affect persons or companies with which there is conflict; and (c) refrain from accessing information classified as confidential that affects said conflict. Additionally, these people (except for the members of the Company Board of Directors who will be governed in terms of communicating conflicts under the standards established in the regulation of the Board of Directors) have the obligation to make the Company Regulatory Compliance Unit aware of these operations that would potentially entail the manifestation of conflicts of interest.

#### **D.7 Is more than one group company listed in Spain?**

**No**

Please specify the subsidiary companies listed in Spain:

##### **Subsidiary company listed**

Indicate whether they have provided detailed disclosure on the type of activity they engage in, and any business dealings between them, as well as between the subsidiary and other group companies:

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**Define possible business relations between the parent company and the listed subsidiary, and between the latter and the other Group companies**

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Indicate the mechanisms in place to resolve possible conflicts of interest between the listed subsidiary and other group companies:

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**Mechanisms to resolve possible conflicts of interest**

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## E. Risk control and management systems

### E.1 Describe the risk management system in place at the company, including with relation to taxes.

Telefónica continually monitors the most significant risks in the main companies comprising its Group. The Company therefore has a Corporate Risk Management Framework, based on the model established by the Treadway Commission's Committee of Sponsoring Organizations (COSO). In line with the continuous improvement of the Risk Management Framework, Telefónica will continue with the alignment of its framework with the new requirements of the updated COSO ERM Framework ("Enterprise Risk Management - Integrating with Strategy and Performance"), released in September 2017.

One of the features of this Framework is a map prioritizing risks according to their importance, thereby facilitating their management and an appropriate response to mitigate them. In accordance with this Framework, and based on best practices and benchmarks in risk management, the following four risk categories have been identified:

- Business risk: Possible loss of value or earnings resulting from changes in the business environment, the competition and market scenario, the regulatory framework or the strategic uncertainty.
- Operational risk: Possible loss of value or earnings as a result of events caused by inadequacies or failures in the network or the IT systems, security, customer service, supply chain, human resources, as well as operational management.
- Financial risk: Possible loss of value or earnings as a result of adverse movements in financial variables and the inability of the Company to meet its obligations or convert its assets into cash. Additionally, the risks of a fiscal nature are included in this category.
- Global risk: Possible loss of value or earnings as a result of events that affect in a transversal way the entire Telefónica Group, including sustainability and compliance issues.

### E.2 Identify the bodies responsible for preparing and implementing the risk management system, including tax matters.

Telefónica, S.A.'s Board of Directors reserves the power to approve the general risk policy. The Audit and Control Committee shall be responsible for proposing to the Board of Directors a risk control and management policy, which shall identify at least: the categories of risks facing the Company, the setting of the risk level that the Company deems acceptable, the measures to mitigate the impact of the identified risks, and the control and information systems to be used to control and manage the above-mentioned risks. The powers and duties of the Audit and Control Committee also include the supervision of the Company's risk management system.

As stated by the Group's Risk Management Policy, various local and corporate units are involved in the risk management process.

The entire organization is responsible for contributing to the identification and management of risks, following the procedures defined to implement and ensure the effectiveness of the Group's risk management processes.

In order to coordinate and report these activities, there is an internal Risk Management function, within the Internal Audit department, reporting functionally to the Audit and Control Committee.

The Group's Fiscal Control Policy, approved by the Board of Directors of the Company in February 2012 and updated in December 2016, establishes the rules for the prevention and management of fiscal risk. The development of the fiscal control function corresponds to the Group's Fiscal Management, which performs this task through the Regional Fiscal Directorates and the local fiscal control officers in the different subsidiaries in accordance with the principles defined in said document.

### **E.3 Indicate the main risks, including tax risks, which may prevent the company from achieving its targets.**

Information regarding this point is contained in the Annex to this Report.

### **E.4. State whether the company has a risk tolerance level, including tax risk.**

The Company has a level of risk tolerance or acceptable risk level established at a corporate level. This threshold represents the extent to which it is prepared to assume a certain level of risk, insofar as it may contribute to generating value and developing the business, achieving an appropriate balance between growth, performance and risk.

The range of risks to which the Company may be exposed, described below, is considered when evaluating risk:

- Generally, albeit mainly related to operational and business risks, tolerance thresholds are defined pursuant to the impact and probability of the risk. These thresholds are revised annually based on the performance of the main financials for both the Group as a whole and the business lines and main companies therein.
- The tolerance level for financial risks (including fiscal risks) is set in terms of their economic impact.
- A zero-tolerance level is established for global risks, principally those affecting corporate reputation and responsibility.

### **E.5 Identify any risks, including fiscal risks, which have occurred during the year.**

The strategy and management of the Telefónica Group's activities tend to minimize the impact of the risks, as well as counterbalance the negative effects of some issues with the favourable evolution of others.

The Shareholders Meeting of Colombia Telecomunicaciones, S.A. E.S.P. -“ColTel”- (company with a direct or indirect investment by Telefónica of 67.5% and by the Colombian Government of 32.5%), approved on August 30, 2017 a capital increase for a total amount (capital and premium) of 1.651 billion Colombian pesos, approximately 472 million Euro at the exchange rate of said date, in order to make the payment of the amount set in the arbitral award issued in the arbitration begun by the Ministry of Information Technologies and Communications -“MinTIC” of Colombia, in relation to its claim that certain assets subject to the provision of services be reversed under old concessions. The aforementioned arbitral award was unfavourable for both ColTel and another telecommunications operator in Colombia. The Telefónica Group and the Nation subscribed said amount as a proportion of their respective share participations in ColTel, thus entailing a disbursement for the Telefónica Group of 1.114 billion Colombian pesos, approximately 318 million Euro at the exchange rate of said date.

Further details on Income tax matters are provided by Telefónica in its Annual Accounts (Note 17 of the Individual and Consolidated Financial Statements).

### **E.6 Explain the response and monitoring plans for the main risks the company is exposed to, including fiscal risks.**

The Corporate Risk Management Framework, which has been devised in accordance with the main international best practices and guidelines, involves identifying and evaluating risks to respond to and monitor them.

Given the diverse range of risks, the mechanisms for responding to risks include overarching initiatives that are developed and coordinated as standard across the Group's main operations and/or specific measures aimed at managing certain risks at company level.

Overarching measures, mainly involving the use of financial derivatives, are taken to mitigate certain financial risks such as those relating to exchange-rate and interest-rate fluctuations. Regarding fiscal risks, the key issues identified are monitored, the Group uses Multinational Programs for insurance or insurance arranged locally in each country to cover operational risks, depending on the type of risk and cover required.

## F. Systems of Internal Risk Management and Internal Control over Financial Reporting (ICFR)

Describe the mechanisms which comprise the internal control over financial reporting (ICFR) risk control and management system at the company.

### F.1 The company's control environment

Specify at least the following components with a description of their main characteristics:

#### F.1.1 The bodies and/or functions responsible for: (i) the existence and regular updating of a suitable, effective ICFR; (ii) its implementation; and (iii) its monitoring.

The Board of Directors of Telefónica, S.A. (hereinafter "Telefónica") assumes ultimate responsibility of ensuring that an adequate and effective system of internal control over financial reporting (ICFR) exists and is updated.

The Board of Directors is, in accordance with prevailing laws and the Bylaws, the highest administrative and representative body of the Company, and basically consists of a supervisory and control body, while the executive bodies and management team are responsible for the day-to-day management of the Company's businesses.

The Bylaws and Regulations of the Board of Directors state that the primary duty of the Audit and Control Committee shall be to support the Board of Directors in its supervisory duties. Specifically, and in particular, highlighting, among others, the following powers and duties:

- i. Submitting to the Board of Directors proposals for the selection, appointment, re-election and replacement of the Auditor, being responsible for the selection process in accordance with the provisions of the Law, as well as the conditions of their engagement, and regularly collecting information from the Auditor of the audit plan and its execution, in addition to preserving its independence in the exercise of its functions.
- ii. Supervise the Internal Audit, and, in particular:
  - a) Ensure the independence and effectiveness of the Internal Audit function;
  - b) Propose the selection, appointment and removal of the person responsible for the Internal Audit service;
  - c) Propose the budget for that service;
  - d) Review the annual work plan of the Internal Audit and the annual activity report;
  - e) Receive periodic information on their activities; and
  - f) Verify that Senior Management takes into account the conclusions and recommendations of its reports.
- iii. Supervise the process of preparing and presenting the mandatory financial information and submit recommendations or proposals to the Administration Body aimed at safeguarding its integrity. In relation to this, it is responsible for supervising the process of preparation and integrity of the financial information relating to the Company and the Group, reviewing compliance with the regulatory requirements, the appropriate delimitation of the consolidation perimeter, and the correct application of the accounting criteria, reporting to the Board of Directors.
- iv. Supervise the effectiveness of the Company's internal control, Internal Audit and risk management systems, including fiscal ones, as well as discuss with the Auditor the significant weaknesses of the internal control system detected in the performance of the audit, all without breaking their independence. Therefore, where appropriate, it may submit recommendations or proposals to the Board of Directors and the corresponding deadline for follow-up. Additionally, the Board of Directors is the responsible to propose the risk control and management policy, which will identify, at least:
  - a) Risk types (at least, operational, technological, financial, legal and reputational which the Company faces)
  - b) the level of risk which the Company considers acceptable; the measures for mitigating the impact of the identified risks should they materialize; and
  - c) control and information systems to be employed to control and manage those risks



- v. Establish and supervise a system that enables employees to communicate, in a confidential and anonymous manner, irregularities of potential importance, especially financial and accounting irregularities, that may be noticed within the Company.
- vi. Establish and maintain the opportune relations with the Auditor to receive information on those issues that may be a threat to the independence of the Auditor, for examination by the Commission, and any other related to the process of developing the audit of accounts, and, when applicable, the authorization of services other than those prohibited, in the terms stated in the applicable legislation, as well as other communications included in the legislation on audit of accounts, and in the auditing standards. In any case, the Audit and Control Committee shall receive annually from the Auditor the declaration of its independence in relation to the entity or entities linked to it directly or indirectly, as well as the detailed and individualized information of the additional services of any type provided and the corresponding fees received from these entities by the aforementioned Auditor, or by the persons or entities linked to them in accordance with the provisions of current regulations.
- vii. Issue on an annual basis, prior to the issuance of the accounts audit report, a report expressing an opinion on whether the Auditor's independence is compromised. This report must conclude, in any case, on the reasoned assessment of the provision of each and every one of the additional services referred to in point vii above, individually considered and as a whole, other than the legal audit and in relation to the independence regime or with the regulations governing the activity of the accounts audit.
- viii. Analyze and report the economic conditions, the accounting impact and, if applicable, the exchange ratio proposed for the operations of structural and corporate modifications that the Company plans to carry out, before being submitted to the Board of Directors.
- ix. Inform, in advance and in the terms established in the applicable regulations, to the Board of Directors, on all matters stated in the Law and the Bylaws, and, in particular, on:
  1. The financial information that the Company must periodically publish;
  2. The creation or acquisition of participations in special purpose entities or domiciled in countries or territories that are considered to be tax havens; and
  3. Transactions with related parties.
- x. To exercise, regarding those companies of its Group that are considered Public Interest Entities (as they are defined in the current legislation) for the approval of the Board of Directors, provided they are fully owned, directly or indirectly, by the Company, in accordance with the provisions of current legislation, and which are not attributed to a Board of Directors, all the functions of the Audit Committee contemplated at any time by current legislation.

The provisions of sections ii), vii) and viii) of this article are understood without prejudice to the regulations governing the audit of accounts.

According to the Regulation of the Board of Directors, the Audit and Control Committee must meet at least once every quarter. In practice, the Committee meets every month, and, additionally, every time it is considered appropriate.

In order to carry out this supervisory function, the Audit and Control Committee is assisted by the entire Company management, including Internal Audit.

All the different areas and functional units of the Telefónica Group are important in ICFR (internal control over financial reporting), the Strategy and Financial areas playing a key role, as they are responsible for preparing, maintaining and updating the different procedures that govern their operations and identify the tasks to be carried out, as well as the persons in charge for executing these tasks.

**F.1.2 Whether the following components exist, especially in connection with the process for the preparation of the financial information reporting:**

- **The departments and/or mechanisms in charge of: (i) the design and review of the organizational structure; (ii) defining clearly the lines of responsibility and authority, with an appropriate distribution of tasks and functions; and (iii) sufficient deploying procedures so this structure is communicated effectively throughout the company.**

The Board of Directors is responsible for designing and reviewing the Company's organizational structure, ensuring there is an adequate separation of functions and that satisfactory coordination mechanisms among the different areas are established. The Human Resources Division carries out the deployment of the organizational structure in the respective fields.

Use of the Telefónica Group's economic-financial information system is regulated through several manuals, instructions and internal rules and regulations, internally made available, the most noteworthy of which are as follows:

- **Corporate Regulations on the Control, Registration and Reporting of Financial and Accounting Information of the Telefónica Group**, which set out the basic principles of the financial and accounting reporting system of the Group, and the procedures and mechanisms in place to oversee this system.
- **Accounting Policies Manual under IFRS**, designed to unify and homogenize the accounting policies and criteria used by all the Group companies to ensure Telefónica operates as a consolidated and homogeneous group.
- **Reporting and external audit instructions**: they are published on a quarterly basis and are intended to establish procedures and a calendar to be followed by all the Companies of the Telefónica Group and by their external auditors in the reporting of the financial-accounting information and results of the processes of external audit at the closing of each period, to comply with legal and information obligations of Telefónica, S.A. both in Spain and in the rest of the countries where Telefónica's shares are listed.
- **Manual for Completion of the Reporting for Consolidation of the Telefónica Group**, which is updated annually and establishes specific instructions completing the reporting forms necessary for the preparation of consolidated financial statements and interim consolidated financial information.
- **Annual calendar of financial accounting information**, applicable to all Telefónica Group companies to establish from the start of each period the monthly accounting-financial information reporting dates.
- **Corporate Accounting Plan ("PCC")**, which consists of the following documents: a) Table of accounts; b) Manual of definitions and Accounting Relations; and c) Auxiliary tables. The PCC intends to homogenize the sources of financial information included in the accounts of all the Telefónica Group companies, mandatory for all Companies in the Telefónica Group
- **Corporate Regulations on Intragroup Operations (NCC-006)**, mandatory for all companies in the Telefónica Group, and whose purpose is to recast in a specific regulation the criteria of mandatory compliance with regard to the accounting register and payment of transactions between companies in the Group and reinforce controls to avoid non-compliance cases.

These documents define and delimit responsibilities at each level of the organization regarding the reliability of the information published.

Additionally, the Management levels of the Company are available on the Group Intranet.

- **Code of conduct, approving body, dissemination and instruction degree, principles and values covered (stating whether it makes specific reference to the recording of operations and the preparation of financial information), body in charge of investigating breaches and proposing corrective or disciplinary action.**

With regard to the Code of Conduct, the Board of Directors of Telefónica approved, in December 2006, the unification of the Codes of Ethics of the Group's companies, in the so-called Business Principles. The Business Principles, are applied as a standard in all countries where the Telefónica Group operates, and apply to all its employees (the Business Principles affect at all levels of the organization, directors and non-directors).

The Business Principles are based on a series of general criteria which concern honesty and trust, abidance by prevailing laws, integrity and respect for human rights. They also set out specific principles focused on ensuring the trust of customers, professionals, shareholders, suppliers and of society at large.

They expressly mention issues related to the recording of transactions and the preparation of financial information: *"We prepare financial and accounting records in an accurate and reliable manner"*.

This Code of Ethics is accessible to all employees via the intranet, and procedures are in place in the Telefónica Group to update, monitor adherence to and disseminate these Business Principles.

Telefónica has an Office of Responsible Business Principles, which comprises the most senior representatives of the General Secretary's Office, Human Resources, Public Affairs and Regulation, CCDO, Operations, Purchases, Compliance, Internal Audit, Corporate Ethics and Sustainability, Security and CDO.

Among the responsibilities of this Office, the following stand out:

- Guaranteeing that Telefónica conducts business in an ethical and responsible manner, through the follow-up and monitoring of the Responsible Business Plan.
- Propose and supervise initiatives and measures that contribute to compliance with the Principles of Responsible Business in the Group.
- Analyze any matters or proposals in the Group that could represent a risk to the Business Principles and associated policies.

On a different issue should any type of conduct which does not comply with applicable laws, the Responsible Business Principles or internal regulations come to light, then, after the pertinent analysis, disciplinary measures will be applied in accordance with the regime established in the applicable labor laws, distinguishing between minor, serious and very serious sanctions, depending on the circumstances.

Training programmes are also regularly organized to ensure employees are aware of these rules and principles.

Telefónica also has an "Internal Code of Conduct" for Securities Markets issues, setting out the general guidelines and principles of conduct for the persons involved in securities and financial instrument transactions entered into by the Company and its subsidiaries. The Board of Directors on its meeting held on December 14, 2016, approved a new version of the Internal Code of Conduct in order to adapt it to the regulatory changes on this matter.

- **Whistle-blowing channel, for the reporting to the Audit Committee of any irregularities of a financial or accounting nature, as well as breaches of the code of conduct and malpractice within the organisation, stating whether reports made through this channel are confidential.**

With regard to the whistle-blowing channel, as specified in Article 22 of Telefónica, S.A.'s Regulations for the Board of Directors, and in Article 4 of Regulation for the Audit and Control Committee, this Committee's duties include: "Establishing and maintaining a mechanism to allow employees to confidentially and anonymously report potentially significant irregularities, particularly any financial or accounting irregularities detected within the Company".

The Telefónica Group has two main whistle-blowing channels:

**SOX Whistle-blowing Channel:** this channel was approved by the Audit and Control Committee in April 2004 to fulfil the obligations laid down in the Sarbanes-Oxley Act (SOX), as a listed company on the New York Stock Exchange. It is open to all Telefónica Group employees. Any irregularities reported through the channel must only be related with financial-accounting information, internal controls thereof, and/or audit-related matters.

This channel is confidential and anonymous, since the contents of any reports are sent automatically to the Compliance Department, removing the sender's name, and the source of the message cannot be traced in any event.

The channel is accessible through the Internal Audit webpage on Telefónica's intranet, through the section: Rules of Telefónica's Group, Control over the financial report process.

The Compliance and Internal Audit Departments, as delegate areas of the Audit and Control Committee of Telefónica, S.A., to these purposes, receive all complaints made through this channel regarding internal controls, accounting or the audit of the financial statements, therefore these Departments will be aware of these complaints, will solve them or give each of these complaints the treatment they deem convenient, analyzing the effects if any, they may have in relation to internal control over financial information, as well as monitoring the corresponding remediation plans.

**Business Principles Whistle-blowing Channel:** through this channel, professionals can notify the Company of any behavior, actions or events that could breach the ethical code, the Company's internal rules, or any regulations governing its activity, and jeopardize the contractual relationship between the Company and the accused party. Questions, advice and information on compliance with the Business Principles and associated policies and rules can also be submitted through this channel.

As a general rule, the policy of the Business Principles Whistle-blowing Channel is not to promote anonymous messages. Notwithstanding the foregoing, the confidentiality of the complainant's identity is safeguarded at all times.

Telefónica S.A.'s Compliance Department is responsible for the Responsible Business Principles Whistle-blowing Channel.

- **Training and refresher courses for personnel involved in preparing and reviewing financial information or evaluating ICFR, which address, at least, accounting rules, auditing, internal control and risk management.**

With regard to employee training in financial and control issues, we would note that in 2007 the Telefónica Corporate University (Universitas Telefónica) was opened to help contribute to the Telefónica Group's advancement through lifelong learning. All the University's training programs are based on developing the corporate culture, the business strategy and management and leadership skills.

Likewise, the Consolidation and Accounting Policies Area offers training plans and seminars to all personnel working in the Group's financial areas and other pertinent areas (tax, M&A, etc.), with the aim of informing them of any accounting or financial changes which are applicable to their job of preparing consolidated financial information. This area also publishes IFRS (International Financial Reporting Standards) information bulletins summarizing the main changes to accounting methodology, as well as clarifications on various other related issues.

Financial reporting personnel also attend technical sessions run by external consultancy firms and covering developments in accounting.

Lastly, the Telefónica Group also has an on-line training platform which includes a finance school providing specific training and refresher courses on financial information, as well as an internal control school providing instruction on auditing, internal control and risk management.

## F.2. Risk assessment in financial reporting

### Report, at least:

#### F.2.1 The main characteristics of the risk identification process, including risks of error or fraud, stating whether:

- **The process exists and is documented.**

Given the vast number of processes involved in financial reporting at the Telefónica Group, a model has been developed to select the most significant processes by applying a so-called Scope Definition Model, which is a part of the internal methodology of internal control audit over financial information. This model is applied to the financial information reported by subsidiaries companies. The model selects the significant accounts, i.e., those accounts with the largest contribution to the Group's consolidated financial information and then identifies the processes used to generate this information. Once the processes have been identified, the risks that may potentially have an impact on financial reporting are analyzed.

- **The process covers all financial reporting objectives, (existence and occurrence; completeness; valuation; presentation, disclosure and comparability; and rights and obligations), is updated and with what frequency.**

This identification procedure covers all the financial reporting objectives of existence and occurrence, completeness, valuation, presentation, disclosure and fraud. Risk identification is carried out on an annual basis.

- **A specific process is in place to define the scope of consolidation, with reference to the possible existence of complex corporate structures, special purpose vehicles, holding companies, etc.**

In the process of identifying the consolidation scope, the Finance and Control Areas regularly updates the consolidation scope, verifying additions and removals of companies with the legal and financial departments of the different companies which are part of the Group, including the corporate departments.

- **The process addresses other types of risk (operational, technological, financial, legal, fiscal, reputational, environmental, etc.) insofar as they may affect the financial statements.**

As indicated above, Telefónica also has a Risk Management Model covering four key areas of risk:

- Business risks
- Operational risks
- Global risks (Sustainability and Compliance)
- Financial risks

- **Which of the company's governing bodies is responsible for overseeing the process.**

Pursuant to the provisions of Article 22 of the Regulation of the Board of Directors of Telefónica, S.A., the Board of Directors, through the Audit and Control Committee, supervises this process.

## F.3 Control activities.

### Indicate the existence of at least the following components, and specify their main characteristics:

#### F.3.1 Procedures for reviewing and authorizing the financial information and description of ICFR to be disclosed to the markets, stating who is responsible in each case and documentation and flow charts

**of activities and controls (including those addressing the risk of fraud) for each type of transaction that may materially affect the financial statements, including procedures for the closing of accounts and for the separate review of critical judgments, estimates, evaluations and projections.**

On March 26, 2003 Board of Directors of Telefónica, S.A. approved the "Regulations Governing Disclosure and Reporting to the Markets". These regulate the basic principles of operation of the financial disclosure control processes and systems which guarantee that all relevant consolidated financial information of Telefónica, S.A. is communicated to the Company's senior executives and its management team, assigning to the Internal Audit the duty of periodically assessing the functioning of these processes and systems.

Each quarter the Consolidation and Accounting Policies Department submits the periodic financial information to the Audit and Control Committee, highlighting the main events and accounting criteria applied and clarifying any major events which occurred during the period.

Likewise, the Telefónica Group has documented financial processes in place which stipulate common criteria for preparing financial information in all Group companies, as well as any outsourced activities.

The Company also follows documented procedures for preparing consolidated financial information whereby those employees responsible for the different areas are able to verify this information.

Also, and pursuant to the internal regulations, the Executive Chairmen or Chief Executive Officers and the Finance Directors of Group companies must submit a certificate to the Corporate Consolidation and Accounting Policies Department stating that they have reviewed the financial information being presented, that the financial statements give a true and fair view, in all material respects, of the financial position, results and cash position, and that there are no significant risks to the business or unhedged risks which may have a material impact on the Company's equity and financial position.

In relation to the accounting close, the Consolidation and Accounting Policies Department issues mandatory instructions setting out the calendar and contents for the financial reporting period for the preparation of the consolidated annual financial statements.

The Corporate Consolidation and Accounting Policies Department reviews the key judgments, estimates, valuations and forecasts to identify critical accounting policies that require the use of estimates and value judgments. In these cases, the Corporate Consolidation and Accounting Policies Department also establishes the necessary operational co-ordination actions with the rest of the Telefónica Group units for their specific areas of activity and knowledge before presenting them to the Audit and Control Committee. The most relevant are dealt with by the Audit and Control Committee. Senior management defines the format for presenting the annual financial statements prior to approval by the Board.

Lastly, Internal Audit, as part of its annual audit plan, among others actions, sets out work plans every year to assess the internal control of financial reporting model.

**F.3.2. Internal control policies and procedures for information systems (including secure access, control of changes, system operation, continuity and segregation of duties) giving support to key company processes regarding the preparation and publication of financial information.**

The Global Networks and Information Systems Department of the Telefónica Group is responsible for the global management of Information Systems for all the Group's businesses, defining strategy and technological planning, ensuring quality in service, cost and security required by the Group.

One of its duties is to develop and implement systems to improve the efficiency, efficacy and profitability of Group processes, the definition and implementation of policies and security standards for applications and infrastructures (in conjunction with the Global Security Department), which includes IT aspects of the internal control model.

The Global Security Policy considers human resources, the information, the technological and material resources that support them, to be fundamental assets. For this reason, guaranteeing their security is considered to be an essential asset within the Telefónica strategy, and an essential enabler of the organization's activity.

With the approval of this Policy, the Board of Directors expresses its determination and commitment to reaching a level of security that is adequate to the needs of the business and that homogeneously guarantees the protection of the assets in all Telefónica Group companies.

The security activities developed by the different environments, organizational structures, parties responsible for assets, and employees will be governed by the principles of legality, efficiency, Corresponsibility, cooperation, and coordination. Any and all adequate promotion, conduction, control, and improvement measures will be established to this end.

- **Principle of Legality:** the necessary compliance of all national and international laws and regulations regarding the matter of security that may be valid at any given time in any of the territories where the Telefónica Group operates, shall be ensured.
- **Principle of Efficiency:** in order to efficiently reach the required level of security, the anticipatory and preventive nature of said actions shall rule over any passive and reactionary nature. To this end, knowledge of potential threats as well as the analysis of potential risks shall be privileged as part of an intelligence process that identifies and understands the most relevant threats that affect the organization. In order to get ahead of their action and evolution, and to safeguard the Telefónica Group's global organization from their potentially harmful effects, mitigating these risk's damages down to an acceptable level for the business.

A Global Security Regulations Framework is defined for the purpose of reaching a standardized level of security. This framework will take into account the analyses of risks and threats and will also establish the precise preventive or corrective protection measures.

In addition, strategic plans will be conceived and prepared in order to identify and prioritize the projects and budgets necessary for reaching those adequate levels of security and auditability, minimizing the security risks identified in the corresponding analyses, and maximizing the effectiveness of the investment made and the resources used.

- **Principle of Corresponsibility:** users must preserve the security of the assets that Telefónica makes available to them in accordance to the security criteria, requirements, procedures, and technologies defined in the Security Regulations Framework, as well as the applicable laws and regulations regarding the matter of security. At the same time, users must exclusively use the assets for the performance of activities that correspond to their workstation and assigned tasks.
- **Principle of Cooperation and Coordination:** in order to reach the levels of efficiency required by Telefónica business project, the global action and comprehensive concept of security activities shall be preserved together with the aforementioned requirements of anticipation and prevention, cooperation and coordination between all business units and employees will be prioritized, in order to generate the adequate synergies and to jointly reinforce the capabilities.

The Security Organization coordinates the security responsibilities of the different Telefónica Group structures, promoting cooperation between them in order to guarantee the efficient and joint protection of the assets.

Lastly, Internal Audit unit, within the scope established in its annual audit plan, sets out work plans to verify the efficacy and efficiency of the IT governance model, the information security Policy, suitability of controls and data integrity.

### **F.3.3. Internal control policies and procedures for overseeing the management of outsourced activities, and of the appraisal, calculation or valuation services commissioned from independent experts, when these may materially affect the financial statements.**

If a process or part of a process is outsourced to an independent party, controls are still required to ensure the entire process is adequately controlled. Given the importance of outsourcing services and the impacts that this



can have on the opinion about ICFR, measures are taken in the Telefónica Group to demonstrate an appropriate level of control in the independent party. Actions taken to achieve this objective are three-fold:

- **Certification of internal control by an independent third party:** ISAE3402 and/or SSAE16 certifications.
- **Implementation of specific controls:** identified, designed, implemented and assessed by the Company.
- **Direct assessment:** an assessment carried out by Internal Audit, on certain administrative outsourced processes, with the scope established in its annual audit plan.

When Telefónica, S.A. or any of its subsidiaries engage the services of an independent expert whose findings may potentially show impacts on the consolidated financial statements, as part of the selection process the competence, training, credentials and independence of the third party as regards the methods and main hypothesis used, is verified directly by the area contracting the service and, if applicable with the procurement department. The Finance and Control Department has established control activities geared towards guaranteeing the validity of data, the methods used, and the reasonability of the assumptions used by the third party using regular monitoring of each function's own KPIs in order to ensure compliance of the outsourced process according to the Group's different policies and guidelines.

Likewise, there is an internal procedure for engaging independent experts which requires specific levels of approval.

#### F.4 Information and communication

Indicate the existence of at least the following components, and specify their main characteristics:

**F.4.1 A specific function in charge of defining and maintaining accounting policies (accounting policies area or department) and settling doubts or disputes over their interpretation, which is in regular communication with the team in charge of operations, and a manual of accounting policies regularly updated and communicated to all the company's operating units.**

The Consolidation and Accounting Policies Department of the Group is charged with defining and updating the accounting policies used for preparing the consolidated financial information.

Thus, this area publishes IFRS (International Financial Reporting Standards) information bulletins summarizing the main changes to accounting methodology, as well as clarifications on various other related issues, which are systematically monitored by the Accounting Policies area. This bulletins are published on a monthly basis.

Also, the Telefónica Group has an Accounting Policies Manual which is updated annually, the last update took place in December 2017. The objectives of this manual are: to align the corporate accounting principles and policies with IFRS; to maintain accounting principles and policies which ensure that the information is comparable within the Group and offers optimum management of the source of information; to improve the quality of the accounting information of the various Group companies and of the Consolidated Group by disclosing, agreeing and introducing accounting principles which are unique to the Group; and to facilitate the accounting integration of acquired and newly-created companies into the Group's accounting system by means of a reference manual.

This Manual is mandatory for all companies belonging to the Telefónica Group, and shall be applied to their reporting methods when preparing the consolidated financial statements.

This documentation is regularly sent by email and is available for the entire Group on the Telefónica intranet.

The accounting policies area maintains a constant dialogue with the accounting heads of the Group's main operations, both proactively and reactively. This dialogue is useful not only for resolving doubts or conflicts but also to ensure that accounting criteria in the Group are uniform and also for sharing best practices between operators.



**F.4.2 Mechanisms in standard format for the capture and preparation of financial information, which are applied and used in all units within the entity or group, and support its main financial statements and accompanying notes as well as disclosures concerning ICFR.**

As stated above, there is a Compliance Manual for Consolidation Reporting which includes specific instructions on preparing the disclosures which comprise the reporting pack reported by all components of the Telefónica Group for the preparation of the Telefónica Group's consolidated financial statements and the consolidated explanatory notes.

Likewise, the Telefónica Group has implemented a specific system, through a software, which supports the reporting of the individual financial statements at its various subsidiaries, as well as the necessary notes and disclosures for preparing the consolidated annual financial statements. This tool is also used to carry out the consolidation process and its subsequent analysis. The system is managed centrally and all components of the Telefónica Group use the same accounts plan.

**F.5 System function monitoring**

Indicate the existence of at least the following components, describing their main characteristics:

**F.5.1 The ICFR monitoring activities undertaken by the Audit Committee and the Company has an internal audit function whose powers include supporting the Audit Committee in its role of monitoring the internal control system, including ICFR. Describe the scope of the ICFR assessment conducted in the year and the procedure for the person in charge to communicate its findings. State also whether the company has an action plan specifying corrective measures for any flaws detected, and whether it has taken stock of their potential impact on its financial information.**

As mentioned beforehand, the Corporate Bylaws and Regulations of the Board of Directors state that the primary duty of the Audit and Control Committee shall be to support the Board of Directors in its supervisory duties, with its main functions including: supervising the effectiveness of the Company's internal control system and risk management systems, and discussing with the Auditors significant or material weaknesses in the internal control system detected during the audit.

The Audit and Control Committee is responsible for supervising the effectiveness of the internal controls carried out by the Telefónica Group's Internal Audit function.

The Internal Audit function reports functionally to the Audit and Control Committee, with the primary goal of lending them support in their responsibilities concerning ensuring governance, risk management, and the Group's Internal Control System. Internal Control comprises all process which may reasonably ensure compliance with laws, regulations and internal rules, reliability of information, efficiency and efficacy of operations, and the integrity of the organisation's net worth.

The Internal Audit function is carried out in accordance with the International Standards for the Professional Practice of Internal Auditing and has been awarded a Quality Certificate from the Institute of Internal Auditors.

With regard to supervision of Internal Control over Financial Reporting (ICFR), Telefónica, S.A. is listed on the New York Stock Exchange and is therefore subject to the regulatory requirements established by the US authorities applicable to all companies trading on this exchange.

Among the above mentioned requirements is the aforementioned Sarbanes-Oxley Act and, specifically, Section 404 which stipulates that all listed companies in the US market must evaluate on an annual basis the effectiveness of their ICFR procedures and internal control structure.

In this regard, the External Auditor issues its own independent opinion on the effectiveness of the internal control over financial information (ICFR).

Additionally, to fulfil this requirement, the Telefónica Group uses a three-tier (next detailed) internal control of financial reporting evaluation model, while every year the Internal Audit function is responsible for evaluating its performance.

**Review of processes and specific controls**

In certain companies, in addition to filling out the self-appraisal questionnaire, taking into account the significance of their contribution to the Group's key economic-financial figures and other risk factors considered, their processes and controls are directly reviewed applying the General Assessment Model of the Telefónica Group, which in turn uses the Definition of Scopes Model, in order to identify the significant accounts of each company of the Telefónica Group in accordance with the previously established criteria for the assessment of the internal control over financial information (ICFR) at the Telefonica Group level.

Once the significant accounts are identified for review, the General Evaluation Model is applied as follows:

- The processes and systems associated with the significant accounts are determined.
- Risks affecting the financial reporting vis-à-vis these processes are identified.
- Checks and, where necessary, process controls are put in place to provide reasonable assurance that the documentation and design of controls over financial reporting are adequate.
- Audit tests are carried out to assess the effectiveness of the design and execution of key control activities, both at process or transaction level and general entity level controls.

#### **Review on IT general controls**

The Information Technology General Controls are assessed at least once a year, largely taking into account questions regarding regulations and guidelines applied at global level across the Group.

The supervision of IT general controls systems is designed to review management of changes to programs, data and systems access, and the operation (management of changes to infrastructures, back-ups, scheduled tasks and issues).

#### **Self-assessment Questionnaires**

All the subsidiaries of the Group receive annual self-assessment questionnaires, whose answers should be certified by the responsible of the Internal Control Over Financial Reporting (ICFR) System, in each company (Chief Executives or Chief Executive Officer (CEO) and Chief Financial Officer (CFO)). These questionnaires cover those ICFR aspects that are deemed to be minimum requirements to achieve reasonable assurance of the reliability of the financial information reported. A sample of responses is audited by the Internal Audit unit.

If any control deficiency or opportunity for improvement is detected while performing the procedures mentioned above, they should be reported to Management through reports prepared by the Internal Audit unit, analyzing their impact, both individual and aggregated, on the assessment on the internal control over financial information (ICFR) if applicable. Additionally, for this assessment, it is necessary to consider the existing compensating controls which validate the processes supported in case that the original controls could not be corrected. After receiving the report, the control owners provide action plans for solving the identified control deficiencies, as well as the foreseen implementation dates of those action plans.

These action plans have as main objectives:

- Mitigate the deficiency from the control defined originally so that the control works as expected.
- Prioritize the implementation of improvement opportunities, since improvement opportunities are not internal control deficiencies.

**F.5.2 If it has a discussion procedure whereby the auditor (pursuant to TAS), the internal audit function and other experts can report any significant internal control weaknesses encountered during their review of the financial statements or other assignments, to the company's senior management and its Audit Committee or Board of Directors. State also whether the entity has an action plan to correct or mitigate the weaknesses found.**

As explained beforehand, the Internal Audit unit also provides support to the Audit and Control Committee in monitoring the correct functioning of the ICFR system.

The Internal Audit unit participates in the Audit and Control Committee meetings, and reports regularly on the findings of the performed tasks, as well as action plans established to mitigate and of the degree of implementation thereof. This includes to communicate significant or material internal control weaknesses which have been identified.

Furthermore, the External Auditor participates in the Audit and Control Committee meetings, when called to do so by the Audit and Control Committee, to explain and clarify different aspects of the audit reports and other aspects of its work, including tasks performed to guarantee the effectiveness of the system of internal control over financial reporting (ICFR). The External Auditor is obliged to communicate the significant or material internal control weaknesses identified and, for this purpose, has immediate access to the Senior management and the Chairman of the Audit and Control Committee.

## **F.6 Other relevant information**

Not applicable

## **F.7 External auditor review**

**State whether:**

**F.7.1 The ICFR information supplied to the market has been reviewed by the external auditor, in which case the corresponding report should be attached. Otherwise, explain the reasons for the absence of this review. Otherwise, explain the reasons for the absence of this review.**

As stated above, the attached information on ICFR has been submitted to review by the External Auditor, whose report is attached as an appendix to this document.

## G. Degree of Compliance with Corporate Governance Recommendations

Indicate the extent to which the company follows the recommendations of the Good Governance Code of listed companies.

Should any recommendation not be followed or be only partially followed, a detailed explanation should be given of the reasons so that the shareholders, investors and the market in general have sufficient information to assess the way the company works. General explanations will not be acceptable.

1. The bylaws of listed companies should not place an upper limit on the votes that can be cast by a single shareholder, or impose other obstacles to the takeover of the company by means of share purchases on the market.

### Explain

In accordance with Article 26 of the Corporate Bylaws, no shareholder may cast a number of votes in excess of 10 percent of the total voting capital existing at any time, regardless of the number of shares held by such shareholder and in full compliance with mandatory requirements of law. In determining the maximum number of votes that each shareholder may cast, only the shares held by each such shareholder shall be computed. It does not include additional votes cast on behalf of other shareholders who may have appointed them as proxy, who are themselves likewise restricted by the 10 percent voting ceiling.

The limitation established in the preceding paragraphs shall also apply to the maximum number of votes that may be collectively or individually cast by two or more shareholder companies belonging to the same group of entities, as well as to the maximum number of votes that may be cast by an individual or corporate shareholder and the entity or entities that are shareholders themselves and which are directly or indirectly controlled by such individual or corporate shareholder.

In addition, Article 30 of the Corporate Bylaws stipulates that no person may be appointed as Director unless they have held, for more than three years prior to their appointment, a number of shares of the Company representing a nominal value of at least 3,000 euros, which the Director may not transfer while in office. These requirements shall not apply to those persons who, at the time of their appointment, are related to the Company under an employment or professional relationship, or when the Board of Directors resolves to waive such requirements with the favorable vote of at least 85 percent of its members.

Article 31 of the Corporate Bylaws establishes that, in order for a Director to be appointed Chairman, Vice-Chairman, Chief Executive Officer or member of the Executive Commission, it shall be necessary for such Director to have served on the Board for at least the three years immediately prior to any such appointment. However, such length of service shall not be required if the appointment is made with the favorable vote of at least 85 percent of the members of the Board of Directors.

The Corporate Bylaws (Article 26) restrict the number of shares that may be cast by a single shareholder or by shareholders belonging to the same group in order to achieve a suitable balance and protect the position of minority shareholders, thus avoiding a potential concentration of votes among a reduced number of shareholders, which could impact on the guiding principle that the General Shareholders' Meeting must act in the interest of all the shareholders. Telefónica believes that this measure does not constitute a blocking mechanism of takeover bids but rather a guarantee that the acquisition of control required the majority support of all shareholders, because, naturally, and as taught by experience, potential offerors may make their offer conditional upon the removal of the defense mechanism.

In relation to the above and in accordance with the provisions of Article 527 of the Spanish Corporations Act, any clauses in the Bylaws of listed corporations that directly or indirectly restrict the number of shares that may be cast by a single shareholder by shareholders belonging to the same group or by any parties acting together with the aforementioned, will be rendered null and void when, subsequent to a takeover bid, the offeror has a stake equal to or over 70% of the share capital which confers voting rights, unless the offeror was not subject to neutralization measures to prevent a takeover bid or had not adapted these measures accordingly.

In addition, the special requirements for appointment as Director (Article 30 of the Corporate Bylaws) or as Chairman, Vice-Chairman, Chief Executive Officer or member of the Executive Commission (Article 31 of the Corporate Bylaws) are justified by the desire that access to the management decision-making body and to the most significant positions thereon is reserved to persons who have demonstrated their commitment to the Company and who, in addition, have adequate experience as members of the Board, such that continuity of the management model adopted by the Telefónica Group may be assured in the interest of all of its shareholders and stakeholders. In any event, these special requirements may be waived by broad consensus among the members of the Board of Directors, namely, with the favorable vote of at least 85 percent of its members, as provided by the aforementioned Articles of the Corporate Bylaws.

2. **When a dominant and a subsidiary company are both listed, they should provide detailed disclosure on:**
  - a) **The activity they engage in and any business dealings between them, as well as between the listed subsidiary and other group companies.**
  - b) **The mechanisms in place to resolve possible conflicts of interest.**

Not applicable

3. **During the annual general meeting the Chairman of the Board should verbally inform shareholders in sufficient detail of the most relevant aspects of the company's corporate governance, supplementing the written information circulated in the Annual Corporate Governance Report. In particular:**
  - a) **Changes taking place since the previous annual general meeting.**
  - b) **The specific reasons for the company not following a given Good Governance Code recommendation and any alternative procedures followed in its stead.**

Complies

4. **The company should draw up and implement a policy of communication and contacts with shareholders, institutional investors and proxy advisors that complies in full with market abuse regulations and accords equitable treatment to shareholders in the same position.**

This policy should be disclosed on the company's website, complete with details of how it has been put into practice and the identities of the relevant interlocutors or those charged with its implementation.

Complies

5. **The Board of Directors should not make a proposal to the general meeting for the delegation of powers to issue shares or convertible securities without pre-emptive subscription rights for an amount exceeding 20% of capital at the time of such delegation.**

When a board approves the issuance of shares or convertible securities without pre-emptive subscription rights, the company should immediately post a report on its website explaining the exclusion as envisaged in company legislation.

Complies

6. Listed companies drawing up the following reports on a voluntary or compulsory basis should publish them on their website well in advance of the annual general meeting, even if their distribution is not obligatory:
- a) Report on auditor independence.
  - b) Reviews of the operation of the Audit Committee and the Nomination and Remuneration Committee.
  - c) Audit Committee report on third-party transactions.
  - d) Report on corporate social responsibility policy.

Complies

7. The company should broadcast its general meetings live on the corporate website.

Explain

The Company decided not to offer a live webcast of its 2017 General Shareholders Meeting, for organisational reasons and owing to the way the Meeting was developed (possible changes which could arise). Nonetheless, Telefónica is analysing the possibility of broadcasting future General Shareholders meetings live on its website.

8. The Audit Committee should strive to ensure that the Board of Directors can present the company's accounts to the general meeting without limitations or qualifications in the auditor's report. In the exceptional case that qualifications exist, both the Chairman of the Audit Committee and the auditors should give a clear account to shareholders of their scope and content.

Complies

9. The company should disclose its conditions and procedures for admitting share ownership, the right to attend general meetings and the exercise or delegation of voting rights, and display them permanently on its website.

Such conditions and procedures should encourage shareholders to attend and exercise their rights and be applied in a non-discriminatory manner.

Complies

10. When an accredited shareholder exercises the right to supplement the agenda or submit new proposals prior to the general meeting, the company should:

- a) Immediately circulate the supplementary items and new proposals.
- b) Disclose the model of attendance card or proxy appointment or remote voting form duly modified so that new agenda items and alternative proposals can be voted on in the same terms as those submitted by the Board of Directors.
- c) Put all these items or alternative proposals to the vote applying the same voting rules as for those submitted by the Board of Directors, with particular regard to presumptions or deductions about the direction of votes.
- d) After the general meeting, disclose the breakdown of votes on such supplementary items or alternative proposals.

Not applicable

11. In the event that a company plans to pay for attendance at the general meeting, it should first establish a general, long-term policy in this respect.

Not applicable

12. The Board of Directors should perform its duties with unity of purpose and independent judgement, according to the same treatment to all shareholders in the same position. It should be guided at all times by the company's best interest, understood as the creation of a profitable business that promotes its sustainable success over time, while maximising its economic value.

In pursuing the corporate interest, it should not only abide by laws and regulations and conduct itself according to principles of good faith, ethics and respect for commonly accepted customs and good practices, but also strive to reconcile its own interests with the legitimate interests of its employees, suppliers, clients and other stakeholders, as well as with the impact of its activities on the broader community and the natural environment.

Complies

13. The Board of Directors should have an optimal size to promote its efficient functioning and maximize participation. The recommended range is accordingly between five and fifteen members.

Explain

In accordance with article 29 of the Telefónica, S.A. corporate bylaws, the Board of Directors shall be composed of a minimum of five and a maximum of twenty members. However, in line with the Good Governance tendencies to reduce the number of Board Members, the General Shareholder's Meeting held on June 9, 2017 approved the establishment of seventeen members as the number of Board of Directors members, based on the recommendation of the Company Board of Directors and the favorable report of the Nominating, Compensation and Corporate Governance Committee.

The complexity of the Telefónica Group organizational structure, given the considerable number of companies it comprises, the variety of sectors it operates in, its multinational nature, as well as its economic and business relevance, justify the fact that the number of members of the Board is adequate to achieve an efficient and operative operation.

Likewise, it is important to bear in mind that the Board of Directors of the Company have six Committees (the Executive Commission and five Advisory Committees), which ensures the active participation of all its Directors.

14. The Board of Directors should approve a Director selection policy that:

- a) Is concrete and verifiable.
- b) Ensures that the appointment or reelection proposals are based on a prior analysis of the Board's needs.
- c) Favours a diversity of knowledge, experience and gender.

The results of the prior analysis of board needs should be written up in the Nomination Committee's explanatory report, to be published when the general meeting is convened that will ratify the appointment and re-election of each Director.

The director selection policy should pursue the goal of having at least 30% of total board places occupied by women Directors before the year 2020.

**The Nomination Committee should run an annual check on compliance with the director selection policy and set out its findings in the Annual Corporate Governance Report.**

**Complies**

- 15. Proprietary and independent Directors should constitute an ample majority on the Board of Directors, while the number of Executive Directors should be the minimum practical bearing in mind the complexity of the corporate group and the ownership interests they control.**

**Complies**

- 16. The percentage of Proprietary Directors out of all Non-executive Directors should be no greater than the proportion between the ownership stake of the shareholders they represent and the remainder of the company's capital.**

**This criterion can be relaxed:**

- a) In large cap companies where few or no equity stakes attain the legal threshold for significant shareholdings.**
- b) In companies with a plurality of shareholders represented on the Board but not otherwise related.**

**Explain**

The aforementioned recommendation 16 refers to the composition of the group of non executive Directors. As stated in Section C.1.3 of this Annual Corporate Governance Report, at December 31, 2017, the group of non Executive Directors of Telefónica, S.A. was composed of 14 members (of a total of 16 Members), of whom 4 are Proprietary Directors, 9 are Independent Directors and 1 falls under the "Other External Directors" category.

At December 31, 2017, of the four Proprietary Directors, one act in representation of CaixaBank, S.A., which holds 5.01% of the capital of Telefónica, S.A., two act in representation of Banco Bilbao Vizcaya Argentaria, S.A. (BBVA), which holds 5.17% of the capital, and one acts in representation of China Unicom (Hong Kong) Limited (China Unicom) which holds a 1.24% stake.

Applying the proportional criterion established in Article 243 of the LSC regarding the total number of Directors, the stakes held by "la Caixa" and BBVA are sufficient to entitle each entity to appoint a Director.

Moreover, it must be taken into account that recommendation 16 stipulates that this strict proportionality criterion can be relaxed so the weight of Proprietary Directors is greater than would strictly correspond to the total percentage of capital they represent in large cap companies where few or no equity stakes attain the legal threshold for significant shareholdings.

In this regard, Telefónica ranks among the top listed companies on Spanish stock exchanges in terms of stock market capitalization, reaching the figure of 42,186 million euros at December 31, 2017, which means a very high absolute value of the stakes of "la Caixa" and BBVA in Telefónica (that of "la Caixa" is 2,112 million euros, and that of BBVA is 2,179 million euros). This justifies the overrepresentation of these entities on the Board of Directors, rising from one member of the Board each (to which they would strictly have the right in accordance with Article 243 of the Spanish Corporations Act) to two members, i.e. permitting the appointment of just one more Proprietary Director over the strictly legal proportion.

On January 23, 2011, China Unicom and Telefónica, S.A. expanded on their existing strategic alliance and signed an extension to their Strategic Partnership Agreement, in which both companies agreed to strengthen and deepen their strategic cooperation in certain business areas, and committed to investing the equivalent of 500 million US dollars in ordinary shares of the other party. In recognition of China Unicom's stake in Telefónica, approval was given at Telefónica's General Shareholders' Meeting held on May 18, 2011 for the appointment of a board member named by China Unicom.



17. Independent Directors should be at least half of all board members.

However, when the company does not have a large market capitalisation, or when a large cap company has shareholders individually or concertedly controlling over 30 percent of capital, independent Directors should occupy, at least, a third of board places.

Complies

18. Companies should disclose the following Director particulars on their websites and keep them regularly updated:

- a) Background and professional experience.
- b) Directorships held in other companies, listed or otherwise, and other paid activities they engage in, of whatever nature.
- c) Statement of the Director class to which they belong, in the case of proprietary Directors indicating the shareholder they represent or have links with.
- d) Dates of their first appointment as a board member and subsequent re-elections.
- e) Shares held in the company, and any options on the same.

Complies

19. Following verification by the Nomination Committee, the Annual Corporate Governance Report should disclose the reasons for the appointment of proprietary Directors at the urging of shareholders controlling less than 3 percent of capital; and explain any rejection of a formal request for a board place from shareholders whose equity stake is equal to or greater than that of others applying successfully for a proprietary Directorship.

Complies

20. Proprietary Directors should resign when the shareholders they represent dispose of their ownership interest in its entirety. If such shareholders reduce their stakes, thereby losing some of their entitlement to proprietary Directors, the latter's number should be reduced accordingly.

Complies

21. The Board of Directors should not propose the removal of independent Directors before the expiry of their tenure as mandated by the Bylaws, except where they find just cause, based on a proposal from the Nomination Committee. In particular, just cause will be presumed when Directors take up new posts or responsibilities that prevent them allocating sufficient time to the work of a board member, or are in breach of their fiduciary duties or come under one of the disqualifying grounds for classification as independent enumerated in the applicable legislation.

The removal of independent Directors may also be proposed when a takeover bid, merger or similar corporate transaction alters the company's capital structure, provided the changes in board membership ensue from the proportionality criterion set out in recommendation 16.

Complies

22. Companies should establish rules obliging Directors to disclose any circumstance that might harm the organisation's name or reputation, tendering their resignation as the case may be, and, in particular, to inform the Board of any criminal charges brought against them and the progress of any subsequent trial.

The moment a Director is indicted or tried for any of the offences stated in company legislation, the Board of Directors should open an investigation and, in light of the particular circumstances, decide whether or not he or she should be called on to resign. The Board should give a reasoned account of all such determinations in the Annual Corporate Governance Report.

Complies

23. Directors should express their clear opposition when they feel a proposal submitted for the Board's approval might damage the corporate interest. In particular, independents and other Directors not subject to potential conflicts of interest should strenuously challenge any decision that could harm the interests of shareholders lacking board representation.

When the Board makes material or reiterated decisions about which a Director has expressed serious reservations then he or she must draw the pertinent conclusions. Directors resigning for such causes should set out their reasons in the letter referred to in the next recommendation.

The terms of this recommendation also apply to the secretary of the Board, even if he or she is not a Director.

Complies

24. Directors who give up their place before their tenure expires, through resignation or otherwise, should state their reasons in a letter to be sent to all members of the Board. Whether or not such resignation is disclosed as a material event, the motivating factors should be explained in the Annual Corporate Governance Report.

Complies

25. The Nomination Committee should ensure that Non-executive Directors have sufficient time available to discharge their responsibilities effectively.

The Board of Directors regulations should lay down the maximum number of company boards on which Directors can serve.

Complies

26. The Board should meet with the necessary frequency to properly perform its functions, eight times a year at least, in accordance with a calendar and agendas set at the start of the year, to which each Director may propose the addition of initially unscheduled items.

Complies

27. Director absences should be kept to a strict minimum and quantified in the Annual Corporate Governance Report. In the event of absence, Directors should delegate their powers of representation with the appropriate instructions.

Complies

28. When Directors or the secretary express concerns about some proposal or, in the case of Directors, about the company's performance, and such concerns are not resolved at the meeting, they should be recorded in the minute book if the person expressing them so requests.

Complies

29. The company should provide suitable channels for Directors to obtain the advice they need to carry out their duties, extending if necessary to external assistance at the company's expense.

Complies

30. Regardless of the knowledge Directors must possess to carry out their duties, they should also be offered refresher programmes when circumstances so advise.

Complies

31. The agendas of board meetings should clearly indicate on which points Directors must arrive at a decision, so they can study the matter beforehand or gather together the material they need.

For reasons of urgency, the Chairman may wish to present decisions or resolutions for board approval that were not on the meeting agenda. In such exceptional circumstances, their inclusion will require the express prior consent, duly minuted, of the majority of Directors present.

Complies

32. Directors should be regularly informed of movements in share ownership and of the views of major shareholders, investors and rating agencies on the company and its group.

Complies

33. The Chairman, as the person charged with the efficient functioning of the Board of Directors, in addition to the functions assigned by law and the company's bylaws, should prepare and submit to the Board a schedule of meeting dates and agendas; organise and coordinate regular evaluations of the Board and, where appropriate, the company's chief executive officer; exercise leadership of the Board and be accountable for its proper functioning; ensure that sufficient time is given to the discussion of strategic issues, and approve and review refresher courses for each Director, when circumstances so advise.

Complies

34. When a lead independent Director has been appointed, the Bylaws or Board of Directors regulations should grant him or her the following powers over and above those conferred by law: chair the Board of Directors in the absence of the Chairman and Vice-Chairman give voice to the concerns of Non-executive Directors; maintain contacts with investors and shareholders to hear their views and develop a balanced understanding of their concerns, especially those to do with the company's corporate governance; and coordinate the Chairman's succession plan.

**Complies**

35. The Board Secretary should strive to ensure that the Board's actions and decisions are informed by the governance recommendations of the Good Governance Code of relevance to the company.

**Complies**

36. The Board in full should conduct an annual evaluation, adopting, where necessary, an action plan to correct weakness detected in:

- a) The quality and efficiency of the Board's operation.
- b) The performance and membership of its Committees.
- c) The diversity of board membership and competences.
- d) The performance of the Chairman of the Board of Directors and the company's chief executive.
- e) The performance and contribution of individual Directors, with particular attention to the chairmen of board committees.

The evaluation of board committees should start from the reports they send the Board of Directors, while that of the Board itself should start from the report of the nomination committee.

Every three years, the Board of Directors should engage an external facilitator to aid in the evaluation process. This facilitator's independence should be verified by the nomination committee.

Any business dealings that the facilitator or members of its corporate group maintain with the company or members of its corporate group should be detailed in the Annual Corporate Governance Report.

The process followed and areas evaluated should be detailed in the Annual Corporate Governance Report.

**Complies**

37. When an Executive Committee exists, its membership mix by Director class should resemble that of the Board. The Secretary of the Board should also act as secretary to the Executive Committee.

**Complies**

38. The Board of Directors should be kept fully informed of the business transacted and decisions made by the Executive Committee. To this end, all board members should receive a copy of the committee's minutes.

Complies

39. All members of the Audit Committee, particularly its Chairman, should be appointed with regard to their knowledge and experience in accounting, auditing and risk management matters. A majority of Committee places should be held by independent Directors.

Complies

40. Listed companies should have a unit in charge of the internal audit function, under the supervision of the Audit Committee, to monitor the effectiveness of reporting and control systems. This unit should report functionally to the Board's Non-executive Chairman or the Chairman of the Audit Committee.

Complies

41. The head of the unit handling internal audit function should present an annual work programme to the Audit Committee, inform it directly of any incidents arising during its implementation and submit an activities report at the end of each year.

Complies

42. The Audit Committee should have the following functions over and above those legally assigned:

1º With respect to internal control and reporting systems:

- a) Monitor the preparation and the integrity of the financial information prepared on the company and, where appropriate, the group, checking for compliance with legal provisions, the accurate demarcation of the consolidation perimeter, and the correct application of accounting principles.
- b) Ensure the independence of the unit handling the internal audit function; propose the selection, appointment, re-election and removal of the head of the internal audit service; propose the service's budget; approve its priorities and work programmes, ensuring that it focuses primarily on the main risks the company is exposed to; receive regular report-backs on its activities; and verify that senior management are acting on the findings and recommendations of its reports.
- c) Establish and supervise a mechanism whereby staff can report, confidentially and, if appropriate and feasible, anonymously, any significant irregularities that they detect in the course of their duties, in particular financial or accounting irregularities.

2º With regard to the external auditor:

- a) Investigate the issues giving rise to the resignation of the external auditor, should this come about.
- b) Ensure that the remuneration of the external auditor does not compromise its quality or independence.
- c) Ensure that the company notifies any change of external auditor to the CNMV as a material event, accompanied by a statement of any disagreements arising with the outgoing auditor and the reasons for the same.
- d) Ensure that the external auditor has a yearly meeting with the Board in full to inform it of the work undertaken and developments in the company's risk and accounting positions.

- e) Ensure that the company and the external auditor adhere to current regulations on the provision of non-audit services, limits on the concentration of the auditor's business and other requirements concerning auditor independence.

Complies

43. The Audit Committee should be empowered to meet with any company employee or manager, even ordering their appearance without the presence of another senior officer.

Complies

44. The Audit Committee should be informed of any fundamental changes or corporate transactions the company is planning, so the committee can analyse the operation and report to the Board beforehand on its economic conditions and accounting impact and, when applicable, the exchange ratio proposed.

Complies

45. Risk control and management policy should identify at least:

- a) The different types of financial and non-financial risk the company is exposed to (including operational, technological, financial, legal, social, environmental, political and reputational risks), with the inclusion under financial or economic risks of contingent liabilities and other off-balance sheet risks.
- b) The determination of the risk level the company sees as acceptable.
- c) The measures in place to mitigate the impact of identified risk events should they occur.
- d) The internal control and reporting systems to be used to control and manage the above risks, including contingent liabilities and off-balance sheet risks.

Complies

46. Companies should establish a risk control and management function in the charge of one of the company's internal department or units and under the direct supervision of the Audit Committee or some other dedicated board committee. This function should be expressly charged with the following responsibilities:

- a) Ensure that risk control and management systems are functioning correctly and, specifically, that major risks the company is exposed to are correctly identified, managed and quantified.
- b) Participate actively in the preparation of risk strategies and in key decisions about their management.
- c) Ensure that risk control and management systems are mitigating risks effectively in the frame of the policy drawn up by the Board of Directors.

Complies

- 47. Appointees to the Nomination and Remuneration Committee – or of the Nomination Committee and Remuneration Committee, if separately constituted – should have the right balance of knowledge, skills and experience for the functions they are called on to discharge. The majority of their members should be independent Directors.**

**Complies**

- 48. Large cap companies should operate separately constituted Nomination and Remuneration Committees.**

**Explain**

Article 40 of the Bylaws, and Article 23 of the Regulation of the Board of Directors, expressly state, on regulating the Nominating, Compensation and Corporate Governance Committees, that the Board of Directors shall be entitled to set up two Committees, separately giving each of them powers for appointments, and the other the powers for remuneration, while the corporate governance powers may be included in either one of them.

The Board of Directors of Telefónica, S.A. has not considered appropriate, so far, separating the functions of the Nominating, Compensation and Corporate Governance Committee) because it believes that by putting the powers to assess Directors and determine their remuneration in the same Committee, is helpful to coordinate and to produce a results-driven remuneration system (pay for performance). Furthermore, it is noted that the Board of Directors currently has five Consultative Committees (Audit and Control Committee, the Nominating, Compensation and Corporate Governance Committee, Regulation and Institutional Affairs Committee, Service Quality and Customer Care Committee and the Strategy and Innovation Committee), in addition to the Executive Commission.

In this context, the separation of the Nominating, Compensation and Corporate Governance Committee would not have been appropriate with the facilitating objective of the reorganization of the Consultative or Committees of the Company, approved by the Board of Directors on April 27, 2016, generating unnecessary inefficiencies and needs for additional allocations.

- 49. The Nomination Committee should consult with the company's Chairman and chief executive, especially on matters relating to Executive Directors.**

**When there are vacancies on the Board, any Director may approach the Nomination Committee to propose candidates that it might consider suitable.**

**Complies**

- 50. The Remuneration Committee should operate independently and have the following functions in addition to those assigned by law:**

- a) Propose to the Board the standard conditions for senior officer contracts.**
- b) Monitor compliance with the remuneration policy set by the company.**
- c) Periodically review the remuneration policy for Directors and senior officers, including share-based remuneration systems and their application, and ensure that their individual compensation is proportionate to the amounts paid to other Directors and senior officers in the company.**
- d) Ensure that conflicts of interest do not undermine the independence of any external advice the Committee engages.**
- e) Verify the information on Director and senior officers' pay contained in corporate documents, including the annual Directors' remuneration statement.**

**Complies**

- 51. The Remuneration Committee should consult with the company's Chairman and chief executive, especially on matters relating to Executive Directors and senior officers.**

**Complies**

- 52. The terms of reference of supervision and control committees should be set out in the Board of Directors regulations and aligned with those governing legally mandatory board committees as specified in the preceding sets of recommendations. They should include at least the following terms:**

- a) Committees should be formed exclusively by Non-executive Directors, with a majority of independents.**
- b) They should be chaired by independent Directors.**
- c) The Board should appoint the members of such committees with regard to the knowledge, skills and experience of its Directors and each committee's terms of reference; discuss their proposals and reports; and provide report-backs on their activities and work at the first board plenary following each committee meeting.**
- d) They may engage external advice, when they feel it necessary for the discharge of their functions.**
- e) Meeting proceedings should be minuted and a copy made available to all board members.**

**Explain**

1. The supervision and control committees which are attributed the powers referred to in recommendation 52 are the Audit and Control Committee and the Nominating, Compensation and Corporate Governance Committee. The composition and operation rules of the two Committees are set out in the Regulation of the Board of Directors (and, also, in the Regulation of the Audit and Control Committee) and are not only consistent with legally dispositions applicable but are also an improvement upon them, in certain areas. For example, according to the Regulation of the Board of Directors, the Nominating, Compensation and Corporate Governance Committee must have a majority of independent members, as opposed to the minimum of two according to prevailing laws. In fact, in practice the five members of this committee are all independent.

2. The Board of Directors has other Consultative Committees which are allocated other functions (Regulation and Institutional Affairs Committee, Service Quality and Customer Service Committee, Strategy and Innovation Committee), which are strongly linked with the businesses developed by the Company and with management aspects.

These Committees are not expressly regulated in the Regulation of the Board of Directors or they are regulated with fewer details as those which are legally mandatory.

In particular, it has been decided that Committees with powers in matters linked to the Company's businesses and management aspects do not necessarily have to be chaired by independent Directors nor do most of the members of the committees need to have independent directors, but that it is preferable to take into account the technical knowledge and specific expertise of their members when appointing the Director to chair them and the other Directors who should sit on these committees.

- 53. The task of supervising compliance with corporate governance rules, internal codes of conduct and corporate social responsibility policy should be assigned to one board committee or split between several, which could be the Audit Committee, the Nomination Committee, the Corporate social responsibility Committee, where one exists, or a dedicated committee established ad hoc by the Board under its powers of self-organisation, with at the least the following functions:**

- a) Monitor compliance with the company's internal codes of conduct and corporate governance rules.**



- b) Oversee the communication and relations strategy with shareholders and investors, including small and medium-sized shareholders.
- c) Periodically evaluate the effectiveness of the company's corporate governance system, to confirm that it is fulfilling its mission to promote the corporate interest and catering, as appropriate, to the legitimate interests of remaining stakeholders.
- d) Review the company's corporate social responsibility policy, ensuring that it is geared to value creation.
- e) Monitor corporate social responsibility strategy and practices and assess compliance in their respect.
- f) Monitor and evaluate the company's interaction with its stakeholder groups.
- g) Evaluate all aspects of the non-financial risks the company is exposed to, including operational, technological, legal, social, environmental, political and reputational risks.
- h) Coordinate non-financial and diversity reporting processes in accordance with applicable legislation and international benchmarks.

Complies

54. The corporate social responsibility policy should state the principles or commitments the company will voluntarily adhere to in its dealings with stakeholder groups, specifying at least:

- a) The goals of its corporate social responsibility policy and the support instruments to be deployed.
- b) The corporate strategy with regard to sustainability, the environment and social issues.
- c) Concrete practices in matters relative to: shareholders, employees, clients, suppliers, social welfare issues, the environment, diversity, fiscal responsibility, respect for human rights and the prevention of illegal conducts.
- d) The methods or systems for monitoring the results of the practices referred to above, and identifying and managing related risks.
- e) The mechanisms for supervising non-financial risk, ethics and business conduct.
- f) Channels for stakeholder communication, participation and dialogue.
- g) Responsible communication practices that prevent the manipulation of information and protect the company's honour and integrity.

Complies

55. The company should report on corporate social responsibility developments in its Directors' report or in a separate document, using an internationally accepted methodology.

Complies

56. Director's remuneration should be sufficient to attract individuals with the desired profile and compensate the commitment, abilities and responsibility that the post demands, but not so high as to compromise the independent judgement of Non-executive Directors.

Complies

57. Variable remuneration linked to the company and the Director's performance, the award of shares, options or any other right to acquire shares or to be remunerated on the basis of share price movements, and membership of long-term savings schemes such as pension plans should be confined to Executive Directors.

The company may consider the share-based remuneration of Non-executive Directors provided they retain such shares until the end of their mandate. This condition, however, will not apply to shares that the Director must dispose of to defray costs related to their acquisition.

Complies

58. In the case of variable awards, remuneration policies should include limits and technical safeguards to ensure they reflect the professional performance of the beneficiaries and not simply the general progress of the markets or the company's sector, or circumstances of that kind.

In particular, variable remuneration items should meet the following conditions:

- a) Be subject to predetermined and measurable performance criteria that factor the risk assumed to obtain a given outcome.
- b) Promote the long-term sustainability of the company and include non-financial criteria that are relevant for the company's long-term value, such as compliance with its internal rules and procedures and its risk control and management policies.
- c) Be focused on achieving a balance between the delivery of short, medium and long-term objectives, such that performance-related pay rewards ongoing achievement, maintained over sufficient time to appreciate its contribution to long-term value creation. This will ensure that performance measurement is not based solely on one-off, occasional or extraordinary events.

Complies

59. A major part of variable remuneration components should be deferred for a long enough period to ensure that predetermined performance criteria have effectively been met.

Complies

60. Remuneration linked to company earnings should bear in mind any qualifications stated in the external auditor's report that reduce their amount.

Not applicable

61. A major part of Executive Directors' variable remuneration should be linked to the award of shares or financial instruments whose value is linked to the share price.

Complies

62. Following the award of shares, share options or other rights on shares derived from the remuneration system, Directors should not be allowed to transfer a number of shares equivalent to twice their annual fixed remuneration, or to exercise the share options or other rights on shares for at least three years after their award.

**The above condition will not apply to any shares that the Director must dispose of to defray costs related to their acquisition.**

**Explain**

On December 31, 2017, the Executive Director of the company, Mr. José María Álvarez-Pallete López held a shareholding at Telefónica, S.A., which amounted to 1,351,958 voting rights, which were valued with a price of 8.13 euros per share, represented 572% of his fixed remuneration. In this regard, it is noted that since his appointment as Executive Chairman, Mr. Álvarez-Pallete, as a demonstration of his commitment with Telefónica, has acquired a total of 798,704 shares.

Likewise, the Chief Operating Officer (C.O.O.), Mr. Ángel Vilá Boix, held a shareholding at Telefónica, S.A., which amounted to 333,463 ting rights, which were valued with a price of 8.13 euros per share, represented 226% of his fixed remuneration.

This shareholding owned demonstrate his commitment to Telefónica, and show that his own interests are aligned with the other shareholders' interests.

- 63. Contractual arrangements should include provisions that permit the company to reclaim variable components of remuneration when payment was out of step with the Director's actual performance or based on data subsequently found to be misstated.**

**Partially complies**

The Nominating, Compensation and Corporate Governance Committee is empowered to propose that the Board of Directors cancels a variable remuneration payment in the event of circumstances such as those described in this recommendation. The Nominating, Compensation and Corporate Governance Committee will also assess if exceptional circumstances of this kind may even entail the termination of the relationship with the person responsible, proposing measures which are deemed pertinent to the Board of Directors.

- 64. Termination payments should not exceed a fixed amount equivalent to two years of the Director's total annual remuneration and should not be paid until the company confirms that he or she has met the predetermined performance criteria.**

**Explain**

With regards to the conditions applicable to termination of contracts, the Executive Chairman, Mr. José María Álvarez-Pallete López, and the Chief Operating Officer (C.O.O.), Mr. Ángel Vilá Boix, maintain the conditions of their previous contract which provided for agreed economic compensation for the termination of the employment relationship, where applicable, that can amount to four years' of remuneration at the most. Annual remuneration on which the indemnity is based is the last fixed remuneration and the arithmetic mean of the last two variable remuneration payments received by contract.

## H. Other information of interest

1. If you consider that there is any material aspect or principle relating to the corporate governance practices followed by your company that has not been addressed in this report and which is necessary to provide a more comprehensive view of the corporate governance structure and practices at the company or group, explain briefly.

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2. You may include in this Section any other information, clarification or observation related to the above sections of this report, provided that they are relevant and non-reiterative.

Specifically indicate whether the company is subject to corporate governance legislation from a country other than Spain and, if so, include the compulsory information to be provided when different to that required by this report.

3. The company may also state whether it voluntarily subscribes to other international, sectorial or other ethical principles or standard practices. If applicable, identify the name of the code and the date of subscription.

GENERAL CLARIFICATION: It is hereby stated that the details contained in this report refer to the financial year ended on December 31, 2017, except in those issues in which a different date of reference is specifically mentioned.

### - Note 1 to Section A.2.]

On January 30, 2018, BlackRock, Inc. informed to the Securities Exchange Commission that, at December 31, 2017, its shareholding on the share capital of Telefónica, S.A. was 6.63%.

On December 18, 2017, BlackRock, Inc. informed to the Spanish National Securities Market Commission (CNMV) that, at December 14, 2017, its shareholding on the share capital of Telefónica, S.A. was 5.04%.

Likewise, and in accordance with the submitted communication by BlackRock, Inc. to the Spanish National Securities Market Commission (CNMV) on May 9, 2017, May 16, 2017, June 5, 2017, June 23, 2017, December 1, 2017, and December 18, 2017, the details of the control chain through this entity owns the voting right and/or the financial instruments is the following:

1.- BlackRock, Inc, BlackRock Holdco 2, Inc., BlackRock Financial Management, Inc., BlackRock International Holdings, Inc., BR Jersey International Holdings, L.P., BlackRock (Singapore) Holdco Pte. Ltd., Blackrock HK Holdco Limited, BlackRock Cayco Limited, BlackRock Trident Holding Company Limited, BlackRock Japan Holdings GK, BlackRock Japan Co., Ltd.

2.- BlackRock, Inc, Trident Merger, LLC, BlackRock Investment Management, LLC.

3.- BlackRock, Inc, BlackRock Holdco 2, Inc, BlackRock Financial Management, Inc, BlackRock International Holdings, Inc, BR Jersey International Holdings, L.P., BlackRock Group Limited, BlackRock Investment Management (UK) Limited.

4.- BlackRock, Inc, BlackRock Holdco 2, Inc, BlackRock Financial Management, Inc, BlackRock International Holdings, Inc, BR Jersey International Holdings, L.P., BlackRock Australia Holdco Pty. Ltd., BlackRock Investment Management (Australia) Limited.

5.- BlackRock, Inc, BlackRock Holdco 2, Inc, BlackRock Financial Management, Inc, BlackRock International Holdings, Inc, BR Jersey International Holdings, L.P., BlackRock Group Limited, BlackRock International Limited.

6.- BlackRock, Inc, BlackRock Holdco 2, Inc, BlackRock Financial Management, Inc, BlackRock Holdco 4, LLC, BlackRock Holdco 6, LLC, BlackRock Delaware Holdings Inc, BlackRock Institutional Trust Company, National Association.

7.- BlackRock, Inc, BlackRock Holdco 2, Inc, BlackRock Financial Management, Inc, BlackRock Holdco 4, LLC, BlackRock Holdco 6, LLC, BlackRock Delaware Holdings Inc., BlackRock Fund Advisors.

8.- BlackRock, Inc, BlackRock Holdco 2, Inc, BlackRock Financial Management, Inc.

9.- BlackRock, Inc, BlackRock Holdco 2, Inc., BlackRock Financial Management, Inc., BlackRock International Holdings, Inc., BR Jersey International Holdings, L.P., BlackRock (Singapore) Holdco Pte. Ltd., BlackRock HK Holdco Limited, BlackRock Asset Management North Asia Limited.

10.- BlackRock, Inc, BlackRock Holdco 2, Inc, BlackRock Financial Management, Inc, BlackRock International Holdings, Inc, BR Jersey International Holdings, L.P., BlackRock Group Limited, BlackRock Investment Management (UK) Limited, BlackRock Asset Management Deutschland AG.

11.- BlackRock, Inc, BlackRock Holdco 2, Inc., BlackRock Financial Management, Inc., BlackRock International Holdings, Inc., BR Jersey International Holdings, L.P., Blackrock Holdco 3, LLC, BlackRock Canada Holdings LP, BlackRock Canada Holdings ULC, BlackRock Asset Management Canada Limited.

12.- BlackRock, Inc, BlackRock Holdco 2, Inc, BlackRock Financial Management, Inc, BlackRock Capital Holdings, Inc, BlackRock Advisors, LLC.

13.- BlackRock, Inc, BlackRock Holdco 2, Inc, BlackRock Financial Management, Inc, BlackRock International Holdings, Inc, BR Jersey International Holdings, L.P., BlackRock Group Limited, BlackRock Advisors (UK) Limited.

14.- BlackRock, Inc, BlackRock Holdco 2, Inc, BlackRock Financial Management, Inc, BlackRock International Holdings, Inc, BR Jersey International Holdings, L.P., BlackRock (Singapore) Holdco Pte. Ltd, BlackRock (Singapore) Limited.

15.- BlackRock, Inc, BlackRock Holdco 2, Inc, BlackRock Financial Management, Inc, BlackRock International Holdings, Inc, BR Jersey International Holdings, L.P., BlackRock Group Limited, BlackRock (Netherlands) B.V.

**- Note 2 to Section A.3.]**

On January 5, 2018, Telefónica, S.A. notified the Spanish National Securities Market Commission of the acquisition, on behalf of Board Member Mr. José María Abril Pérez, of 38,984 direct shares, and 33,965 indirect shares. Currently, on the registered date of this Report, Board Member Mr. José María Abril Pérez has a total of 388,237 shares, 196,061 of which are direct and 192,176 of which are indirect.

On January 17, 2018, Telefónica, S.A. notified the Spanish National Securities Market Commission of the acquisition of 2,500,000 indirect shares, on behalf of Board Member Mr. Francisco José Riberas Mera. Currently, on the registered date of this report, Board Member Mr. Francisco José Riberas Mera has a total of 2,549,173 indirect shares.

**- Note 3 to Section A.3.]**

It should be noted that the Company has an Internal Code of Conduct for Securities Markets Issues setting out, among other issues, the general operating principles for Directors and senior executives when carrying out personal trades involving securities issued by Telefónica, S.A. and financial instruments and contracts whose underlying securities or instruments are issued by the Company. The Board of Directors on its meeting held on December 14, 2016, approved a new version of the Internal Code of Conduct in order to adapt it to the regulatory changes on this matter.

The general operating principles of this Internal Code of Conduct include transactions subject to notification, action limitations as well as the minimum holding period when acquiring securities in the Company, during which time these may not be transferred, except in the event of extraordinary situations that justify their transfer, subject to authorisation by the Regulatory Compliance Committee.

**- Note 4 to Section A.3.]**

The General Shareholders' Meeting on May 30, 2014, shareholders approved the introduction of a long-term incentive plan for managers of the Group (including Executive Directors), also known as the Performance & Investment Plan ("PIP"). Under this plan, participants who met the qualifying requirements were also awarded a certain number of Telefónica, S.A. shares as a form of variable remuneration. This General Shareholders' Meeting approved the maximum number of shares to be awarded to Executive Directors subject to their meeting the co-investment requirement established in the Plan and the maximum target total shareholder return (TSR) established for each phase.

In accordance with the above, the amounts appearing in Section A.3. of this report under "Number of direct votes" and "Equivalent number of shares" (i.e. Mr. José María Álvarez-Pallete López, 192,000-300,000 and Mr. Ángel Vilá Boix, 120,000-187,500) relate to the theoretical number of shares assigned and the maximum possible number of shares in the Second Phase of the Plan approved by the General Shareholders Meeting of 30 May 2014, if the co-investment requirement established in the Plan and the maximum target TSR established for each phase are met.

The first cycle of this Plan started in 2014 and ended in October 2017. In accordance with that established in the general conditions, the delivery of shares from the first cycle of the Plan did not occur (2014-2017), which is why no shares were delivered to the Executive Board Members who participated in it.

The second cycle of this Plan started in 2015 and will end in October 2018.

Regarding the third phase of this Plan (2016-2019), the Board of Directors of the Company, after a favourable report from the Nominating, Compensation and Corporate Governance Committee, agreed not to execute nor implement, it due to it was not aligned enough with the strategic plan of Group Telefónica, considering the circumstances and the macroeconomic environment.

**- Note 5 to Section A.6.]**Shareholder Pact between Telefónica, S.A. – Vivendi, S.A.

In September 2015, after the regulatory approval from Conselho Administrativo de Defesa Econômica (CADE), Telefónica, S.A. delivered to Vivendi, S.A. 46.0 million of its treasury shares representing, in that moment, 0.95% of its share capital, in exchange for 58.4 million preference shares of Telefónica Brasil, S.A. (received by Vivendi, S.A. as part of the acquisition of GVT Participações, S.A.), accounting for approximately 3.5% of the share capital of Telefónica Brasil, S.A.

By virtue of this agreement, Vivendi, S.A. agreed to a number of obligations, including the following: (i) to refrain from selling shares of Telefónica during certain periods (lock up), and (ii) accept certain restrictions which, in the event of transfer, once the lock up periods have elapsed, guarantee that such shares are sold in an orderly manner.

As of 31 December 2017, the shareholding of Vivendi on the share capital of Telefónica, S.A. was 0.95%.

Shareholder Pact between Telefónica, S.A. - China Unicom (Hong Kong) Limited

In accordance with the provisions of Article 112, Section 2 of the Securities Market Act 24/1988, of July 28 (currently replaced by Article 531 Section 1 of the revised text of the Spanish Corporations Act approved by Royal Decree Law 1/2010, of July 2), on October 22, 2009, the Company notified the Spanish Securities Market Commission (Comisión Nacional del Mercado de Valores, "CNMV") that on September 6, 2009 Telefónica had entered into a mutual share exchange agreement with China Unicom (Hong Kong) Limited, whose clauses 8.3 and 9.2 were considered a shareholder agreement as per Article 530 of the Spanish Corporations Act. By virtue of these clauses, Telefónica undertook not to, while the strategic partnership agreement was in force, offer, issue or sell a significant number of its shares or any convertible security or security that conferred the right to subscribe or acquire a significant number of shares of Telefónica, S.A. to any of the main competitors of China Unicom (Hong Kong) Limited. In addition, China Unicom (Hong Kong) Limited undertook not to sell, use or transfer, directly or indirectly, for a period of one year its share in Telefónica's voting share capital (excluding

intragroup transfers). This undertaking expired when the aforementioned period of one year had elapsed. At the same time, both parties also undertook similar obligations with respect to the share capital of China Unicom (Hong Kong) Limited. This mutual share exchange agreement, which includes the shareholder agreement, was filed with the Madrid Mercantile Registry on November 24, 2009. The aforementioned undertakings are no longer in force.

On January 23, 2011, Telefónica, S.A. and China Unicom (Hong Kong) Limited signed an agreement to enhance their strategic partnership, in which both companies agreed to strengthen and deepen their strategic cooperation in certain business areas, and committed to investing the equivalent of 500 million US dollars in ordinary shares of the other party. Through its subsidiary Telefónica Internacional, S.A.U., Telefónica acquired a number of China Unicom shares amounting to 500 million US dollars from third parties, within nine months of signature of this agreement. In recognition of China Unicom's stake in Telefónica, the latter commits to proposing the appointment of a board member nominated by China Unicom in the next General Shareholders' Meeting, in accordance with prevailing legislation and the Company's By-laws.

China Unicom completed the acquisition of Telefónica shares on January 28, 2011, giving it ownership of 1.37% of the Company's capital.

The Telefónica Group purchased China Unicom shares during 2011 to the amount of 358 million euros. At December 31, 2011, the Telefónica Group held a 9.57% stake in the company.

On June 10, 2012, Telefónica, S.A. through its wholly-owned subsidiary Telefónica Internacional, S.A.U., and China United Network Communications Group Company Limited, through a wholly-owned subsidiary, signed an agreement for the purchase by the latter of 1,073,777,121 shares in China Unicom (Hong Kong) Limited owned by Telefónica, equivalent to 4.56% of its capital.

After securing the requisite regulatory authorizations, the sales transaction was completed on July 30, 2012.

Subsequent to the transaction, Telefónica and China Unicom remained firmly committed to their strategic partnership.

Telefónica agreed not to sell the shares it holds directly and indirectly in China Unicom for a period of 12 months as from the date of the agreement.

On November 10, 2014 Telefónica sold 597,844,100 shares in China Unicom, representing 2.5% of the capital of the latter, in a block trade process, at a price of HK \$ 11.14 per share, in a total amount of HK \$ 6,660 million, approximately 687 million euros at exchange rates on that date.

Telefónica undertook not to sell any shares held directly or indirectly in China Unicom on the market for a period of 12 months from the selling date.

Likewise, on July 13, 2016, Telefónica through its 100% subsidiary, Telefónica Internacional, S.A.U. proceeded with the sale of 361,794,559 shares of China Unicom, representing 1.51% of the share capital of the company, by a block trade process, at a price of HK \$ 7.80 per share, for a total amount of HK \$ 2,822 million, approximately € 322 million,

Telefónica committed not to transfer to the market the shares of China Unicom, which it may own directly or indirectly, over a period of 90 days from the sales date.

As of December 31, 2017 Telefónica held a shareholding of 0.59% in the share capital of China Unicom and China Unicom held a shareholding of 1.24% in the share capital of Telefónica. Mr. César Alierta, former chairman of Telefónica, is a member of the Board of Directors of China Unicom while Mr. Wang Xiaochu, Chairman and Chief Executive Officer of China Unicom, is currently a board member of Telefónica.

Telefónica maintains its commitment to the strategic partnership with China Unicom, strengthened through cooperation in digital areas such as the big data joint venture between both companies, which is now a market leader of telco location based big data services in the urban planning sector in China.

Shareholders' Agreement Telefónica, S.A. - Koninklijke KPN NV



On March 13, 2017, Telefónica, S.A. (“Telefónica”) entered into a swap agreement with Koninklijke KPN NV (“KPN”) by virtue of which Telefónica delivered 72.0 million of its treasury shares (representing 1.43% of its share capital), in exchange for 178.5 million shares of its subsidiary Telefónica Deutschland Holding AG, representing 6.0% of the share capital of the latter.

As a result of this agreement, Telefónica increased from 63.2% to 69.2% its shareholding in Telefonica Deutschland Holding AG.

By virtue of said agreement, KPN undertook, among other obligations, to comply with certain restrictions which, in case of sale of the aforementioned Telefónica shares, would ensure an orderly sale of such shares.

Such shareholder agreement is no longer in force.

#### **- Note 6 to Section A.9.bis]**

As stated in Section A.6 of this report, in September 2015, after the regulatory approval from Conselho Administrativo de Defesa Econômica (CADE), Telefónica, S.A. delivered to Vivendi 46.0 million of its treasury shares, representing, in that moment, 0.95% of its share capital, in exchange for 58.4 million preference shares of Telefónica Brasil, S.A. (received by Vivendi, S.A. as part of the acquisition of GVT Participações, S.A.), accounting for approximately 3.5% of the share capital of Telefónica Brasil, S.A.

By virtue of this agreement, Vivendi, S.A. agreed to a number of obligations, including the following: (i) refrain from selling shares of Telefónica during certain periods (lock up), and (ii) accept certain restrictions which, in the event of transfer, once the lock up periods have elapsed, guarantee that such shares are sold in an orderly manner.

As of December 31, 2017, the shareholding of Vivendi on the share capital of Telefónica, S.A. was 0.95%.

Therefore, the aforementioned percentage of 0.95% of share capital has not been included in the percentage of “estimated free-float capital” set out in section A.9.bis of this Report.

#### **- Note 7 to Section A.10.]**

In accordance with Article 26 of the Corporate By-laws, no shareholder may cast a number of votes in excess of 10% of the total voting capital existing at any time, regardless of the number of shares held by such shareholder and in full compliance with mandatory requirements of law. In determining the maximum number of votes that each shareholder may cast, only the shares held by each such shareholder shall be computed. It does not include additional votes cast on behalf of other shareholders who may have appointed them as proxy, who are themselves likewise restricted by the 10% voting ceiling.

The limit described above also applies to the number of votes that can be cast either jointly or separately by two or more legal entity shareholders belonging to the same corporate group and to the number of votes that may be cast altogether by an individual or legal entity shareholder and any entity or entities that they directly or indirectly control and which are also shareholders.

For the purposes of the provisions contained in the preceding paragraph, the provisions of Section 18 of the current Spanish Corporations Act shall apply in order to decide whether or not a group of entities exists and to examine the situations of control indicated above.

In relation to the above and in accordance with the provisions of Article 527 of the Spanish Corporations Act, any clauses in the By-laws of listed corporations that directly or indirectly restrict the number of shares that may be cast by a single shareholder by shareholders belonging to the same group or by any parties acting together with the aforementioned, will be rendered null and void when, subsequent to a takeover bid, the buyer has a stake equal to or over 70% of share capital which confers voting rights, unless the buyer was not subject to neutralization measures to prevent a takeover bid or had not adapted these measures accordingly.

#### **- Note 8 to Section C.1.2.]**



On January 31, 2018, the Board of Directors, unanimously appointed by co-optation, and at the recommendation of the Nominating, Compensation and Corporate Governance Committee, Mr. Jordi Gual Solé as a Telefónica Board Member, with the condition of Proprietary Director (at the proposal of CaixaBank, S.A.), replacing Mr. Antonio Massanell Lavilla, who had voluntarily resigned from his position as Board Member of the Company on December 21, 2017. Likewise, the Board of Directors agreed to appointment Mr. Jordi Gual Solé as member of the Regulation and Institutional Affairs Committee, and of the Strategy and Innovation Committee.

#### - Note 9 to Section C.1.5.]

The search for women who meet the necessary professional profile is a question of principle and, in this regard, it is clear that Telefónica has taken this concern on board. In this regard, it should be noted that, on January 23, 2008, the Board of Directors unanimously agreed to co-opt, at the proposal of the Nominating, Compensation and Corporate Governance Committee, Ms. Eva Castillo Sanz as a Director of Telefónica. This appointment was ratified by the Ordinary General Shareholders Meeting held on April 22, 2008, and she was re-elected to serve in this position by the Ordinary General Shareholders' Meeting on May 31, 2013.

Likewise, on April 8, 2016, the Board of Directors unanimously agreed to co-opt, at the proposal Nominating, Compensation and Corporate Governance Committee, Ms. Sabina Fluxà Thienemann as a Director of Telefónica. The Ordinary General Shareholders Meeting, held on May 12, 2016, ratified this appointment.

Additionally, on May 4, 2017, the Board of Directors unanimously appointed by co-optation, and at the recommendation of the Nomination, Compensation and Corporate Governance Committee, Ms. Carmen García de Andrés as Telefónica Board Member. This appointment was ratified by the General Shareholder's Meeting held on June 9, 2017.

Similarly, on December 19, 2007, the Board of Directors unanimously agreed, following a recommendation from the Nominating, Compensation and Corporate Governance Committee, to appoint Ms. María Luz Medrano Aranguren as the Deputy Secretary General and Secretary to the Board of Directors.

Article 10.3. of the Regulations of the Board of Directors stipulates that the Board of Directors and the Nominating, Compensation and Corporate Governance Committee shall ensure, within the scope of their respective powers, that the candidates chosen are persons of recognized caliber, qualifications and experience, who are willing to devote a sufficient portion of their time to the Company, and shall take extreme care in the selection of the persons to be appointed as Independent Directors.

Article 10.4 of the Regulations of the Board of Directors also provides that the Board will have to ensure that Board members are selected using procedures that guarantee gender equality and diversity of knowledge and experience, that prevent any underlying bias which could cause any kind of discrimination, and, in particular, that the procedures should favor the selection of female directors.

With respect to this appointment, the Board of Directors approved, at its meeting on November 25, 2015, a Board Member Selection Policy, that has been updated on December 13, 2017, by agreement of the Board of Directors, which includes the Diversity Policy applicable to the Board of Directors. It was therefore renamed the Diversity Policy with respect to the Telefónica, S.A. Board of Directors and Board Member Selection, which includes the latest regulatory demands regarding diversity. The purpose of this Policy is to ensure that the proposals for appointment and re-election are based on a prior analysis of the Board's needs, and that they favor the diversity of knowledge, education and professional experience, age, and gender, but without implicit biases that could entail any discrimination, particularly based on gender, disability, or any other personal condition.

The Diversity Policy, with respect to the Telefónica, S.A. Board of Directors and Board Member Selection, is available on the corporate website of the Company.

In accordance with the aforesaid Policy, candidates to be Telefónica Directors will be selected using the following principles:

1.- The Company will ensure that the Board of Directors has a balanced structure, with an ample majority of non-executive Directors and an adequate proportion between Proprietary and Independent Directors.

2. The Board of Directors shall ensure that the selection procedures for Board Members favor the diversity of knowledge, education, professional experience, age, and gender, without implicit biases that could entail any discrimination. This is all done in order to ensure that the Board of Directors has a diverse and balanced composition in their group, which i) enriches the analysis and debate, ii) includes several points of view and positions, iii) favors the making of decisions, and iv) benefits from full independence.

It will also ensure that candidates put forward to be non-executive Directors have enough time available to be able to adequately perform their duties.

3.- A preliminary analysis of the Company's and of the Group's requirements will be used in the process of selecting candidates to be Directors. This analysis will be made by the Company's Board of Directors, which will be advised and which will receive a mandatory preliminary report by the Nominating, Compensation and Corporate Governance Committee.

4.- This report by the Nominating, Compensation and Corporate Governance Committee will be published when calling the General Shareholders Meeting at which each Director will be submitted for confirmation, appointment or re-election.

5. The Nominating, Compensation and Corporate Governance Committee shall annually verify compliance with the Diversity Policy with respect to the Telefónica, S.A. Board of Directors and Board Member Selection, and shall disclose this in the Annual Corporate Governance Report and any other documents deemed appropriate.

Likewise, and with respect to the Board Member candidates, the Diversity Policy related to the Telefónica, S.A. Board of Directors and Board Member Selection, it establishes that the Board of Directors and the Nominating, Compensation and Corporate Governance Committee will ensure, within the scope of their respective powers, that the election of a candidate for the position of Board Member will fall to people with recognized solvency, competence and experience, and who are available to dedicate the necessary time and effort to perform their duties, taking extreme care when selecting those people called upon to fill in the positions of Independent Board Members.

Therefore, the Board candidates shall be people with recognized prestige, solvency, education and professional experience, especially in telecommunications, financial and economic management, accounting, auditing, risk management, and/or company administration, experience leading teams made up of people belonging to different areas of business and extensive experience at large companies.

Therefore, the selection procedure described above is based exclusively on the personal merits of the candidates ("recognised calibre, qualifications and experience") and their ability to dedicate themselves to the functions of members of the Board, so there is no implicit bias capable of impeding the selection of women directors, if, within the potential candidates, there are women candidates who meet the professional profile sought at each moment.

**- Note 10 to Section C.1.11.]**

On September 4, 2017, Mr. Ángel Vilá Boix presented his resignation as Board Member of Telefónica Brasil, S.A. Likewise, on October 4, 2017, Mr. Ángel Vilá Boix presented his resignation as Member of the Supervisory Board of Telefónica Deutschland Holding, AG.

**- Note 11 to Section C.1.12.]**

According to the Significant Event registered by Gas Natural SDG, S.A. on February 6, 2018, Mr. Isidro Fainé Casas presented his resignation as Member of Gas Natural SDG, S.A., being named as Honorary Chairman.

Mr. Peter Löscher is Chairman of the Supervisory Board of OMV Aktiengesellschaft and Chairman of Sulzer AG.

**- Note 12 to Section C.1.16.]**

For these purposes, Senior Executives are understood to be individuals who perform senior management functions reporting directly to the management bodies, or their Executive Commissions or CEOs. For the purposes of annual remuneration, the head of Internal Audit is also included.

Ms. Laura Abasolo García de Baquedano was appointed Chief Finance and Control Officer, replacing the current Chief Operating Officer (C.O.O.), Mr. Ángel Vilá Boix on July 26, 2017, in light of the remuneration received up to this date by Mr. Ángel Vilá Boix, and that received since this date by Ms. Laura Abasolo García de Baquedano.

**- Note 13 to Section C.1.16. and C.1.33]**

On January 31, 2018, Mr. Pablo de Carvajal González was appointed Secretary of the Board of Directors and Director of Public Affairs and Regulation, replacing Mr. Ramiro Sánchez de Lerín García-Ovies.

**- Note 14 to Section C.1.17]**

Ms. Sabina Fluxà Thienemann is member of the Regional Advisory Board of the East (joining Valencia, Murcia and Balears) of Banco Bilbao Vizcaya Argentaria, S.A., to whom she advises as prominent businesswoman on their objective to keep on approaching their business strategy to the current social-economic situation of such regions, without receiving any remuneration for such position.

**- Note 15 to Section C.1.19.]**

**Selection and appointment**

Telefónica's Bylaws state that the Board of Directors shall be composed of a minimum of five members and a maximum of twenty, to be appointed at the General Shareholders Meeting. Directors are appointed for a period of no longer than four years, and may be re-elected for one or more subsequent periods of no longer than four years at a time. The Board of Directors may, in accordance with the Spanish Corporations Act and the Company Bylaws, provisionally co-opt Directors to fill any vacancies.

The Board of Directors shall have the power to fill, on an interim basis, any vacancies that may occur therein, by appointing, in such manner as is legally allowed, the persons who are to fill such vacancies until the holding of the next General Shareholders Meeting.

Also, in all cases, proposed appointments of Directors must follow the procedures set out in the Company's Bylaws and Regulations of the Board of Directors and be preceded by the appropriate favourable report by the Nominating, Compensation and Corporate Governance Committee and in the case of independent Directors, by the corresponding proposal by the Committee. Proposals for individuals to represent legal entities (companies) have to be made following a report by the Nominating, Compensation and Corporate Governance Committee.

Therefore, in exercise of the powers delegated to it, the Nominating, Compensation and Corporate Governance Committee must assess the skills, knowledge and experience required in the Board of Directors, defining the functions and abilities needed by candidates to cover each vacancy, and evaluating the time and dedication needed for them to efficiently perform their duties. It will also have to escalate proposed appointments of independent Directors to the Board of Directors by co-option or for the decision to be made by the General Shareholders Meeting, as well as proposals for the re-election or removal of said Directors by the General Shareholders Meeting. It will also have to escalate proposed appointments of other Company Directors to the Board of Directors for appointment by co-option or for the design to be made by the General Shareholders Meeting, as well as proposals for the re-election or removal of said Directors by the General Shareholders Meeting.

In line with the provisions of its Regulations, the Board of Directors, exercising the right to fill vacancies by interim appointment and to propose appointments to the shareholders at the General Shareholders Meeting, shall ensure that, in the composition of the Board of Directors, external or non-executive Directors represent an ample majority over executive Directors. Similarly, the Board shall ensure that the total number of independent Directors represents at least one third of the total number of Board members.

The nature of each Director shall be explained by the Board of Directors to the shareholders at the General Shareholders Meeting at which the appointment thereof must be made or ratified. Furthermore, such nature shall be reviewed annually by the Board after verification by the Nominating, Compensation and Corporate Governance Committee, and reported in the Annual Corporate Governance Report.

In any event, and in the event of re-election or ratification of Directors by the General Shareholders Meeting, the report of the Nominating, Compensation and Corporate Governance Committee, or, in the case of independent Directors, the proposal of said Committee, will contain an assessment of the work and effective time devoted to the post during the last period in which it was held by the proposed Director.

Both the Board of Directors and the Nominating, Compensation and Corporate Governance Committee shall ensure, within the scope of their respective powers, that those proposed for the post of Director should be persons of recognised calibre, qualifications and experience, who are willing to devote the time and effort necessary to carrying out their functions, and shall take extreme care in the selection of persons to be appointed as independent Directors.

The Board of Directors will have to ensure that Board members are selected using procedures that guarantee gender equality and diversity of knowledge and experience, that prevent any underlying bias would could cause any kind of discrimination, and, in particular, that the procedures should favour the selection of female directors.

With respect to this, the Board of Directors approved, at their meeting held on November 25, 2015, a Board Member Selection Policy. Likewise, on December 13, 2017, the Board of Directors approved an update of this Policy to include the Diversity Policy applicable to the Board of Directors. It was therefore renamed the Diversity Policy with respect to the Telefónica, S.A. Board of Directors and the Board Member Selection. It also includes the latest regulatory standards regarding diversity. The aim of this Policy is to ensure that the proposed appointment or re-election of Board Members is based on a preliminary analysis of the needs of the Board of Directors, and favors the diversity of knowledge, education and professional experience, age, and gender, but without implicit biases that could entail any discrimination, specifically based on gender, disability, or any other personal condition.

This Diversity Policy, with respect to the Telefónica, S.A. Board of Directors and Board Member Selection, is available on the corporate website of the Company.

The result of the preliminary analysis of the needs of the Board of Directors will be set out in the report of the Nominating, Compensation and Corporate Governance Committee, which will be published on calling the General Shareholders Meeting at which each Director will be submitted for ratification, appointment or re-election.

Every year, the Nominating, Compensation and Corporate Governance Committee will check that the Director selection policy is complied with, and will report with such information in the Annual Corporate Governance Report.

### **Re-election**

Directors can be re-elected once or several times for the same periods as the initial period.

As with appointments, proposals for the reappointment of Directors must be preceded by the corresponding report by the Nominating, Compensation and Corporate Governance Committee, and in the case of independent Directors, by the corresponding proposal by the Committee.

### **Appraisal**

In accordance with the Regulations of the Board of Directors, the Nominating, Compensation and Corporate Governance Committee has the powers to organise and coordinate, together with the Chairman of the Board of Directors, the regular assessment of said body, after which the Board of Directors approves the assessment of its function and the functioning of its Committees.

In accordance with the above, it should be noted that the Board of Directors and its Committees carry out a periodic evaluation of the operation of the Board of Directors and of the Committees thereof in order to determine the opinion of Directors regarding the workings of these bodies and to establish any proposals for improvements to ensure the optimum working of the company's governing bodies.

## Removal and dismissal

Directors' shall cease to hold office when the term for which they were appointed expires, or when so resolved by the shareholders at the General Shareholders Meeting in the exercise of the powers legally granted to them.

Directors who give up their place before their tenure expires, should state their reasons in a letter to be sent to all members of the Board of Directors.

The Board of Directors shall not propose the removal of any independent Director prior to the end of the Bylaw-mandated period for which they have been appointed, unless there are due grounds therefore acknowledged by the Board after a report from the Nominating, Compensation and Corporate Governance Committee. Specifically, due grounds shall be deemed to exist when the Director has failed to perform the duties inherent to his position.

The removal of independent Directors may also be proposed as a result of Takeover Bids, mergers or other similar corporate transactions that represent a change in the structure of the Company's capital.

### - Note 16 to Section C.1.31]

In accordance with US securities market regulations, the information contained in the Annual Report in 20-F format (which includes the Consolidated Financial Statements of the Telefónica Group), filed with the Securities and Exchange Commission, is certified by the Executive Chairman of the Company and by the CFO. This certification is made after the Financial Statements have been prepared by the Board of Directors of the Company.

### - Note 17 to Section C.1.36.]

The Board of Directors of Telefónica, S.A. at its meeting held April 8, 2016, on a proposal from its Audit and Control Committee and as a result of a transparent competitive process, has resolved to propose to the next Ordinary General Shareholders Meeting the appointment of PricewaterhouseCoopers Auditores S.L. as statutory auditor for the Annual Accounts of Telefonica, S.A. and its Consolidated Group of Companies for the years 2017, 2018 and 2019. Such appointment was approved by the General Shareholders Meeting held on May 12, 2016.

### - Note 18 to Section C.1.39.]

Financial year 1983 was the first audited by an External Auditor. Previously the financial statement were revised by chartered accountants (known at the time as "censores de cuentas"). Therefore, 1983 is the base year taken for calculating the percentage in the case of audits of the Financial Statements of Telefónica, S.A., while 1991 is the date taken for the calculation of the percentage in the case of the Consolidated Financial Statements, as 1991 was the first year in which the Telefónica Group prepared Consolidated Financial Statements.

### - Note 19 to Section C.2.1]

The Audit and Control Committee of Telefónica, S.A. is regulated under article 39 of the corporate bylaws of the Company, and under article 22 of the Board of Directors regulations. Likewise, and in order to comply with the recommendations of Technical Guide 3/2017 of the Spanish National Securities Market Commission regarding Audit Committees of Public Interest Companies, the Board of Directors approved the regulations of the Audit and Control Committee of Telefónica, S.A. at their meeting held on December 13, 2017, which regulates the aforementioned Committee under the following terms:

#### a) Composition.

The Audit and Control Committee shall consist of such a number of members as the Board of Directors determines at any given time, who shall in no case be less than three and shall be appointed by the Board of Directors. All members thereof must be external or non-executive Directors, and most of them must be at least Independent Directors. When appointing its members, and, in particular, when appointing its Chairman, the Board of Directors shall take into account the appointees' knowledge and experience in matters of accounting,

auditing or both, as well as in risk management. Overall, the members of the Committee will have the adequate technical knowledge in relation to the Company's sector of activity.

The Chairman of the Audit and Control Committee, who shall in all events be an independent Director, shall be appointed from among its members, and shall be replaced every four years; he may be re-elected after one year from the date when he ceased to hold office.

b) Duties.

Without prejudice to any other tasks that the Board of Directors may assign thereto, the primary duty of the Audit and Control Committee shall be to support the Board of Directors in its supervisory duties. Specifically, it shall have at least the following powers and duties:

1) Report to the General Shareholders Meeting regarding matters addressed in the Committee for which it is responsible, and, in particular, regarding the result of the audit, and explain how the audit has improved the integrity of the financial information and the function played by the Committee in this process.

2) Escalate proposals for selection, appointment, re-election and replacement of the external auditor to the Board of Directors, taking responsibility for the selection process as established in prevailing laws, as well as the recruitment conditions, and regularly gather information from the auditor about the audit plan and its execution, as well as safeguarding its independence in exercising its functions.

3) To supervise internal audit and, in particular:

- a) Ensure the independence and efficiency of the internal audit function;
- b) Propose the selection, appointment and removal of the person responsible for the internal audit;
- c) Propose the budget for such service;
- d) Review the annual internal audit work plan and the annual activities report;
- e) Receive periodic information on its activities; and
- f) Verify that the senior executive officers take into account the conclusions and recommendations of its reports.

4) Oversee the process of preparing and presenting mandatory financial reporting and submitting recommendations of proposals to the administrative body aimed at safeguarding its integrity. With respect thereto, it shall be responsible for supervising the process of preparation and the completeness of the financial information relating to the Company and the Group, reviewing compliance with regulatory requirements, the proper determination of the scope of consolidation, and the correct application of accounting standards, informing the Board of Directors thereof.

5) Monitor the effectiveness of the Company's internal control, internal audit and risk management systems, including fiscal risks, and discuss with the Auditors significant weaknesses in the internal control system detected during the audit, without compromising their independence at any time. For that purposes, if deemed necessary, it can submit recommendations or proposals to the Board of Directors and an appropriate monitoring period. With respect thereto, it shall be responsible for proposing to the Board of Directors a risk control and management policy, which shall identify at least the following:

- a) the types of risk (operational, technological, financial, legal and reputational) facing the company;
- b) the risk level that the Company deems acceptable; the measures to mitigate the impact of the identified risks, should they materialise; and
- c) the control and information systems to be used to control and manage these risks.

6) Establish and supervise a system that allows employees to confidentially and anonymously report potentially significant irregularities, particularly any financial and accounting irregularities detected within the Company.



7) Establish and maintain appropriate relations with the Auditor in order to receive, for review by the Committee, information on all matters that could jeopardize the Auditor's independence, and, when applicable, the authorisation of permitted services, according to current legislation, and such other communications as may be provided for in auditing legislation and in technical auditing regulations. In any event, the Audit and Control Committee must receive, on an annual basis, written confirmation from the Auditor of its independence vis-à-vis the entity or entities directly or indirectly related thereto, as well as in-depth and individualised information regarding additional services of any kind provided as well as the fees received to such entities by the Auditor or by the persons or entities related thereto pursuant to the provisions of prevailing legislation.

8) Issue on an annual basis, prior to the issuance of the audit report, a report stating an opinion on whether the independence of the Auditor is compromised. This report will focus on the assessment of the provision of each and every one of the additional services referred to in point 7) above, considered individual and in their entirety, other than legal audit, and in relation to the regime of independence or laws regulating auditing activities.

9) Analyse and report on economic conditions, the accounting impact, and, if applicable, the proposed exchange ratio in structural and corporative modification transactions which the Company intends to perform, before being submitted to the Board of Directors.

10) Preliminary reporting to the Board of Directors regarding all matters set out in prevailing legislation and in the Bylaws, and, in particular, concerning:

1. The financial information that the Company must periodically disclose;
2. The creation or acquisition of shareholdings in special purpose entities or companies with registered addresses in countries or territories considered to be tax havens; and
3. Related party transactions.

11) Exercise all the pertinent functions of the Audit Committee established at any given time by prevailing laws in regard to Group companies which are considered to be Public Interest Entities (as these are defined in applicable laws), provided that they are fully owned, either directly or indirectly, by the Company pursuant to applicable laws, and whose administration is not attributed to a Board of Directors.

The dispositions of sections 2, 7 and 8 are understood to be without prejudice to general auditing regulations.

#### c) Operation.

The Audit and Control Committee must have access to appropriate, opportune and enough information, for which:

- The Chairman of the Committee and, if it is considered opportune or is requested, the rest of its members, will maintain regular contact with the key personnel involved in the governance and management of the Company.
- The Chairman of the Committee, through the Secretary of the Committee, shall channel and provide the necessary information and documentation to the rest of the Committee Members, far enough in advance so that they can analyze it before their meetings.

The Audit and Control Committee, the Committee, shall meet at least once a quarter and whenever deemed necessary, with prior notice from their Chairman.

In any case, the Committee shall meet, at a minimum, when annual or intermediate financial information is published, and, in these cases, the meeting shall have the presence of the Internal Auditor and, if any kind of revision is issued, the Account Auditor.

Likewise, in the performance of its duties, the Committee may require the attendance of the Account Auditor, any employee or Company Manager, and the experts deemed necessary at its meetings.

Attendance at formal Committee meetings is preceded by the sufficient dedication of its members to analyze and evaluate the information received.

Likewise, the Committee has a secretary, who has the necessary attendance to plan meetings and agendas, for the drafting of the documents and minutes of the meetings, and for the collection and distribution of information, among other tasks.

In order to have an appropriate scheduling that makes it possible to ensure compliance with the effectively pursued objectives, the Committee establishes an Annual Work Plan.

The meetings are planned by the Chairman of the Committee, who notifies these meeting to the meeting secretary so that its members receive the documentation with enough notice. All of this keeping in mind that the Committee members have mainly supervisory and advisory duties, without intervening in the execution or management, as these are the duties of management.

Most important actions during the year.

The main activities and actions carried out by the Audit and Control Committee of the Telefónica, S.A. Board of Directors throughout 2017 have been related to the powers and duties that correspond to this Committee, either by legal requirements or from the interest that arises in each case with respect to the aforementioned powers. Therefore, the Audit and Control Committee has performed, among others, the following jobs:

- Regarding finances: i) revision of the financial information of the Company (Annual Account and Management Reports related to 2016, quarterly and semi-annual periodic financial information of Telefónica Group and the Public Interest Companies of the Group, for which this Committee has assumed the duties of the Audit Committee, and Alternative Performance Measurements, included in the Company Financial Information); ii) revision of the financial debt situation of Telefónica Group, and its development throughout the year; iii) revision of the informative brochures presented by the Company before the different supervisory bodies (among others, 20-F Annual Report and several informative brochures for financing operations, shares and debt); and iv) revision of monographic presentations on financial aspects and modifications to the accounting regulations. Likewise, the Committee has reviewed the non-financial and diversity information prepared by the Company in accordance to what is established by Royal Decree 18/2017 of 24 November which modifies the Code of Commerce, the consolidated text of the Corporate Enterprises Act, and the Accounts Auditing Act in terms of non-financial and diversity information.
- Regarding the external auditor: i) proposal of fees to be received by PwC as the Account Auditor for 2017; and ii) revision of the auditing works and limited revisions made by the external auditor with respect to the aforementioned financial information.
- Regarding internal control: i) proposal to the Board of Directors of the regulations of the Audit and Control Committee; ii) revision of the works performed by Internal Auditing regarding the revision of transversal processes, investigations and inspections; and iii) revision of the risk management system.
- Regarding compliance, revision on regulatory compliance, including anti-corruption standards.
- Other relevant issues: i) 2016 report of the Audit and Control Committee regarding related operations; ii) monthly report of the Telefónica, S.A. Treasury Stock Management Team Supervisor regarding treasury stock operations; iii) review that the financial information published on the Company website is constantly updated and coincides with that which has been formulated, in each case, by the Board of Directors, and published on the CNMV website; iv) drafting of the Welcome Program for new members of the Telefónica, S.A. Audit and Control Committee; and v) periodic training to ensure the Committee members are updated on information.



Furthermore, regarding to the Director member of the Audit and Control Committee who has been appointed based on his knowledges and experience in accounting, audit or both, apart from Mr. José Javier Echenique Landiribar, the Director Mr. Ignacio Moreno Martínez.

**- Note 20 to Section C.2.1.]**

Pursuant to the provisions of Article 40 of the Corporate Bylaws of Telefónica, S.A., Article 23 of the Regulations of the Board of Directors of the Company regulates the Nominating, Compensation and Corporate Governance Committee in the following terms:

**a) Composition.**

The Nominating, Compensation and Corporate Governance Committee shall consist of such a number of members as the Board of Directors determines at any given time, who shall in no case be less than three and shall be appointed by the Board of Directors. All members thereof must be external or non-executive Directors, and most of them must be at least Independent Directors.

The Chairman of the Nominating, Compensation and Corporate Governance Committee, who shall in all events be an Independent Director, shall be appointed from among its members.

**b) Duties.**

Notwithstanding other duties entrusted it by the Board of Directors, the Nominating, Compensation and Corporate Governance Committee shall have the following duties:

- 1) Assess the skills, knowledge and experience necessary in the Board of Directors. For these purposes, it will define the roles and capabilities required of the candidates to fill each vacancy, and assess the time and dedication necessary for them to efficiently perform their duties.
- 2) Set a target of representation for the least represented gender on the Board of Directors and provide guidelines about how this target might be reached.
- 3) Escalate proposed appointments of independent Directors to the Board of Directors by co-option or for the decision to be made by the General Shareholders Meeting, as well as proposals for the re-election or removal of said Directors by the General Shareholders Meeting.
- 4) Submit proposed appointments of other Company Directors to the Board of Directors for appointment by co-option or for the decision to be made by the General Shareholders Meeting, as well as proposals for the re-election or removal of said Directors by the General Shareholders Meeting. It will also have to escalate proposals for appointments or termination of the Secretary, and, if applicable, of the Deputy Secretary of the Board of Directors, and also proposals for the appointment, re-election and termination of Directors in their subsidiary companies.
- 5) Report on proposals to appoint or to terminate the Senior Management of the Company and their subsidiaries.
- 6) To report on the proposals for appointment of the members of the Executive Commission and of the other Committees of the Board of Directors, as well as the respective Secretary and, if applicable, the respective Deputy Secretary.
- 7) To propose to the Board of Directors the appointment of the Lead Director from among the Independent Directors.
- 8) To organise and coordinate, together with the Chairman of the Board of Directors, a periodic assessment of the Board, pursuant to the provisions of these Regulations.
- 9) To inform on the periodic assessment of the performance of the Chairman of the Board of Directors.
- 10) To examine or organize the succession of the Chairman of the Board of Directors and, if applicable, to make proposals to the Board of Directors so that such succession occurs in an orderly and well-planned manner.

11) To propose to the Board of Directors, within the framework established in the Corporate Bylaws, the compensation for the Directors and review it periodically to ensure that it is in keeping with the tasks performed by them, as provided in Article 34 of the Regulations of the Board.

12) To propose to the Board of Directors, within the framework established in the Bylaws, the extent and amount of the compensation, rights and remuneration of a financial nature of the Chairman of the Board of Directors, the Executive Directors and the senior executives of the Company, as well as the basic terms of their contracts, for purposes of contractual implementation thereof.

13) To prepare and propose to the Board of Directors an annual report regarding the Directors' compensation policy.

14) To verify information on the remuneration of Directors and senior management contained in the various corporate documents, including the annual report on Directors' remuneration.

15) To supervise compliance with the Company's internal rules of conduct and the corporate governance rules thereof in effect from time to time.

16) To exercise other powers assigned to the Nominating, Compensation and Corporate Governance Committee in this Regulation.

#### c) Operation.

In addition to the meetings provided for in the annual schedule, the Nominating, Compensation and Corporate Governance Committee shall meet whenever the Board of Directors of the Company or the Chairman of the Board of Directors requests the issuance of a report or the making of a proposal within the scope of its powers and duties, provided that, in the opinion of the Chairman of the Committee, it is appropriate for the proper implementation of its duties.

The Nominating, Compensation and Corporate Governance Committee will consult with the Chairman of the Board of Directors particularly when concerning matters relating to executive directors and senior officers.

Most important actions during the year.

The main activities and actions carried out by the the Nominating, Compensation and Corporate Governance Committee of the Telefónica, S.A. Board of Directors throughout 2017 have been linked to the powers and duties corresponding to this Committee, either by legal requirements or from the interest that arises in each case with respect to the aforementioned powers. Therefore, the Appointments, Remuneration and Good Governance Committee has analyzed and reported on, among others, the following issues:

- The remuneration policy and system of the Telefónica Group Board Members and Management (fixed and variable remuneration, and action plans).
- Proposals for appointments related to the Telefónica, S.A. Board of Directors and its Committees, and with the Boards of subsidiary companies

To this respect, the Nominating, Compensation and Corporate Governance Committee proposed and/or reported, as applicable, the appointment of Telefónica, S.A. Board Members in 2017, addressing the solvency, competency, experience, professional merits and availability of the candidates to dedicate the necessary time and effort for the effective performance their duties, exclusively considering their individual and professional characteristics.

Therefore, at its meeting held on May 3, 2017, the Committee proposed the appointment by co-optation of Ms. Carmen García de Andrés and Mr. Francisco José Riberas Mera as Independent Board Members, after the voluntary resignation from their positions as Board Members, presented by Mr. César Alierta Izuel, Mr. Gonzalo Hinojosa Fernández de Angulo and Mr. Pablo Isla Álvarez de Tejera.

Likewise, the Committee, at the aforementioned meeting on May 3, 2017, proposed the appointment of Independent Board Member Mrs. Carmen García de Andrés as Member of the Company Audit and Control Committee, as well as the appointment of Independent Board

Members Mr. José Javier Echenique Landiribar and Mr. Luiz Fernando Furlán as Members of the Appointments, Remuneration and Good Governance Committee.

Additionally, the Committee favorably informed and/or proposed, as the case may be, the re-election and ratification of Telefónica, S.A. board members by the Company General Shareholder's Meeting held on June 9, 2017, after having taken into consideration and evaluated the duties performed and the dedication given by the aforementioned Board Members during his/her year of duty, basing the entirety of the proposals on a preliminary analysis of the needs of the Board of Directors, whose purpose is to favor the diversity of knowledge, experiences and gender.

As such, the aforementioned General Shareholder's Meeting approved the re-election of Mr. José María Álvarez-Pallete López and Mr. Ignacio Moreno Martínez, as well as the ratification of the appointment of Mrs. Carmen García de Andrés and Mr. Francisco José Riberas Mera.

However, at its meeting held on July 25, 2017, the Committee favorably reported the appointment by co-optation of Mr. Ángel Vilá Boix as Executive Board Member, replacing Mr. Julio Linares López. Likewise, at the aforementioned meeting, the Committee favorably reported the proposal for the appointment of Mr. Ángel Vilá Boix as Chief Operating Officer and Member of the Executive Committee.

Likewise, at its meeting held on July 25, 2017, the Committee proposed the appointment of Independent Board Member Mrs. Carmen García de Andrés as Member of the Service Quality and Customer Service Committee of the Company.

Additionally, throughout the meetings held, the Committee has reported different proposals for the appointment of Board Members at the most relevant subsidiary companies of the Telefónica Group.

- Appointment proposals related with the Senior Management and the organizational structure of the Telefónica Group.
- Corporate Governance Report and 2016 Remuneration Report.

**- Note 21 to Section C.2.1.]**

Pursuant to the provisions of Article 25 of the Regulation of the Board of Directors of the Company, the Service Quality and Customer Service Committee is regulated in the following terms:

a) Composition.

The Service Quality and Customer Service Committee shall consist of such a number of members, all of them Directors, as the Board of Directors determines at any given time, who shall in no case be less than three and the majority of whom must be External Directors.

The Chairman of the Service Quality and Customer Service Committee shall be appointed from among its members.

b) Duties.

Without prejudice to any other duties that the Board of Directors may assign thereto, the Service Quality and Customer Service Committee shall have at least the following duties:

- 1) To periodically examine, review and monitor the quality indices of the principal services provided by the companies of the Telefónica Group.

2) To evaluate levels of customer service provided by the companies of the Group to their customers.

Most significant actions during the year.

In the 5 meetings held by the Service Quality and Customer Service Committee in 2017, it analysed the quality metrics of the main services provided by Telefónica Group companies, while the levels of commercial attention these companies provide to their customers was assessed.

As with the other Board Committees, the relations between the Committee and the Board of Directors are based on a full transparency principle. At the beginning of each one of the monthly meetings of the Board of Directors, the Chairman of the Committee informs about the most important matters addressed, and the activities and tasks performed by the Committee; providing the Directors with the necessary documentation, so that it can take such actions into account when performing its duties.

#### **- Note 22 to Section C. 2.2.]**

Subject to article 20.b) of the Board of Directors' Regulation, the Board has created the Regulation and Institutional Affairs Committee:

##### **a) Composition.**

The Board of Directors shall determine the number of members of this Committee.

The Chairman of the Regulation and Institutional Affairs Committee shall be appointed from among its members.

##### **b) Duties.**

Without prejudice to any other duties that the Board of Directors may assign thereto, the Regulation and Institutional Affairs Committee shall have, at least, the following duties:

- 1) To carry out, through study, analysis and discussion, permanent monitoring of the main matters and themes of the regulatory order that affect the Telefónica Group at all times.
- 2) To provide a channel for communication and information between the management team and the Board of Directors in statutory matters and, when appropriate, to bring to the knowledge of the latter matters that are considered relevant to the Company, or to any of the companies in the Group and on which it may be necessary or convenient to adopt a decision or to establish a specific strategy.
- 3) To review, report and propose to the Board of Directors the principles that must guide the Group's Sponsorship and Patronage policy, monitor such policy and individually approve all sponsorships or patronages that exceed the limit set by the Board, and that have to be approved by the Board.
- 4) To promote the development of the Telefónica Group's Corporate Reputation and Responsibility project and the implementation of the core values of such Group.

Most significant actions during the year.

The Regulation and Institutional Affairs Committee held 11 meetings in the 2017 year, have been analysed and debated:

- The regulatory matters of most significance for the Telefónica Group, were set out in the Regulatory Agenda; at global and European Union level, by regions (Europe and Latin America) and by countries. The most significant developments, as set out in the aforementioned Regulatory Agenda, are updated in each meeting, and in the specific documents or reports submitted to the Committee, when deemed advisable.
- A continuous monitoring of, on the one hand, the Sponsorship and Patronage Policy, and the Sponsorships presented by the Institutional Relations and Sponsorships area of Telefónica, S.A., and, on the other hand, the Corporate Social Responsibility of the Telefónica Group and of the most

significant issues in this field of Sustainability (ethical behavior, sustainable innovation, digital confidence, supply chain, talent and diversity management, customer, environment and climate change), including Responsible Business Plans, Integrated Annual Report, and actions of the Advisory Panel on Responsible Business created in the Telefónica Group.

As with the other Board Committees, the relations between this Committee and the Board of Directors are based on a full transparency principle. At the beginning of each one of the monthly meetings of the Board of Directors, the Chairman of the Committee informs about the most important matters addressed, and the activities and tasks performed by the Committee; providing the Directors with the necessary documentation, so that it can take such actions into account when performing its duties.

**- Note 23 to Section C. 2.2.]**

Subject to article 20.b) of the Board of Directors' Regulation, the Board has created the Strategy and Innovation Committee:

a) Composition.

The Board of Directors shall determine the number of members of this Committee.

The Chairman of the Strategy and Innovation Committee shall be appointed from among its members.

b) Duties.

Without prejudice to any other duties that the Board of Directors may assign thereto, the primary duty of the Strategy and Innovation Committee shall be:

- 1) To support the Board of Directors in the analysis and follow up of the global strategy policy of the Telefónica Group.
- 2) To advise and assist in all matters regarding innovation. Its main object is to perform an examination, analysis and periodic monitoring of the Company's innovation projects, to provide guidance and to help ensure its implementation and development across the Group.

Most significant actions during the year.

The Strategy and Innovation Committee held 11 meetings in the 2017 year, in which it analysed a number of different issues, which mainly concerned the telecommunications sector, in keeping with the strategic policy of the Telefónica Group and its business, and questions relating to these matters.

Likewise, it performed a regular monitoring of the Company's innovation projects, providing guidance and offering its support to help ensure its implementation and development across the Group.

As with the other Board Committees, the relations between the Committee and the Board of Directors are based on a full transparency principle. At the beginning of each one of the monthly meetings of the Board of Directors, the Chairman of the Committee informs about the most important matters addressed, and the activities and tasks performed by the Committee; providing the directors with the necessary documentation, so that it can take such actions into account when performing its duties.

**- Note 24 to Section D. 2.]**

It is important to note that:

Transactions included in this section under 'Other', amounting to 11,371 with BBVA, S.A. refer to Dividends received.

Transactions included in this section under 'Other', for the sum of 6,525 with BBVA, S.A. refer to Other Revenues (99), to Other Expenses (6,418) and to Gains from derecognition or disposal of assets (8).

Transactions included in this section under 'Other', for the sum of 250,012 with la "Caixa Group", refer to Other Expenses (12) and Outstanding factoring operations (250,000)

In addition, the nominal value of outstanding derivatives held with BBVA and la Caixa in 2017 amounted to 21,749 and 404 million euros, respectively. As explained in Derivatives policy in Note 16 of the 2017 Consolidated Annual Accounts, this figure is inflated by the use in some cases of several levels of derivatives applied to the nominal value of a single underlying. The fair value of these same derivatives in the statement of financial position is 390 and -28 million euros, respectively, at December 31, 2017. Additionally, at December 31, 2017 there were collateral guarantees on derivatives with BBVA amounting to 286 million euros.

**- Note 25 to Section D.5.]**

On December 18, 2015, a joint venture was set up between China Unicom for the development of Big Data services in China, using Smart Steps technology developed by Telefónica. Telefónica has a stake of 45% through Telefónica Digital España, S.L.; China Unicom Broadband Online Limited Corp. owns the remaining 55%. In 2016, Telefónica disbursed 7 million euros corresponding to its shareholding in the capital of the company. The company is already commercially operational and obtained a turnover of 8 million euros in 2017.

According to Related Parties in Note 10 of the 2017 Consolidated Annual Accounts of Telefónica, S.A., certain Telefónica Group subsidiaries performed in 2017 transactions with Global Dominion Access Group, related to the Group's ordinary course of business, mainly in Telefónica de España, amounting to 23 million euros.

Finally, it should be said that as of the year 2010, Telefónica, S.A. adheres to the Code of Good Fiscal Practices, as approved by the Large Companies' Forum –a body in which major Spanish companies and the Spanish tax authorities participate–, and complies with the content of the same.

Similarly, Telefónica Group is committed to the application of other international regulations and initiatives in the area of sustainability as well as, among others, the Universal Declaration of Human Rights, the United Nations Global Compact, and other conventions and treaties agreed by international bodies such as the Organization for Economic Cooperation and Development and the International Labor Organization.

**This annual corporate governance report was approved by the company's Board of Directors at its meeting held on February 21, 2018.**

**List whether any directors voted against or abstained from voting on the approval of this report.**

**No**

Name or corporate name of director	Reasons (voted against, abstention, non-attendance)	Explain the reasons
—	—	—

## APPENDIX TO THE TELEFÓNICA, S.A. 2017 ANNUAL CORPORATE GOVERNANCE REPORT

### E.3 Indicate the main risks, including tax risks, which may prevent the company from achieving its targets.

The Telefónica Group's business is affected by a series of intrinsic risk factors that affect exclusively the Group, as well as a series of external factors that are common to businesses of the same sector. The main risks and uncertainties facing the Company which could affect its business, financial position, reputation, corporate image and brand and its results of operations, must be considered jointly with the information in the Consolidated Financial Statements, and are as follows:

#### Group-Related Risks

##### **Worsening of the economic and political environment could negatively affect Telefónica's business.**

Telefónica's international presence enables the diversification of its activities across countries and regions, but it exposes Telefónica to diverse legislation, as well as to the political and economic environments of the countries in which it operates. Any adverse developments or even uncertainties in this regard, including exchange-rate or sovereign-risk fluctuations, may adversely affect the Company's business, financial position, cash flows and results of operations and/or the performance of some or all of the Group's financial indicators.

Economic conditions may adversely affect the level of demand of existing and prospective customers, as they may no longer deem critical the services offered by the Group.

Macroeconomic perspectives in Europe have improved as two major risks from 2017 have diminished. First, political uncertainty has decreased after the results of the general elections in some European countries and, second, the agreement reached in relation to the Greek bailout program and better macroeconomic data in the country have opened the door to a potential solution to the Greek debt crisis in the near term. While such risks have diminished, economic activity and financial stability in Europe could be affected by the monetary normalization that the European Central Bank is expected to continue implementing in the near future, with a negative impact on the balance between the private and public sectors, and by the restructuring processes which the European banking sector is still immersed in. Furthermore, the planned exit of the United Kingdom from the European Union following the outcome of the referendum held in 2016, will result in economic adjustments regardless of the nature of the new trade and investment relationships between the United Kingdom and the rest of Europe in the future. In the meantime, there is uncertainty regarding investment, economic activity, employment and financial market volatility. Finally, another possible source of uncertainty given Telefónica's exposure, could come from Catalonia's political situation and its impact on the Spanish economy. Although recent events point to a lower degree of uncertainty, if political tensions re-emerge or intensify, there could be a negative impact both on financing conditions and on the current positive Spanish macroeconomic scenario. In 2017, the Telefónica Group obtained 24.3% of its revenues in Spain (24.6% in 2016), 14.0% in Germany (14.4% in 2016) and 12.6% in the United Kingdom (13.2% in 2016).

In Latin America, there is an increasing exchange rate risk created by external factors such as the uncertainty derived from the monetary normalization process in the United States, the continuing low commodity prices in certain cases despite recent improvement, and doubts about growth and imbalances in China. Certain internal factors such as high fiscal and external deficits in major Latin American countries and the low liquidity in certain exchange markets, together with a low productivity growth, hinder a more accelerated progress in economic development and the rebalancing of still existent mismatches.

In Brazil, although the political scenario continues to be unstable, the government has approved relevant legislative reforms and promoted the approval of other key legislative items, such as the social security reform, which could be approved before the end of the term, which has improved the confidence levels in the government. While signs of stabilization have emerged and the economy has started to show positive growth figures, the pace of the recovery is still weak and the unemployment rate remains at 12%. Moreover, despite decreasing external financing needs, internal financing needs remain high. The combination of such elements



has led to risks of further downgrades to the country's credit rating, which is already below investment grade, possibly leading to further currency depreciation.

Mexico has a high commercial and financial exposure to the United States, which could generate uncertainty despite having a relatively stable internal outlook, subject to the outcome of the coming general elections and of the renegotiation of the North American Free Trade Agreement (NAFTA), which is now underway. Any increase in interest rates in the United States and/or a possible renegotiation of trade agreements between both countries could result in higher restrictions on imports into the United States which together with political uncertainty surrounding such matters, could negatively impact economic activity and exchange rates in Mexico. The relative weight of Mexico in the consolidated revenues of the Telefónica Group was 2.6% for 2017.

In countries such as Chile, Colombia and Peru, increases in commodity prices are having a positive impact on their respective fiscal and external accounts, but growth continues to be affected by the lower external inflows, which have affected investment and, to a lesser extent, private consumption.

In Argentina, the government is focused on resolving the country's macroeconomic and financial imbalances and on recovering international confidence. The October legislative elections confirmed the good results of the government coalition. However, even though the economy has returned to positive growth rates and the measures taken by the government might continue having positive effects in the medium term, short term risks persist, including exchange rate risk, especially due to the high inflation rate.

In Ecuador, despite the recovery in oil prices and the recent U.S. dollar depreciation, which have allowed for an improvement in economic activity through exports, risks persist, mainly on the fiscal front. The country's financing needs are still high, which, together with low international reserves, keep the country in a more vulnerable position against volatility shocks.

During 2017 Telefónica Hispanoamérica represented 24.1% of the Telefónica Group's revenues (24.2% in 2016), of which 27.8% proceeded from revenues in Argentina, 18.5% in Peru and 17.4% in Chile. During 2017, Telefónica Brazil represented 23.1% of the Telefónica Group's revenues (21.3% in 2016). In this respect, 32.4% of the Group's revenues were generated in countries that do not have investment grade status (in order of importance, Brazil, Argentina, Venezuela, Ecuador, Guatemala, El Salvador, Nicaragua and Costa Rica), and other countries are only one notch away from losing this status.

"Country risk" factors include, among others, the following:

- unexpected adverse changes in regulation or administrative policies, including changes that modify the terms and conditions of licenses and concessions and their renewal (or delay their approval);
- abrupt exchange rate movements;
- high inflation rates;
- expropriation or nationalization of assets, adverse tax decisions, or other forms of state intervention;
- economic-financial downturns, political instability and civil disturbances; and
- maximum limits on profit margins imposed in order to limit the prices of goods and services through the analysis of cost structures (for example, in Venezuela, a maximum profit margin has been introduced that is set annually by the Superintendence for Defense of Socioeconomic Rights).

Any of the foregoing may adversely affect the business, financial position, results of operations and/or cash flows of the Group.



**The Group's financial condition and results of operations may be adversely affected if it does not effectively manage its exposure to foreign currency exchange rates or interest rates.**

In nominal terms, as of December 31, 2017, 71.0% of the Group's net financial debt plus commitments was pegged to fixed interest rates for a period greater than one year. As of the same date, 17.2% of the Group's net financial debt plus commitments was denominated in a currency other than the euro.

To illustrate the sensitivity of financial expenses to variations in short-term interest rates as of December 31, 2017: (i) a 100 basis points increase in interest rates in all currencies in which Telefónica had a financial position at that date would have led to an increase in financial expenses of 91 million euros, (ii) whereas a 100 basis points decrease in interest rates in all currencies (even if negative rates are reached), would have led to a reduction in financial expenses of 74 million euros, in each case for the year ended December 31, 2017. These calculations were made assuming a constant currency and balance position equivalent to the position at that date and taking into account the derivative financial instruments arranged by the Group.

According to the Group's calculations, the impact on results and specifically on net exchange differences due to a 10% depreciation of Latin American currencies against the U.S. dollar and a 10% depreciation of the rest of the currencies against the euro would result in exchange losses of 17 million euros for the year ended December 31, 2017, primarily due to the weakening of the Venezuelan bolivar. These calculations have been made assuming a constant currency position with an impact on profit or loss as of December 31, 2017, taking into account derivative instruments in place.

During 2017, Telefónica Brazil represented 25.9% (24.5% in 2016), Telefónica Hispanoamérica represented 21.9% (23.0% in 2016) and Telefónica United Kingdom represented 10.1% (11.3% in 2016) of the operating income before depreciation and amortization ("OIBDA") of the Telefónica Group.

The Telefónica Group uses a variety of strategies to manage this risk, among others the use of financial derivatives, which themselves are also exposed to risk, including counterparty risk. However, the Group's risk management strategies may not achieve the desired effect, which could adversely affect the Group's business, financial condition, results of operations and/or cash flows.

In 2017, the evolution of exchange rates had a negative impact on results, decreasing the Group's consolidated revenues and OIBDA by an estimated 3.2 p.p. and 4.7 p.p., respectively, mainly due to the depreciation of the Argentine peso, the Venezuelan bolivar and the pound sterling. Furthermore, translation differences had a positive impact on the Group's equity of 2,049 million euros as of December 31, 2016 and a negative impact of 4,607 million euros as of December 31, 2017.

If the Group does not effectively manage its exposure to foreign currency exchange rates or interest rates, it may adversely affect its business, financial position, results of operations and/or cash flows.

**Existing or worsening conditions in the financial markets may limit the Group's ability to finance, and consequently, the ability to carry out its business plan.**

The operation, expansion and improvement of the Telefónica Group's networks, the development and distribution of the Telefónica Group's services and products, the implementation of Telefónica's strategic plan and new technologies, the renewal of licenses or the expansion of the Telefónica Group's business in countries where it operates, may require a substantial amount of financing.

A decrease in the liquidity of Telefónica, or a difficulty in refinancing maturing debt or raising new funds as debt or equity could force Telefónica to use resources allocated to investments or other commitments to pay its financial debt, which could have a negative effect on the Group's business, financial condition, results of operations and/or cash flows.

Funding could be more difficult and costly in the event of a significant deterioration of conditions in the international or local financial markets due to monetary policies set by central banks, including increases in interest rates and/or balance sheet reductions, and oil price instability, or if there is an eventual deterioration in the solvency or operating performance of Telefónica.

As of December 31, 2017, the Group's net financial debt amounted to 44,230 million euros (48,595 million euros as of December 31, 2016) and, as of December 31, 2017, the Group's gross financial debt amounted to 55,746 million euros (60,361 million euros as of December 31, 2016). At such date, the average maturity of the debt was 8.08 years (6.35 years as of December 31, 2016).

As of December 31, 2017, the Group's gross financial debt scheduled to mature in 2018 amounted to 9,414 million euros, and gross financial debt scheduled to mature in 2019 amounted to 6,063 million euros.

In accordance with its liquidity policy, Telefónica has covered its gross debt maturities for the next twelve months with cash and credit lines available at December 31, 2017. As of December 31, 2017, the Telefónica Group had undrawn committed credit facilities arranged with banks for an amount of 13,531 million euros (12,541 million euros of which will expire in more than twelve months). Telefónica's liquidity could be affected if market conditions make it difficult to renew existing undrawn credit lines. As of December 31, 2017, 7.3% of the aggregate undrawn amount under credit lines was scheduled to expire prior to December 31, 2018.

In addition, given the interrelation between economic growth and financial stability, the materialization of any of the economic, political and exchange rate risks referred to above could lead to a negative impact on the availability and cost of Telefónica's financing and its liquidity strategy. This in turn could have a negative effect on the Group's business, financial condition, results of operations and/or cash flows.

#### **Adoption of new accounting standards could affect the Group's reported results and financial position.**

Accounting standard-setting bodies and other authorities may periodically change accounting regulations that govern the preparation of the Group's consolidated financial statements. Those changes could have a significant impact on the way the Group accounts for certain matters and presents its financial position and its results of operations. In some instances, a modified standard or a new requirement with retroactive effect must be implemented, which requires the Group to restate previous financial statements.

In particular, Telefónica is required to adopt the new accounting standards IFRS 15 "Revenue from Contracts with Customers" and IFRS 9 "Financial instruments", effective from January 1, 2018, and IFRS 16 "Leases", effective from January 1, 2019.

These standards present significant changes that will affect the amount and timing of recognition of revenues and expenses related to certain sales transactions (IFRS 15), the estimation processes for the expected impairment losses on financial assets, the recognition period and the documentation of hedging policies and strategies (IFRS 9), as well as the accounting treatment for all lease contracts, other than certain short-term leases and leases of low-value assets (IFRS 16). The Group estimates that the first-time adoption of these changes will have a material impact on the Group's financial statements and may make comparisons between periods difficult and less meaningful.

Note 3 to the Consolidated Financial Statements includes information on the main impacts expected from the first-time adoption of the new requirements.

#### **Risks Relating to the Group's Industry**

##### **The Group operates in a highly regulated industry which requires government concessions for the provision of a large part of its services and the use of spectrum, which is a scarce and costly resource.**

The telecommunications sector is subject to laws and sector-specific regulations in the majority of the countries where the Group operates. Additionally, many of the services the Group provides require the granting of a license, concession or official approval, which usually requires certain obligations and investments to be made, such as those relating to the acquisition of spectrum capacity. Among the main risks of this nature are those related to spectrum regulation and licenses/concessions, rates, universal service regulation, regulated wholesale services over fiber networks, privacy, functional separation of businesses and network neutrality. The fact that the Group's business is highly regulated both affects its revenues and imposes costs on its operations.

As the Group provides most of its services under licenses, authorizations or concessions, it is vulnerable to administrative bodies' decisions, such as economic fines for serious breaches in the provision of services and, potentially, revocation or failure to renew these licenses, authorizations or concessions, or the granting of new licenses to competitors for the provisions of services in a specific market. The spectrum to which each of the licenses and administrative concessions refers is used for the provision of mobile services on 2G, 3G and 4G technologies. The complementarity between the different frequency bands successively assigned to an operator in a geographic market enables greater flexibility and efficiency in both the deployment of the network and the provision of services to final customers over the capacities resulting from such network.

Any challenges or amendments to the terms of licenses, authorizations or concessions granted to the Group and necessary for the provision of its services or the Group's failure to obtain sufficient or appropriate spectrum capacity in the jurisdictions discussed below or any others in which it operates, or its inability to assume the related costs, could have an adverse impact on its ability to launch and provide new services and on its ability to maintain the quality of existing services, which may adversely affect the Group's business, financial condition, results of operations and/or cash flows.

More detailed information can be found in Annex VI to the Consolidated Financial Statements "Key regulatory issues and concessions and licenses held by the Telefónica Group".

Additionally, the Telefónica Group could be affected by regulatory actions of the antitrust authorities. These authorities could prohibit certain actions, such as new acquisitions or specific practices, create obligations or lead to heavy fines. Any such measures implemented by the competition authorities could result in economic and/or reputational loss for the Group, in addition to a loss of market share and/or harm to the future growth of certain businesses.

#### *Regulation of spectrum and access to new government licenses/concessions of spectrum*

On September 14, 2016, the European Commission (EC) adopted, among others, a proposed Directive for the establishment of a European Electronic Communication Code (EECC), which could have significant implications, *inter alia*, for access to networks, spectrum use, auction conditions, duration and renewal of licenses, universal service and consumer protection. The proposed Directive is currently going through the legislative process and its approval is expected in the second quarter of 2018.

On May 17, 2017, the European Parliament and Council approved a decision regarding the use and availability of the 700 MHz band. This could require new cash outflows from Telefónica between 2018 and 2022 in the United Kingdom and Spain. The 700 MHz band will initially allow the expansion of the capacity of 4G networks and, in the near future, the introduction of 5G services with new functionalities. In Spain, it is expected that the Ministry of Energy, Tourism and the Digital Agenda publishes its plan to release the 700 MHz band before June 30, 2018, in line with the calendar approved by the EC and with the 5G National Plan adopted in December 2017. The 5G National Plan also contemplates, among other matters, an urgent auction for the 3.6 GHz band at the beginning of 2018 and, possibly, also in the L band (1452- 1492 MHz).

In connection with the spectrum auction for the 2.3 and 3.4 GHz bands in the United Kingdom, on July 11, 2017 the Office of Communications ("Ofcom") released rules for the upcoming mobile spectrum auction in both the 2.3 GHz (available for "immediate use") and 3.4 GHz bands (which may be used for 5G services). They set forth two separate spectrum caps: a spectrum cap of 255 MHz of immediately usable spectrum and an overall cap of 340 MHz. Hutchison 3G UK Ltd ("H3G") and BT filed a motion to review Ofcom's decision regarding the 3.4 GHz band based on the constraints imposed by the spectrum limits set forth in this band for which they can bid. The judgment was released in December 2017 and both appeals were dismissed. H3G tried to appeal the decision to the Court of Appeal and a hearing took place on February 13, 2018. The appeal was refused and the litigation ended. Therefore, the auction can now proceed without delay. Telefónica UK expects the bidding to start in March 2018.

In Germany, regarding its process to provide new frequencies for the further development of digital infrastructures, the regulatory agency for electricity, gas, telecommunications, post and railway ("BNetzA") published its position on the key elements on June 27, 2017 and, at the same time, initiated a procedure for

determining the frequency demand for nationwide assignments in the 2 GHz and the 3.6 GHz bands (3.6 GHz is the official wording of BNetzA when referring to 3.4-3.8 GHz). Among other things, for the 2 GHz band, BNetzA proposed the joint award of the frequencies expiring at the end of 2020 and 2025 and indicated that, following the merger of Telefónica Deutschland and E-Plus, it does not intend to withdraw any rights of use allocated to Telefónica Deutschland before their expiration (2020 and 2025, respectively). For the 3.6 GHz band, regional assignments for a part of the frequencies are provided for in the paper, as well as mutual co-usage rights between national and regional assignments. Additionally, it also foresees a demand-based supply with 5G. The procedures to auction both bands could begin in 2018 or 2019. The Telefónica Deutschland Group reported its request for frequency by the deadline of September 30, 2017 and commented on the key elements of the proposal. The final determination of the frequency demand and the first draft decisions in this regard are expected in the first quarter of 2018. For frequencies above 24 GHz, BNetzA intends to initially develop an application process in the 26 GHz frequency band.

In Latin America, spectrum auctions are expected to take place in the coming years, requiring potential cash outflows to obtain additional spectrum or to meet the coverage requirements associated with these licenses. Specifically, the procedures expected to take place in 2018 in jurisdictions that are relevant for the Group are:

- Mexico: An auction of spectrum in the 2500 MHz band is expected to take place in 2018.
- Colombia: In February 2017, the Ministry of Information Technologies and Communications ("ITC") published the conditions for the auction of 70 MHz of spectrum in the 700 MHz band and of 5 MHz of spectrum in the 1900 MHz band. The ITC modified through Decree 2194 of December 27, 2017 the spectrum caps, increasing them by 5MHz for high bands, reaching a total of 90 MHz, and by 15MHz for low bands, reaching a total of 45 MHz. On January 23, 2018, the ITC published a second project on the conditions of the 700 MHz auction, which included certain modifications, such as: the auction mechanism would be based on a multiple-round ascending clock auction, and the obligation to provide free wifi zones would be removed. This second project was subject to comments until February 20, 2018. The schedule for the auction has not yet been set but the ITC has announced that it should take place in 2018.
- Argentina: The government instructed the regulatory authority to issue new regulations during 2017 (i) to ensure the reassignment of frequencies of the radio spectrum for the provision of wireless or fixed wireless services (known as the "refarming process"), which Telefónica has challenged in court, and (ii) to enable the reassignment of frequencies previously granted to other providers (known as the "spectrum on demand process"). In connection with the latter, in May 2017 such "spectrum on demand process" was launched and, in June 2017, certain 2.6 GHz spectrum was granted to Telefónica and other licensed mobile operators, but the effective distribution of the spectrum is still pending.

It is possible that some of the above-mentioned spectrum tender procedures will not be completed, or even initiated within the proposed time frames. In addition to the above, it may be the case that certain administrations which have not yet announced their intention to release new spectrum, may do so during 2018 or thereafter. The above does not include processes announced through general statements by administrations, which involve bands not key to Telefónica's needs. Furthermore, Telefónica may also seek to acquire spectrum on the secondary market where opportunities might arise.

#### *Risks relating to concessions and licenses previously granted*

In the United Kingdom, Telefónica has an obligation under the terms of its 800 MHz spectrum license to provide indoor coverage to 98% of the United Kingdom population (and 95% of the population of each of England, Wales, Scotland and Northern Ireland). It also has an obligation under the terms of its 900/1800 MHz spectrum license to provide voice and text services to 90% of the United Kingdom landmass. Both requirements had to be met by the end of 2017 and must be maintained thereafter. Telefónica United Kingdom continues to invest in its infrastructure improvement program, upgrading its 2G and 3G networks and working on the roll-out of its 4G network. Telefónica United Kingdom is in the process of providing information to the UK's regulatory authority, Ofcom, to demonstrate its compliance with the obligations mentioned above.

In Spain, also related to the licenses of the 800 MHz spectrum band, the assignee operators of 2x10MHz spectrum (Telefónica, Vodafone and Orange) must jointly complete before January 1, 2020 the offering of services provided with other technologies or in other bands of frequency, with the purpose of reaching coverage that allows access, with a speed of 30 megabits per second or faster, to at least 90% of the inhabitants in population units of less than 5,000 inhabitants. In this regard, there was a public consultation process open until January 22, 2018 regarding the way to implement this obligation. In any event, Telefónica is undergoing a constant process of deployment and densification of Long-Term Evolution ("LTE") solutions over the 800 MHz band that will be the base for compliance with such obligations.

In Germany, in connection with the merger of Telefónica Deutschland Holding AG and E-Plus, three legal proceedings remain open before the European General Court against the decision of the EC authorizing such merger. Oral hearings were held in December 2017 and the decisions are expected in the first quarter of 2018.

In the state of São Paulo, Telefônica Brazil provides local and national long-distance Fixed Switched Telephony Services ("STFC") under the so-called public regime, through a concession agreement, which is expected to remain in force until 2025. In accordance with current regulations, Telefônica Brazil informed the Brazilian regulatory authority (*Agência Nacional de Telecomunicações* or "ANATEL") that the net value of assets assigned to the provision of STFC was estimated to total 8,763 million Brazilian reais as of December 31, 2017 (approximately 2,209 million euros under the exchange rate applicable on such date). Under current regulations, Telefónica must update this information by April 30, 2018 by sending the updated list and value of the assets assigned to the provision of STFC as of December 31, 2017. In principle, such assets were considered to be reversible assets, and were thus supposed to be reverted to the Federal Government at the end of the concession agreement. A bill amending the regulatory framework in Brazil is in process, establishing, among other things, that such assets would no longer be reversible under a new license regime in exchange for significant broadband investment commitments. The bill has been approved at both legislative houses but has been challenged before the Federal Supreme Court due to an alleged procedural defect. The outcome of this lawsuit is uncertain, although the Senate's governing board may overcome it by sending the bill for voting in the Plenary (such action depends on the political environment, which is also uncertain). Such Court and, consequently, the Senate's governing board, has each decided to send the bill for voting in the Plenary. In the event that the bill is finally approved, ANATEL would be entitled to adopt the relevant administrative decisions for the amendment of the respective licenses with the consequent amendment of the future obligations imposed on STFC providers.

In Colombia, the ITC issued resolution 597 on March 27, 2014 to renew 850 MHz/1900 MHz band licenses for ten additional years. Under the scope of such resolution, Colombia Telecomunicaciones, S.A., ESP ("ColTel") (67.5% of which is owned, directly and indirectly, by Telefónica and 32.5% of which is owned by the government of Colombia), renewed its license to exploit such radioelectric spectrum to provide telecommunication services.

The concession agreements from 1994, which were renewed in 2004 and under which the mobile telephone services were provided until 28 November 2013, contained a reversion clause for the underlying assets. However, Law 422 of 1998 and Law 1341 of 2009 provided that upon expiration of a concession agreement for telecommunication services, only the spectrum reverts to the State. That was the understanding under which all the operators, including the authorities, were operating between 1998 and 2013. In 2013, however, when analyzing an appeal on the constitutionality of said laws, the Constitutional Court confirmed the constitutionality of the laws but ruled that it could not be concluded that those laws modified with retroactive effect the reversion clause of the concession agreements of 1994. On February 16, 2016, the ITC started an arbitration proceeding against ColTel and other defendants in accordance with the terms of the relevant concession agreement of 1994, in order to clarify the validity and scope of such reversion clause. The arbitration award was rendered on July 25, 2017 and was not favorable to ColTel and its co-defendants.

The arbitration tribunal ordered ColTel to pay 1,651,012 million Colombian pesos, after finding on August 4, 2017 that an arithmetic error required that the amount contained in the original award from July 25, 2017 be revised slightly downwards. On August 29, 2017, the shareholders' meeting of ColTel approved a capital increase in a total amount of 1,651,012 million Colombian pesos, 470 million euros at the exchange rate as of such date, to pay the amount imposed by the arbitration award. The Telefónica Group and the Colombian government subscribed the capital increase pro rata to their respective shareholding in ColTel. Telefónica's decision to participate in the capital increase does not constitute, and should not be understood as, an acceptance of the



arbitration award. Telefónica reserves all of its legal rights and the exercise by Telefónica or ColTel of any applicable legal action, national or international. Both ColTel and Telefónica have started legal actions. On August 18, 2017, ColTel filed an appeal to challenge the arbitration award at Colombia's highest court of administrative litigation (*Consejo de Estado*). In addition, on December 18, 2017, ColTel also filed a constitutional action "*acción de tutela*" seeking to protect its constitutional rights jeopardized by the arbitration award. On the other hand, pursuant to the relevant bilateral treaty, Telefónica notified Colombia of its intention to file a claim in the International Centre for Settlement of Investment Disputes ("ICSID") after the expiration of the 90-day notice period. After the expiration of such deadline, on February 1, 2018, Telefónica submitted the arbitration request to the ICSID.

In Peru, Telefónica has concessions for the provision of fixed-line services until November 2027. In December 2013, Telefónica filed a partial renewal request for these concessions for five more years. In December 2014 and June 2016, Telefónica filed renewal requests for an additional twenty years in relation to a concession for the provision of local carrier services and to one of the concessions to provide mobile line services in certain provinces, respectively. As of the date of this Annual Report, the decision of the Ministry of Transport and Communications (*Ministerio de Transportes y Comunicaciones*) in these proceedings is still pending and, according to the legislation, the underlying concessions remain in force as long as the proceedings are pending.

Telefónica Móviles Chile, S.A. was awarded 2x10 MHz spectrum on the 700 MHz band in March 2014. While services are being provided on such spectrum, a consumer organization filed a claim against the allocation of spectrum on the 700 MHz band that is still pending.

During 2017, the Group's consolidated investment in spectrum acquisitions and renewals amounted to 538 million euros.

#### *Regulation of wholesale services*

The EC's proposal in respect of the regulatory framework intends, among other measures, to incorporate a methodology and a European upper limit for the call-termination prices for landline phones/mobile phones (FTRs/MTRs) applicable in the EU. The decreases in wholesale mobile termination rates ("**MTRs**") in Europe are noteworthy. Since termination fees in mobile and fixed communications have decreased substantially in recent years, future decreases are expected to become smaller so that the negative impact on turnover is expected to be less significant than in the past.

In the United Kingdom, the current rate is 0.495 pence per minute. On June 27, 2017, Ofcom made a consultation on a proposal for a progressive reduction over a three-year period from April 1, 2018, which would result in a 10% reduction in real terms in MTRs during that period.

In Spain, in November 2017, the Spanish National Regulatory and Competition Authority (*Comisión Nacional de los Mercados y la Competencia* or "**CNMC**") submitted to the EC the draft measures to set the new MTRs for all the mobile operators, which would imply a progressive reduction of 40% from current levels. The proposed dates and MTRs would be as follows: since the decision becomes effective until December 31, 2018 at 0.0070 €/min; from January 1, 2019 until December 31, 2019 at 0.0066 €/min; and as from January 1, 2020 at 0.0064 €/min. A final decision was adopted in 2018 setting the rate at 0.0067 €/min during the year 2019.

In Latin America, the Group believes it is likely that MTRs will also be reduced in the short to medium term.

In Brazil, the *Plano Geral de Metas de Competição* ("**PGMC**"), amended by Resolution 649/2015, established that mobile termination fees are subject to successive yearly reductions from 2016 until 2019, when the definitive cost-oriented-model fees are expected to be in force (such Resolution has been challenged in courts and the proceedings are ongoing). On December 5, 2016, ANATEL issued a public consultation for the revision of the PGMC, which addresses changes in the relevant wholesale markets regulated by the PGMC and also in the cost-oriented model. ANATEL is expected to deliberate on the new regulations during 2018.

In Mexico, on November 9, 2017, the *Instituto Federal de Telecomunicaciones* ("**IFT**") announced that the MTRs applicable to the so-called Prevailing Economic Agent ("**PEA**") for 2018 shall be 0.028562 pesos per minute while the MTRs applicable to the operators other than the PEA shall be 0.112799. The IFT fixed the MTRs on

the PEA's network as a result of a prior ruling of the Supreme Court of Justice in favor of the PEA and against its obligation to refrain from charging fees for the termination of mobile, fixed and SMS traffic on its network.

In Peru, the *Organismo Supervisor de las Telecomunicaciones* ("**OSIPTEL**") started in November 2016 the process to amend the maximum MTRs. On January 28, 2018, OSIPTEL published the caps on interconnection rates for MTRs. The approved rate is the same for all networks and entails a decrease of 63% (USD 0.00661 per minute rated at the second). The new fees established by OSIPTEL will apply as of the adoption of the regulation.

As a result of the foregoing regulatory actions, Telefónica may receive lower prices for certain of its services, which may materially adversely affect its business, financial condition, results of operations and/or cash flows. During the year ended December 31, 2017 the negative impact of these regulations is estimated to have resulted in the deduction of approximately 1 percentage point from the organic growth of the Group's revenues.

#### *Regulation of universal service obligations*

Universal service obligations ("**USO**") refers to the obligations imposed on telecommunication operators which are aimed at granting access to all the consumers in a country to a minimum set of services offered at reasonable and fair prices in order to avoid social exclusion. On its proposal for the reform of the regulatory framework issued on September 14, 2016, the EC sought to modernize USO in Europe, removing the mandatory inclusion of the legacy outdated services (telephone boxes, directories and information services) and focusing on the provision of affordable broadband services. The EC also proposed that USO should be funded out of general budgets and not from the sectoral budget. However, if this funding method does not thrive, the inclusion of affordable broadband services could end up being more expensive for the sector. In any case, the new regulation is not expected to be applicable before 2020.

In Spain, the USO for 2017 were extended for 2018, with Telefónica being responsible for the provision of the elements of Universal Service to fixed-broadband access, pay phones and directories.

In Brazil, a proposal of the General Plan for Universalization of Fixed Switched Telephony Services was approved by ANATEL in 2016. The final version, however, has not been published because the amendment to the underlying concession agreement has not been yet finalized.

The imposition on the Telefónica Group of additional or more onerous USO in the jurisdictions where it operates could have a material adverse effect on its business, financial condition, results of operations and/or cash flows.

#### *Regulation of fiber networks*

On December 29, 2017, a draft measure on the economic replicability methodology to be used to assess the maximum wholesale access price which Telefónica could charge to other operators for accessing the optical fiber network in regulated areas (NEBA Local and NEBA services), was notified to the EC establishing a maximum wholesale access price of 16.38 €/month. The final decision is expected within the current first quarter of 2018. In June 2017, CNMC launched a public consultation on the methodology to analyze if Telefónica's business offers can be replicated by other operators. The final decision is not expected before mid-2018.

Any of such obligations and restrictions could raise costs and limit Telefónica's freedom to provide the aforementioned services, which could materially adversely affect Telefónica's business, financial condition, results of operations and/or cash flows.

#### *Regulations on privacy*

In Europe, the General Data Protection Regulation ("**GDPR**") of April 27, 2016, will be directly applicable in all Member States from May 25, 2018. In addition, on January 10, 2017, the EC presented its proposal for a Regulation on privacy and electronic communications ("**ePrivacy**"), which will replace the current Directive 2002/58/EC. The proposal implies an extra layer of regulation on top of the GDPR and also introduces administrative fines of up to 4% of an undertaking's annual global turnover for breaching new regulations. In this area, a strict data protection and privacy regulation may result in limitations on the ability to offer innovative digital services such as big data services. The future ePrivacy Regulation is not expected to be adopted before the end of 2018.

The Privacy Shield, approved by the EC on July 12, 2016 to lay out the framework for the international transfer of personal data from the EU to the US, has been challenged before the EU's General Court by civil-society groups, but the admission of their appeals is still pending as at the date of this Annual Report. Nevertheless, the EC completed on October 18, 2017 its first annual review on the performance of the Privacy Shield and concluded that the Privacy Shield continues to ensure an adequate level of data protection for personal data of European citizens.

In Brazil, the adoption of a Personal Data Protection Act is still pending. This act could lead to further obligations and restrictions for operators in relation to the collection of personal data and its treatment.

Any obligations and restrictions arising from privacy regulations could raise costs and limit Telefónica's ability to provide certain services, which could materially adversely affect Telefónica's business, financial condition, results of operations and/or cash flows.

#### *Regulation of network neutrality*

Under the principle of network neutrality applicable to the Internet access services realm, network operators are not permitted to establish technical or commercial restrictions regarding the terminals that can be connected or the services, or applications and contents that can be accessed or distributed through the Internet by the end user. It also refers to the non-discriminatory behavior (e.g. non-anticompetitive) to be adopted by operators regarding the different types of Internet traffic circulating through their networks.

In Europe, network neutrality is regulated by Regulation (EU) 2015/2120 of November 25, 2015.

Telefónica operates in Latin American countries where net neutrality is being implemented, such as Chile, Colombia, Mexico, Peru (where OSIPTEL implemented regulations on net neutrality on January 1, 2017) and in Brazil. In Mexico, it is expected that IFT will issue guidelines during 2018. In Chile, on November 22, 2016, the Commission of Telecommunications submitted a bill for amending the Network Neutrality Act. The main changes proposed concern the establishment of rules applying measures for traffic management and restrictive rules for "Zero Rating".

If changes to regulation such as those described above, or otherwise, occur in the various jurisdictions where the Telefónica Group operates, it could have a material adverse effect on its business, financial condition, results of operations and/or cash flows.

#### **The Telefónica Group is exposed to risks in relation to compliance with anti-corruption laws and regulations and economic sanctions programs.**

The Telefónica Group is required to comply with the laws and regulations of various jurisdictions where it conducts operations. In particular, the Group's international operations are subject to various anti-corruption laws, including the US Foreign Corrupt Practices Act of 1977 and the United Kingdom Bribery Act of 2010, and economic sanctions programs, including those administered by the United Nations, the European Union and the United States, including the US Treasury Department's Office of Foreign Assets Control. The anti-corruption laws generally prohibit providing anything of value to government officials for the purposes of obtaining or retaining business or securing any improper business advantage. As part of the Telefónica Group's business, it may deal with entities, the employees of which are considered government officials. In addition, economic sanctions programs restrict the Group's business dealings with certain sanctioned countries, individuals and entities.

Although the Group has internal policies and procedures designed to ensure compliance with applicable anti-corruption laws and sanctions regulations, there can be no assurance that such policies and procedures will be sufficient or that the Group's employees, directors, officers, partners, agents and service providers will not take actions in violation of the Group's policies and procedures (or otherwise in violation of the relevant anti-corruption laws and sanctions regulations) for which the Group or they may be ultimately held responsible. Violations of anti-corruption laws and sanctions regulations could lead to financial penalties, exclusion from government contracts, damage to the Group's reputation and other consequences, that could have a material adverse effect on the Group's business, results of operations and financial condition.



As of the date of this Annual Report, Telefónica is conducting internal investigations covering various countries regarding possible violations of applicable anti-corruption laws. Telefónica has been in contact with and cooperating with governmental authorities about these matters and intends to continue to cooperate with those authorities as the investigations continue. It is not possible at this time to predict the scope or duration of these matters or their likely outcome.

**Customers' perceptions of services offered by the Company may put it at a disadvantage compared to competitors' offerings.**

Customers' perceptions of the assistance and services offered are critical to operating in highly-competitive markets. The ability to predict and respond to the changing needs and demands of customers affects Telefónica's competitive position relative to other technology sector companies, and its ability to extract the value generated during the process of digital transformation we are immersed in. Failure to do so adequately could have an adverse impact on the Group's business, financial condition, results of operations and/or cash flows.

**Telefónica may not be able to adequately foresee and respond to technological changes and sector trends.**

In a sector characterized by rapid technological change, it is essential to be able to offer the products and services demanded by the market and consider the impacts of changes in the life cycle of technical assets, secure margins and select the right investments to make.

The Telefónica Group operates in markets that are highly competitive and subject to constant technological development. Therefore, as a consequence of both of these characteristics, it is subject to the effects of actions by competitors in these markets and to its ability to anticipate and adapt, in a timely manner, to constant technological changes, changes in customer preferences that are taking place in the industry, as well as economic, political and social circumstances. The entry of new competitors in the markets where the Group is the leader, such as Chile and Peru, has resulted in the Group losing market share in the mobile phone market during the period between 2014 and the end of 2017. In this competitive environment, the Group has focused on its high-value customers and estimates that the loss of revenues has been lower than the loss of accesses.

Failure to adequately anticipate and adapt to constant technological changes, changes in customer preferences that are taking place in the industry, as well as economic, political and social circumstances could have an adverse effect on the Group's business, financial condition, results of operations and/or cash flows.

New products and technologies arise constantly and their development can render obsolete the products and services the Telefónica Group offers and the technology it uses. This means that Telefónica must invest in the development of new products, technology and services so it can continue to compete effectively with current or future competitors, which may result in the decrease of the Group's profits and revenue margins. In this respect, margins from traditional voice and data business are shrinking, while new sources of revenues are deriving from mobile Internet and connectivity services that are being launched. Research and development costs amounted to 862 million euros in 2017, representing a decrease of 4.8% from 906 million euros in 2016 (1,055 million euros in 2015). These expenses represented 1.7%, 1.7% and 1.9% of the Group's consolidated revenues in 2017, 2016 and 2015, respectively. These figures have been calculated using the guidelines established in the Organization for Economic Cooperation and Development ("OECD") manual. One technology that telecommunications operators, including Telefónica (in Spain and Latin America), are focused on is the new FTTx-type network, which offers broadband access using optical fiber with superior services, such as Internet speed of up to 300MB or HD television services. However, substantial investment is required to deploy these networks, which entails fully or partially substituting copper loop access with optic fiber. In Spain, as of December 2017 Telefónica has already 19.2 million premises passed with fibre (representing 66% of the households), as a proxy of the investment required. While an increasing demand for the capabilities offered by these new networks to end users exists, the high level of the investments requires a continuous analysis of the return on investment.

The explosion of the digital market and entry of new players in the communications market, such as MVNOs, Internet companies or device manufacturers, may cause the loss of value of certain assets, and affect the Group's ability to generate income. Therefore, it is necessary to update the business model, encouraging the pursuit of

income and additional efficiencies to those traditionally sought. Failure to do so adequately could have an adverse effect on the Group's business, financial condition, results of operations and/or cash flows.

In addition, the ability of the Telefónica Group's IT systems (operational and backup) to respond to Telefónica's operating requirements is a key factor to be taken into account with respect to the commercial development, customer satisfaction and business efficiency. Any failure by Telefónica Group's IT systems to adequately respond to the Group's evolving operating requirements could have an adverse effect on the Group's business, financial condition and/or results of operations.

#### **Telefónica depends on its suppliers.**

The existence of critical suppliers in the supply chain, especially in areas such as network infrastructure, information systems or handsets, with a high concentration in a small number of suppliers, poses risks that may affect Telefónica's operations, and may cause legal contingencies or damages to its image in the event that inappropriate practices are produced by a participant in the supply chain.

As of 31 December 2017, the Telefónica Group depended on three handset suppliers and 10 network infrastructure suppliers, which, together, accounted for 79% and 78%, respectively, for the awarded contracts as of such date (for their products groups). One of the handset suppliers represented two-fifths of all handset allocations as of such date. These suppliers may, among other things, extend delivery times, raise prices and limit supply due to their own stock shortfalls and business requirements.

If these suppliers fail to deliver products and services to the Telefónica Group on a timely basis, it could jeopardize network deployment and expansion plans, which in some cases could adversely affect the Telefónica Group's ability to satisfy its license terms and requirements, or otherwise have an adverse effect on the Group's business, financial condition, results of operations and/or cash flows.

#### **Unanticipated network interruptions can lead to quality loss or the interruption of the service.**

Unanticipated network interruptions as a result of system failures, including those due to natural disasters caused by natural or meteorological events (due, in turn, to extreme weather conditions, especially in the geographies with greater exposure to them), network, hardware or software failures, stealing of infrastructure elements or cyber-attacks, which affect the quality of or cause an interruption in the Telefónica Group's service, could lead to customer dissatisfaction, reduced revenues and traffic, costly repairs, penalties or other measures imposed by regulatory authorities and could harm the Telefónica Group's image and reputation.

Telecommunications companies worldwide face increasing cybersecurity threats as businesses have become increasingly dependent on telecommunications and computer networks and adopt cloud computing technologies. Cybersecurity threats may include gaining unauthorized access to Telefónica's systems or inserting computer viruses or malicious software in its systems to misappropriate consumer data and other sensitive information, corrupt Telefónica's data or disrupt its operations. Unauthorized access may also be gained through traditional means such as the theft of laptop computers, data devices and mobile phones and intelligence gathering on employees with access. Further, our employees or other persons may have unauthorized or authorized access to our systems and/or take actions that affect our networks in an inconsistent manner with the Group's policies or otherwise adversely affect the Group or its ability to adequately process internal information.

Telefónica attempts to mitigate these risks through a number of measures, including backup, log review, vulnerabilities checks, network segregation measures and protective systems such as firewalls, intrusion detection or prevention systems, virus scanners and other physical and logical security measures. However, the application of these measures may not always be effective. Although the Telefónica Group has insurance policies to cover these types of incidents, and the claims and loss in revenue caused by service interruptions to date have been covered by these policies, these policies may not be sufficient to cover all possible monetary losses.

**The telecommunications industry may be affected by the possible effects that electromagnetic fields, emitted by mobile devices and base stations, may have on human health.**

In some countries, there is a concern regarding potential effects of electromagnetic fields, emitted by mobile devices and base stations, on human health. This public concern has caused certain governments and administrations to take measures that have hindered the deployment of the infrastructures necessary to ensure quality of service, and affected the deployment criteria of new networks and digital services such as smart meters development.

There is a consensus between certain expert groups and public health agencies, including the World Health Organization, that states that currently there are no established risks associated with exposure to low frequency signals in mobile communications. However, the scientific community is still investigating this issue especially with respect to mobile devices. Exposure limits for radio frequency suggested in the guidelines of the Protection of Non-Ionizing Radiation Protection Committee have been internationally recognized. The mobile industry has adopted these exposure limits and works to request authorities worldwide to adopt these standards.

Worries about radio frequency emissions may discourage the use of mobile devices and new digital services, which could cause the public authorities to implement measures restricting where transmitters and cell sites can be located, how they operate, the use of mobile telephones and the massive deployment of smart meters and other products using mobile technology. This could lead to Telefónica being unable to expand or improve its mobile network.

The adoption of new measures by governments or administrations or other regulatory interventions in this respect, and any future assessment on the adverse impact of electromagnetic fields on health, may adversely affect the business, financial conditions, results of operations and/or cash flows of the Telefónica Group.

**Possible regulatory, business, economic or political changes could lead to asset impairment.**

The Telefónica Group reviews on an annual basis, or more frequently when the circumstances require it, the value of assets and cash-generating units, to assess whether their carrying values can be supported by the future expected cash flows, including, in some cases synergies allowed for in acquisition costs. Potential changes in the regulatory, business, economic or political environment may result in the need to introduce changes to estimates made and to recognize impairments in goodwill, intangible assets, property, plant and equipment or financial assets. Although the recognition of impairments of these assets results in a non-cash charge on the income statement, it could adversely affect the results of the Telefónica Group's operations. In this respect, the Telefónica Group has experienced impairments on certain of its investments, affecting its results of operations in the year in which they were experienced. No impairments were recognized in 2017. In 2016, impairment losses in goodwill were recognized amounting to an aggregate amount of 215 million euros, relating to Telefónica's operations in Venezuela (124 million euros) and in Mexico (91 million euros).

**The Telefónica Group's networks carry and store large volumes of confidential, personal and corporate data, and its Internet access and hosting services may lead to claims for illegal or illicit use of the Internet.**

The Telefónica Group's networks carry and store large volumes of confidential, personal and business data, through both voice and data traffic. The Telefónica Group stores increasing quantities and types of customer data in both business and consumer segments. Despite its best efforts to prevent it, the Telefónica Group may be found liable for any loss, transfer, or inappropriate modification of the customer data or general public data stored on its servers or transmitted through its networks, any of which could involve many people and have an impact on the Group's reputation, or lead to legal claims and liabilities that are difficult to measure in advance.

In addition, the Telefónica Group's Internet access and hosting servers could lead to claims for illegal or unlawful use of the Internet. Telefónica, like other telecommunications providers, may be held liable for any loss, transfer or inappropriate modification of the customer data stored on its servers or carried by its networks.

In most countries in which the Telefónica Group operates, the provision of its Internet access and hosting services (including the operation of websites with shelf-generated content) are regulated under a limited liability regime applicable to the content that it makes available to the public as a technical service provider, particularly content protected by copyright or similar laws. However, regulatory changes have been introduced imposing additional

obligations on access providers (such as blocking access to a website) as part of the struggle against some illegal or illicit uses of the Internet, notably in Europe.

Any of the foregoing could have an adverse effect on the business, financial position, results of operations and/or cash flows of the Group.

**Telefónica and Telefónica Group companies are party to lawsuits, tax claims, antitrust and other legal proceedings.**

Telefónica and Telefónica Group companies are party to lawsuits, tax claims, antitrust and other legal proceedings in the ordinary course of their businesses, the financial outcome of which is unpredictable. An adverse outcome or settlement in these or other proceedings could result in significant costs and may have a material adverse effect on the Group's business, financial condition, results of operations, reputation and/or cash flows. In particular, the Telefónica Group is party to certain judicial tax proceedings in Peru concerning the clearance of certain previous years' income tax, in respect of which a contentious-administrative appeal is currently pending and to certain tax and regulatory proceedings in Brazil, primarily relating to the ICMS (a Brazilian tax on telecommunication services) and the corporate tax. Further details on these matters are provided in Notes 15, 17 and 21 to the Consolidated Financial Statements.

## **APPENDIX TO THE ANNUAL CORPORATE GOVERNANCE REPORT 2017**

### **E.3 Indicate the main risks, including tax risks, which may prevent the company from achieving its targets.**

The Telefónica Group's business is affected by a series of intrinsic risk factors that affect exclusively the Group, as well as a series of external factors that are common to businesses of the same sector. The main risks and uncertainties facing the Company which could affect its business, financial position, reputation, corporate image and brand and its results of operations, must be considered jointly with the information in the Consolidated Financial Statements, and are as follows:

#### **Group-Related Risks**

##### **Worsening of the economic and political environment could negatively affect Telefónica's business.**

Telefónica's international presence enables the diversification of its activities across countries and regions, but it exposes Telefónica to diverse legislation, as well as to the political and economic environments of the countries in which it operates. Any adverse developments or even uncertainties in this regard, including exchange-rate or sovereign-risk fluctuations, may adversely affect the Company's business, financial position, cash flows and results of operations and/or the performance of some or all of the Group's financial indicators.

Economic conditions may adversely affect the level of demand of existing and prospective customers, as they may no longer deem critical the services offered by the Group.

Macroeconomic perspectives in Europe have improved as two major risks have diminished during 2017. First, political uncertainty has decreased after the results of the general elections in some European countries and, second, the agreement reached in relation to the Greek bailout program and better macroeconomic data in the country have opened the door to a potential solution to the Greek debt crisis in the near term. While such risks have diminished, economic activity and financial stability in Europe could be affected by the monetary normalization that the European Central Bank is expected to continue implementing in the near future, with a negative impact on the balance between the private and public sectors, and by the restructuring processes which the European banking sector is still immersed in. Furthermore, the planned exit of the United Kingdom from the European Union following the outcome of the referendum held in 2016, will result in economic adjustments regardless of the nature of the new trade and investment relationships between the United Kingdom and the rest of Europe in the future. In the meantime, there is uncertainty regarding investment, economic activity, employment and financial market volatility. Finally, another possible source of uncertainty given Telefónica's exposure, could come from Catalonia's political situation and its impact on the Spanish economy. Although recent events point to a lower degree of uncertainty, if political tensions re-emerge or intensify, there could be a negative impact both on financing conditions and on the current positive Spanish macroeconomic scenario. In 2017, the Telefónica Group obtained 24.3% of its revenues in Spain (24.6% in 2016), 14.0% in Germany (14.4% in 2016) and 12.6% in the United Kingdom (13.2% in 2016).

In Latin America, there is an increasing exchange rate risk created by external factors such as the uncertainty derived from the monetary normalization process in the United States, the continuing low commodity prices in certain cases despite recent improvement, and doubts about growth and imbalances in China. Certain internal factors such as high fiscal and external deficits in major Latin American countries and the low liquidity in certain exchange markets, together with a low productivity growth, hinder a more accelerated progress in economic development and the rebalancing of still existent mismatches.

In Brazil, although the political scenario continues to be unstable, the government has approved relevant legislative reforms and promoted the approval of other key legislative items, such as the social security reform, which could be approved before the end of the term, which has improved the confidence levels in the government. While signs of stabilization have emerged and the economy has started to show positive growth figures, the pace of the recovery is still weak and the unemployment rate remains at 12%. Moreover, despite decreasing external financing needs, internal financing needs remain high. The combination of such elements has led to risks of further downgrades to the country's credit rating, which is already below investment grade, possibly leading to further currency depreciation.

Mexico has a high commercial and financial exposure to the United States, which could generate uncertainty despite having a relatively stable internal outlook, subject to the outcome of the coming general elections and of the renegotiation of the North American Free Trade Agreement (NAFTA), which is now underway. Any increase in interest rates in the United States and/or a possible renegotiation of trade agreements between both countries could result in higher restrictions on imports into the United States which together with political uncertainty surrounding such matters, could negatively impact economic activity and exchange rates in Mexico. The relative weight of Mexico in the consolidated revenues of the Telefónica Group was 2.6% for 2017.

In countries such as Chile, Colombia and Peru, increases in commodity prices are having a positive impact on their respective fiscal and external accounts, but growth continues to be affected by the lower external inflows, which have affected investment and, to a lesser extent, private consumption.

In Argentina, the government is focused on resolving the country's macroeconomic and financial imbalances and on recovering international confidence. The October legislative elections confirmed the good results of the government coalition. However, even though the economy has returned to positive growth rates and the measures taken by the government might continue having positive effects in the medium term, short term risks persist, including exchange rate risk, especially due to the high inflation rate.

In Ecuador, despite the recovery in oil prices and the recent U.S. dollar depreciation, which have allowed for an improvement in economic activity through exports, risks persist, mainly on the fiscal front. The country's financing needs are still high, which, together with low international reserves, keep the country in a more vulnerable position against volatility shocks.

During 2017 Telefónica Hispanoamérica represented 24.1% of the Telefónica Group's revenues (24.2% in 2016), of which 27.8% proceeded from revenues in Argentina, 18.5% in Peru and 17.4% in Chile. During 2017, Telefónica Brazil represented 23.1% of the Telefónica Group's revenues (21.3% in 2016). In this respect, 32.4% of the Group's revenues were generated in countries that do not have investment grade status (in order of importance, Brazil, Argentina, Venezuela, Ecuador, Guatemala, El Salvador, Nicaragua and Costa Rica), and other countries are only one notch away from losing this status.

“Country risk” factors include, among others, the following:

- unexpected adverse changes in regulation or administrative policies, including changes that modify the terms and conditions of licenses and concessions and their renewal (or delay their approval);
- abrupt exchange rate movements;
- high inflation rates;
- expropriation or nationalization of assets, adverse tax decisions, or other forms of state intervention;
- economic-financial downturns, political instability and civil disturbances; and
- maximum limits on profit margins imposed in order to limit the prices of goods and services through the analysis of cost structures (for example, in Venezuela, a maximum profit margin has been introduced that is set annually by the Superintendence for Defense of Socioeconomic Rights).

Any of the foregoing may adversely affect the business, financial position, results of operations and/or cash flows of the Group.

**The Group's financial condition and results of operations may be adversely affected if it does not effectively manage its exposure to foreign currency exchange rates or interest rates.**

In nominal terms, as of December 31, 2017, 71.0% of the Group's net financial debt plus commitments was pegged to fixed interest rates for a period greater than one year. As of the same date, 17.2% of the Group's net financial debt plus commitments was denominated in a currency other than the euro.

To illustrate the sensitivity of financial expenses to variations in short-term interest rates as of December 31, 2017: (i) a 100 basis points increase in interest rates in all currencies in which Telefónica had a financial position at that date would have led to an increase in financial expenses of 91 million euros, (ii) whereas a 100 basis points decrease in interest rates in all currencies (even if negative rates are reached), would have led to a reduction in financial expenses of 74 million euros, in each case for the year ended December 31, 2017. These calculations were made assuming a constant currency and balance position equivalent to the position at that date and taking into account the derivative financial instruments arranged by the Group.

According to the Group's calculations, the impact on results and specifically on net exchange differences due to a 10% depreciation of Latin American currencies against the U.S. dollar and a 10% depreciation of the rest of the currencies against the euro would result in exchange losses of 17 million euros for the year ended December 31, 2017, primarily due to the weakening of the Venezuelan bolivar. These calculations have been made assuming a constant currency position with an impact on profit or loss as of December 31, 2017, taking into account derivative instruments in place.



During 2017, Telefónica Brazil represented 25.9% (24.5% in 2016), Telefónica Hispanoamérica represented 21.9% (23.0% in 2016) and Telefónica United Kingdom represented 10.1% (11.3% in 2016) of the operating income before depreciation and amortization ("OIBDA") of the Telefónica Group.

The Telefónica Group uses a variety of strategies to manage this risk, among others the use of financial derivatives, which themselves are also exposed to risk, including counterparty risk. However, the Group's risk management strategies may not achieve the desired effect, which could adversely affect the Group's business, financial condition, results of operations and/or cash flows.

In 2017, the evolution of exchange rates had a negative impact on results, decreasing the Group's consolidated revenues and OIBDA by an estimated 3.2 p.p. and 4.7 p.p., respectively, mainly due to the depreciation of the Argentine peso, the Venezuelan bolivar and the pound sterling. Furthermore, translation differences had a positive impact on the Group's equity of 2,049 million euros as of December 31, 2016 and a negative impact of 4,607 million euros as of December 31, 2017.

If the Group does not effectively manage its exposure to foreign currency exchange rates or interest rates, it may adversely affect its business, financial position, results of operations and/or cash flows.

**Existing or worsening conditions in the financial markets may limit the Group's ability to finance, and consequently, the ability to carry out its business plan.**

The operation, expansion and improvement of the Telefónica Group's networks, the development and distribution of the Telefónica Group's services and products, the implementation of Telefónica's strategic plan and new technologies, the renewal of licenses or the expansion of the Telefónica Group's business in countries where it operates, may require a substantial amount of financing.

A decrease in the liquidity of Telefónica, or a difficulty in refinancing maturing debt or raising new funds as debt or equity could force Telefónica to use resources allocated to investments or other commitments to pay its financial debt, which could have a negative effect on the Group's business, financial condition, results of operations and/or cash flows.

Funding could be more difficult and costly in the event of a significant deterioration of conditions in the international or local financial markets due to monetary policies set by central banks, including increases in interest rates and/or balance sheet reductions, and oil price instability, or if there is an eventual deterioration in the solvency or operating performance of Telefónica.

As of December 31, 2017, the Group's net financial debt amounted to 44,230 million euros (48,595 million euros as of December 31, 2016) and, as of December 31, 2017, the Group's gross financial debt amounted to 55,746 million euros (60,361 million euros as of December 31, 2016). At such date, the average maturity of the debt was 8.08 years (6.35 years as of December 31, 2016).

As of December 31, 2017, the Group's gross financial debt scheduled to mature in 2018 amounted to 9,414 million euros, and gross financial debt scheduled to mature in 2019 amounted to 6,063 million euros.

In accordance with its liquidity policy, Telefónica has covered its gross debt maturities for the next twelve months with cash and credit lines available at December 31, 2017. As of December 31, 2017, the Telefónica Group had undrawn committed credit facilities arranged with banks for an amount of 13,531 million euros (12,541 million euros of which will expire in more than twelve months). Telefónica's liquidity could be



affected if market conditions make it difficult to renew existing undrawn credit lines. As of December 31, 2017, 7.3% of the aggregate undrawn amount under credit lines was scheduled to expire prior to December 31, 2018.

In addition, given the interrelation between economic growth and financial stability, the materialization of any of the economic, political and exchange rate risks referred to above could lead to a negative impact on the availability and cost of Telefónica's financing and its liquidity strategy. This in turn could have a negative effect on the Group's business, financial condition, results of operations and/or cash flows.

**Adoption of new accounting standards could affect the Group's reported results and financial position.**

Accounting standard-setting bodies and other authorities may periodically change accounting regulations that govern the preparation of the Group's consolidated financial statements. Those changes could have a significant impact on the way the Group accounts for certain matters and presents its financial position and its results of operations. In some instances, a modified standard or a new requirement with retroactive effect must be implemented, which requires the Group to restate previous financial statements.

In particular, Telefónica is required to adopt the new accounting standards IFRS 15 "Revenue from Contracts with Customers" and IFRS 9 "Financial instruments", effective from January 1, 2018, and IFRS 16 "Leases", effective from January 1, 2019.

These standards present significant changes that will affect the amount and timing of recognition of revenues and expenses related to certain sales transactions (IFRS 15), the estimation processes for the expected impairment losses on financial assets, the recognition period and the documentation of hedging policies and strategies (IFRS 9), as well as the accounting treatment for all lease contracts, other than certain short-term leases and leases of low-value assets (IFRS 16). The Group estimates that the first-time adoption of these changes will have a material impact on the Group's financial statements and may make comparisons between periods difficult and less meaningful.

Note 3 to the Consolidated Financial Statements includes information on the main impacts expected from the first-time adoption of the new requirements.

**Risks Relating to the Group's Industry**

**The Group operates in a highly regulated industry which requires government concessions for the provision of a large part of its services and the use of spectrum, which is a scarce and costly resource.**

The telecommunications sector is subject to laws and sector-specific regulations in the majority of the countries where the Group operates. Additionally, many of the services the Group provides require the granting of a license, concession or official approval, which usually requires certain obligations and investments to be made, such as those relating to the acquisition of spectrum capacity. Among the main risks of this nature are those related to spectrum regulation and licenses/concessions, rates, universal service regulation, regulated wholesale services over fiber networks, privacy, functional separation of businesses and network neutrality. The fact that the Group's business is highly regulated both affects its revenues and imposes costs on its operations.

As the Group provides most of its services under licenses, authorizations or concessions, it is vulnerable to administrative bodies' decisions, such as economic fines for serious breaches in the provision of services and, potentially, revocation or failure to renew these licenses, authorizations or concessions, or the granting

of new licenses to competitors for the provisions of services in a specific market. The spectrum to which each of the licenses and administrative concessions refers is used for the provision of mobile services on 2G, 3G and 4G technologies. The complementarity between the different frequency bands successively assigned to an operator in a geographic market enables greater flexibility and efficiency in both the deployment of the network and the provision of services to final customers over the capacities resulting from such network.

Any challenges or amendments to the terms of licenses, authorizations or concessions granted to the Group and necessary for the provision of its services or the Group's failure to obtain sufficient or appropriate spectrum capacity in the jurisdictions discussed below or any others in which it operates, or its inability to assume the related costs, could have an adverse impact on its ability to launch and provide new services and on its ability to maintain the quality of existing services, which may adversely affect the Group's business, financial condition, results of operations and/or cash flows.

More detailed information can be found in Annex VI to the Consolidated Financial Statements "Key regulatory issues and concessions and licenses held by the Telefonica Group".

Additionally, the Telefónica Group could be affected by regulatory actions of the antitrust authorities. These authorities could prohibit certain actions, such as new acquisitions or specific practices, create obligations or lead to heavy fines. Any such measures implemented by the competition authorities could result in economic and/or reputational loss for the Group, in addition to a loss of market share and/or harm to the future growth of certain businesses.

#### *Regulation of spectrum and access to new government licenses/concessions of spectrum*

On September 14, 2016, the European Commission (EC) adopted, among others, a proposed Directive for the establishment of a European Electronic Communication Code (EECC), which could have significant implications, *inter alia*, for access to networks, spectrum use, auction conditions, duration and renewal of licenses, universal service and consumer protection. The proposed Directive is currently going through the legislative process and its approval is expected in the second quarter of 2018.

On May 17, 2017, the European Parliament and Council approved a decision regarding the use and availability of the 700 MHz band. This could require new cash outflows from Telefónica between 2018 and 2022 in the United Kingdom and Spain. The 700 MHz band will initially allow the expansion of the capacity of 4G networks and, in the near future, the introduction of 5G services with new functionalities. In Spain, it is expected that the Ministry of Energy, Tourism and the Digital Agenda publishes its plan to release the 700 MHz band before June 30, 2018, in line with the calendar approved by the EC and with the 5G National Plan adopted in December 2017. The 5G National Plan also contemplates, among other matters, an urgent auction for the 3.6 GHz band at the beginning of 2018 and, possibly, also in the L band (1452- 1492 MHz).

In connection with the spectrum auction for the 2.3 and 3.4 GHz bands in the United Kingdom, on July 11, 2017 the Office of Communications ("Ofcom") released rules for the upcoming mobile spectrum auction in both the 2.3 GHz (available for "immediate use") and 3.4 GHz bands (which may be used for 5G services). They set forth two separate spectrum caps: a spectrum cap of 255 MHz of immediately usable spectrum and an overall cap of 340 MHz. Hutchison 3G UK Ltd ("H3G") and BT filed a motion to review Ofcom's decision regarding the 3.4 GHz band based on the constraints imposed by the spectrum limits set forth in this band for which they can bid. The judgment was released in December 2017 and both appeals were dismissed.

H3G tried to appeal the decision to the Court of Appeal and a hearing took place on February 13, 2018. The appeal was refused and the litigation ended. Therefore, the auction can now proceed without delay. Telefónica UK expects the bidding to start in March 2018.

In Germany, regarding its process to provide new frequencies for the further development of digital infrastructures, the regulatory agency for electricity, gas, telecommunications, post and railway ("BNetzA") published its position on the key elements on June 27, 2017 and, at the same time, initiated a procedure for determining the frequency demand for nationwide assignments in the 2 GHz and the 3.6 GHz bands (3.6 GHz is the official wording of BNetzA when referring to 3.4-3.8 GHz). Among other things, for the 2 GHz band, BNetzA proposed the joint award of the frequencies expiring at the end of 2020 and 2025 and indicated that, following the merger of Telefónica Deutschland and E-Plus, it does not intend to withdraw any rights of use allocated to Telefónica Deutschland before their expiration (2020 and 2025, respectively). For the 3.6 GHz band, regional assignments for a part of the frequencies are provided for in the paper, as well as mutual co-usage rights between national and regional assignments. Additionally, it also foresees a demand-based supply with 5G. The procedures to auction both bands could begin in 2018 or 2019. The Telefónica Deutschland Group reported its request for frequency by the deadline of September 30, 2017 and commented on the key elements of the proposal. The final determination of the frequency demand and the first draft decisions in this regard are expected in the first quarter of 2018. For frequencies above 24 GHz, BNetzA intends to initially develop an application process in the 26 GHz frequency band.

In Latin America, spectrum auctions are expected to take place in the coming years, requiring potential cash outflows to obtain additional spectrum or to meet the coverage requirements associated with these licenses. Specifically, the procedures expected to take place in 2018 in jurisdictions that are relevant for the Group are:

- Mexico: An auction of spectrum in the 2500 MHz band is expected to take place in 2018.
- Colombia: In February 2017, the Ministry of Information Technologies and Communications ("ITC") published the conditions for the auction of 70 MHz of spectrum in the 700 MHz band and of 5 MHz of spectrum in the 1900 MHz band. The ITC modified through Decree 2194 of December 27, 2017 the spectrum caps, increasing them by 5MHz for high bands, reaching a total of 90 MHz, and by 15MHz for low bands, reaching a total of 45 MHz. On January 23, 2018, the ITC published a second project on the conditions of the 700 MHz auction, which included certain modifications, such as: the auction mechanism would be based on a multiple-round ascending clock auction, and the obligation to provide free wifi zones would be removed. This second project was subject to comments until February 20, 2018. The schedule for the auction has not yet been set but the ITC has announced that it should take place in 2018.
- Argentina: The government instructed the regulatory authority to issue new regulations during 2017 (i) to ensure the reassignment of frequencies of the radio spectrum for the provision of wireless or fixed wireless services (known as the "refarming process"), which Telefónica has challenged in court, and (ii) to enable the reassignment of frequencies previously granted to other providers (known as the "spectrum on demand process"). In connection with the latter, in May 2017 such "spectrum on demand process" was launched and, in June 2017, certain 2.6 GHz spectrum was granted to Telefónica and other licensed mobile operators, but the effective distribution of the spectrum is still pending.

It is possible that some of the above-mentioned spectrum tender procedures will not be completed, or even initiated within the proposed time frames. In addition to the above, it may be the case that certain administrations which have not yet announced their intention to release new spectrum, may do so during 2018 or thereafter. The above does not include processes announced through general statements by administrations, which involve bands not key to Telefónica's needs. Furthermore, Telefónica may also seek to acquire spectrum on the secondary market where opportunities might arise.

*Risks relating to concessions and licenses previously granted*

In the United Kingdom, Telefónica has an obligation under the terms of its 800 MHz spectrum license to provide indoor coverage to 98% of the United Kingdom population (and 95% of the population of each of England, Wales, Scotland and Northern Ireland). It also has an obligation under the terms of its 900/1800 MHz spectrum license to provide voice and text services to 90% of the United Kingdom landmass. Both requirements had to be met by the end of 2017 and must be maintained thereafter. Telefónica United Kingdom continues to invest in its infrastructure improvement program, upgrading its 2G and 3G networks and working on the roll-out of its 4G network. Telefónica United Kingdom is in the process of providing information to the UK's regulatory authority, Ofcom, to demonstrate its compliance with the obligations mentioned above.

In Spain, also related to the licenses of the 800 MHz spectrum band, the assignee operators of 2x10MHz spectrum (Telefónica, Vodafone and Orange) must jointly complete before January 1, 2020 the offering of services provided with other technologies or in other bands of frequency, with the purpose of reaching coverage that allows access, with a speed of 30 megabits per second or faster, to at least 90% of the inhabitants in population units of less than 5,000 inhabitants. In this regard, there was a public consultation process open until January 22, 2018 regarding the way to implement this obligation. In any event, Telefónica is undergoing a constant process of deployment and densification of Long-Term Evolution ("LTE") solutions over the 800 MHz band that will be the base for compliance with such obligations.

In Germany, in connection with the merger of Telefónica Deutschland Holding AG and E-Plus, three legal proceedings remain open before the European General Court against the decision of the EC authorizing such merger. Oral hearings were held in December 2017 and the decisions are expected in the first quarter of 2018.

In the state of São Paulo, Telefônica Brazil provides local and national long-distance Fixed Switched Telephony Services ("STFC") under the so-called public regime, through a concession agreement, which is expected to remain in force until 2025. In accordance with current regulations, Telefônica Brazil informed the Brazilian regulatory authority (*Agencia Nacional de Telecomunicações* or "ANATEL") that the net value of assets assigned to the provision of STFC was estimated to total 8,763 million Brazilian reais as of December 31, 2017 (approximately 2,209 million euros under the exchange rate applicable on such date). Under current regulations, Telefónica must update this information by April 30, 2018 by sending the updated list and value of the assets assigned to the provision of STFC as of December 31, 2017. In principle, such assets were considered to be reversible assets, and were thus supposed to be reverted to the Federal Government at the end of the concession agreement. A bill amending the regulatory framework in Brazil is in process, establishing, among other things, that such assets would no longer be reversible under a new license regime in exchange for significant broadband investment commitments. The bill has been approved at both legislative houses but has been challenged before the Federal Supreme Court due to an alleged procedural defect. The outcome of this lawsuit is uncertain, although the Senate's governing board may overcome it by

sending the bill for voting in the Plenary (such action depends on the political environment, which is also uncertain). Such Court and, consequently, the Senate's governing board, has each decided to send the bill for voting in the Plenary. In the event that the bill is finally approved, ANATEL would be entitled to adopt the relevant administrative decisions for the amendment of the respective licenses with the consequent amendment of the future obligations imposed on STFC providers.

In Colombia, the ITC issued resolution 597 on March 27, 2014 to renew 850 MHz/1900 MHz band licenses for ten additional years. Under the scope of such resolution, Colombia Telecomunicaciones, S.A., ESP ("ColTel") (67.5% of which is owned, directly and indirectly, by Telefónica and 32.5% of which is owned by the government of Colombia), renewed its license to exploit such radioelectric spectrum to provide telecommunication services.

The concession agreements from 1994, which were renewed in 2004 and under which the mobile telephone services were provided until 28 November 2013, contained a reversion clause for the underlying assets. However, Law 422 of 1998 and Law 1341 of 2009 provided that upon expiration of a concession agreement for telecommunication services, only the spectrum reverts to the State. That was the understanding under which all the operators, including the authorities, were operating between 1998 and 2013. In 2013, however, when analyzing an appeal on the constitutionality of said laws, the Constitutional Court confirmed the constitutionality of the laws but ruled that it could not be concluded that those laws modified with retroactive effect the reversion clause of the concession agreements of 1994. On February 16, 2016, the ITC started an arbitration proceeding against ColTel and other defendants in accordance with the terms of the relevant concession agreement of 1994, in order to clarify the validity and scope of such reversion clause. The arbitration award was rendered on July 25, 2017 and was not favorable to ColTel and its co-defendants.

The arbitration tribunal ordered ColTel to pay 1,651,012 million Colombian pesos, after finding on August 4, 2017 that an arithmetic error required that the amount contained in the original award from July 25, 2017 be revised slightly downwards. On August 29, 2017, the shareholders' meeting of ColTel approved a capital increase in a total amount of 1,651,012 million Colombian pesos, 470 million euros at the exchange rate as of such date, to pay the amount imposed by the arbitration award. The Telefónica Group and the Colombian government subscribed the capital increase pro rata to their respective shareholding in ColTel. Telefónica's decision to participate in the capital increase does not constitute, and should not be understood as, an acceptance of the arbitration award. Telefónica reserves all of its legal rights and the exercise by Telefónica or ColTel of any applicable legal action, national or international. Both ColTel and Telefónica have started legal actions. On August 18, 2017, ColTel filed an appeal to challenge the arbitration award at Colombia's highest court of administrative litigation (*Consejo de Estado*). In addition, on December 18, 2017, ColTel also filed a constitutional action "*acción de tutela*" seeking to protect its constitutional rights jeopardized by the arbitration award. On the other hand, pursuant to the relevant bilateral treaty, Telefónica notified Colombia of its intention to file a claim in the International Centre for Settlement of Investment Disputes ("ICSID") after the expiration of the 90-day notice period. After the expiration of such deadline, on February 1, 2018, Telefónica submitted the arbitration request to the ICSID.

In Peru, Telefónica has concessions for the provision of fixed-line services until November 2027. In December 2013, Telefónica filed a partial renewal request for these concessions for five more years. In December 2014 and June 2016, Telefónica filed renewal requests for an additional twenty years in relation to a concession for the provision of local carrier services and to one of the concessions to provide mobile line services in certain provinces, respectively. As of the date of this Annual Report, the decision of the

Ministry of Transport and Communications (*Ministerio de Transportes y Comunicaciones*) in these proceedings is still pending and, according to the legislation, the underlying concessions remain in force as long as the proceedings are pending.

Telefónica Móviles Chile, S.A. was awarded 2x10 MHz spectrum on the 700 MHz band in March 2014. While services are being provided on such spectrum, a consumer organization filed a claim against the allocation of spectrum on the 700 MHz band that is still pending.

During 2017, the Group's consolidated investment in spectrum acquisitions and renewals amounted to 538 million euros.

#### *Regulation of wholesale services*

The EC's proposal in respect of the regulatory framework intends, among other measures, to incorporate a methodology and a European upper limit for the call-termination prices for landline phones/mobile phones (FTRs/MTRs) applicable in the EU. The decreases in wholesale mobile termination rates ("**MTRs**") in Europe are noteworthy. Since termination fees in mobile and fixed communications have decreased substantially in recent years, future decreases are expected to become smaller so that the negative impact on turnover is expected to be less significant than in the past.

In the United Kingdom, the current rate is 0.495 pence per minute. On June 27, 2017, Ofcom made a consultation on a proposal for a progressive reduction over a three-year period from April 1, 2018, which would result in a 10% reduction in real terms in MTRs during that period.

In Spain, in November 2017, the Spanish National Regulatory and Competition Authority (*Comisión Nacional de los Mercados y la Competencia* or "**CNMC**") submitted to the EC the draft measures to set the new MTRs for all the mobile operators, which would imply a progressive reduction of 40% from current levels. The proposed dates and MTRs would be as follows: since the decision becomes effective until December 31, 2018 at 0.0070 €/min; from January 1, 2019 until December 31, 2019 at 0.0066 €/min; and as from January 1, 2020 at 0.0064 €/min. A final decision was adopted in 2018 setting the rate at 0.0067 €/min during the year 2019.

In Latin America, the Group believes it is likely that MTRs will also be reduced in the short to medium term.

In Brazil, the *Plano Geral de Metas de Competição* ("**PGMC**"), amended by Resolution 649/2015, established that mobile termination fees are subject to successive yearly reductions from 2016 until 2019, when the definitive cost-oriented-model fees are expected to be in force (such Resolution has been challenged in courts and the proceedings are ongoing). On December 5, 2016, ANATEL issued a public consultation for the revision of the PGMC, which addresses changes in the relevant wholesale markets regulated by the PGMC and also in the cost-oriented model. ANATEL is expected to deliberate on the new regulations during 2018.

In Mexico, on November 9, 2017, the *Instituto Federal de Telecomunicaciones* ("**IFT**") announced that the MTRs applicable to the so-called Prevailing Economic Agent ("**PEA**") for 2018 shall be 0.028562 pesos per minute while the MTRs applicable to the operators other than the PEA shall be 0.112799. The IFT fixed the MTRs on the PEA's network as a result of a prior ruling of the Supreme Court of Justice in favor of the PEA and against its obligation to refrain from charging fees for the termination of mobile, fixed and SMS traffic on its network.



In Peru, the *Organismo Supervisor de las Telecomunicaciones* ("**OSIPTEL**") started in November 2016 the process to amend the maximum MTRs. On January 28, 2018, OSIPTEL published the caps on interconnection rates for MTRs. The approved rate is the same for all networks and entails a decrease of 63% (USD 0.00661 per minute rated at the second). The new fees established by OSIPTEL will apply as of the adoption of the regulation.

As a result of the foregoing regulatory actions, Telefónica may receive lower prices for certain of its services, which may materially adversely affect its business, financial condition, results of operations and/or cash flows. During the year ended December 31, 2017 the negative impact of these regulations is estimated to have resulted in the deduction of approximately 1 percentage point from the organic growth of the Group's revenues.

#### *Regulation of universal service obligations*

Universal service obligations ("**USO**") refers to the obligations imposed on telecommunication operators which are aimed at granting access to all the consumers in a country to a minimum set of services offered at reasonable and fair prices in order to avoid social exclusion. On its proposal for the reform of the regulatory framework issued on September 14, 2016, the EC sought to modernize USO in Europe, removing the mandatory inclusion of the legacy outdated services (telephone boxes, directories and information services) and focusing on the provision of affordable broadband services. The EC also proposed that USO should be funded out of general budgets and not from the sectoral budget. However, if this funding method does not thrive, the inclusion of affordable broadband services could end up being more expensive for the sector. In any case, the new regulation is not expected to be applicable before 2020.

In Spain, the USO for 2017 were extended for 2018, with Telefónica being responsible for the provision of the elements of Universal Service to fixed-broadband access, pay phones and directories.

In Brazil, a proposal of the General Plan for Universalization of Fixed Switched Telephony Services was approved by ANATEL in 2016. The final version, however, has not been published because the amendment to the underlying concession agreement has not been yet finalized.

The imposition on the Telefónica Group of additional or more onerous USO in the jurisdictions where it operates could have a material adverse effect on its business, financial condition, results of operations and/or cash flows.

#### *Regulation of fiber networks*

On December 29, 2017, a draft measure on the economic replicability methodology to be used to assess the maximum wholesale access price which Telefónica could charge to other operators for accessing the optical fiber network in regulated areas (NEBA Local and NEBA services), was notified to the EC establishing a maximum wholesale access price of 16.38 €/month. The final decision is expected within the current first quarter of 2018. In June 2017, CNMC launched a public consultation on the methodology to analyze if Telefónica's business offers can be replicated by other operators. The final decision is not expected before mid-2018.

Any of such obligations and restrictions could raise costs and limit Telefónica's freedom to provide the aforementioned services, which could materially adversely affect Telefónica's business, financial condition, results of operations and/or cash flows.

*Regulations on privacy*

In Europe, the General Data Protection Regulation ("**GDPR**") of April 27, 2016, will be directly applicable in all Member States from May 25, 2018. In addition, on January 10, 2017, the EC presented its proposal for a Regulation on privacy and electronic communications ("**ePrivacy**"), which will replace the current Directive 2002/58/EC. The proposal implies an extra layer of regulation on top of the GDPR and also introduces administrative fines of up to 4% of an undertaking's annual global turnover for breaching new regulations. In this area, a strict data protection and privacy regulation may result in limitations on the ability to offer innovative digital services such as big data services. The future ePrivacy Regulation is not expected to be adopted before the end of 2018.

The Privacy Shield, approved by the EC on July 12, 2016 to lay out the framework for the international transfer of personal data from the EU to the US, has been challenged before the EU's General Court by civil-society groups, but the admission of their appeals is still pending as at the date of this Annual Report. Nevertheless, the EC completed on October 18, 2017 its first annual review on the performance of the Privacy Shield and concluded that the Privacy Shield continues to ensure an adequate level of data protection for personal data of European citizens.

In Brazil, the adoption of a Personal Data Protection Act is still pending. This act could lead to further obligations and restrictions for operators in relation to the collection of personal data and its treatment.

Any obligations and restrictions arising from privacy regulations could raise costs and limit Telefónica's ability to provide certain services, which could materially adversely affect Telefónica's business, financial condition, results of operations and/or cash flows.

*Regulation of network neutrality*

Under the principle of network neutrality applicable to the Internet access services realm, network operators are not permitted to establish technical or commercial restrictions regarding the terminals that can be connected or the services, or applications and contents that can be accessed or distributed through the Internet by the end user. It also refers to the non-discriminatory behavior (e.g. non-anticompetitive) to be adopted by operators regarding the different types of Internet traffic circulating through their networks.

In Europe, network neutrality is regulated by Regulation (EU) 2015/2120 of November 25, 2015.

Telefónica operates in Latin American countries where net neutrality is being implemented, such as Chile, Colombia, Mexico, Peru (where OSIPTEL implemented regulations on net neutrality on January 1, 2017) and in Brazil. In Mexico, it is expected that IFT will issue guidelines during 2018. In Chile, on November 22, 2016, the Commission of Telecommunications submitted a bill for amending the Network Neutrality Act. The main changes proposed concern the establishment of rules applying measures for traffic management and restrictive rules for "Zero Rating".

If changes to regulation such as those described above, or otherwise, occur in the various jurisdictions where the Telefónica Group operates, it could have a material adverse effect on its business, financial condition, results of operations and/or cash flows.



**The Telefónica Group is exposed to risks in relation to compliance with anti-corruption laws and regulations and economic sanctions programs.**

The Telefónica Group is required to comply with the laws and regulations of various jurisdictions where it conducts operations. In particular, the Group's international operations are subject to various anti-corruption laws, including the US Foreign Corrupt Practices Act of 1977 and the United Kingdom Bribery Act of 2010, and economic sanctions programs, including those administered by the United Nations, the European Union and the United States, including the US Treasury Department's Office of Foreign Assets Control. The anti-corruption laws generally prohibit providing anything of value to government officials for the purposes of obtaining or retaining business or securing any improper business advantage. As part of the Telefónica Group's business, it may deal with entities, the employees of which are considered government officials. In addition, economic sanctions programs restrict the Group's business dealings with certain sanctioned countries, individuals and entities.

Although the Group has internal policies and procedures designed to ensure compliance with applicable anti-corruption laws and sanctions regulations, there can be no assurance that such policies and procedures will be sufficient or that the Group's employees, directors, officers, partners, agents and service providers will not take actions in violation of the Group's policies and procedures (or otherwise in violation of the relevant anti-corruption laws and sanctions regulations) for which the Group or they may be ultimately held responsible. Violations of anti-corruption laws and sanctions regulations could lead to financial penalties, exclusion from government contracts, damage to the Group's reputation and other consequences, that could have a material adverse effect on the Group's business, results of operations and financial condition.

As of the date of this Annual Report, Telefónica is conducting internal investigations covering various countries regarding possible violations of applicable anti-corruption laws. Telefónica has been in contact with and cooperating with governmental authorities about these matters and intends to continue to cooperate with those authorities as the investigations continue. It is not possible at this time to predict the scope or duration of these matters or their likely outcome.

**Customers' perceptions of services offered by the Company may put it at a disadvantage compared to competitors' offerings.**

Customers' perceptions of the assistance and services offered are critical to operating in highly-competitive markets. The ability to predict and respond to the changing needs and demands of customers affects Telefónica's competitive position relative to other technology sector companies, and its ability to extract the value generated during the process of digital transformation we are immersed in. Failure to do so adequately could have an adverse impact on the Group's business, financial condition, results of operations and/or cash flows.

**Telefónica may not be able to adequately foresee and respond to technological changes and sector trends.**

In a sector characterized by rapid technological change, it is essential to be able to offer the products and services demanded by the market and consider the impacts of changes in the life cycle of technical assets, secure margins and select the right investments to make.

The Telefónica Group operates in markets that are highly competitive and subject to constant technological development. Therefore, as a consequence of both of these characteristics, it is subject to the effects of

actions by competitors in these markets and to its ability to anticipate and adapt, in a timely manner, to constant technological changes, changes in customer preferences that are taking place in the industry, as well as economic, political and social circumstances. The entry of new competitors in the markets where the Group is the leader, such as Chile and Peru, has resulted in the Group losing market share in the mobile phone market during the period between 2014 and the end of 2017. In this competitive environment, the Group has focused on its high-value customers and estimates that the loss of revenues has been lower than the loss of accesses.

Failure to adequately anticipate and adapt to constant technological changes, changes in customer preferences that are taking place in the industry, as well as economic, political and social circumstances could have an adverse effect on the Group's business, financial condition, results of operations and/or cash flows.

New products and technologies arise constantly and their development can render obsolete the products and services the Telefónica Group offers and the technology it uses. This means that Telefónica must invest in the development of new products, technology and services so it can continue to compete effectively with current or future competitors, which may result in the decrease of the Group's profits and revenue margins. In this respect, margins from traditional voice and data business are shrinking, while new sources of revenues are deriving from mobile Internet and connectivity services that are being launched. Research and development costs amounted to 862 million euros in 2017, representing a decrease of 4.8% from 906 million euros in 2016 (1,055 million euros in 2015). These expenses represented 1.7%, 1.7% and 1.9% of the Group's consolidated revenues in 2017, 2016 and 2015, respectively. These figures have been calculated using the guidelines established in the Organization for Economic Cooperation and Development ("**OECD**") manual. One technology that telecommunications operators, including Telefónica (in Spain and Latin America), are focused on is the new FTTx-type network, which offers broadband access using optical fiber with superior services, such as Internet speed of up to 300MB or HD television services. However, substantial investment is required to deploy these networks, which entails fully or partially substituting copper loop access with optic fiber. In Spain, as of December 2017 Telefónica has already 19.2 million premises passed with fibre (representing 66% of the households), which shows the level of investment required. While an increasing demand for the capabilities offered by these new networks to end users exists, the high level of the investments requires a continuous analysis of the return on investment.

The explosion of the digital market and entry of new players in the communications market, such as MVNOs, Internet companies or device manufacturers, may cause the loss of value of certain assets, and affect the Group's ability to generate income. Therefore, it is necessary to update the business model, encouraging the pursuit of income and additional efficiencies to those traditionally sought. Failure to do so adequately could have an adverse effect on the Group's business, financial condition, results of operations and/or cash flows.

In addition, the ability of the Telefónica Group's IT systems (operational and backup) to respond to Telefónica's operating requirements is a key factor to be taken into account with respect to the commercial development, customer satisfaction and business efficiency. Any failure by Telefónica Group's IT systems to adequately respond to the Group's evolving operating requirements could have an adverse effect on the Group's business, financial condition and/or results of operations.

**Telefónica depends on its suppliers.**

The existence of critical suppliers in the supply chain, especially in areas such as network infrastructure, information systems or handsets, with a high concentration in a small number of suppliers, poses risks that may affect Telefónica's operations, and may cause legal contingencies or damages to its image in the event that inappropriate practices are produced by a participant in the supply chain.

As of 31 December 2017, the Telefónica Group depended on three handset suppliers and 10 network infrastructure suppliers, which, together, accounted for 79% and 78%, respectively, for the awarded contracts as of such date (for their products groups). One of the handset suppliers represented two-fifths of all handset allocations as of such date. These suppliers may, among other things, extend delivery times, raise prices and limit supply due to their own stock shortfalls and business requirements.

If these suppliers fail to deliver products and services to the Telefónica Group on a timely basis, it could jeopardize network deployment and expansion plans, which in some cases could adversely affect the Telefónica Group's ability to satisfy its license terms and requirements, or otherwise have an adverse effect on the Group's business, financial condition, results of operations and/or cash flows.

**Unanticipated network interruptions can lead to quality loss or the interruption of the service.**

Unanticipated network interruptions as a result of system failures, including those due to natural disasters caused by natural or meteorological events (due, in turn, to extreme weather conditions, especially in the geographies with greater exposure to them), network, hardware or software failures, stealing of infrastructure elements or cyber-attacks, which affect the quality of or cause an interruption in the Telefónica Group's service, could lead to customer dissatisfaction, reduced revenues and traffic, costly repairs, penalties or other measures imposed by regulatory authorities and could harm the Telefónica Group's image and reputation.

Telecommunications companies worldwide face increasing cybersecurity threats as businesses have become increasingly dependent on telecommunications and computer networks and adopt cloud computing technologies. Cybersecurity threats may include gaining unauthorized access to Telefónica's systems or inserting computer viruses or malicious software in its systems to misappropriate consumer data and other sensitive information, corrupt Telefónica's data or disrupt its operations. Unauthorized access may also be gained through traditional means such as the theft of laptop computers, data devices and mobile phones and intelligence gathering on employees with access. Further, our employees or other persons may have unauthorized or authorized access to our systems and/or take actions that affect our networks in an inconsistent manner with the Group's policies or otherwise adversely affect the Group or its ability to adequately process internal information.

Telefónica attempts to mitigate these risks through a number of measures, including backup, log review, vulnerabilities checks, network segregation measures and protective systems such as firewalls, intrusion detection or prevention systems, virus scanners and other physical and logical security measures. However, the application of these measures may not always be effective. Although the Telefónica Group has insurance policies to cover these types of incidents, and the claims and loss in revenue caused by service interruptions to date have been covered by these policies, these policies may not be sufficient to cover all possible monetary losses.

**The telecommunications industry may be affected by the possible effects that electromagnetic fields, emitted by mobile devices and base stations, may have on human health.**

In some countries, there is a concern regarding potential effects of electromagnetic fields, emitted by mobile devices and base stations, on human health. This public concern has caused certain governments and administrations to take measures that have hindered the deployment of the infrastructures necessary to ensure quality of service, and affected the deployment criteria of new networks and digital services such as smart meters development.

There is a consensus between certain expert groups and public health agencies, including the World Health Organization, that states that currently there are no established risks associated with exposure to low frequency signals in mobile communications. However, the scientific community is still investigating this issue especially with respect to mobile devices. Exposure limits for radio frequency suggested in the guidelines of the Protection of Non-Ionizing Radiation Protection Committee have been internationally recognized. The mobile industry has adopted these exposure limits and works to request authorities worldwide to adopt these standards.

Worries about radio frequency emissions may discourage the use of mobile devices and new digital services, which could cause the public authorities to implement measures restricting where transmitters and cell sites can be located, how they operate, the use of mobile telephones and the massive deployment of smart meters and other products using mobile technology. This could lead to Telefónica being unable to expand or improve its mobile network.

The adoption of new measures by governments or administrations or other regulatory interventions in this respect, and any future assessment on the adverse impact of electromagnetic fields on health, may adversely affect the business, financial conditions, results of operations and/or cash flows of the Telefónica Group.

**Possible regulatory, business, economic or political changes could lead to asset impairment.**

The Telefónica Group reviews on an annual basis, or more frequently when the circumstances require it, the value of assets and cash-generating units, to assess whether their carrying values can be supported by the future expected cash flows, including, in some cases synergies allowed for in acquisition costs. Potential changes in the regulatory, business, economic or political environment may result in the need to introduce changes to estimates made and to recognize impairments in goodwill, intangible assets, property, plant and equipment or financial assets. Although the recognition of impairments of these assets results in a non-cash charge on the income statement, it could adversely affect the results of the Telefónica Group's operations. In this respect, the Telefónica Group has experienced impairments on certain of its investments, affecting its results of operations in the year in which they were experienced. No impairments were recognized in 2017. In 2016, impairment losses in goodwill were recognized amounting to an aggregate amount of 215 million euros, relating to Telefónica's operations in Venezuela (124 million euros) and in Mexico (91 million euros).

**The Telefónica Group's networks carry and store large volumes of confidential, personal and corporate data, and its Internet access and hosting services may lead to claims for illegal or illicit use of the Internet.**

The Telefónica Group's networks carry and store large volumes of confidential, personal and business data, through both voice and data traffic. The Telefónica Group stores increasing quantities and types of customer data in both business and consumer segments. Despite its best efforts to prevent it, the Telefónica Group

may be found liable for any loss, transfer, or inappropriate modification of the customer data or general public data stored on its servers or transmitted through its networks, any of which could involve many people and have an impact on the Group's reputation, or lead to legal claims and liabilities that are difficult to measure in advance.

In addition, the Telefónica Group's Internet access and hosting servers could lead to claims for illegal or unlawful use of the Internet. Telefónica, like other telecommunications providers, may be held liable for any loss, transfer or inappropriate modification of the customer data stored on its servers or carried by its networks.

In most countries in which the Telefónica Group operates, the provision of its Internet access and hosting services (including the operation of websites with shelf-generated content) are regulated under a limited liability regime applicable to the content that it makes available to the public as a technical service provider, particularly content protected by copyright or similar laws. However, regulatory changes have been introduced imposing additional obligations on access providers (such as blocking access to a website) as part of the struggle against some illegal or illicit uses of the Internet, notably in Europe.

Any of the foregoing could have an adverse effect on the business, financial position, results of operations and/or cash flows of the Group.

**Telefónica and Telefónica Group companies are party to lawsuits, tax claims, antitrust and other legal proceedings.**

Telefónica and Telefónica Group companies are party to lawsuits, tax claims, antitrust and other legal proceedings in the ordinary course of their businesses, the financial outcome of which is unpredictable. An adverse outcome or settlement in these or other proceedings could result in significant costs and may have a material adverse effect on the Group's business, financial condition, results of operations, reputation and/or cash flows. In particular, the Telefónica Group is party to certain judicial tax proceedings in Peru concerning the clearance of certain previous years' income tax, in respect of which a contentious-administrative appeal is currently pending and to certain tax and regulatory proceedings in Brazil, primarily relating to the ICMS (a Brazilian tax on telecommunication services) and the corporate tax. Further details on these matters are provided in Notes 15, 17 and 21 to the Consolidated Financial Statements.





*This version of our report is a free translation of the original, which was prepared in Spanish. All possible care has been taken to ensure that the translation is an accurate representation of the original. However, in all matters of interpretation of information, views or opinions, the original language version of our report takes precedence over this translation.*

## **INDEPENDENT REASONABLE ASSURANCE REPORT ON THE DESIGN AND EFFECTIVENESS OF THE INTERNAL CONTROL OVER FINANCIAL REPORTING (ICFR)**

To the Board of Directors of Telefónica, S.A.:

We have carried out a reasonable assurance report of the design and effectiveness of the Internal Control over Financial Reporting (hereinafter, ICFR) and the description of it that is included in the attached Report that forms part of the corresponding section of the Annual Corporate Governance Report of the Directors Report accompanying the consolidated financial statements of Telefónica, S.A., and its subsidiaries (hereinafter, the Telefónica Group) as at December 31, 2017. This system is based on the criteria and policies defined by the Telefónica Group in accordance with the guidelines established by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in its "Internal Control-Integrated Framework 2013" report.

An Internal Control over Financial Reporting is a process designed to provide reasonable assurance over the reliability of financial information in accordance with the applicable financial reporting framework and includes those policies and procedures that: (i) enable the records reflecting the transactions performed to be kept accurately and with a reasonable level of detail; (ii) provide reasonable assurance as to the proper recognition of transactions to make it possible to prepare the financial information in accordance with the accounting principles and standards applicable to it and that they are made only in accordance with established authorizations; and (iii) provide reasonable assurance in relation to the prevention or timely detection of unauthorised acquisitions, use or sales of the Group's assets that could have material effect on the financial information.

### **Inherent Limitations**

In this regard, it should be borne in mind that, given the inherent limitations of any Internal Control over Financial Reporting, regardless of the quality of the design and operation of the system, it can only allow reasonable, but not absolute security, in relation to the objectives it pursues, which may lead to errors, irregularities or fraud that may not be detected. On the other hand, the projection to future periods of the evaluation of internal control is subject to risks such that said internal control being inadequate as a result of future changes in the applicable conditions, or that in the future the level of compliance of the established policies or procedures may be reduced.

### **Director's responsibility**

The Directors of Telefónica, S.A. are responsible for taking the necessary measures to reasonably ensure the implementation, maintenance and supervision of an appropriate Internal Control over Financial Reporting, as well as the evaluation of its effectiveness, the development of improvements to that system and the preparation and establishment of the content of the information relating to the ICFR attached.



### **Our Responsibility**

Our responsibility is to issue a reasonable assurance report on the design and effectiveness of the Telefónica Group Internal Control over Financial Reporting, based on the work we have performed and on the evidence we have obtained. We have performed our reasonable assurance engagement in accordance with "International Standard on Assurance Engagements 3000 (ISAE 3000)" (Revised), "Assurance Engagements other than Auditing or Reviews of Historical Financial Information", issued by the International Auditing and Assurance Standards Board (IAASB) of the International Federation of Accountants (IFAC).

A reasonable assurance report includes the understanding of the Internal Control over Financial Reporting, assessing the risk of material weaknesses in the internal control, that the controls are not properly designed or they do not operate effectively, the execution of tests and evaluations on the design and effective implementation of this ICFR, based on our professional judgment, and the performance of such other procedures as may be deemed necessary.

We believe that the evidence we have obtained provides a sufficient and adequate basis for our opinion.

### **Our Independence and Quality Control**

We have complied with the independence requirements and other ethical requirements of the Accounting Professionals Code of Ethics issued by the International Ethics Standards Board for Accountants (IESBA), which is based on the fundamental principles of integrity, objectivity, professional competence and diligence, confidentiality and professional behavior.

Our firm applies the "International Standard on Quality Control 1 (ISQC 1)" and maintains an exhaustive qualitative control system that includes documented policies and procedures regarding compliance with ethical requirements, professional standards, and applicable legal and regulatory provisions.

### **Opinion**

In our opinion, the Telefónica Group maintained, as at December 31, 2017, in all material respects, an effective Internal Control over Financial Reporting for the period ended at December 31, 2017, which is based on the criteria and the policies defined by the Telefónica Group's management in accordance with the guidelines established by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in its "Internal Control-Integrated Framework 2013" report.

In addition, the attached description of the ICFR Report as at December 31, 2017 has been prepared, in all material respects, in accordance with the requirements established by article 540 of the Consolidated Text of the Capital Companies Act and with the Circular 5/2013 of June 12, 2013 of the CNMV, as amended by CNMV Circular No. 7/2015 dated December 22, 2015 for the purposes of the description of the ICFR in the Annual Reports of Corporate Governance.

This work does not constitute an audit nor is it subject to the regulations governing the audit activity in force in Spain, so we do not express any audit opinion in the terms provided in the aforementioned regulations.

PricewaterhouseCoopers Auditores, S.L.

A handwritten signature in blue ink, appearing to read "Virginia Arce", followed by a horizontal line and a small flourish.

Virginia Arce Peralta

February 22, 2018