

# 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
2014-12-09	4,657,204,330.00	4,657,204,330	4,657,204,330

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 organization 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.	291,194,876	13,132	6.25%
Fundación Bancaria Caixa d'Estalvis i Pensions de Barcelona, "la Caixa"	0	244,647,885	5.25%
Blackrock, Inc.	0	177,257,649	3.81%

Name or corporate name of indirect holder	Through: Name or corporate name of the direct holder	Number of voting rights
Banco Bilbao Vizcaya Argentaria, S.A.	BBVA Seguros, S.A. de Seguros y Reaseguros	13,132
Fundación Bancaria Caixa d'Estalvis i Pensions de Barcelona, "la Caixa"	Caixabank, S.A.	244,604,533
Fundación Bancaria Caixa d'Estalvis i Pensions de Barcelona, "la Caixa"	Vidacaixa, S.A. Seguros y Reaseguros	43,352
Blackrock, Inc	Blackrock Investment Management (UK)	177,257,649

Indicate the most significant movements in the shareholder 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 director	Number of direct voting rights	Number of indirect voting rights	% of total voting rights
Mr. César Alierta Izuel	4,545,928	0	0.10%
Mr. Isidro Fainé Casas	523,414	0	0.01%
Mr. José María Abril Pérez	97,288	111,481	0.00%
Mr. Julio Linares López	430,923	1,941	0.01%
Mr. José María Álvarez-Pallete López	335,260	0	0.01%
Mr. José Fernando de Almansa Moreno-Barreda	19,562	0	0.00%
Ms. Eva Castillo Sanz	99,863	0	0.00%
Mr. Carlos Colomer Casellas	49,360	63,190	0.00%
Mr. Peter Erskine	73,111	0	0.00%
Mr. Santiago Fernández Valbuena	111,210	0	0.00%
Mr. Alfonso Ferrari Herrero	603,105	20,057	0.01%
Mr. Luiz Fernando Furlán	35,031	0	0.00%
Mr. Gonzalo Hinojosa Fernández de Angulo	47,725	197,474	0.01%
Mr. Pablo Isla Álvarez de Tejera	9,067	0	0.00%
Mr. Antonio Massanell Lavilla	2,413	0	0.00%
Mr. Ignacio Moreno Martínez	13,076	0	0.00%
Mr. Francisco Javier de Paz Mancho	57,024	0	0.00%

Name or company name of indirect shareholder	Through: Name or company name of direct shareholder	Number of voting rights
Mr. José María Abril Pérez	Other shareholders of the company	111,481
Mr. Julio Linares López	Other shareholders of the company	1,941
Mr. Carlos Colomer Casellas	Other shareholders of the company	63,190
Mr. Alfonso Ferrari Herrero	Other shareholders of the company	20,057
Mr. Gonzalo Hinojosa Fernández de Angulo	Other shareholders of the company	197,474

% of total voting rights held by the Board of Directors	0,16%
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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	% total voting rights
Mr. César Alierta Izuel	972,417	0	1,519,401	0.02%
Mr. Julio Linares López	13,878	0	21,686	0.00%
Mr. José María Álvarez-Pallete López	572,131	0	893,955	0.01%
Mr. Santiago Fernández Valbuena	1,311,223	0	1,486,287	0.03%

**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 insignificant or arise from ordinary trading or exchange activities:**

Name or company name of related party	Type of relationship	Brief description
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**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 insignificant 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	Joint shareholding with Telefónica Móviles España, S.A.U. in Mobipay España, S.A.
Banco Bilbao Vizcaya Argentaria, S.A.	Corporate	Joint shareholding of Banco Bilbao Vizcaya Argentaria, S.A. (or any of its Group Companies), with Telefónica, S.A. and with Caixabank, S.A., in Telefónica Factoring España, S.A., Telefónica Factoring Perú, S.A.C. (TFP), 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.
Fundación Bancaria Caixa d' Estalvis i Pensions de Barcelona, "la Caixa"	Corporate	Joint shareholding of Caixabank, S.A. with Telefónica, S.A. and with Banco Bilbao Vizcaya Argentaria, S.A. (or any of its Group Companies), in Telefónica Factoring España, S.A., Telefónica Factoring Perú, S.A.C., 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.
Fundación Bancaria Caixa d' Estalvis i Pensions de Barcelona, "la Caixa"	Corporate	Joint shareholding of Finconsum, Establecimiento Financiero de Crédito, S.A.U. (subsidiary of CaixaBank, S.A.) with Telefónica, S.A., in Telefónica Consumer Finance, Establecimiento Financiero de Crédito, S.A.
Fundación Bancaria Caixa d' Estalvis i Pensions de Barcelona, "la Caixa"	Corporate	Joint shareholding of Caixa Card 1 Establecimiento Financiero de Crédito, S.A.U. with Telefónica Digital España, S.L., and with Banco Santander, S.A., in Yaap Digital Services, S.L.

- A.6. Indicate whether any shareholders' agreements have been notified to the company pursuant to Articles 530 and 531 of the Corporate Enterprises 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

Shareholders bound by agreement	
Telefónica, S.A.	
China Unicom (Hong Kong) Limited	
% of share capital affected	
	1.38%

Brief description of the agreement:

See Section H "Other Information of Interest", Note 3 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

Shareholders involved in concerted action	% of share capital affected	Brief description of the concerted action
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Expressly indicate any amendments to or termination of such agreements or concerted actions during the year:

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- A.7. Indicate whether any individuals or bodies corporate currently exercise control or could exercise control over the company in accordance with Article 4 of the Spanish Securities' Market Act (*Ley del Mercado de Valores*). If so, identify:

No

Name or corporate name
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Remarks
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**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
128,227,971	0	2.75%

(\*) Through:

Name or corporate name of direct shareholder	Number of shares held directly
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<b>Total</b>	

**Give details of any significant changes during the year, in accordance with Royal Decree 1362/2007:**

Date of notification	Total number of direct shares acquired	Total number of indirect shares acquired	% of total share capital
2014/01/29	47,122,215	0	1.04%
2014/07/01	46,011,480	0	1.01%

**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 authorization 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) To authorize, pursuant to the provisions of Section 144 et seq., of the Spanish Companies Act (Ley de Sociedades de Capital), the derivative acquisition by Telefónica, S.A. -either directly or through any of the subsidiaries- at any time and as many times as it deems appropriate, of its own fully-paid in shares through purchase and sale, exchange or any other legal transaction.

The minimum price or minimum value consideration shall be equal to the par value of the shares of its own stock acquired, and the maximum acquisition price or maximum value consideration 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 any of its 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 market 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 their option rights, 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 shareholders at the Ordinary General Shareholders Meeting of the Company on June 2, 2010".

**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**

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**Description of the restrictions**

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See Section H "Other Information of Interest", Note 4 to Section A.10

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**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.

The shares of Telefónica, S.A. are traded on the Spanish Continuous Markets, as well as on the markets of New York, London, Lima and Buenos Aires, and all shares have the same characteristics, rights and obligations.

On the stock markets of New York and Lima, Telefónica, S.A.'s shares are traded via American Depositary Shares (ADSs), representing each ADS one share in the Company.

## B. General Shareholders' Meeting

- B.1. Indicate the quorum required for constitution of the General Shareholders' Meeting established in the company's By-laws. Describe how it differs from the system of minimum quorums established in the Corporate Enterprises 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 By-laws. In particular, indicate the majorities required to amend the By-laws and, if applicable, the rules for protecting shareholders' rights when changing the By-laws.**

The Articles of Association and the Rules of Procedure of the Telefónica General Meeting of Shareholders award to the General Meeting of Shareholders the power to amend the Articles of Association (articles 15 and 5, respectively), referring otherwise to the applicable legal provisions.

The procedure to amend the Articles of Association is set down in articles 285 and thereafter in the Corporate Enterprises Act, and requires approval by the General Meeting of Shareholders with the majorities foreseen in articles 194 and 201 of the aforementioned Act. In particular, if the General Meeting is held to deliberate amendments to the Articles of Association, including capital increases and decreases, eliminating or limiting the right to first refusal to buy shares, and the transformation, merger, spin-off and global conveyance of assets and liabilities and transferring the registered office abroad, shall be necessary, at the first call, these decisions require the attendance of shareholders or representatives of shareholders representing at least fifty percent of the subscribed capital with voting rights. If there is not a sufficient quorum, a General Meeting will be held where the attendance of at least twenty five percent of the subscribed stock capital with voting rights. Where the shareholders in attendance represent less than fifty percent of the subscribed capital with voting rights, the decisions referred to in the paragraph above may only be validly adopted with the vote in favour of at least two thirds of the capital presented or represented at the Meeting.

Pursuant to the provisions of article 286 of the Corporate Enterprises Act, in the event the Articles of Association are amended, the Directors or, where applicable, the partners tabling the proposal must write the full text of their proposal amendment, and a written report to justify the change, which must be made available to the shareholders for the General Meeting called to deliberate on said amendment.

Furthermore, and pursuant to article 287 of the Corporate Enterprises Act, the announcement of a meeting of the General Assembly should explicitly state with due clarity the points to be amended, and mention the right of all partners to examine the full text of the proposal amendment and the report at the company's headquarters, and to request the delivery or sending of said documents free of charge.

Article 291 of the Corporate Enterprises Act set out that where changes to the Articles of Association involve new obligations for the partners the affected parties must give their consent to the decision. Equally, if the amendment directly or indirectly affects a class of shareholders, or part thereof, the provisions of article 293 of the aforementioned Act must be applied.

The voting procedure on proposals is governed by article 197 bis of the Corporate Enterprises Act and by Telefónica's internal regulations (in particular, article 23 of the Rules of Procedure of the General Assembly). These states, i.e., that in

case of amending the Articles of Association, each substantially independent article of group of articles shall be voted on 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	
2013/05/31	6.53%	47.35%	0.01%	0.59%	54.48%
2014/05/30	5.66%	48.65%	0.01%	0.48%	54.80%

**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
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**B.6. Indicate whether decisions involving a fundamental corporate change ("subsidiarization", acquisitions/disposals of key operating assets, operations that effectively entail the company's liquidation...) must be submitted to the General Shareholders' Meeting for approval or ratification even when not expressly required under company law.**

Yes

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**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 fulfills both the technical requirements for access to the Company's website and the requirements on the content thereof (including information on the 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"** (<http://www.telefonica.com/en/shareholders-investors/jsp/home/home.jsp>), 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 Telefónica 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	Position on the board	Date of first appointment	Date of last appointment	Election procedure
Mr. César Alierta Izuel	-	Chairman	1997/01/29	2012/05/14	Resolution approved at General Shareholders' Meeting
Mr. Julio Linares López	-	Vice Chairman	2005/12/21	2011/05/18	Resolution approved at General Shareholders' Meeting
Mr. José María Abril Pérez	-	Vice Chairman	2007/07/25	2013/05/31	Resolution approved at General Shareholders' Meeting
Mr. Isidro Fainé Casas	-	Vice Chairman	1994/01/26	2011/05/18	Resolution approved at General Shareholders' Meeting
Mr. José María Álvarez-Pallete López	-	Chief Operating Officer	2006/07/26	2012/05/14	Resolution approved at General Shareholders' Meeting
Mr. Peter Erskine	-	Director	2006/01/25	2011/05/18	Resolution approved at General Shareholders' Meeting
Ms. Eva Castillo Sanz	-	Director	2008/01/23	2013/05/31	Resolution approved at General Shareholders' Meeting
Mr. Luiz Fernando Furlán	-	Director	2008/01/23	2013/05/31	Resolution approved at General Shareholders' Meeting
Mr. Chang Xiaobing	-	Director	2011/05/18	2011/05/18	Resolution approved at General Shareholders' Meeting
Mr. José Fernando de Almansa Moreno-Barreda	-	Director	2003/02/26	2013/05/31	Resolution approved at General Shareholders' Meeting
Mr. Gonzalo Hinojosa Fernández de Angulo	-	Director	2002/04/12	2012/05/14	Resolution approved at General Shareholders' Meeting
Mr. Carlos Colomer Casellas	-	Director	2001/03/28	2011/05/18	Resolution approved at General Shareholders' Meeting
Mr. Antonio Massanell Lavilla	-	Director	1995/04/21	2011/05/18	Resolution approved at General Shareholders' Meeting
Mr. Pablo Isla Álvarez de Tejera	-	Director	2002/04/12	2012/05/14	Resolution approved at General Shareholders' Meeting
Mr. Ignacio Moreno Martínez	-	Director	2011/12/14	2012/05/14	Resolution approved at General Shareholders' Meeting
Mr. Santiago Fernández Valbuena	-	Director	2012/09/17	2013/05/31	Resolution approved at General Shareholders' Meeting
Mr. Alfonso Ferrari Herrero	-	Director	2001/03/28	2011/05/18	Resolution approved at General Shareholders' Meeting
Mr. Francisco Javier de Paz Mancho	-	Director	2007/12/19	2013/05/31	Resolution approved at General Shareholders' Meeting

Total number of directors	18
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Indicate any board members who left during this period:

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

**EXECUTIVE DIRECTORS**

Name or corporate name of director	Committee proposing appointment	Post held in the company
Mr. César Alierta Izuel	Nominating, Compensation and Corporate Governance Committee	Executive Chairman
Mr. José María Álvarez-Pallete López	Nominating, Compensation and Corporate Governance Committee	Chief Operating Officer (C.O.O.)
Mr. Santiago Fernández Valbuena	Nominating, Compensation and Corporate Governance Committee	Chief Strategy Officer
<b>Total number of executive directors</b>		<b>3</b>
<b>% of the board</b>		<b>16.67%</b>

**EXTERNAL PROPRIETARY DIRECTORS**

Name or Corporate Name Director	Committee proposing appointment	Name or corporate name of significant shareholder represented or proposing appointment
Mr. José María Abril Pérez	Nominating, Compensation and Corporate Governance Committee	Banco Bilbao Vizcaya Argentaria, S.A.
Mr. Ignacio Moreno Martínez	Nominating, Compensation and Corporate Governance Committee	Banco Bilbao Vizcaya Argentaria, S.A.
Mr. Isidro Fainé Casas	Nominating, Compensation and Corporate Governance Committee	Fundación Bancaria Caixa d'Estalvis i Pensions de Barcelona, "la Caixa"
Mr. Antonio Massanell Lavilla	Nominating, Compensation and Corporate Governance Committee	Fundación Bancaria Caixa d'Estalvis i Pensions de Barcelona, "la Caixa"
Mr. Chang Xiaobing	Nominating, Compensation and Corporate Governance Committee	China Unicom (Hong Kong) Limited
<b>Total number of proprietary directors</b>		<b>5</b>
<b>% of the board</b>		<b>27.78%</b>

## INDEPENDENT EXTERNAL DIRECTORS

Name or Corporate name of Director	Profile
Mr. Alfonso Ferrari Herrero	Industrial Engineer. He was formerly Executive Chairman of Beta Capital, S.A. and senior manager at Banco Urquijo.
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. José Fernando de Almansa Moreno-Barreda	Law Graduate. Joined the diplomatic corps in 1974 and was appointed by His Majesty the King Juan Carlos I as Chief of the Royal Household in 1993, with the rank of Minister, and is currently Personal Adviser to His Majesty the King Juan Carlos I.
Mr. Gonzalo Hinojosa Fernández de Angulo	Industrial Engineer. He was formerly Chairman and CEO of Cortefiel Group
Mr. Carlos Colomer Casellas	Graduate in Economics. He was Chairman of the Colomer Group until 2013
Mr. Pablo Isla Álvarez de Tejera	Law Graduate. Member of the Body of State Lawyers (on sabbatical). Chairman and CEO of Inditex, S.A.
Mr. Peter Erskine	Psychology Graduate. He was General manager of Telefónica Europe until 2007. Currently Chairman of Ladbrokes, Plc.
Mr. Luiz Fernando Furlán	Degrees in chemical engineering and business administration, specializing in financial administration. From 2003 to 2007 he was Minister of Development, Industry and Foreign Trade of Brazil.
Total number of independent directors	8
% of the board	44.44%

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.

Yes

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

Name or corporate name Director	Description relationship	Reasons
Mr. Carlos Colomer Casellas	Mr. Carlos Colomer Casellas is an independent Director of Abertis Infraestructuras, S.A., parent company of Abertis Group, which has made certain transactions with Telefónica Group (transmission and leasing of mobile phone towers). Described in detail in section H "Other Information of Interest" (Note 16 paragraph D.5)	According to the assessment made attending the nature, the transactions are not liable, by its object and specialty, to generate any ability to influence by one party over the other; attending to the amount, from the point of view of Telefónica and Abertis immaterial; and attending to the fact that Mr. Colomer Casellas is an Independent Director in Abertis Infraestructuras, S.A., the Board of Directors of Telefónica, S.A. considers that those transactions constitute a not suitable transaction in order to condition in any way the independence of Mr. Colomer Casellas.

## Other External Directors

Name or corporate name of director	Committee notifying or proposing appointment
Mr. Julio Linares López	Nominating, Compensation and Corporate Governance Committee
Ms. Eva Castillo Sanz	Nominating, Compensation and Corporate Governance Committee
Total number of Other External Directors	2
% of the board	11.11%

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 Director	Reasons
Mr. Julio Linares López	On September 17, 2012, Mr. Julio Linares López resigned from his post as Chief Operating Officer (C.O.O.) of Telefónica, S.A. and his managerial post in the Telefónica Group and therefore went from being an Executive Director to being classified in the "Other External Directors" category.
Ms. Eva Castillo Sanz	On February 26, 2014, Ms. Eva Castillo Sanz resigned from her executive position as Chairwoman of Telefónica Europe, and being classified in the "Other External Directors" category.

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

Name or corporate name of director	Date of change	Previous classification	Current classification
Ms. Eva Castillo Sanz	2014/02/26	Executive Director	Other External Directors

**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 2014	Year 2013	Year 2012	Year 2011	Year 2014	Year 2013	Year 2012	Year 2011
Executive	0	1	1	0	0.00%	25.00%	25.00%	0.00%
Proprietary	0	0	0	0	0.00%	0.00%	0.00%	0.00%
Independent	0	0	0	1	0.00%	0.00%	0.00%	12.50%
Other External	1	0	0	0	50.00%	0.00%	0.00%	0.00%
Total:	1	1	1	1	5.56%	5.56%	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

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 coopt, at the proposal of the Nominating, Compensation and Corporate Governance Committee, Ms. Eva Castillo Sanz as Director of Telefónica. This appointment was ratified by the Ordinary General

Shareholders' Meeting of Telefónica held on April 22, 2008, and having been re-elected for that position by the Ordinary General Shareholders' Meeting held on May 31, 2013.

Likewise, 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 Vice General Counsel of the Board of Directors of Telefónica.

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.

Therefore, the selection procedure described above is based exclusively on the personal merits of the candidates ("recognized caliber, 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.

**C.1.6. Explain the measures taken, if applicable, by the Nomination 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 caliber, qualifications and experience, who are willing to devote a sufficient portion of their time to the Company.

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

**Explanation of reasons**

All the measures and processes agreed and adopted by the Board of Directors and by the Nominating, Compensation and Corporate Governance Committee to ensure the number of females on the Board guarantees 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. Nevertheless, in the year 2014, there has been no circumstance to alter the current composition of the Board.

**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, 2014, the group of External Directors of Telefónica, S.A. was composed of 15 members (of a total of 18 Board members), of whom 5 are Proprietary Directors, 8 are Independent Directors and 2 falls under the "Other External Directors" category.

Of the five Proprietary Directors, two act in representation of Fundación Bancaria Caixa d'Estalvis i Pensions de Barcelona "la Caixa", which holds 5.25% of the capital of Telefónica, S.A., two act in representation of Banco Bilbao Vizcaya Argentaria, S.A. (BBVA), which holds 6.25% of the capital, and one acts in representation of China Unicom (Hong Kong) Limited (China Unicom) which holds a 1.38% stake.

**C.1.8. Explain, when applicable, the reasons why proprietary directors have been appointed upon the request of shareholders who hold less than 5% of the share capital:**

Name or corporate name of shareholder	Reasons
China Unicom (Hong Kong) Limited	<p>As explained in Section H "Other Information of Interest", Note 3 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 cooperation 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 the next General Shareholders' Meeting, in accordance with prevailing legislation and the Company's By-laws.</p> <p>The General Shareholders' Meeting held on May 18, 2011 approved the appointment of China Unicom's nominee, Mr. Chang Xiaobing, as member of the Board of Directors in accordance with the addendum to the Strategic Partnership Agreement signed in January 2011. This commitment to China Unicom is a consequence of the Strategic Partnership, which is intended to strengthen Telefónica's position in the global communications market.</p>

**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:**

No

Name of director	Reasons for resignation
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**C.1.10. Indicate what powers, if any, have been delegated to the Chief Executive Officer:**

Name or corporate name of director	Brief description
Mr. César Alierta Izuel – Executive Chairman (Chief Executive Officer)	<p>The Chairman of the Company, as the Executive Chairman, has been expressly delegated all the powers of the Board of Directors, except those that cannot be delegated by Law, by the Corporate By-laws, or by the Regulations of the Board of Directors which establishes, in Article 5.4, the competencies that the Board of Directors reserves itself, and may not delegate.</p> <p>Article 5.4 specifically stipulates that the Board of Directors reserves the power to: (i) approve the general policies and strategies of the Company; (ii) evaluate the performance of the Board of Directors, its Committees and the Chairman; (iii) appoint Senior Executives, as well as determine the remuneration of Directors and Senior Executives; and (iv) decide on strategic investments.</p>

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Mr. José María Álvarez-Pallete López (Chief Operating Officer)

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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	Post
Mr. Alfonso Ferrari Herrero	Telefónica del Perú, S.A.A.	Director
	Telefónica Chile, S.A.	Acting Director
	Telefónica de Argentina, S.A.	Director
	Telefónica Brasil, S.A.	Director
	Telefónica Gestión de Servicios Compartidos, S.A.	Chairman
Mr. Francisco Javier de Paz Mancho		
Mr. Gonzalo Hinojosa Fernández de Angulo	Telefónica del Perú, S.A.A.	Director
	Telefónica Brasil, S.A.	Director
Mr. José Fernando de Almansa Moreno-Barreda	Telefónica Móviles México, S.A. de C.V.	Director
	Telefónica Brasil, S.A.	Director
Mr. Luiz Fernando Furlán		Chairwoman of the Supervisory Board
Ms. Eva Castillo Sanz	Telefónica Deutschland Holding, A.G.	
	Colombia Telecomunicaciones, S.A. E.S.P.	Director
	Telefónica América, S.A.	Chairman
	Telefónica Brasil, S.A.	Vice Chariman
	Telefónica Capital, S.A.	Sole Director
	Telefónica Chile, S.A.	Acting Director
	Telefónica Internacional, S.A.U.	Chairman
	Telefónica Móviles México, S.A. de C.V.	Vice Chairman
D. Santiago Fernández Valbuena	Fonditel Pensiones, Entidad Gestora de Fondos de Pensiones, S.A. (E. G. F. P.)	Chairman



**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 Director	Name of listed company	Post
Mr. César Alierta Izuel	China Unicom (Hong Kong) Limited	Director
	International Consolidated Airlines Group, S.A. ("IAG")	Director
	Banco Português de Investimento, S.A. (BPI)	Director
	The Bank of East Asia	Director
	Abertis Infraestructuras, S.A.	First Vice Chairman
Mr. Isidro Fainé Casas	Repsol, S.A.	First Vice Chairman
	Caixabank, S.A.	Chairman
	Suez Environnement Company	Director
	Abertis Infraestructuras, S.A.	Director
	Inversiones Mobiliarias Urquiola, S.A. SICAV	Chairman
Mr. Carlos Colomer Casellas	Ahorro Bursatil, S.A. SICAV	Chairman
Ms. Eva Castillo Sanz	Bankia, S.A.	Director
D. Pablo Isla Álvarez de Tejera	Inditex, S.A.	Chairman-CEO
D. Luiz Fernando Furlán	Brasil Foods, S.A. (BRF)	Director
	AGCO Corporation	Director
D. Ignacio Moreno Martínez	Secuoya, Grupo de Comunicación, S.A.	Director
D. Santiago Fernández Valbuena	Ferrovial, S.A.	Director
D. Peter Erskine	Ladbroke's, Plc	Chairman
D. Antonio Massanell Lavilla	Boursorama, S.A.	Director
	Caixabank, S.A.	Vice Chairman
	Banco Português de Investimento, S.A. (BPI)	Director
	China United Network Communications Limited	Chairman
	China Unicom (Hong Kong) Limited	Chairman-CEO

**C.1.13. Indicate and, where appropriate, explain whether the company has established rules about the number of boards on which its directors may sit:**

No

**C.1.14. Indicate the company's general policies and strategies that are reserved for approval by the Board of Directors in plenary session:**

Investment and financing policy	Yes
Design of the structure of the corporate group	Yes
Corporate governance policy	Yes
Corporate social responsibility policy	Yes
Strategic or business plans, management targets and annual budgets	Yes
Remuneration and evaluation of senior officers	Yes
Risk control and management, and the periodic monitoring of internal information and control systems	Yes
Dividend policy, as well as the policies and limits applying to treasury stock	Yes

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

Board remuneration (thousands of euros)	25,528
Amount of total remuneration corresponding to accumulated pension rights (thousands of euros)	1,375
Total board remuneration (thousands of euros)	26,903

**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. Ignacio Cuesta Martín-Gil	Director Internal Audit
Mr. Ramiro Sánchez de Lerín García-Ovies	General Counsel and Secretary of the Board of Directors
Mr. Ángel Vilá Boix	General Manager of Finance and Corporate Development
Mr. Guillermo Ansaldo Lutz	General manager of Global Resources
Mr. Eduardo Navarro de Carvalho	Chief Commercial Digital Officer (CCDO)

Total remuneration received by senior management (in thousands of euros)	26,766
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**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	Post
Mr. Isidro Fainé Casas	Fundación Bancaria Caixa d'Estalvis i Pensions de Barcelona, "la Caixa"	Chairman Criteria Caixaholding, S.A.
		Chairman Fundación Bancaria Caixa d'Estalvis i Pensions de Barcelona, "la Caixa"
		Chairman Caixabank, S.A.
		Director Boursorama, S.A.
		Vice Chairman Caixabank, S.A.
		Non Executive Chairman Cecabank, S.A.
		Director Banco Portugués de Investimento, S.A. (BPI)
Mr. Antonio Massanell Lavilla	Fundación Bancaria Caixa d'Estalvis i Pensions de Barcelona, "la Caixa"	Director Sociedad de Gestión de Activos procedentes de la Reestructuración Bancaria (SAREB)
		Chairman Barcelona Digital Centre Tecnològic
		Director Mediterranea Beach & Golf Community, S.A.
Mr. José Fernando de Almansa Moreno-Barreda	Banco Bilbao Vizcaya Argentaria, S.A.	Acting Director Grupo Financiero BBVA Bancomer, S.A. de C.V.
		Acting Director BBVA Bancomer, S.A.

**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. Cesar Alierta Izuel	Fundación Bancaria Caixa d'Estalvis i Pensions de Barcelona, "la Caixa"	Trustee of Fundación Bancaria Caixa d'Estalvis i Pensions de Barcelona, "la Caixa"
Mr. José María Abril Pérez	Banco Bilbao Vizcaya Argentaria, S.A.	Early retirement. Formerly General Manager of Wholesale and Investment Banking.
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

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**Description of amendments**

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**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.****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. The Board of Directors may, in accordance with the Corporate Enterprises Act and the Company Bylaws, provisionally co-opt Directors to fill any vacancies.

In this regard, on certain occasions that it is essential due to vacancies after the Annual General Meeting, is appropriate in accordance with the provisions of the Corporate Enterprises Act, to the appointment by cooptation; submitting to ratification such appointment at the next General Meeting of Shareholders held.

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 favorable report by the Nominating, Compensation and Corporate Governance Committee and in the case of independent Directors, by the corresponding proposal by the Committee.

Therefore, in exercise of the powers delegated to it, the Nominating, Compensation and Corporate Governance Committee must report, based on criteria of objectivity and the best interests of the Company, on proposals to appoint, re-appoint or remove Company Directors, taking into account the skills, knowledge and experience required of candidates to fill the vacancies.

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.

Similarly 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 case, 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.

Lastly, 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 recognized caliber, 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.

**Re-election**

The Directors may be re-elected for one or more subsequent similar 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.

### **Evaluation**

In accordance with the Regulations of the Board of Directors, the latter reserves expressly the duty to approve on a regular basis its functioning and the functioning of its Committees, it being the duty of the Nominating, Compensation and Corporate Governance Committee to organize and coordinate, together with the Chairman of the Board of Directors, the regular assessment of said Body.

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 or 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.

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.

### **C.1.20. Indicate whether the board has evaluated its performance during the year:**

#### **Yes**

Explain, if applicable, to what extent this evaluation has prompted significant changes in its internal organization and the procedures applicable to its activities:

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#### **Description of amendments**

In a meeting on February 26, 2014 the Nominating, Compensation and Corporate Governance Committee revised and analyzed the results of Telefónica, S.A.'s evaluation of the performance in 2013 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 organization 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 to work towards ensuring the earliest possible submission of the documentation and information needed to examine and analyze in advance matters tabled for discussion at Board meetings, whenever possible
  - ii) Oversee all necessary measures in order to ensure the General Shareholders' Meetings of the Company are conducted normally.
  - iii) Conduct a detailed review of the 2014 Action Plans review of each Board Committees, to avoid duplication in the subjects treated by them.
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**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 fulfill 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 jeopardize its interests.

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

**C.1.22. Indicate whether the duties of chief executive officer fall upon the Chairman of the Board of Directors. If so, describe the measures taken to limit the risk of powers being concentrated in a single person:**

Yes

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**Measures for limiting risk**

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- The Company's Articles of Association (article 32) and the Rules of Procedure of the Board of Directors (article 17) cover and regulate the role of the Lead Director, whose functions and tasks include the following:
  - a) To coordinate the work of External Directors appointed by the Company to defend the interests of all company shareholders and represent the concerns of said Directors.
  - b) To request the Chairman of the Board of Directors call a meeting of the Board when appropriate under Good Governance practices.
  - c) Consequently, to request the inclusion of certain matters on the Agenda of meetings of the Board of Directors.
  - d) To direct the Board of Directors when it evaluates the Chairman of the Board.

Mr. Alfonso Ferrari Herrero was appointed as Lead Director by the Board of Directors in its meeting of May 31, 2013.

- At its meeting on the 17th of September 2012 the Company Board of Directors agreed to appoint Mr. José María Álvarez Pallete-López as Chief Operating Officer of Telefónica, S.A., reporting directly to the Chairman and with responsibilities for all of the Business Units in Telefónica Group. Between the 19th of December 2007 and the 17th of September 2012, the Chief Operating Officer of the Company was Mr. Julio Linares López.
- Equally, pursuant to the provisions of article 28 of the Rules of Procedure of the Board of Directors, any Member of the Board can urge that a meeting of the Board of Directors be called when he deems necessary, or request the inclusion on the Agenda of any matters he considers pertinent.
- Otherwise, as per the Rules of Procedure of the Board of Directors, the Chairman must at all times act in accordance with the guidelines set by the General Meeting of Shareholders and the Board of Directors.
- In the same manner, all decisions of particular importance to the Company are submitted for prior approval to the Board of Directors or the Executive Committee, depending on the case in question.

- It also states that the Board of Directors has exclusive competence over certain matters, such as: general policy and strategies; evaluation of the Board, its Committees and its Chairman, appointment of Senior Managers; remuneration of Board Members and Senior Managers; and strategic investments, without prejudice to the powers of the General Meeting of Shareholders under the law, Bylaws and Regulations of the General Meeting.
  - Additionally, reports and proposals from certain Committees of the Board of Directors are required to take some decisions.
  - Finally, it is important to highlight that the Chairman does not have a casting vote on the Board of Directors.
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Indicate, and if necessary, explain whether rules have been established that enable any of the independent directors to convene board meetings or include new items on the agenda, to coordinate and voice the concerns of external directors and oversee the evaluation by the Board of Directors.

Yes

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Explanation of rules

Subsequent to the Ordinary General Shareholders' Meeting on May 31, 2013, the Company's By-laws (Article 32) and, since June 2013, the Regulations of the Board of Directors (Article 17), set forth and regulate the position of Lead Director (*Consejero Independiente Coordinador*), the duties and tasks of which include:

- a) Coordinating the work of the External Directors appointed by the Company, in defense of the interests of all shareholders of the Company, and hearing the concerns of such directors.
- b) Requesting the Chairman of the Board of Directors call a meeting of the Board of Directors when appropriate in accordance with good governance rules.
- c) In said instances, requesting the inclusion of certain items on the agenda for meetings of the Board of Directors.
- d) Directing the evaluation by the Board of Directors of its Chairman.

In its meeting of May 31, 2013, the Board also appointed the Chairman of the Nominating, Compensation and Corporate Governance Committee, Mr. Alfonso Ferrari Herrero, as Lead Director.

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

No

If applicable, describe the differences.

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Description of differences

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

Yes



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Description of requirements

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In order for a Director to be appointed Chairman, said 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 favorable 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 indicate whether only one director of the same category may be appointed as a proxy. 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 endeavor to ensure that the proxy they grant to another member of the Board includes, as far as is practicable, appropriate instructions. 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 By-laws 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 endeavor, to the extent possible, to include voting instructions in the proxy document.

Moreover, the Article 529 quater of the Corporate Enterprises Act states that the Non-Executive Directors may only delegate their representation to another Non-Executive Director.

**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.**

Number of board meetings	14
Number of Board meetings held without the Chairman's attendance	0

Indicate the number of meetings of the various board committees held during the year:

Number of meetings of the Executive or Delegated Committee	18
Number of meetings of the Audit and Compliance Committee	11
Number of meetings of the Nominating, Compensation and Corporate Governance Committee	11
Number of meetings of the Regulation Committee	5
Number of meetings of the Service Quality and Customer Service Committee	2
Number of meetings of the Institutional Affairs Committee	6
Number of meetings of the Strategy Committee	5
Number of meetings of the Innovation Committee	5

**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	11
% of attendances of the total votes cast during the year	98.81%

**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.

Name	Position
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**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 laid before 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:

- 1) Supervising the process of preparing and submitting regulated financial information. With respect thereto, it shall be responsible for supervising the preparation and 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.
- 2) Monitoring the effectiveness of the Company's internal control and risk management systems, and to discuss with the auditors significant weaknesses in the internal control system detected during the audit. With respect thereto, it shall be responsible for proposing to the Board of Directors a risk control and management policy.

- 3) Establishing and maintaining 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, as well as any other matters relating to the audit procedure, 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 information regarding additional services of any kind provided to such entities by the Auditor or by the persons or entities related thereto pursuant to the provisions of prevailing regulations.

- 4) Issuing on an annual basis, prior to the issuance of the audit report, a report stating an opinion regarding the independence of the Auditor. This report must in all cases include an opinion on the provision of the additional services referred to in the previous paragraph.
- 5) Supervising internal audit, in particular:
- a) To ensure the independence and efficiency of the internal audit function;
  - b) To propose the selection, appointment and removal of the person responsible for internal audit;
  - c) To propose the budget for such service;
  - d) To review the internal audit work plan and its annual activities report;
  - e) To receive periodic information on its activities; and
  - f) To verify that the senior executive officers take into account the conclusions and recommendations of its reports.

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. To this effect, the Audit and Control Committee meets whenever appropriate, holding eleven (11) meetings in 2014.

Furthermore, the External Auditor participates regularly in the Audit and Control Committee meetings, when called to do so by the Committee, to explain and clarify different aspects of the audit reports and other aspects of its work. Additionally and when requested by the Committee, other members of the management of the Company and its subsidiaries have attended Committee meetings to explain specific matters that are directly within their scope of competence. In particular, managers from the finance, as well as those in charge of internal audit, have attended these meetings. The members of the Committee have held separate meetings with each of these when it was deemed necessary to closely monitor the preparation of the Company's financial information.

The above notwithstanding, Article 40 of the Regulations of the Board of Directors establishes that the Board of Directors shall endeavor to prepare the final financial statements in a manner that will give no for the Auditor to qualify its opinion. However, whenever the Board considers that it should maintain its standards, it shall publicly explain the contents and scope of the discrepancies.

**C.1.33. Is the Secretary of the board also a director?**

No

**C.1.34. Explain the procedures for appointing and removing the Secretary of the board, indicating whether their appointment and removal have been notified by the Nomination Committee and approved by the board in plenary session.**

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**Appointment and removal procedure**

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In accordance with Article 15 of the Regulations of the Board of Directors, the Board of Directors, upon the proposal of the Chairman, and after a report from the Nominating, Compensation and Corporate Governance Committee, shall appoint a Secretary to the Board, and shall follow the same procedure for approving his/her removal.

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Does the Nomination Committee propose appointments?	Yes
Does the Nomination Committee advise on dismissals?	Yes
Do appointments have to be approved by the board in plenary session?	Yes
Do dismissals have to be approved by the board in plenary session?	Yes

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Is the Secretary of the board entrusted in particular with the function of overseeing corporate governance recommendations?

Yes

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**Remarks**

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The Secretary to the Board shall, at all times, attend to the formal and substantive legality of the Board's actions, and the conformance thereof to the Corporate By-laws, the Regulations for the General Shareholders' Meeting and of the Board, and ensure that these actions are in line with the corporate governance recommendations assumed by the Company at any given time (Article 15 of the Regulations of the Board).

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**C.1.35. Indicate and explain, where applicable, the 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 jeopardize the Auditor's independence, as well as any other matters relating to the audit procedure, 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 information regarding additional services of any kind provided 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 regarding the independence of the External Auditor. This report must in all cases include an opinion on the provision of the additional services referred to in the previous paragraph.

In addition, in accordance with Article 22 of the Regulations of the Board of Directors, it is the Audit and Control Committee that proposes to the Board of Directors, for submission to the shareholders at the General Shareholders' Meeting, the appointment of the Auditor as well as, if necessary, the appropriate terms for the hiring thereof, the scope of its professional engagement and the revocation or non-renewal of its appointment.

Likewise, 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.

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 jeopardize 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:**

No

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 paid for such work and the percentage they represent of the fees invoiced to the company and/or its group.**

No

**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	10	10
	Company	Group
Number of years audited by current audit firm/Number of years the company's financial statements have been audited (%)	31.30%	41.70%

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

Yes

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**Procedures**

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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 formalized through the Secretary to the Board, unless the Board of Directors does not consider such engagement to be necessary or appropriate.

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**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

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**Procedures**

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The Company adopts the measures necessary to ensure 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, 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.

Also, and in accordance with Recommendation 18 of the Unified Good Governance Code (2013 revised version), at the beginning of the year the Board and its Committees prepare an Action Plan detailing the activities 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. For the same purpose, the Directors are sent the documentation related to the agenda of the meetings sufficiently in advance. Such information is subsequently supplemented with the written documentation and presentations handed out to the Directors at the meeting.

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 competencies.

Furthermore, and as a general rule, the Regulations of the Board of Directors 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 channeled 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 organization.

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**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

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**Details of rules**

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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 when their remaining on the Board might affect the Company's credit or reputation in the market or otherwise jeopardizes its interests.

Likewise, Article 31.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.

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**C.1.43. Indicate whether any director has notified the company that they have been indicted or tried for any of the offences stated in Article 213 of the LSC.**

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.

No

Decision/action taken	Justified explanation
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**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 (a company forming part of the Guatemalan business group Corporación Multi-Inversiones) ("CMI") signed an agreement to establish a joint venture between Telefónica and CMI, Telefónica Centroamérica Inversiones, S.L.U. ("TCI"). Telefónica contributed its assets in Central America (excluding assets in Costa Rica) and CMI made a monetary contribution of 500,000,000 US dollars. As a result of these contributions, Telefónica holds 60% and CMI 40% of TCI's share capital. 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 Financing Reporting Standards (IFRS).

2.- On February 18, 2014, Telefónica, SA, as borrower, and a group of credit institutions as lenders, with The Royal Bank of Scotland PLC as bank agent, signed a syndicated loan agreement in an aggregate amount up to three thousand (3,000) million euros (the "Facility Agreement").

As provided in the Facility Agreement, in the event of a change of control in Telefónica, S.A., the lenders entities may, under certain circumstances, require the early cancellation of the Facility Agreement.

To determine whether there has been a change of control for these purposes, the Facility Agreement serves the usual criteria of such agreements, such as obtaining control of the majority of the voting rights, on the appointment of the majority of the members of the board, or on the financial and operating policies of the company.

**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.**

Number of beneficiaries	48
Type of beneficiary	
Executive Directors, Senior Executive Officers and other Employees	

**Description of the resolution**

With regard to Executive Directors and the conditions for termination of their contracts, since 2006, in line with typical market practices, the Company policy applicable to Executive Directors provides for compensation equivalent to two years' worth of remuneration, calculated based on the last fixed payment and the arithmetical average of the total for the last two annual variable payments, in the event their contract is terminated for reasons attributable to the Company or objective circumstances, such as a change in control of the Company. Otherwise, if the contract is terminated because of a failure



attributable to the Executive Director, he is entitled to no compensation whatsoever.

Therefore, the contracts executed since 2006 have followed the criteria stated above regarding the compensation rules.

In the case of contracts signed before 2006, the compensation due to Executive Directors, pursuant to their contracts, does not follow the policy outlined above, but rather is based on the Director's personal and professional circumstances and when he signed the contract. In these cases, the financial compensation agreed to for contract termination, where applicable, may be up to a maximum of four times annual remuneration depending on the time the Director has been with the Company. Each annual payment includes the last fixed payment and the arithmetical average of the sum of the two last variable annual payments under the contract.

Regarding the Executive Chairman, as of the date of issuance of this Report, the Chairman has no golden parachute provision.

As regards the Company's Senior Management (excluding Executive Directors), their contracts recognise an entitlement to financial compensation, as indicated below, in the event they are terminated for a reason attributable to the Company and, in certain cases, for objective circumstances such as a change in control of the Company. Otherwise, if the contract is terminated because of a failure attributable to the Senior Manager, he is entitled to no compensation whatsoever. However, it should be noted that, in certain cases, the compensation to which the Senior Manager is entitled, depending on his contract, is not governed by these general rules but instead by his personal and professional circumstances and when he signed his contract. The financial compensation agreed for termination of the contract, where applicable, consists of a maximum of three annual payments plus one more depending on length of service with the Company. The annual payment includes the last fixed payment and the arithmetical average of the sum of the last two variable annual payments under the contract.

Employment contracts that link employees to the Company under a standard employment relationship do not contain a compensation clause for termination of the contract. As such, the employee is entitled, where applicable, to the compensation established under employment legislation. Notwithstanding the above, certain Company employees, depending on their level and length of service, their personal and professional circumstances and when they signed their contracts, have a recognised contractual entitlement to receive compensation, in some cases, under the same conditions as set out in the paragraph above, generally consisting of one and a half annual payments. This annual payment includes the last fixed payment and the arithmetical average of the sum of the last two variable annual payments under the 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 board committees, their members and the proportion of proprietary and independent directors:

#### EXECUTIVE COMMISSION

Name	Post	Type
Mr. César Alierta Izuel	Chairman	Executive
Mr. Isidro Fainé Casas	Vice Chairman	Proprietary
Mr. José María Abril Pérez	Vice Chairman	Proprietary
Mr. Alfonso Ferrari Herrero	Member	Independent

Mr. Carlos Colomer Casellas	Member	Independent
Mr. Francisco Javier de Paz Mancho	Member	Independent
Mr. Gonzalo Hinojosa Fernández de Angulo	Member	Independent
Mr. José María Álvarez-Pallete López	Member	Executive
Mr. Peter Erskine	Member	Independent

% of executive directors	22.00%
% of proprietary directors	22.00%
% of independent directors	56.00%
% of Other External Directors	0.00%

#### AUDIT AND CONTROL COMMITTEE

Name	Post	Type
Mr. Carlos Colomer Casellas	Chairman	Independent
Mr. Gonzalo Hinojosa Fernández de Angulo	Member	Independent
Mr. Alfonso Ferrari Herrero	Member	Independent
Mr. Antonio Massanell Lavilla	Member	Proprietary
Mr. Ignacio Moreno Martínez	Member	Proprietary

% of executive directors	0.00%
% of proprietary directors	40.00%
% of independent directors	60.00%
% of Other External Directors	0.00%

## NOMINATING, COMPENSATION AND CORPORATE GOVERNANCE COMMITTEE

Name	Position	Type
Mr. Alfonso Ferrari Herrero	Chairman	Independent
Mr. Carlos Colomer Casellas	Member	Independent
Mr. Gonzalo Hinojosa Fernández de Angulo	Member	Independent
Mr. Pablo Isla Álvarez de Tejera	Member	Independent
Mr. Peter Erskine	Member	Independent

% of executive directors	0.00%
% of proprietary directors	0.00%
% of independent directors	100.00%
% of Other External Directors	0.00%

## REGULATION COMMITTEE

Name	Position	Type
Mr. Gonzalo Hinojosa Fernández de Angulo	Chairman	Independent
Mr. Alfonso Ferrari Herrero	Member	Independent
Mr. Francisco Javier de Paz Mancho	Member	Independent
Mr. José Fernando de Almansa Moreno-Barreda	Member	Independent
Ms. Eva Castillo Sanz	Member	Other External
Mr. Ignacio Moreno Martínez	Member	Proprietary

% of executive directors	0.00%
% of proprietary directors	17.00%
% of independent directors	67.00%
% of Other External Directors	17.00%

## SERVICE QUALITY AND CUSTOMER SERVICE COMMITTEE

Name	Position	Type
Mr. Antonio Massanell Lavilla	Chairman	Proprietary
Mr. Alfonso Ferrari Herrero	Member	Independent
Mr. Carlos Colomer Casellas	Member	Independent
Mr. Gonzalo Hinojosa Fernández de Angulo	Member	Independent
Ms. Eva Castillo Sanz	Member	Other External
Mr. Ignacio Moreno Martínez	Member	Proprietary
Mr. Francisco Javier de Paz Mancho	Member	Independent

% of executive directors	0.00%
% of proprietary directors	29.00%
% of independent directors	57.00%
% of Other External Directors	14.00%

## INSTITUTIONAL AFFAIRS COMMITTEE

Name	Post	Type
Mr. Julio Linares López	Chairman	Other External
Mr. José Fernando de Almansa Moreno-Barreda	Member	Independent
Mr. Alfonso Ferrari Herrero	Member	Independent
Mr. Gonzalo Hinojosa Fernández de Angulo	Member	Independent
Mr. Antonio Massanell Lavilla	Member	Proprietary
Mr. Francisco Javier de Paz Mancho	Member	Independent

% of executive directors	0.00%
% of proprietary directors	17.00%
% of independent directors	67.00%
% of Other External Directors	17.00%

## STRATEGY COMMITTEE

Name	Position	Type
Mr. Peter Erskine	Chairman	Independent
Mr. Alfonso Ferrari Herrero	Member	Independent
Mr. Gonzalo Hinojosa Fernández de Angulo	Member	Independent
Mr. José Fernando de Almansa Moreno-Barreda	Member	Independent
Ms. Eva Castillo Sanz	Member	Other External
Mr. Julio Linares López	Member	Other External

% executive directors	0.00%
% proprietary directors	0.00%
% independent directors	67.00%
% of Other External Directors	33.00%

## INNOVATION COMMITTEE

Name	Position	Type
Mr. Carlos Colomer Casellas	Chairman	Independent
Mr. Antonio Massanell Lavilla	Member	Proprietary
Mr. José María Abril Pérez	Member	Proprietary
Mr. Peter Erskine	Member	Independent
Mr. Julio Linares López	Member	Other External

% executive directors	0.00%
% proprietary directors	40.00%
% independent directors	40.00%
% of Other External Directors	20.00%

**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			
	Year 2014 Number %	Year 2013 Number %	Year 2012 Number %	Year 2011 Number %
Executive Committee	0	0	0	0
Audit and Control Committee	0	0	0	0
Nomination, Compensation and Corporate Governance Committee	0	0	0	0
Regulation Committee	1 (16.67%)	1 (14.29%)	1 (20.00%)	1 (16.67%)
Service Quality and Customer Service Committee	1 (14.29%)	1 (14.29%)	1 (16.67%)	1 (16.67%)
Institutional Affairs Committee	0	0	0	0
Strategy Committee	1 (16.67%)	1 (16.67%)	1 (20.00%)	1 (20.00%)
Innovation Committee	0	0	0	0

**C.2.3. Indicate whether the Audit Committee is responsible for the following:**

To supervise the preparation process, monitoring the integrity of financial information on the company and, if applicable, the group, and revising compliance with regulatory requirements, the adequate boundaries of the scope of consolidation and correct application of accounting principles	Yes
To regularly review internal control and risk management systems, so main risks are correctly identified, managed and notified	Yes
To safeguard the independence and efficacy of the internal audit function; propose the selection, appointment, reappointment and removal of the head of internal audit; propose the department's budget; receive regular report-backs on its activities; and verify that senior management are acting on the findings and recommendations of its reports	Yes
To establish and supervise a mechanism whereby staff can report, confidentially and, if necessary, anonymously, any irregularities they detect in the course of their duties, in particular financial or accounting irregularities, with potentially serious implications for the firm	Yes
To submit to the board proposals for the selection, appointment, reappointment and removal of the External Auditor, and the engagement conditions	Yes
To receive regular information from the External Auditor on the progress and findings of the audit program and check that senior management are acting on its recommendations	Yes
To ensure the independence of the External Auditor	Yes

**C.2.4. Describe the organizational and operational rules and the responsibilities attributed to each of the board committees.**

See Section H "Other Information of Interest", Note 14 to Section C.2.4.

**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 are governed by the Regulations of the Board of Directors. Also, and particularly, the Executive Commission is regulated in Article 38 of the Corporate By-laws, the Audit and Control Committee in Article 39 of the Corporate By-laws, and the Nominating, Compensation and Corporate Governance Committee in the Article 40 of the Corporate By-laws. These documents are available for consultation on the Company's website.

As mentioned in Note 14 to Section C.2.4 of Section H "Other Information of Interest", the Board Committees draw up an internal Activities Report summarizing 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.

**C.2.6. Indicate whether the composition of the Executive Committee reflects the participation within the board of the different types of directors.**

Yes

## D. Related-party and intragroup transactions

### D.1. Identify the competent body and explain, if applicable, the procedures for approving related-party or intragroup transactions.

#### **Competent body**

Board of Directors

#### **Procedures**

As per Article 5 of the Regulations of the Board of Directors, the Board reserves the power to approve, inter alia, transactions entered into by the Company with related parties.

In this regard, and pursuant to Article 38 of the Regulations of the Board of Directors, the Board of Directors shall examine the transactions that the Company enters into, either directly or indirectly, with Directors, with significant shareholders or shareholders represented on the Board of Directors, or with persons related thereto.

The performance of such transactions shall require the authorization of the Board of Directors, on the recommendation of the Nominating, Compensation and Corporate Governance Committee, unless they are transactions or operations that form part of the customary or ordinary activity of the parties involved that are performed on an arm's-length basis and in insignificant amounts for the Company.

The transactions referred to in the preceding sub-section 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.

#### **Explain if the authority to approve related-party transactions has been delegated to another body or person**

The powers to approve transactions entered into by the Company with related parties, may be adopted, by the Executive Commission in urgent cases and subsequently ratified by the Board of Directors (pursuant to Article 5.4.C 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	7,944
Banco Bilbao Vizcaya Argentaria, S.A.	Telefónica, S.A.	Contractual	Receipt of services	4,136
Banco Bilbao Vizcaya Argentaria, S.A.	Telefónica, S.A.	Contractual	Interest charged	4,105
Banco Bilbao Vizcaya Argentaria, S.A.	Telefónica, S.A.	Contractual	Finance arrangements: other	1,106,941
Banco Bilbao Vizcaya Argentaria, S.A.	Telefónica, S.A.	Contractual	Finance arrangements: loans	302,921
Banco Bilbao Vizcaya Argentaria, S.A.	Telefónica, S.A.	Contractual	Guarantees	67,951
Banco Bilbao Vizcaya Argentaria, S.A.	Telefónica, S.A.	Contractual	Dividends and other distributed earning	193,840
Banco Bilbao Vizcaya Argentaria, S.A.	Telefónica, S.A.	Contractual	Others	23,247.109
Banco Bilbao Vizcaya Argentaria, S.A.	Rest Telefonica Group	Contractual	Interest paid	18,553
Banco Bilbao Vizcaya Argentaria, S.A.	Rest Telefonica Group	Contractual	Operating lease contracts	325
Banco Bilbao Vizcaya Argentaria, S.A.	Rest Telefonica Group	Contractual	Receipt of services	3,956
Banco Bilbao Vizcaya Argentaria, S.A.	Rest Telefonica Group	Contractual	Interest charged	9,663
Banco Bilbao Vizcaya Argentaria, S.A.	Rest Telefonica Group	Contractual	Services delivery	61,176
Banco Bilbao Vizcaya Argentaria, S.A.	Rest Telefonica Group	Contractual	Sale of goods (finished or unfinished)	5,471
Banco Bilbao Vizcaya Argentaria, S.A.	Rest Telefonica Group	Contractual	Finance arrangements: other	339
Banco Bilbao Vizcaya Argentaria, S.A.	Rest Telefonica Group	Contractual	Finance arrangements: loans	113,639
Banco Bilbao Vizcaya Argentaria, S.A.	Rest Telefonica Group	Contractual	Financial Lease Arrangement	159
Banco Bilbao Vizcaya Argentaria, S.A.	Rest Telefonica Group	Contractual	Guarantees	461,054
Banco Bilbao Vizcaya Argentaria, S.A.	Rest Telefonica Group	Contractual	Stock options purchase agreements	31,545
Banco Bilbao Vizcaya Argentaria, S.A.	Rest Telefonica Group	Contractual	Other	1,150,169
Fundación Bancaria Caixa d'Estalvis i Pensions de Barcelona, "la Caixa"	Telefónica, S.A.	Contractual	Interest paid	1,860
Fundación Bancaria Caixa d'Estalvis i Pensions de Barcelona, "la Caixa"	Telefónica, S.A.	Contractual	Receipt of services	2,939
Fundación Bancaria Caixa d'Estalvis i Pensions de Barcelona, "la Caixa"	Telefónica, S.A.	Contractual	Interest charged	19,032
Fundación Bancaria Caixa d'Estalvis i Pensions de Barcelona, "la Caixa"	Telefónica, S.A.	Contractual	Finance arrangements: other	1,173,075
Fundación Bancaria Caixa d'Estalvis i Pensions de Barcelona, "la Caixa"	Telefónica, S.A.	Contractual	Finance arrangements: loans	21,071
Fundación Bancaria Caixa d'Estalvis i Pensions de Barcelona, "la Caixa"	Telefónica, S.A.	Contractual	Guarantees	8,271
Fundación Bancaria Caixa d'Estalvis i Pensions de Barcelona, "la Caixa"	Telefónica, S.A.	Contractual	Dividends and other distributed earning	98,271
Fundación Bancaria Caixa d'Estalvis i Pensions de Barcelona, "la Caixa"	Telefónica, S.A.	Contractual	Others	1,220,965
Fundación Bancaria Caixa d'Estalvis i Pensions de Barcelona, "la Caixa"	Rest Telefonica Group	Contractual	Interest paid	353
Fundación Bancaria Caixa d'Estalvis i Pensions de Barcelona, "la Caixa"	Rest Telefonica Group	Contractual	Operating Lease Arrangements	306
Fundación Bancaria Caixa d'Estalvis i Pensions de Barcelona, "la Caixa"	Rest Telefonica Group	Contractual	Receipt of services	56,430
Fundación Bancaria Caixa d'Estalvis i Pensions de Barcelona, "la Caixa"	Rest Telefonica Group	Contractual	Interest charged	24
Fundación Bancaria Caixa d'Estalvis i Pensions de Barcelona, "la Caixa"	Rest Telefonica Group	Contractual	Receipt of services	95,042



Fundación Bancaria Caixa d'Estalvis i Pensions de Barcelona, "la Caixa"	Rest Telefonica Group	Contractual	Sale of goods (finished or unfinished)	1,608
Fundación Bancaria Caixa d'Estalvis i Pensions de Barcelona, "la Caixa"	Rest Telefonica Group	Contractual	Finance arrangements: loans	10,000
Fundación Bancaria Caixa d'Estalvis i Pensions de Barcelona, "la Caixa"	Rest Telefonica Group	Contractual	Guarantees	66,600
Fundación Bancaria Caixa d'Estalvis i Pensions de Barcelona, "la Caixa"	Rest Telefonica Group	Contractual	Stock options purchase agreements	67,348
Fundación Bancaria Caixa d'Estalvis i Pensions de Barcelona, "la Caixa"	Rest Telefonica Group	Contractual	Other	53

**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 related-party transactions.**

**193,615 (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.**

In accordance with the provisions of the Company in its corporate governance rules, the principles governing possible conflicts of interest that may affect Directors, senior executives or significant shareholders are:

- With respect to Directors, Article 31 of the Regulations of the Board of Directors expressly 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.

- With regards to significant shareholders, Article 38 of the Regulations of the Board of Directors stipulates that the Board of Directors shall know the transactions that the companies enter into, either directly or indirectly, with Directors, with significant shareholders or shareholders represented on the Board, or with persons related thereto.

The performance of such operations or transactions shall require the authorization of the Board, on the recommendation of the Nominating, Compensation and Corporate Governance Committee, unless they are transactions or operations that form part of the customary or ordinary activity of the parties involved that are performed on customary market terms and in insignificant or immaterial amounts for the Company.

The transactions referred to in the preceding paragraph 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 information of the Company upon the terms set forth in applicable laws and regulations.

- 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 the provisions of this Code, senior executives are obliged to (a) act at all times with loyalty to the Telefónica Group and its shareholders, regardless of their own or other interests; (b) refrain from interfering in or influencing the making of decisions that may affect individuals or entities with whom there is a conflict; and (c) refrain from receiving information classified as confidential which may affect such conflict. Furthermore, these persons are obliged to inform the Company's Regulatory Compliance function of all transactions that may potentially give rise to conflicts of interest.

**D.7. Is more than one Group Company listed in Spain?**

**No**

Identify the listed subsidiaries in Spain:

Listed Subsidiaries		
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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.

**No**

Business dealings between the parent and listed subsidiary, as well as between the subsidiary and 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.

Mechanisms to resolve any 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.

Telefónica continually monitors the most significant risks in the main companies comprising its Group. The Company therefore has a Corporate Risk Management Model based on the model established by the Treadway Commission's Committee of Sponsoring Organizations (COSO), which is used to evaluate the probability of the various risks arising and the impact thereof.

One of the features of this Model is a map prioritizing risks according to their importance, thereby facilitating their control and appropriate responses to mitigate them. In accordance with this Model, 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 as a result of strategic uncertainty or uncertainty about competitors, changes in the business, competition and market scenario, or changes in the legal framework.
- Operational risk: Possible loss of value or earnings as a result of events caused by inadequacies or failures in customer service, processes, human resources, business teams and IT systems, security, compliance with contracts, laws and regulations, or due to external factors.
- 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.
- Global risk: Possible loss of value or earnings as a result of events that affect in a transversal way the entire Telefónica Group in terms of its corporate reputation and responsibility, corporate public relations, marketing strategy, brand, sponsorship and innovation.

### E.2. Identify the bodies responsible for preparing and implementing the risk management system.

Telefónica, S.A.'s Board of Directors reserves the power to approve the general risk policy. Audit and Control Committee analyzes and evaluates risks and then proposes to the Board of Directors the risk control and management policy to be adopted, identifying the categories of risks to which the Company is exposed, the level of acceptable risk, measures to mitigate the impacts of identified risks, control systems and the reporting to be used to control and manage said risks. The responsibilities of the Audit and Control Committee also includes the monitoring risk management.

As per the Group's Risk Management Policy, various local and corporate units are involved in managing risks.

All staff in the organization are responsible for contributing to the identification and management of risk following the procedures defined to implement and ensure the effectiveness of the Group's risk management processes.

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

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

### E.4. Identify if the company has a risk tolerance level.

The Company has a risk or acceptable risk tolerance level that is set at 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 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 is set in terms of their economic impact.
- A tolerance level of zero is established for global risks, principally those affecting corporate reputation and responsibility.

**E.5. Identify any risks which have occurred during the year.**

Telefónica Group reviews the value of its assets and cash generating units annual, or on a more frequent basis if the circumstances so require, in order to determine whether their book value can be supported by their expected revenue generation. In some cases this includes expected synergies included in the acquisition price. Any potential regulatory, business, financial or political changes require that modifications be made to the estimates and that the goodwill be adjusted, for either real estate or intangible assets. Although it has no impact on cash flow, acknowledging a drop in the value of assets affects negatively the profit and loss account and may have a negative impact on operating results. In this regard the Group has made a number of corrections to the value of some of its shares. This has had a knock-on impact on the results for the financial year when the adjustments were made.

Thus, regarding the investment in Telco, S.p.A. ("Telco") has been made correction to the value in the 2013 and 2014 financials years, with a negative impact of 267 and 464 millions euros respectively. .

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

The Corporate Risk Management Model, 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. 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 Telefónica, S.A. (hereinafter "Telefónica") assumes ultimate responsibility of ensuring that an adequate and effective internal control over financial reporting system (ICFRS) exists and is updated.

Pursuant to Law and the Corporate By-laws, the Board of Directors is the Company's most senior governing body and representative, 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 By-laws 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, it shall have at least the following powers and duties:

- To supervise the process of preparing and submitting financial information. In this regard, to supervise the process of preparation and the completeness of the financial information related to the Company and the Group, reviewing compliance with the regulatory requirements, the proper determination of the scope of consolidation, and the correct application of the accounting standards.
- To supervise the effectiveness of the Company's internal control system and risk management systems, and to discuss with the Auditors significant weaknesses in the internal control system detected during the audit. 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 types of risk which the Company faces; the level of risk which the Company deems acceptable; the measures for mitigating the impact of the identified risks should they materialize; and the control and information systems to be employed to control and manage said risks.
- To ensure the independence of the External Auditor, supervising their work and acting as a channel of communication between the Board of Directors and the External Auditor, as well as between the External Auditor and the Company's Management Team.
- To supervise internal audit services and, in particular: to ensure the independence and efficiency of the internal audit function; to receive periodic information on its activities; and to verify that senior executives take into account the conclusions and recommendations of its reports.

The Audit and Control Committee shall meet monthly and any additional time as appropriate.

In order to carry out this supervisory function, the Audit and Control Committee is assisted by all the Senior Management of the Company, including Internal Audit.

The different areas and functional units of the Telefónica Group, primarily the financial teams, also play a key role in ICFR 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 of the same.

**F.1.2. The existence or otherwise of the following components, especially in connection with the financial reporting process:**

- **The departments and/or mechanisms in charge of: (i) the design and review of the organizational structure; (ii) defining clear lines of responsibility and authority, with an appropriate distribution of tasks and functions; and (iii) 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.

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

**Corporate Regulations on the Control, Registration and Reporting of Financial and Accounting Information**, which sets out the basic principles of the Telefónica Group's financial and accounting reporting system, and the procedures and mechanisms in place to oversee this system.

**Accounting Policies and Measurement Criteria Manual**, designed to unify and standardize the accounting criteria and policies used by all the Group companies to ensure Telefónica operates as a consolidated and uniform Group.

**Reporting and Audit instructions for the third quarter and 2014 year-end closings**, published annually and quarterly to establish the procedures and the schedule all Telefónica Group companies must follow when reporting financial and accounting information to prepare the Group's consolidated financial information, to comply with Telefónica's legal and reporting requirements in Spain and the other countries in which its shares are listed.

**Annual calendar of financial-accounting information**, applicable to all Telefónica Group companies to establish at the beginning of each period the monthly accounting-financial reporting dates.

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

- Code of conduct, approving body, dissemination and instruction degree, principles and values included (stating whether there are specific reference to operation recording and the preparation of financial information), body in charge of analyzing non-compliance and of suggesting corrective actions and sanctions.

Regarding the Code of conduct, in December 2006, Telefónica's Board of Directors approved the unification of the Codes of Ethics of the Group's different companies in a new Code of conduct, named "Business Principles", to be applied as standard in all countries where the Telefónica Group operates, and for all its employees (at all levels of the organization, directors and non-directors).

The Business Principles are based on a number of general principles associated with honesty, trust, respect for the law, integrity and respect for human rights. Also, they include specific principles aimed at ensuring the trust of the customers, professionals, shareholders, suppliers and society in general.

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

This ethical code 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 Business Principles which is responsible for ensuring compliance therewith. It comprises senior representatives of the General Secretary's Office, Human Resources, Internal Audit and Public Affairs and Regulations.

The following the responsibilities of this office stand out:

- 1.- Guaranteeing that Telefónica conducts business in an ethical and responsible manner, and that the Company's reputation is not tarnished.
  - 2.- Developing the mechanisms need to ensure the Ethical Code is followed to the letter in all regions/countries/business units.
  - 3.- Overseeing, reviewing and contemplating the implementation of the Business Principles across the entire Telefónica Group.
- Training courses are provided to all employees through the online training platform to strengthen the knowledge of Business Principles.
- 4.- Examining any matters or proposals in the Group that could represent a risk to the Business Principles and associated policies and therefore, the brand and reputation.

Telefónica also has an "Internal Code of Conduct for Securities Markets Issues" setting out the general guidelines and the principles of conduct for the persons involved in securities and financial instrument transactions entered into by the Company and its subsidiaries.

- Whistle-blowing channel, which enables communication to the Audit Committee about irregularities of a financial and accounting nature, and also about possible cases of non-compliance with the code of conduct as well as about irregular activities in the organization, informing, where applicable, if non-compliance is of a confidential nature.

Regarding the 'Whistle-blowing' channel, as specified in Article 22 of Regulations for the Board of Directors, the Audit and Control 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 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 company listed 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 accounting, internal controls over reporting and/or audit-related matters.

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

This channel is accessible from the Internal Audit webpage on Telefónica's intranet.

The Telefónica Audit and Control Committee receives all complaints regarding internal controls, accounting and the audit of the financial statements. All complaints of this nature will be treated and resolved by the Committee appropriately.

**Business Principles Whistle-blowing Channel:** In addition to the "Business Principles" ethical code, the Board of Directors approved a whistle-blowing channel for employees through which 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.

This channel follows the principle of not encouraging anonymous communication. Confidentiality of the identity of the whistle-blower is guaranteed at every moment.



The channel is accessible through the Business Principles webpage on Telefónica's intranet. Telefónica S.A.'s

Office of Business Principles is responsible for the Business Principles Whistle-blowing Channel.

- Periodic training and refresher programs for staff involved in the preparation and review of financial information, as well as in ICFR assessment, which cover, at least, accounting, auditing, internal control and risk management standards.

Also, and 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, Telefónica S.A.'s Finance Department offers specific 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, from an accounting and financial point of view, are relevant in order to prepare consolidated financial information.

Updated Information Newsletters on NIIF (International Financial Reporting Standards) are also issued, these newsletters provide a summary of the main novelties in the accounting field, as well as clarifying on the various aspects which may rise with regard to this issue.

Finance personnel also attend technical sessions run by external consultancy firms related to main accounting changes. Finally, 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 documented. This model is applied to the financial information reported by subsidiaries or companies managed by Telefónica. The model selects the 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 in the processes affecting 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 Corporate perimeter, the Finance Department periodically monitors the changes in the Corporate Group's perimeter. On a periodic basis, an updating of the consolidation perimeter is made, checking additions and deletions in companies with legal and financial departments in the various companies which are part of the Group.

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

Telefónica, besides what has been explained in the previous items, has a Risk Management Model covering four key areas of risk:

- Business risks
- Operational risks
- Global risks
- Financial risks

Financial risks include risks associated with the accuracy, completeness and publication of reporting information.

- Finally, which of the company's governing bodies is responsible for overseeing the process.

The Board of Directors, through the Audit and Control Committee, is the body in the entity which oversees the process, as defined in art. 22 of the Regulations of the Board of Directors of Telefónica.

### F.3. Control activities

Indicate the existence of at least the following components, specifying 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 the Telefónica Board approved the "Regulations governing disclosure and reporting to the markets". This regulation establishes 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 Telefónica's Finance 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 accounting-financial processes in place which stipulate common criteria for preparing financial information in all Group companies, as well as any outsourced activities.

Also, the Company 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 and the Finance Directors of the Group companies must submit a certificate to the Corporate Finance 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 Finance Department issues instructions setting out the calendar and contents for the financial reporting period for the preparation of the consolidated annual financial statements. These instructions are mandatory.

The Corporate Finance 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 Finance 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.

Finally, Internal audit, within its annual audit plan establishes, annually work plans to assess the Internal Control Model over financial reporting.

F.3.2. Internal control policies and procedures for IT 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 Information Systems Department of the Telefónica Group is in charge of the information systems for all the Group's business defining the strategy and technology planning, ensuring the conditions of quality of service, cost and safety required by the Group.

Within its different functions is in charge of the development and the implementation of systems that improve the efficiency, effectiveness and profitability of the group processes, the definition and implementation of security policies and standards for applications and infrastructures (in conjunction with the Security and Networks Department), among which is included the internal control model in the field of information technologies.

The Corporate Policy on Information Security defines as strategic assets the information and the systems that treat it and establishes both the safety requirements which Group companies must have and the action lines to be followed compulsorily by implementing appropriate controls according to the following domains:

- Organization and functions
- Obligations relating to staff
- Classification and information processing
- Identification and authentication
- Access control
- Audit Logs and monitoring
- Networking and Communications
- Software Control
- Development and maintenance of systems
- Incident management
- Management and distribution of supports
- Backup & Recovery copies
- Business Continuity
- Physical and environmental security
- Compliance with currently legislation

Finally, Internal Audit in its annual audit plan establishes work plans to verify the effectiveness and efficiency of IT governance model, the adequacy of controls, and the completeness of information.

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 with 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 the effectiveness of the internal control for financial reporting ICFR, measures are taken in the Telefónica Group to demonstrate a minimum 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 certificates.
- **Implementation of specific controls:** Determined, designed, introduced and evaluated by the company.
- **Direct evaluation:** An evaluation of the outsourced processes by the Internal Audit area.

When Telefónica, S.A. or any of its subsidiaries engage the services of an independent expert whose findings and conclusions may materially impact the consolidated financial statements, as part of the selection process the competence, training, credentials and independence of the third party are verified directly by the area contracting the service and, if applicable jointly with the procurement department. The finance department has control activities in place to guarantee the validity of the data, the methods used and the reasonability of the assumptions used by the third party by making a recurrent follow-up of KPIs specific to each function which enable to ensure compliance with the outsourced process in accordance with policies and guidelines provided by the Group.

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

#### F.4. Information and communication

Report, specifying, at least, the main characteristics the existence of at least:

F.4.1. A specific function in charge of defining and maintaining update 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 Group Finance Department is in charge of defining and updating the accounting policies used for preparing the consolidated financial information.

Thus, this area publishes IFRS (International Financial Reporting Standards) information newsletters summarizing the main changes to accounting methodology, as well as clarifications on various other related issues. These newsletters are monthly.

Also, the Telefónica Group has an Accounting Policies Manual which is annually updated. 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 sent periodically via electronic mail and is available for the whole Group at the eAccounting portal in the Intranet of Telefónica.

Likewise, the accounting policies department has a fluent communication with the people responsible for accounting in the main companies of the Group, both proactively and reactively. This communication is useful to solve doubts or

conflicts and it is also useful to guarantee homogeneity in accounting criteria in the Group and it also enables to share best practices among the 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

There is a **Compliance Manual for Consolidation Reporting** which includes specific instructions on preparing the disclosures which comprise the reporting for the consolidation of the Telefónica Group's financial statements and the preparation of consolidated financial information.

Likewise, the Telefónica Group uses specific software system for 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 uses the same accounts plan.

## **F.5. 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 an internal audit function whose competencies include supporting the Audit Committee in its role of monitoring the internal control system, including ICFR. Likewise 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 By-laws 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 Auditor significant 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 Telefónica Group's Internal Audit function reports hierarchically to the General Secretary and the Board and functionally to the Audit and Control Committee. Its activities include: ensuring compliance with applicable laws, internal regulations and the principles of the Group's Code of Ethics; safeguarding the Group's assets, the efficiency and effectiveness of operations, the reliability of information, and the controlled transparency vis-à-vis third parties, and safeguarding the image of the Telefónica Group.

Internal Audit function is developed according to 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 ICFR, Telefónica as a company listed on the New York Stock Exchange is therefore subject to the regulatory requirements established by the US authorities applicable to all companies trading on this exchange.

Among these 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 structure.

The external Auditor issue an independent evaluation on the effectiveness of the Internal Control over the financial reporting.

To fulfil this objective, the Telefónica Group uses the aforementioned ICFR Evaluation Model on three levels the Internal Audit function is responsible for evaluating its performance annually.

**Self-assessment Questionnaires**

All the Group's subsidiaries complete Self-assessment Questionnaires every year, the responses to which are certified by officers in charge of internal control over financial reporting in each company (Chief Executive Officer (CEO) and Chief Financial Officer (CFO)). These questionnaires cover those aspects of ICFR that are deemed to be minimum requirements to achieve reasonable assurance of the reliability of the financial information. A sample of responses is audited.

**Review of processes and specific controls**

As well as the requirement to complete the Self-assessment Questionnaire, certain companies are subject to a direct review of their processes and controls due to the significance of their contribution to the Group's economic and financial figures and other risk factors considered. This review is conducted using the General Evaluation Model, for this purpose, the Scope Definition Model is used, which enables to identify critical accounts in each Telefónica Group company employing previously-established assumptions.

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

- The processes and systems associated with the critical 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 sound.
- Audit tests are carried out to assess the effectiveness of the controls.

**General controls review**

Group general controls are assessed at least annually, considering aspects mainly related to rules and guidelines in force across the entire Group.

Supervision of general controls over information systems has as objective reviewing the management of changes in programs, access to data and systems and the management of changes in infrastructures, back up, programmed tasks and incidents.

**F.5.2. 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 unit of Internal Audit also provides support to the Audit and Control Committee in monitoring the correct functioning of the ICFR system. The results of the final appraisal for 2014 were presented at the February 2015 meeting of the Audit and Control Committee. No material weaknesses or significant shortcomings in the ICFR structure and procedures were identified.

The results of the assessment for the year 2014 have been presented in the Audit and Control in February 2015, informing that this evaluation have not revealed material weaknesses or significant deficiencies in the structure and procedures of internal control over financial reporting (ICFR).

Each year the External Auditor issues its own opinion on the effectiveness of ICFR. At the date of this report, the External Auditor has not notified the Audit and Control Committee of the existence of any control shortcomings which constitute material weaknesses or significant deficiencies for 2014.

Furthermore, the External Auditor participates regularly in the Audit and Control Committee meetings, when called to do so by the 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.

**F.6. Other relevant information**

Not Applicable

**F.7. External auditor report**

**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.**

The attached information on ICFR has been submitted for 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 degree of the company's compliance with Corporate Governance recommendations.

Should the company not comply with any of the recommendations or comply only in part, include a detailed explanation of the reasons so that shareholders, investors and the market in general have enough information to assess the company's behavior. General explanations are not 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.

See sections: A.10, B.1, B.2, C.1.23 and C.1.24.

### Explain

In accordance with Article 26 of the Corporate By-laws, 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 By-laws 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 By-laws 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 By-laws (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 in the interests of all shareholders, , an offer for one hundred percent of the capital, 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 Corporate Enterprises 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 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.

In addition, the special requirements for appointment as Director (Article 30 of the Corporate By-laws) or as Chairman, Vice Chairman, Chief Executive Officer or member of the Executive Commission (Article 31 of the Corporate By-laws) 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 By-laws.

**2 When a dominant and a subsidiary company are stock market listed, the two should provide detailed disclosure on:**

- a) **The type of activity they engage in, and any business dealings between them, as well as between the subsidiary and other group companies;**
- b) **The mechanisms in place to resolve possible conflicts of interest.**

See sections: D.4 and D.7

**Not applicable**

**3 Even when not expressly required under company law, any decisions involving a fundamental corporate change should be submitted to the General Shareholders' Meeting for approval or ratification. In particular:**

- a) **The transformation of listed companies into holding companies through the process of subsidiarization, i.e. reallocating core activities to subsidiaries that were previously carried out by the originating firm, even though the latter retains full control of the former;**
- b) **Any acquisition or disposal of key operating assets that would effectively alter the company's corporate purpose;**
- c) **Operations that effectively add up to the company's liquidation.**

See section: B.6

**Complies**

**4 Detailed proposals of the resolutions to be adopted at the General Shareholders' Meeting, including the information stated in Recommendation 27, should be made available at the same time as the publication of the Meeting notice.**

**Complies**

**5 Separate votes should be taken at the General Meeting on materially separate items, so shareholders can express their preferences in each case. This rule shall apply in particular to:**

- a) The appointment or ratification of directors, with separate voting on each candidate;
- b) Amendments to the bylaws, with votes taken on all articles or group of articles that are materially different.

Complies

- 6. Companies should allow split votes, so financial intermediaries acting as nominees on behalf of different clients can issue their votes according to instructions.

Complies

- 7. The Board of Directors should perform its duties with unity of purpose and independent judgment, according all shareholders the same treatment. It should be guided at all times by the company's best interest and, as such, strive to maximize its value over time.

It should likewise ensure that the company abides by the laws and regulations in its dealings with stakeholders; fulfils its obligations and contracts in good faith; respects the customs and good practices of the sectors and territories where it does business; and upholds any additional social responsibility principles it has subscribed to voluntarily.

Complies

- 8 The board should see the core components of its mission as to approve the company's strategy and authorize the organizational resources to carry it forward, and to ensure that management meets the objectives set while pursuing the company's interests and corporate purpose. As such, the board in full should reserve the right to approve:

- a) The company's general policies and strategies, and, in particular:
  - i. The strategic or business plan, management targets and annual budgets;
  - ii. Investment and financing policy;
  - iii. Design of the structure of the corporate group;
  - iv. Corporate governance policy;
  - v. Corporate social responsibility policy;
  - vi. Remuneration and evaluation of senior officers;
  - vii. Risk control and management, and the periodic monitoring of internal information and control systems.
  - viii. Dividend policy, as well as the policies and limits applying to treasury stock.

See sections: C.1.14, C.1.16 and E.2

- b) The following decisions:
  - i. On the proposal of the company's chief executive, the appointment and removal of senior officers, and their compensation clauses.

- ii. Directors' remuneration, and, in the case of executive directors, the additional consideration for their management duties and other contract conditions.
  - iii. The financial information that all listed companies must periodically disclose.
  - iv. Investments or operations considered strategic by virtue of their amount or special characteristics, unless their approval corresponds to the General Shareholders' Meeting;
  - v. The creation or acquisition of shares in special purpose vehicles or entities resident in countries or territories considered tax havens, and any other transactions or operations of a comparable nature whose complexity might impair the transparency of the group.
- c) Transactions which the company conducts with directors, significant shareholders, shareholders with board representation or other persons related thereto ("related-party transactions").

However, board authorization need not be required for related-party transactions that simultaneously meet the following three conditions:

1. They are governed by standard form contracts applied on an across-the-board basis to a large number of clients;
2. They go through at market prices, generally set by the person supplying the goods or services;
3. Their amount is no more than 1% of the company's annual revenues.

It is advisable that related-party transactions should only be approved on the basis of a favorable report from the Audit Committee or some other committee handling the same function; and that the directors involved should neither exercise nor delegate their votes, and should withdraw from the meeting room while the board deliberates and votes.

Ideally the above powers should not be delegated with the exception of those mentioned in b) and c), which may be delegated to the Executive Committee in urgent cases and later ratified by the full board.

See sections: D.1 and D.6

#### **Complies**

- 9 In the interests of maximum effectiveness and participation, the Board of Directors should ideally comprise no fewer than five and no more than fifteen members.

See sections: C.1.2

#### **Explain**

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.

In addition, it is important to bear in mind the Company's large number of Board committees, which ensures the active participation of all its Directors.

- 10 External directors, proprietary and independent, should occupy an ample majority of board places, 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.**

See sections: A.3 and C.1.3

#### **Complies**

- 11 That among external directors, the relation between proprietary members and independents should match the proportion between the capital represented on the board by proprietary directors and the remainder of the company's capital.**

**This proportional criterion can be relaxed so the weight of proprietary directors is greater than would strictly correspond to the total percentage of capital they represent:**

- 1. In large cap companies where few or no equity stakes attain the legal threshold for significant shareholdings, but where there are shareholders with high absolute value shareholdings.**
- 2. In companies with a plurality of shareholders represented on the board but not otherwise related.**

See sections: A.2, A.3 and C.1.3

#### **Explain**

The aforementioned recommendation 11 refers to the composition of the group of External Directors. As stated in Section C.1.3 of this Annual Corporate Governance Report, at 31 December 2014, the group of External Directors of Telefónica, S.A. was composed of 15 members (of a total of 18 Members), of whom 5 are Proprietary Directors, 8 are Independent Directors and 2 falls under the "Other External Directors" category.

Of the five Proprietary Directors, two act in representation of Fundación Bancaria Caixa d'Estalvis i Pensions de Barcelona, "la Caixa", which holds 5.25% of the capital of Telefónica, S.A., two act in representation of Banco Bilbao Vizcaya Argentaria, S.A. (BBVA), which holds 6.25% of the capital, and one acts in representation of China Unicom (Hong Kong) Limited (China Unicom) which holds a 1.38% 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 11 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, despite the considerable sums actually invested.

In this regard, Telefónica ranks among the top listed companies on Spanish stock exchanges in terms of stock market capitalization, reaching the figure of 55,514 million euros at December 31, 2014, which means a very high absolute value of the stakes of "la Caixa" and BBVA in Telefónica (that of "la Caixa" is 2,914 million euros, and that of BBVA is 3,470 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 Corporate Enterprises 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.

**12 The number of independent directors should represent at least one third of all board members.**

See section: C.1.3

**Complies**

**13 The nature of each director should be explained to the General Meeting of Shareholders, which will make or ratify his or her appointment. Such determination should subsequently be confirmed or reviewed in each year's Annual Corporate Governance Report, after verification by the Nomination Committee. Said Report should also disclose the reasons for the appointment of proprietary directors at the urging of shareholders controlling less than 5% 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 directorships.**

See sections: C.1.3 and C.1.8

**Complies**

**14 When women directors are few or non existent, the Nomination Committee should take steps to ensure that:**

- a) The process of filling board vacancies has no implicit bias against women candidates;**
- b) The company makes a conscious effort to include women with the target profile among the candidates for board places.**

See sections: C.1.2, C.1.4, C.1.5, C.1.6, C.2.2 and C.2.4

**Explain**

In fact, 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 coopt, at the proposal of the Nominating, Compensation and Corporate Governance Committee, Ms. María Eva Castillo Sanz as an Independent Director of Telefónica. This appointment was ratified by the Ordinary General Shareholders' Meeting of Telefónica held on April 22, 2008, having been re-elected for that position by the General Shareholders Meeting that was held on May 31, 2013.

Likewise, on December 19, 2007, the Board of Directors unanimously agreed, following a favorable report from the Nominating, Compensation and Corporate Governance Committee, to appoint Ms. María Luz Medrano Aranguren as Vice General Counsel of the Board of Directors of Telefónica.

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.

Therefore, the selection procedure described above is based exclusively on the personal merits of the candidates ("recognized caliber, 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.

- 15 The Chairman, as the person responsible for the proper operation of the Board of Directors, should ensure that directors are supplied with sufficient information in advance of board meetings, and work to procure a good level of debate and the active involvement of all members, safeguarding their rights to freely express and adopt positions; he or she should organize and coordinate regular evaluations of the board and, where appropriate, the company's chief executive, along with the chairmen of the relevant board committees.**

See sections: C.1.19 and C.1.41

**Complies**

- 16 When a company's Chairman is also its chief executive, an independent director should be empowered to request the calling of board meetings or the inclusion of new business on the agenda; to coordinate and give voice to the concerns of external directors; and to lead the board's evaluation of the Chairman.**

See sections: C.1.22

**Complies**

- 17 The Secretary should take care to ensure that the board's actions:**
- a) Adhere to the spirit and letter of laws and their implementing regulations, including those issued by regulatory agencies;**
  - b) Comply with the company bylaws and the regulations of the General Shareholders' Meeting, the Board of Directors and others;**
  - c) Are informed by those good governance recommendations of the Unified Code that the company has subscribed to.**

In order to safeguard the independence, impartiality and professionalism of the Secretary, his or her appointment and removal should be proposed by the Nomination Committee and approved by a full board meeting; the relevant appointment and removal procedures being spelled out in the board's regulations.

See section: C.1.34

**Complies**

- 18 The board should meet with the necessary frequency to properly perform its functions, in accordance with a calendar and agendas set at the beginning of the year, to which each director may propose the addition of other items.**

See sections: C.1.29

**Complies**

- 19 Director absences should be kept to the bare minimum and quantified in the Annual Corporate Governance Report. When directors have no choice but to delegate their vote, they should do so with instructions.

See sections: C.1.28, C.1.29 and C.1.30

**Complies**

- 20 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, the person expressing them can request that they be recorded in the minute book.

**Complies**

- 21 The board in full should evaluate the following points on a yearly basis:

- a) The quality and efficiency of the board's operation;
- b) Starting from a report submitted by the Nomination Committee, how well the Chairman and chief executive have carried out their duties;
- c) The performance of its committees on the basis of the reports furnished by the same.

See sections: C.1.19 and C.1.20

**Complies**

- 22 All directors should be able to exercise their right to receive any additional information they require on matters within the board's competence. Unless the bylaws or board regulations indicate otherwise, such requests should be addressed to the Chairman or Secretary.

See sections: C.1.41

**Complies**

- 23 All directors should be entitled to call on the company for the advice and guidance they need to carry out their duties. The company should provide suitable channels for the exercise of this right, extending in special circumstances to external assistance at the company's expense.

See sections: C.1.40

**Complies**

- 24 Companies should organize induction programs for new directors to acquaint them rapidly with the workings of the company and its corporate governance rules. Directors should also be offered refresher programs when circumstances so advise.

**Complies**

- 25 Companies should require their directors to devote sufficient time and effort to perform their duties effectively, and, as such:

- a) Directors should apprise the Nomination Committee of any other professional obligations, in case they might detract from the necessary dedication;
- b) Companies should lay down rules about the number of directorships their board members can hold.

See sections: C.1.12, C.1.13 and C.1.17

**Partially Complies**

Telefónica, SA has not established quantitative rules about the number of Boards that its Directors may sit. Nevertheless, the Regulations of the Board of Directors includes among the obligations of Directors (Article 28.2 of the Board Regulations) that Directors must devote the time and effort required to perform its functions and, to this end, shall inform to the Nominating, Compensation and Corporate Governance Committee about any other professional obligations that might interfere with the performance of their duties as Directors.

- 26 The proposal for the appointment or renewal of directors which the board submits to the General Shareholders' Meeting, as well as provisional appointments by the method of co-option, should be approved by the board:

- a) On the proposal of the Nomination Committee, in the case of independent directors.
- b) Subject to a report from the Nomination Committee in all other cases.

See sections: C.1.3

**Complies**

- 27 Companies should post the following director particulars on their websites, and keep them permanently updated:

- a) Professional experience and background;
- b) Directorships held in other companies, listed or otherwise;
- c) An indication of the director's classification as executive, proprietary or independent; In the case of proprietary directors, stating the shareholder they represent or have links with.
- d) The date of their first and subsequent appointments as a company director; and
- e) Shares held in the company and any options on the same.



Complies

- 28 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.

See sections: A.2, A.3 and C.1.2

Complies

- 29 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 just cause is found by the board, based on a proposal from the Nomination Committee. In particular, just cause will be presumed when a director is in breach of his or her fiduciary duties or comes under one of the disqualifying grounds enumerated in Ministerial Order ECC/461/2013.

The removal of independents may also be proposed when a takeover bid, merger or similar corporate operation produces changes in the company's capital structure, in order to meet the proportionality criterion set out in Recommendation 11.

See sections: C.1.2, C.1.9, C.1.19 and C.1.27

Complies

- 30 Companies should establish rules obliging directors to inform the board of any circumstance that might harm the organization's name or reputation, tendering their resignation as the case may be, with particular mention 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 crimes stated in article 213 of the Public Limited Companies Act, the board should examine the matter and, in view of the particular circumstances and potential harm to the company's name and reputation, decide whether or not he or she should be called on to resign. The board should also disclose all such determinations in the Annual Corporate Governance Report.

See sections: C.1.42, C.1.43

Complies

- 31 All directors should express clear opposition when they feel a proposal submitted for the board's approval might damage the corporate interest. In particular, independents and other directors unaffected by the conflict of interest should challenge any decision that could go against 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.

This terms of this Recommendation should also apply to the Secretary of the board, director or otherwise.

Complies

- 32 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. Irrespective of whether such resignation is filed as a significant event, the motive for the same must be explained in the Annual Corporate Governance Report.

See sections: C.1.19

Not applicable

- 33 Remuneration comprising the delivery of shares in the company or other companies in the group, share options or other share-based instruments, payments linked to the company's performance or membership of pension schemes should be confined to executive directors.

The delivery of shares is excluded from this limitation when directors are obliged to retain them until the end of their tenure.

Complies

- 34 External directors' remuneration should sufficiently compensate them for the dedication, abilities and responsibilities that the post entails, but should not be so high as to compromise their independence.

Complies

- 35 In the case of remuneration linked to company earnings, deductions should be computed for any qualifications stated in the external auditor's report.

Not applicable

- 36 In the case of variable awards, remuneration policies should include 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, atypical or exceptional transactions or circumstances of this kind.

Complies

- 37 When the company has an Executive Committee, the breakdown of its members by director category should be similar to that of the board itself. The Secretary of the board should also act as secretary to the Executive Committee.

See sections: C.2.1 and C.2.6.

Complies

- 38 The board 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 In addition to the Audit Committee mandatory under the Securities Market Act, the Board of Directors should form a committee, or two separate committees, of Nomination and Remuneration.

The rules governing the make-up and operation of the Audit Committee and the committee or committees of Nomination and Remuneration should be set forth in the board regulations, and include the following:

- a) The Board of Directors should appoint the members of such committees with regard to the knowledge, aptitudes and experience of its directors and the terms of reference of each committee; discuss their proposals and reports; and be responsible for overseeing and evaluating their work, which should be reported to the first board plenary following each meeting;
- b) These committees should be formed exclusively of external directors and have a minimum of three members. Executive directors or senior officers may also attend meetings, for information purposes, at the Committees' invitation.
- c) Committees should be chaired by an independent director.
- d) They may engage external advisors, when they feel this is necessary for the discharge of their duties.
- e) Meeting proceedings should be minuted and a copy of the minutes sent to all board members.

See sections: C.2.1 and C.2.4

Complies

- 40 The job of supervising compliance with internal codes of conduct and corporate governance rules should be entrusted to the Audit Committee, the Nomination Committee or, as the case may be, separate Compliance or Corporate Governance committees.

See sections: C.2.3 and C.2.4

Complies

- 41 All members of the Audit Committee, particularly its chairman, should be appointed with regard to their knowledge and background in accounting, auditing and risk management matters.

Complies

- 42 Listed companies should have an internal audit function, under the supervision of the Audit Committee, to ensure the proper operation of internal reporting and control systems.

See sections: C.2.3

**Complies**

- 43 The head of internal audit should present an annual work program to the Audit Committee, report to it directly on any incidents arising during its implementation, and submit an activities report at the end of each year.

**Complies**

- 44 Control and risk management policy should specify at least:

- a) The different types of risk (operational, technological, financial, legal, reputational, ...) the company is exposed to, 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) Measures in place to mitigate the impact of risk events should they occur;
- d) The internal reporting and control systems to be used to control and manage the above risks, including contingent liabilities and off-balance sheet risks.

See section: E

**Complies**

- 45 The Audit Committee's role should be:

1<sup>st</sup>. With respect to internal control and reporting systems:

- a) Review internal control and risk management systems on a regular basis, so the main risks are properly identified, managed and disclosed.
- b) Monitor the independence and efficacy of the internal audit function; propose the selection, appointment, reappointment and removal of the head of internal audit; propose the department's budget; 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 necessary, anonymously, any irregularities they detect in the course of their duties, in particular financial or accounting irregularities, with potentially serious implications for the firm.

2<sup>nd</sup>. With respect of the external auditor:

- a) Receive regular information from the external auditor on the progress and findings of the audit programme, and check that senior management are acting on its recommendations.
- b) Monitor the independence of the external auditor, to which end:
  - i. The company should notify any change of auditor to the CNMV as a significant event, accompanied by a statement of any disagreements arising with the outgoing auditor and the reasons for the same.

- ii. The Audit Committee will investigate the issues giving rise to the resignation of any external auditor.

See sections: C.1.36, C.2.3, C.2.4 and E.2

**Complies**

- 46 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**

- 47 The Audit Committee should prepare information on the following points from Recommendation 8 for input to board decision-making:

a) The financial information that all listed companies must periodically disclose. The Committee should ensure that interim statements are drawn up under the same accounting principles as the annual statements and, to this end, may ask the external auditor to conduct a limited review.

b) The creation or acquisition of shares in special purpose vehicles or entities resident in countries or territories considered tax havens, and any other transactions or operations of a comparable nature whose complexity might impair the transparency of the group.

c) Related-party transactions, except where their scrutiny has been entrusted to some other supervision and control committee.

See sections: C.2.3 and C.2.4

**Complies**

- 48 The Board of Directors should seek to present the annual accounts to the General Shareholders' Meeting without reservations or qualifications in the audit report. Should such reservations or qualifications exist, both the Chairman of the Audit Committee and the auditors should give a clear account to shareholders of their scope and content.

See section: C.1.38

**Complies**

- 49 The majority of Nomination Committee members – or Nomination and Remuneration Committee members as the case may be – should be independent directors.

See section: C.2.1

**Complies**

50. The Remuneration Committee should have the following functions in addition to those stated in earlier recommendations:
- a) Evaluate the balance of skills, knowledge and experience on the board, define the roles and capabilities required of the candidates to fill each vacancy, and decide the time and dedication necessary for them to properly perform their duties.
  - b) Examine or organize, in appropriate form, the succession of the chairman and chief executive, making recommendations to the board so the handover proceeds in a planned and orderly manner.
  - c) Report on the senior officer appointments and removals which the chief executive proposes to the board.
  - d) Report to the board on the gender diversity issues discussed in Recommendation 14 of this Code.

See section: C.2.4

**Complies**

51. The Nomination Committee should consult with the company's Chairman and chief executive, especially on matters relating to executive directors.
- Any board member may suggest directorship candidates to the Nomination Committee for its consideration.

**Complies**

52. The Remuneration Committee should have the following functions in addition to those stated in earlier recommendations:
- a) Make proposals to the Board of Directors regarding:
    - i) The remuneration policy for directors and senior officers;
    - ii) The individual remuneration and other contractual conditions of executive directors.
    - iii) The standard conditions for senior officer employment contracts.
  - b) Oversee compliance with the remuneration policy set by the company.

See section: C.2.4

**Complies**

53. The Remuneration Committee should consult with the Chairman and chief executive, especially on matters relating to executive directors and senior officers.

Complies

## H Other information of interest

- i) 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.

--

- ii) You may include in this Section any other information, clarification or observation related to the above Sections of this report.

**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.**

- iii) The company may also state whether it voluntarily subscribes to other international, sectorial or other ethical principles or standard practices. If applicable identify the Code and date of adoption.

GENERAL CLARIFICATION: It is hereby stated that the details contained in this report refer to the financial year ended on December 31, 2014, except in those issues in which a different date of reference is specifically mentioned.

### - Note 1 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 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 authorization by the Regulatory Compliance Committee.

### - Note 2 to Section A.3

At the General Shareholders' Meeting on May 18, 2011, shareholders approved the introduction of a long-term incentive plan for managers of the Group (including Executive Directors) known as the Performance & Investment Plan ("PIP"). Under this plan, participants who met the qualifying requirements were 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.

Moreover, at the General Shareholders' Meeting on May 30, 2014, shareholders approved the introduction of a new 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 options" and "Equivalent number of shares" (i.e. Mr. César Alierta Izuel, 972,417-1,519,401; Mr. Julio Linares López, 13,878-21,686; Mr. José María Álvarez-Pallete López, 572,131-893,955; and Mr. Santiago Fernández Valbuena, 1,311,223-1,486,287) relate to the theoretical number of shares assigned and the maximum possible number of shares to be received in the



second and third phase of the Plan approved by the General Shareholders' Meeting of May 18, 2011, and to the first phase of the Plan approved by the General Shareholders' Meeting of May 30, 2014, if the co-investment requirement established in these Plans and the maximum target TSR established for each phase are met.

In the case of Mr. Julio Linares López, the number of shares quoted exclusively matches the theoretical number of shares assigned, and the maximum possible number of shares to be received, in the second and third phase of the Plan approved by the General Shareholders' Meeting of May 18, 2011.

In the case of Mr. Santiago Fernández Valbuena, this figure includes 500,000 call options granting the right to purchase 500,000 Telefónica, S.A. shares at the maturity date (September 11, 2015) at an exercise price of 12.55 euros, and a further 500,000 call options granting the right to purchase 500,000 Telefónica, S.A. shares at the maturity date (January 29, 2016) at an exercise price of 13.37 euros.

It is further stated for the record that, as of December 31, 2014, a maximum of 149,787 shares and 162,500 shares (in total 312,287) had been allocated to Ms. Eva Castillo Sanz for her participation in the Performance & Investment Plan, for the two cycles of 2012-2015 and 2013-2016, respectively, and that in January 2015, she received 862,475 euros in settlement of her participation in the aforementioned plan.

**- Note 3 to Section A.6.]**

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 Corporate Enterprises 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 are considered a shareholder agreement as per Article 518 of the Corporate Enterprises Act. By virtue of these clauses, Telefónica may not, while the strategic partnership agreement is in force, offer, issue or sell a significant number of its shares or any convertible security or security that confers 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 was rendered null and void 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.

On January 23, 2011, 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 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 committed to proposing the appointment of a board member nominated by China Unicom at the next General Shareholders' Meeting, in accordance with prevailing legislation and the Company's By-laws. The General Shareholders' Meeting held on May 18, 2011 duly approved the appointment of China Unicom's nominee, Mr. Chang Xiaobing, as member of the Board of Directors.

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 current exchange rates.

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.

Telefónica maintains its commitment to the Strategic Partnership with China Unicom.

**Note 4 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 10% 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 Corporate Enterprises 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 Corporate Enterprises 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 5 to Section B.6.]**

Both Article 15 of the Company's By-laws and Article 5 of the Regulations for the General Shareholders' Meeting expressly define the following powers among those conferred on the general Shareholders' Meeting:

- The transformation of the Company into a holding company through "subsidiarization" or by entrusting subsidiaries with the conduct of core activities previously carried out by the Company itself.
- The acquisition or disposal of essential operating assets, when this entails an effective amendment of the corporate purpose.
- Transactions, the effect of which is tantamount to liquidating the Company and, especially, the approval of the final balance sheet upon liquidation.

**- Note 6 to Section C.1.12.]**

Mr. Ignacio Moreno Martínez of Secuoya, Grupo de Comunicación, S.A., is the individual representing the Board member Cardomana Servicios y Gestiones, S.L.

Mr. Antonio Massanell Lavilla, in the Company Boursorama, S.A. is the individual representing the Board member Fundació Bancaria Caixa d'Estalvis i Pensions de Barcelona, "la Caixa".

The appointment of Mr. Antonio Massanell Lavilla as Director of Banco Português de Investimento, S.A. (BPI) is pending of registration in the Public Register of Directors.

**- Note 7 to Section C.1.13.]**

Telefónica, SA has not established quantitative rules about the number of Boards that its Directors may sit. Nevertheless, the Regulations of the Board of Directors includes among the obligations of Directors (Article 28.2 of the Board Regulations) that Directors must devote the time and effort required to perform its functions and, to this end, shall inform to the Nominating, Compensation and Corporate Governance Committee about any other professional obligations that might interfere with the performance of their duties as Directors.

**- Note 8 to Section C.1.14.]**

Although the investment and financing policy is not included literally in Article 5.4. of the Regulations of the Board of Directors, in practice said policy is the exclusive competence of the Board of Directors of the Company.

**- Note 9 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 committees or CEOs. Additionally, and for the purposes of annual remuneration, the person in charge of the internal audit is included.

It is hereby stated that Mr. Matthew Key ceased to be part of the Company's Senior Management on February 26, 2014, having perceived in January 2015 (date of his departure from the company) under the conditions established in its day, on his contract, an amount of 15,150,969 euros as result of the termination of his executive functions in the Telefónica Group. The amount of 15,150,969 euros is included in the amount of 26,766 thousand euros, consigned as "Total remuneration received by senior management" in the section of this report C.1.16 of this report.

**Note 10 to Section C.1.17.]**

Mr. Antonio Massanell Lavilla is Non Executive Chairman of Cecabank, S.A.

Mr. Jose Fernando de Almansa Moreno-Barreda is Acting Director of Grupo Financiero BBVA Bancomer, S.A. de C.V. and of BBVA Bancomer, S.A.

**- Note 11 to Section C.1.31.]**

In accordance with U.S. 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 12 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 Individual 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 13 to Section C.1.45 ]**

It is also stated for the record that in February 2015, the golden parachute provisions included in the four-year contract of the Executive Chairman, Mr. César Alierta Izuel, were replaced by an extraordinary one-time contribution of 35.5 million euro to a benefit plan, as part of the company's policy of reducing indemnity provisions, in line with best corporate governance practices. After this extraordinary contribution, Telefónica, S.A. will not contribute any additional annual amounts to the Benefit Plan for Officers with respect to for Mr. Alierta Izuel. Such contribution would be received by Mr. Alierta Izuel in the same instances established in the benefit plan for officers (*plan de previsión social de directivos*) (PPSD) applicable to the other officers.

**- Note 14 to Section C.2.4.]**

**Audit and Control Committee**

Pursuant to the provisions of Article 39 of the Corporate By-laws of Telefónica, S.A., Article 22 of the Regulations of the Board of Directors regulates the Audit and Control Committee in 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 at least one of them must be an Independent Director. When appointing such members, 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.

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) To report, through its Chairman, to the shareholders at the General Shareholders' Meeting on issues raised therein in connection with matters within its purview.

- To propose to the Board of Directors, for submission to the shareholders at the General Shareholders' Meeting, the appointment of the Auditor mentioned in Article 264 of the Corporate Enterprises Act, as well as, where appropriate, terms for the hiring thereof, the scope of its professional engagement and the revocation or renewal of its appointment.
- To supervise internal audit and, in particular:
  - a) To ensure the independence and efficiency of the internal audit function.
  - b) To propose the selection, appointment and removal of the person responsible for the internal audit.
  - c) To propose the budget for this service.
  - d) To review the annual internal audit work plan and the annual activities report.
  - e) To receive periodic information on its activities.
  - f) To verify that senior executives take account of the conclusions and recommendations of the reports.
- To supervise the process of preparing and submitting regulated financial information. 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.
- To supervise the effectiveness of the Company's internal control system and risk management systems, and to discuss with the Auditor significant weaknesses in the internal control system detected during the audit. 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) establishment of the level of risk that the Company deems acceptable; the measures to mitigate the impact of the identified risks, should they materialize.

c) the control and information systems to be used to control and manage these risks.

- To 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.
- To 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 independence thereof, as well as any other matters relating to the audit procedure, 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 information regarding additional services of any kind provided to such entities by the Auditor or by the persons or entities related thereto pursuant to the provisions of prevailing legislation.

- To issue on an annual basis, prior to the issuance of the audit report, a report stating an opinion regarding the independence of the Auditor. This report must in all cases include an opinion on the provision of the additional services referred to in point 7) above.

c) Operation.

The Audit and Control Committee shall meet at least once every quarter and as often as appropriate, when called by its Chairman.

In the performance of its duties, the Audit and Control Committee may require that the Company's Auditor and the person responsible for internal audit, and any employee or senior executive officer of the Company, attend its meetings.

### **Service Quality and Customer Service Committee**

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:

- To periodically examine, review and monitor the quality indices of the principal services provided by the companies of the Telefónica Group.
- To evaluate levels of customer service provided by the companies of the Group to their customers.

### **Strategy Committee**

a) Composition.

The Board of Directors shall determine the number of members of this Committee.

The Chairman of the Strategy Committee shall be appointed from among its members.

b) Duties.

Without prejudice to any other tasks that the Board of Directors may assign thereto, the primary duty of the Strategy Committee shall be to support the Board of Directors in analyzing and monitoring the Telefónica Group's global strategy policy.

#### **Innovation Committee**

a) Composition.

The Board of Directors shall determine the number of members of this Committee.

The Chairman of the Innovation Committee shall be appointed from among its members.

b) Duties.

The Innovation Committee is primarily responsible for advising and assisting 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.

#### **Nominating, Compensation and Corporate Governance Committee**

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 the majority of them must be 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) Competences.

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

- 1) To report, following standards of objectivity and conformity to the corporate interest, on the proposals for the appointment, re-election and removal of Directors and senior executives of the Company and its subsidiaries, as well as the Secretary and, if applicable, the Deputy Secretary of the respective Board of Directors, and evaluate the qualifications, knowledge and experience required of candidates to fill vacancies.
- 2) 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.
- 3) To propose to the Board of Directors the appointment of the Lead Director from among the Independent Directors.
- 4) Together with the Chairman of the Board of Directors, to organize and coordinate a periodic assessment of the Board of Directors pursuant to Article 13.3 of the Regulations of the Board.
- 5) To inform on the periodic assessment of the performance of the Chairman of the Board of Directors.
- 6) To examine or organize, in such manner as is deemed fit, 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.

- 7) To propose to the Board of Directors, within the framework established in the Corporate By-laws, 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.
  - 8) To propose to the Board of Directors, within the framework established in the By-Laws, 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.
  - 9) To prepare and propose to the Board of Directors an annual report regarding the Director compensation policy.
  - 10) To supervise compliance with the Company's internal rules of conduct and the corporate governance rules thereof in effect at any given time.
  - 11) To exercise such other powers and perform such other duties as are assigned to such Committee in these Regulations.
- 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.

#### **Regulation Committee**

- a) Composition.

The Regulation 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 Regulation Committee shall be appointed from among its members.

- b) Duties.

Notwithstanding other duties entrusted to it by the Board of Directors, the Regulation Committee shall have at least the following functions:

- 1) To monitor on a permanent basis the principal regulatory matters and issues affecting the Group at any time, through the study, review and discussion thereof.
- 2) To act as a communication and information channel on regulatory matters between the management team and the Board of Directors and, where appropriate, to advise the Board of Directors of those matters deemed significant to the Company or to any of the companies of the Group in respect of which it is necessary or appropriate to make a decision or adopt a particular strategy.

#### **Institutional Affairs Committee**

- a) Composition.

The Board of Directors shall determine the number of members of this Committee.

The Chairman of the 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 Institutional Affairs Committee's main duty shall be to examine and analyze matters and issues relating to the Telefónica Group's institutional relations.

### **Executive Commission**

#### **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) Duties.**

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 By-laws, 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 executions of its tasks, since it meets more often.

#### **c) 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) Relations 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).

### **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.

### **- Note 15 to Section D.2.]**

The following is hereby placed on record:

The operations included in this section under the heading "Other", in the amount of 23,247,109 with Banco Bilbao Vizcaya Argentaria, S.A. correspond to Dividends received (13,847) and Derivatives (23,233,262).

The operations included in this section under the heading "Other", in the amount of 1,150,169 with Banco Bilbao Vizcaya Argentaria, S.A. correspond to Other costs (3,280), Profits from retirement or disposal of assets (6), Other income (2,504), Other operations (111,562), and Derivatives (1,032,817).

The operations included in this section under the heading "Other", in the amount of 1,220,965 with la Caixa Group, correspond to Derivatives.

The operations included in this section under the heading "Other", in the amount of 53 with la Caixa Group, correspond to Other costs.

**- Note 16 to Section D.5.]**

Certain members of the Board of Directors of Telefónica, SA are themselves members of the Board of Directors of Abertis Infraestructuras, S.A., parent company of the Group Abertis. In 2014 and 2013, Telefónica has reached agreements with Abertis, through its company Abertis Tower, S.A., under which Telefónica Móviles Spain, S.A.U. transferred mobile telephone towers to Abertis, earning capital gains of 193 and 70 million euros, respectively. An agreement was also drawn up whereby Abertis Tower, S.A.U. leased space in this infrastructure for Telefónica Móviles España, S.A.U. to install its communications equipment.

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 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 adopted by the Company's Board of Directors at its meeting held on February 23, 2015.**

**State whether any directors voted against approval of this Report, or abstained from voting.**

**No**

Name or corporate name of director	Reasons (voted against, abstention, non-attendance)	Explain the reasons
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## **ANNEX TO THE ANNUAL CORPORATE GOVERNANCE REPORT**

E.3 Indicate the main risks that may affect the achievement of business objectives.

### **Risks and Uncertainties Facing the Company**

The Telefónica Group's business is conditioned 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 is affected by various legislations, as well as 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 business, financial position, cash flows and/or the performance of some or all of the Group's financial indicators.

With respect to the economic environment, the Telefónica Group's business is impacted by overall economic conditions in each of the countries in which it operates. 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. Factors such as high debt levels, ongoing restructuring of the banking sector, the implementation of pending structural reforms and continued fiscal austerity measures could hinder more dynamic growth in Europe and, in turn, the consumption and volume of demand for the Group's services, which could materially adversely affect the Group's business, financial condition, results of operations and cash flows.

The soft economic recovery in Europe together with low inflation rates, and the risk of deflation, has led and may still lead to monetary and fiscal easing from key players, with a view to creating a relatively benign scenario for Europe. In this region, the Telefónica Group generated 23.9% of its total revenues in Spain, 14.0% in the United Kingdom and 11.0% in Germany in 2014.

In addition, the Group's business may be affected by other possible effects from the economic crisis, including possible insolvency of key customers and suppliers.

In Latin America, the most important challenge is the exchange-rate risk in Venezuela and Argentina, given the negative impact that depreciation in their currencies could have on cash flows from both countries. International financial conditions may be unfavorable and may lead to potential periods of volatility linked to the evolution of the developed financial markets (especially long-term interest rates in the United States affected by the U.S. Federal Reserve's intervention that are not discounted in the market), an economic slowdown in Asia (a key region for Latin America) and slow progress with structural reforms projects in the majority of these countries limiting potential for higher growth rates. Among the most significant macroeconomic risk factors in the region are the high inflation rates, negative economic growth and high internal and external funding needs in Venezuela. These funding needs are significant and are affected by the recent fall in oil prices, which is the main and almost sole source of foreign currency in the country. These factors are affecting Venezuela's competitiveness and may result in a currency devaluation. Other risks in the region are Argentina's high level of inflation coupled with a phase of economic slowdown and weak public finances. Moreover, the recent decline in the prices of oil and other commodities could have a negative impact on the external accounts of countries such as Brazil, Chile, Peru and Colombia.

In relation to the political environment, the Group's investments and operations in Latin America could be affected by a series of risks related to economic, political and social factors in these countries, collectively denominated "country risk". For the year ended December 31, 2014, Telefónica Hispanoamérica and Telefónica Brazil represented 26.1% and 22.3% of the Telefónica Group's revenues, respectively. Moreover, approximately 9.6% of the Group's revenues in the telephony business are generated in countries that do not have investment grade status (in order of importance, Argentina, Venezuela, Ecuador, Nicaragua, Guatemala, El Salvador and Costa Rica), and other countries are only one notch away

from losing this threshold. It is also significant that, despite clear improvements in Brazil, the uncertainty surrounding the political situation, fiscal policy stimuli and a relatively high inflation rate could result in a rating downgrade that, depending on the extent of such downgrade, could result in strong exchange-rate volatility due to an outflow of investments, especially in relation to fixed-income.

“Country risk” factors include the following:

- government regulation or administrative policies may change unexpectedly, including changes that modify the terms and conditions of licenses and concessions and their renewal (or delay their approvals), which could negatively affect the Group's business in such countries;
- abrupt exchange-rate fluctuations may occur mainly due to high levels of inflation and both fiscal and external deficits with the resulting exchange-rate overvaluation. This movement could lead to strong exchange-rate depreciation in the context of a floating exchange rate regime, a significant devaluation off the back of abandoning fixed exchange rates regimes or the introduction of varying degrees of restrictions on capital movement. For example, in Venezuela, the official U.S. dollar to bolívar fuerte exchange rate is established by the Central Bank of Venezuela and the Minister of Finance, with an alternative market for attracting foreign currency through the Complementary System for Administration of Foreign Currency (*Sistema Complementario de Administración de Divisas* or “SICAD”) regular and selective auctions. In February 2015, a new Exchange Rate Agreement was established, including the regulations for the Foreign Exchange Marginal System (SIMADI), and the Central Bank of Venezuela published on February 18, 2015 a weighted average exchange rate equal to 172.1 bolívares to the U.S. dollar for the markets referred to in chapters II and IV of such Exchange Rate Agreement. Additionally, the acquisition or use of foreign currencies by Venezuelan or Argentinean companies (in some cases) to pay foreign debt or dividends is subject to the pre-authorization of the relevant authorities. Also, the Argentinean peso, despite its recent stability, continues to be under the threat of a sustained accelerated depreciation against the U.S. dollar;
- governments may expropriate or nationalize assets, make adverse tax decisions or increase their participation in the economy and in companies;
- economic-financial downturns, political instability and civil disturbances may negatively affect the Telefónica Group's operations in such countries; and
- maximum limits on profit margins may be 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 will be 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 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, interest rates or financial investment risks.**

At December 31, 2014, 70% of the Group's net debt (in nominal terms) was pegged to fixed interest rates for a period greater than one year, while 27% was denominated in a currency other than the euro.

To illustrate the sensitivity of financial expenses to a change in short-term interest rates at December 31, 2014: (i) a 100 basis points increase in interest rates in all currencies in which Telefónica has a financial position at that date would lead to an increase in financial expenses of 111 million euros, (ii) whereas a 100 basis points decrease in interest rates in all currencies except the euro, the U.S. dollar and the pound sterling (these to zero rates in order to avoid negative rates), would lead to a reduction in financial expenses of 68 million euros. These calculations were made using the same balance position in each currency and same balance position equivalent at such date and bearing in mind the derivative financial instruments arranged.

According to the Group's calculations, the impact on results and specifically changes in the value of 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 76 million euros, primarily due to the weakening of the Venezuelan bolívar and the Argentinean peso. These calculations were made using the same balance position in each currency with an impact on profit or loss at such date, including derivative instruments in place. For the year ended December 31, 2014, 22.8% of the

Telefónica Group's operating income before depreciation and amortization (OIBDA) was concentrated in Telefónica Brazil, 26.2% in Telefónica Hispanoamérica and 11.2% in the Telefónica United Kingdom.

The Telefónica Group uses a variety of strategies to manage these risks, mainly through the use of financial derivatives, which themselves also expose us to risk, including counterparty risk. Furthermore, 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 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 performance, expansion and improvement of the Telefónica Group's networks, the development and distribution of the Telefónica Group's services and products, the development and implementation of the Company's strategic plan, the development and implementation of new technologies or the renewal of licenses as well as expansion of our business in countries where we operate may require a substantial amount of financing.

The performance of financial markets in terms of liquidity, cost of credit, access and volatility, continues to be overshadowed by persisting uncertainty regarding certain factors such as the pace of economic recovery, the health of the international banking system and concerns regarding the burgeoning deficits of some European countries. The worsening international financial market credit conditions caused by some of these factors could make it more difficult and more expensive to refinance existing financial debt or arrange new debt if necessary, and more difficult to raise funds from the Group's shareholders, and may negatively affect the Group's liquidity. At December 31, 2014, gross financial debt scheduled to mature in 2015 amounted to 8,491 million euros (which includes the net position of derivative financial instruments and certain current payables), and gross financial debt scheduled to mature in 2016 amounted to 8,407 million euros. Despite having covered gross debt maturities of 2015, 2016 and part of 2017 by available cash and lines of credit at December 31, 2014, possible difficulties in maintaining the current safety margin, or the risk that this could be significantly and unexpectedly exhausted, could force Telefónica to use resources allocated for other investments or commitments for payment of its financial debt, which could have a negative effect on the Group's businesses, financial position, results of operations or cash flows.

In 2013 the Telefónica Group issued bonds mainly (i) in euro totaling 3,250 million euros with an average coupon of 3.690%; (ii) in dollars totaling 2,000 million U.S. dollars with an average coupon of 3.709%; and (iii) in Swiss Francs totaling 225 million Swiss francs with an annual coupon of 2.595%. The Telefónica Group also issued undated deeply subordinated securities in euros totaling 1,750 million euros with an average coupon of 6.902%; and in sterling pounds totaling 600 million sterling pounds with a coupon of 6.750%. In 2014 the Telefónica Group issued bonds mainly in the European market with a maturity of eight years totaling 1,250 million euros with an annual coupon of 2.242%, and bonds with a fifteen-year maturity totaling 800 million euros with an annual coupon of 2.932%. In addition, the Telefónica Group issued undated deeply subordinated securities in 2014 totaling 2,600 million euros with an average coupon of 5.075%.

Despite having its gross debt maturities profile covered for more than two years, obtaining financing on the international capital markets could also be restricted, in terms of access and cost, if Telefónica's credit ratings are revised downwards, either due to lower solvency or operating performance, or as a result of a downgrade in the rating for Spanish sovereign risk by rating agencies. Any of these situations could have a negative impact on the Group's ability to meet its debt maturities.

Moreover, market conditions could make it harder to renew existing undrawn credit lines, 8% of which, at December 31, 2014, were scheduled to mature prior to December 31, 2015.

In addition, the impact of the sovereign debt crisis and the rating downgrades in certain Eurozone countries should be taken into account. Any deterioration in the sovereign debt markets, doubts about developments in European projects (such as implementation of the banking union project, the results of the elections in Europe, including Spain among others, or progress towards fiscal integration), as well as further credit restrictions by the banking sector could have an adverse effect on the Telefónica Group's ability to access funding and/or liquidity, which could have a significant adverse effect on the Group's businesses, financial position, results of operations and cash flows.

### **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 regulations in different countries, and 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 spectrum availability. 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.

Thus, 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.

In this regards, the Telefónica Group pursues its license renewals in the terms referred in their respective contractual conditions, though it cannot guarantee that it will always complete this process successfully or under the most beneficial terms for the Group. In many cases complying with certain obligations is required, including, among others, minimum specified quality, service and coverage standards and capital investment. Failure to comply with these obligations could result in the imposition of fines, revision of the contractual terms, or even the revocation of the license, authorization or concession. Additionally, the Telefónica Group could be affected by regulatory actions carried out by 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 government concessions*

In Europe, the amendments by the EU Parliament to the Commission's proposal on the "Digital Single Market" (the "DSM") package of measures are currently being discussed by the European Council. The "DSM" measures include important measures affecting, inter alia, spectrum regulation. Although these measures are not yet final, they could have significant implications as they include new provisions on secondary markets, criteria to apply at auctions, renewals and terms of licenses, etc.

In addition, the main allocation criteria for the 700 MHz band of "Digital Dividend II" (the second spectrum allocation process from television operators to electronic communications services) will be defined in the coming years. This could require new cash outflows ahead of the Group's previously anticipated schedule (it is expected that the spectrum will be available between 2018 and 2021).

Nevertheless, Germany will be the first country in Europe to award spectrum in the 700 MHz band. On January 29, 2015, the German regulator ("BNetzA") published respective final decisions on the spectrum allocation proceedings and on the auction conditions of the 700 MHz and 1500 MHz bands. The auction will also include the spectrum corresponding to GSM licenses – the entire 900 MHz band and most of the 1800 MHz band (which will expire at the end of 2016) –. Interested bidders may submit applications by March 6, 2015. The auction (Simultaneous Multi-Round Auction) will take place in the second quarter of 2015.

On July 4, 2014, BNetzA adopted a decision concerning the frequency aspects of the Telefónica Deutschland Holding AG merger with E-Plus Mobilfunk GmbH & Co KG ("E-Plus"). BNetzA has instructed Telefónica Deutschland (the surviving entity after the merger takes place) to anticipate the termination of its rights of use in the 900 / 1800 MHz bands by December 31, 2015, (instead of December 31, 2016), if Telefónica Deutschland does not reacquire these frequencies at the above-mentioned auction proceeding. Both Telefónica Deutschland and E-Plus have legally challenged this BNetzA decision on August 4, 2014. The German regulator also announced that, once the auction of spectrum mentioned above mentioned is over, it will perform a frequency distribution analysis, and determine whether any additional action is needed, particularly in the area of the 2GHz spectrum band granted to Telefonica Deutschland.

In addition, and within the framework of the conditions imposed by the European Commission in connection with the merger, the surviving entity of the merger is obliged to offer up to 2x10 MHz in the 2600 MHz as well as up to 2x10 MHz in the 2100 MHz spectrum band to one potential new mobile network operator. This offer is open to any potential new mobile network operator that had declared a respective interest by December 31, 2014, and to the operator with whom Telefónica Deutschland has signed the network access agreement (Drillisch Group).

On December 26, 2014, the Spanish Government adopted a law in which it delayed, to a maximum period ended on April 1, 2015, the effective delivery of the frequencies in the 800 MHz spectrum which are part of the "Digital Dividend" (the

spectrum allocation process from television operators to electronic communications services), and which were expected to be delivered on January 1, 2015 to the already awarded mobile operators. The license term has been extended accordingly to April 24, 2031.

In the United Kingdom a significant increase in the annual license fees charged for the use of the spectrum in 900 MHz and 1800 MHz bands has been proposed by the regulator (the Office of Communications ("Ofcom")). The outcome of it remains uncertain. Separately, the United Kingdom Government announced recently an agreement with the United Kingdom mobile operators, including Telefonica UK, under which the mobile operators would accept a 90% geographic coverage obligation for voice and text services. Given the agreement, Ofcom has agreed to consider the impact of the geographic coverage obligation on its valuation of annual fees for 900 MHz and 1800 MHz spectrum. This is expected to delay Ofcom's decision. In addition, on November 7, 2014, Ofcom released a public consultation on the award of 2.3 GHz and 3.4 GHz bands that is expected to take place in late 2015 or early 2016.

In Latin America, spectrum auctions are expected to take place implying 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 2015 are:

- Peru: The government announced plans to auction the 700 MHz spectrum band in the first half of 2015 (three blocks of 2x15 MHz have been defined).
- Costa Rica: Costa Rica's government has communicated its intention to auction spectrum in the 1800 MHz and AWS bands during 2015.
- Mexico: The Federal Institute of Telecommunications (Instituto Federal de Telecomunicaciones) ("IFT") published its Annual Program for Frequency Use and Development 2015. The program specifies IFT's intention to award Advanced Wireless Services "AWS" concessions during the course of 2015.

Further to the above, certain administrations may not have announced their intention to release new spectrum and may do so during the year. The above does not include processes announced via general statements by administrations, which involve bands not key to Telefónica's needs. Telefónica may also seek to acquire spectrum on the secondary market should opportunities arise.

In Argentina, on December 1, 2014, the Secretary of Communication through Resolution 85/2014 officially awarded Telefónica Argentina the block 1710-1720/2110-2120 for a period of 15 years and the 700 MHz block (703-713/758-768 MHz) is expected to be officially transferred to Telefónica Argentina during 2015.

In the state of São Paulo, Telefónica Brasil provides local and national long-distance Commuted Fixed Telephony Service (CFTS) under the public regime, through a concession agreement, which will be in force until 2025. In this regard, in June 27, 2014, as established in the concession agreement, the National Telecommunications Agency (Agência Nacional de Telecomunicações) ("ANATEL") issued a public consultation for the revision of the concession agreement. Such public consultation revising the concession agreement ended on December 26, 2014 and allowed contributions on certain topics such as service universalization, rates and fees and quality of services, among others. Definitive conditions will be published in 2015.

Additionally, in Colombia the Information and Communication Technologies ("ITC") Ministry issued a Resolution on March 27, 2014 to renew 850 MHz/1900 MHz licenses for 10 additional years. The reversion of assets and the liquidation of the concession contract will be discussed until May 2015, taking into consideration the terms of the contract, and the Constitutional Court's review of Law 422 of 1998, which established the reversion of only the radio-electric frequencies.

In Peru, an application for partial renewal of the concessions for the provision of the fixed-line service for another five years has been issued, although assurance has been given by the "Ministry of Transport and Communications" (Ministerio de Transportes y Comunicaciones) in previous renewals, that the concession will remain in force until November 2027. Also, a new law has been enacted establishing mobile virtual network operator (MVNOs) and Rural Mobile Infrastructure Operators (RMIOs) in the Peruvian market.

In Mexico, in light of the constitutional reform resulting from the "Pact for Mexico" political initiative, it is expected that a publicly-owned wholesale network, which will offer wholesale services in the 700 MHz band, will be created. As of today, the funding and the marketing model of this project have not yet been determined.

Telefónica Móviles Chile, S.A. was awarded spectrum on the 700 MHz (2x10 MHz) band in March 2014. A third party provider opposed this allocation of spectrum on the basis that it would exceed the limit spectrum of 60 MHz established by a judgment of the Supreme Court of January 27, 2009. This cap was established for the AWS auction held in 2009, but not for subsequent auctions (2600 MHz and 700 MHz). In a judgment on December 31, 2014, the court of appeals rejected the third party claim. Consequently, the regulator is in a position to adopt a Decree awarding the concession to Telefónica.

The consolidated investment in spectrum acquisitions and renewals in 2014 amounted to 1,294.2 million euros.

The Company's failure to obtain sufficient or appropriate spectrum capacity in the jurisdictions discussed above 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 the Company's ability to maintain the quality of existing services, which may adversely affect the Group's business, financial condition, results of operations and cash flows.

#### *Regulation of wholesale and retail charges*

In terms of roaming, the regulated "Eurotariffs" were reduced on July 1, 2014 (in the wholesale market, the price of data was reduced by 67%, the price of call by 50%; and in the retail market, the price of data was reduced by 55%, the price of outgoing voice call by 21%, the price of incoming voice call by 28% and the price of outgoing texts by 25%), as per the regulation approved in 2012. The structural roaming solutions which could lead to a price decrease in the intra-European Union roaming services also took effect in July 2014. Furthermore, the package of DSM measures mentioned above, which is under discussion, also includes a proposal to eliminate European Union roaming charges as of a yet to be determined date. However, the European Parliament proposed the "end of roaming" by December 15, 2015 in a proposal known as "Roaming Like at Home".

The decreases in wholesale mobile network termination rates ("MTR") in Europe are also noteworthy. In the United Kingdom, wholesale MTRs have been reduced to 0.845 ppm (pence/minute) from April 1, 2014 (representing a 0.3% reduction compared to the previous rates). In a consultation document published in June 2014, Ofcom has proposed a further reduction to 0.545 ppm, from April 1, 2015.

In Germany, on September 3, 2014, the BNetzA adopted a proposal to reduce MTRs. The new prices will gradually decrease to 0.0172 euro/minute from December 1, 2014, and in a second stage, from 0.0172 euro/minute to 0.0166 euro/minute from December 1, 2015 until the end of November 2016. The European Commission has requested that the German regulator withdraw or amend its latest decision on mobile termination rates, in force as at the date of this Annual Report. There is a risk that the European Commission will initiate infringement proceedings against Germany, and rates may be further reduced.

In Spain, the National Regulatory & Competition Authority (*Comisión Nacional de los Mercados y la Competencia*) has adopted a final decision on the third round analysis of the wholesale market for fixed call termination. From November 1, 2014, a symmetric fixed termination rate ("FTR") of 0.0817 euro cents/minute applies, based on pure bottom-up long run incremental costs ("BU-LRIC") meaning that billing must be entirely conducted on a "per second" basis, without a peak/off-peak differentiation. The decision therefore eliminates the asymmetry in FTRs that existed since 2006 when alternative network operators were allowed to charge up to 30% above Telefónica's per minute local FTR. It also brings forth an important reduction in average termination prices for Telefónica (by 80%) in comparison to the former applicable tariffs.

In Latin America, there are also moves to review MTRs leading to these being reduced. Thus, for example, developments in Mexico are among the most relevant, where the IFT has declared the América Móvil Group a preponderant operator in the telecommunications market. As a result, on March 26, 2014, it introduced, among others, special regulations on asymmetric interconnection rates. In that sense, the Federal Telecommunications and Broadcasting law, effective as of August 13, 2014, imposed several obligations on the preponderant operator, which are quite extensive and, in principle, potentially significantly beneficial to Telefónica's competitive position, particularly with regards to the measures imposed on preponderant operators (to the extent they nominally retain such qualification). With regards to MTR, Telefónica México filed an administrative appeal against the 2011 resolutions of the Federal Telecommunications Commission of México (Cofetel) regarding mobile network termination rates (representing a 61% reduction compared to the previous rates). As of the date of this Annual Report, no ruling has been made on this appeal. Recently, IFT determined the mobile termination rates for 2012, and Telefónica México filed an injunction against this rate. Once these appeals have been concluded, the rates applied may be further reduced retroactively. As of the date of this Annual Report, IFT has not approved the termination rates for 2013, 2014 or 2015 for Telefónica México.



In Brazil, at the end of 2012, ANATEL launched the “*Plano Geral de Metas de Competição*” (“PGMC”) regarding fixed-mobile rate adjustment reductions until February 2016 and amending the previous reduction conditions (75% of the 2013 rate in 2014 and 50% of the 2013 rate in 2015). In order to complement reductions and approach the cost of the services according to a financial cost model, on July 7, 2014, ANATEL published reference values for MTR taking effect from 2016 to 2019. Such reductions are approximately 44% per year. Furthermore, there are several legislative initiatives that aim to abolish the basic fee of fixed-telephony service. “Price protection” practices (reimbursement of differences in prices of a product to customers if this falls within a relative short period of time) may also have a negative impact in Telefónica Brasil, in both economic and image terms.

In Chile, a tariff decree was issued to set fixed-line termination charges for the 2014-2019 periods. The new tariff entered into effect on May 8, 2014 and applies a reduction of 37% in prices against those charged for the period prior to such tariff. A tariff decree has been issued for mobile networks covering the 2014-2019 five-year period. Such tariff decree entered into effect on January 25, 2014 and implies a reduction of 74.7% with respect to the previous rates. After a review by the general comptroller (*Contraloría General*) an additional 1.7% reduction was approved on May 27, 2014.

In Ecuador the rate-related risks relate to a reduction in rural and urban telephony charges, a reimbursement of top-up balances, as well as rounding to the nearest minute.

The implementation of the Enabling Act (*Ley Habilitante*) in Venezuela also confers full powers to the President to implement price control measures. Under this Act, in January 2014, an organic fair price law was issued, which caps the revenue of related enterprises at 30% of their operating costs. In relation to MTRs with the national operator of reference (Compañía Anónima Nacional Teléfonos de Venezuela) (“CANTV”), these have been reduced by 6% compared to the previous rates. In November 2014, near the end of the term allowing the enactment of laws autonomously granted to the President of the Republic, new important decree-laws were enacted, in particular, the Reform of the Law on Foreign Investment, in which, among other things, new requirements for the return of foreign investment were established; the Reform of the Antitrust Law, which was predominantly aimed at enhancing monopoly control regulation and increasing penalties for infringement; and the Reform of the Exchange Crimes Law, which increased economic sanctions.

In Colombia, on December 30, 2014, the Colombian regulator (“CRC”) enacted Resolution 4660 establishing a gradual reduction for MTRs. The glide path initiates in 2015 in 32.88 Colombian pesos per minute representing a decrease of 41.7% and then descends approximately 42.2% in 2016 and 42.2% in 2017 (each such reduction being as compared to the previous year). This regulatory measure also imposes asymmetric MTRs to the dominant provider (the América Móvil Group), imposing the final rate established in the glide path from 2015 to 2017. The CRC also regulated the charges for national roaming and the SMS termination rates, setting a reduction of 41.5% in 2015, 39.6% in 2016 and 43.3% in 2017 (each such reduction being as compared to the previous year).

#### *Regulation of universal services*

Further to its formal obligation to review the scope of the Universal Service Directive (the set of basic electronic communication services whose provision is guaranteed to any user requesting it, regardless of its location, with a specified quality at an affordable price), the European Commission is expected to undertake a public consultation in the months following the date of this Annual Report, which may include both the potential inclusion of broadband in its scope and a possible reduction of some of the current universal service obligations. Depending on the terms that will be set forth in the new regulation, implementation at a local level could lead to higher costs for both the universal service provider and the operators forced to finance the universal service.

The last *Plano Geral de Metas de Universalização* (“PGMU”) was published in Brazil on June 30, 2011 and applies to the 2011-2015 period. This sets goals for public phones, low cost fixed-lines and coverage density in rural and poor areas with 2.5GHz/450 MHz. Also according to such PGMU, the assets assigned to the provision of the services described in the public concession agreement are considered reversible assets. In 2014, ANATEL issued a public consultation with its proposals for the 2015-2020 period universalization targets. The agency’s proposal focuses on reducing the distance between public telephones and backhaul’s expansion.

#### *Regulation of fiber networks*

In December 2014, the Spanish National Regulatory & Competition Authority (*Comisión Nacional de los Mercados y la Competencia*) has conducted a public consultation on the regulatory obligations for broadband market regulation in Spain. As a result of this consultation, the new regulation that will apply to NGN (Next Generation Networks) could be approved

in the fourth quarter of 2015 and will last for at least three years. This could increase Telefónica's regulatory obligations in Spain and the ability of other operators to compete in such market.

In Colombia, the regulatory authority CRC published a regulatory project for transmission capacity between municipalities through fiber networks or connectivity to impose open network and elements access through a mandatory offer for those enterprises that have overcapacity and have some unused installed network elements. This project will be discussed in the first half of 2015.

#### *Regulations on privacy*

In Europe, a new Data Protection Regulation is undergoing the European legislative process which, as the date of this Annual Report, is not expected to end before mid-2015. This could lead to certain critical provisions laid down in the current draft of the regulation (presently under debate) being worded in such a way that stops or hinders Telefónica from launching some services, that focus on the processing of personal data.

In Brazil, triggered by the approval of Civil Rights Framework for Internet Governance, which provides certain generic rules about data protection, the Ministry of Justice could in the near future, adopt the final version of the Draft Personal Data Protection Act. This could lead to a greater number of obligations for operators in relation to the collection of personal data of telecom services users and further restrictions on the treatment of such data.

#### *Regulation of functional separation*

The principles established in Europe's common regulatory framework, adopted in 2009 and transposed in the national legislation of each Member State in which Telefónica operates could result in greater regulatory pressure on the local competitive environment. Specifically, this framework supports the possibility of national regulators (in specific cases and under exceptional conditions) forcing operators with significant market power and vertically-integrated operators to separate their wholesale and retail businesses at a functional level. They would therefore be required to offer equal wholesale terms to third-party operators that acquire these products.

#### *Regulation of network neutrality*

In Europe, national regulators are seeking to strengthen their supervision of operators with regard to the blocking of access, discrimination of applications or Internet service quality. The European Parliament and the Council are simultaneously debating the draft of the European DSM Regulation proposed by the European Commission that, among other things, deals with the principle of network neutrality. The regulation of network neutrality could directly affect possible future business models of Telefónica and may affect the network management or differentiation of characteristics and quality of Internet access service.

Telefónica is present in countries where net neutrality has already been ruled, such as Chile, Colombia, Peru and more recently Brazil, but this remains a live issue and with varying degrees of development in other countries where it operates. In Germany, the Economy Minister withdrew a draft law that it published on June 20, 2013, to regulate net neutrality, especially with regard to the blocking and discrimination of content and Internet services. It plans to submit a new draft after the EU has settled on a position on net neutrality within the DSM approach, which might occur in early 2015. In addition, one German region (Bundesland of Thuringia) has passed a new law (which applies only in such region) with the aim that broadcasting and tele-media may not be blocked, limited or treated differently from other data traffic.

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 cash flows.

For a detailed description of these regulations see Appendix VII of the Consolidated Financial Statements "Key Regulatory Issues and Concessions and Licenses Held by the Telefónica Group".

#### **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 the U.S. Foreign Corrupt Practices Act of 1977 ("FCPA") and the United Kingdom Bribery Act of 2010 (the "Bribery Act"), and economic sanction programs,

including those administered by the United Nations, the European Union and the United States, including the U.S. Treasury Department's Office of Foreign Assets Control ("OFAC"). The FCPA prohibits providing anything of value to foreign 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 foreign officials for purposes of the FCPA. 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 have a material adverse effect on the Group's business, reputation, results of operations and financial condition.

**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 the Company's competitive position relative to other technology sector companies, and its ability to extract the value generated during this process of transformation. Failure to do so adequately could have an adverse impact on the Group's business, financial condition, results of operations and cash flows.

**Company 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.

Failure to do so adequately could have an adverse impact on the Group's business, financial condition, results of operations and 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, and 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 1,111 million euros and 1,046 million euros in 2014 and 2013, respectively; representing an increase of 6.2% from 1,046 million euros in 2013. These expenses represented 2.2% and 1.8% of the Group's consolidated revenue, 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 100MB 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. 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 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 incomes and additional efficiencies to those followed traditionally. Failure to do so adequately could have an adverse impact on the Group's business, financial condition, results of operations and cash flows.

In addition, the ability of the Telefónica Group's IT systems (operational and backup) to respond the Company's operating requirements is a key factor to be taken into account with respect to the commercial development, customer satisfaction and business efficiency.

**The Company 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 the Company's operations, and may cause legal contingencies or damages to the Company's image in the event that inappropriate practices are produced by a participant in the supply chain.

As of December 31, 2014, the Telefónica Group depended on six handset suppliers and 11 network infrastructure suppliers, which together accounted for 80% of the awarded contracts for the year then ended. 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 impact on the Group's business, financial condition, results of operations and 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 network, hardware or software, 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.

Telefónica attempts to mitigate these risks through a number of measures, including backup systems and protective systems such as firewalls, virus scanners and other physical and logical security. However, these measures are not always 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 of 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 (WHO), 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 (ICNIRP) 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 the Company 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 negatively affect the business, financial conditions, results of operations and 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 impairment in goodwill, intangible assets or fixed assets. Although the recognition of impairments of property, plant and equipment, intangible assets and financial 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. For example, with respect to the investment in Telco, S.p.A. ("Telco"), value adjustments were made in fiscal years 2013 and 2014 with a negative impact of 267 million euros and 464 million euros, respectively.

**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 impact on the business, financial position, results of operations and 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 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 cash flows. In particular, regarding tax and antitrust claims, the Telefónica Group has open judicial procedures in Peru concerning the clearance of previous years' income tax, for which a contentious-administrative appeal is currently pending; as well as in Brazil, with CADE's (Conselho Administrativo de Defesa Econômica) resolution with regard to the acquisition of a 50% stake in Vivo and with certain open tax procedures, primarily relating to the CIMS (a Brazilian tax on telecommunication services). Further details on these matters are provided in the Note 21 of the Consolidated Financial Statements.

*Translation of an auditor's report on the Internal Control over Financial Reporting originally issued in Spanish. In the event of discrepancy, the Spanish-language version prevails*

## AUDITOR'S REPORT ON THE INTERNAL CONTROL OVER FINANCIAL REPORTING

To the Board of Directors of  
Telefónica, S.A., engaged by the management

We have examined the description of the Internal Control over Financial Reporting of Telefónica, S.A. (the Parent Company) and subsidiaries (the Group) included in Section F of the Annual Corporate Governance Report for the year ended December 31, 2014. This examination included the evaluation of the effectiveness of internal control over financial reporting with respect to the financial information included in the Group's consolidated financial statements at December 31, 2014, prepared in accordance with International Financial Reporting Standards, as adopted by the European Union, and other provisions in the regulatory framework applicable to the Group in Spain. Such internal control is based on the criteria and policies defined by the Parent Company's management in accordance with the guidelines established by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in its report "Internal Control - Integrated Framework" (2013).

Telefónica, S.A.'s management is responsible for maintaining effective internal control over financial reporting included in the consolidated financial statements, and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on the aforementioned effectiveness of internal control over financial reporting, based on the work we have performed in accordance with the requirements of the Standard ISAE 3000 "Assurance Engagement Other than Audits or Reviews of Historical Financial Information" issued by the International Auditing and Assurance Standards Board (IAASB) of the International Federation of Accountants (IFAC) for the issuance of reports to obtain reasonable assurance.

The work performed to obtain reasonable assurance includes obtaining an understanding of the internal control over financial reporting with respect to the financial information included in the consolidated financial statements, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we consider necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and Directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.



Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements, fraud or illegal acts. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, Telefónica, S.A. and subsidiaries maintained, in all material respects, effective internal control over financial reporting with respect to the financial information included in the consolidated financial statements as of December 31, 2014, based on the criteria and policies defined by the Parent Company's management in accordance with the guidelines established by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in its report "Internal Control - Integrated Framework" (2013). We also have checked that the disclosures included in the accompanying description of the internal control over financial reporting at December 31, 2014 comply, in all material respects, with the requirements of article 540 of the Spanish Companies Law, approved by Royal Legislative Decree 1/2010 of July 2, and meets the minimum content of the Annual Corporate Governance Report template required by Circular 5/2013, issued on June 12, 2013 by the Comisión Nacional del Mercado de Valores (Spanish stock market regulator).

The examination indicated in the preceding paragraphs is not subject to the Spanish Audit Law, approved by Royal Legislative Decree 1/2011 of July 1, so we do not express an audit opinion in the terms provided for in the aforementioned Law.

In addition to the aforementioned examination, we have audited, in accordance with prevailing audit regulations in Spain, the consolidated financial statements of Telefónica, S.A. and subsidiaries at December 31, 2014, prepared by the Parent Company's Directors in accordance with International Financial Reporting Standards, as adopted by the European Union, and other provisions in the regulatory framework applicable to the Group in Spain, and our report dated February 27, 2015 expressed an unqualified opinion on the aforementioned consolidated financial statements.

ERNST & YOUNG, S.L.



Ignacio Viota del Corte

February 27, 2015