

*annual report on corporate  
governance 2002*

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[ *overview* ]



- (1) Report presented by the Committee specially created by the NYSE which presented its conclusions to the exchange's Board on 6<sup>th</sup> June 2002. These proposals constituted the base for the NYSE «Listing Standards» amendment, which was subjected to the consideration of the «Securities and Exchange Committee» (SEC), on 1<sup>st</sup> August 2003.
- (2) Prestigious private organisation comprising the Chief Executives of the 150 most important USA undertakings.
- (3) Recommendations included in this Committee's report known as the Olivencia Code.
- (4) Known as the Hampel Report.
- (5) Known as the Cadbury Report.
- (6) Known as the Greenbury Report.

At Telefónica, S.A.'s last Ordinary General Shareholders' Meeting (hereinafter, «Telefónica» or the «Company»), held on April 12<sup>th</sup>, 2002, the Chairman renewed the Company's undertaking with its shareholders to consolidate corporate governance practices. Pursuant to this commitment, the Board of Directors approved at the meeting held on February 26<sup>th</sup>, 2003 this Report, that analyses Telefónica's current corporate governance structures and its compliance with the most recognised corporate governance recommendations.

This Report constitutes a first exercise of analysis and review on the current situation, and a starting point to consider possible long and medium-term improvement initiatives, always aiming at the governance formula which best defends shareholders' interests and value creation.

In assessing the structure and practices of Telefónica corporate governance, the Report takes into consideration the main recommendations on corporate governance put forward both at a national and international level.

In this sense, and as a way of example, the proposals of the following forums and committees have been considered:

- Special Commission Report designed to encourage markets and listed companies' transparency and security of January 8<sup>th</sup> 2003 («Aldama Commission»).

- «New York Stock Exchange Corporate Accountability and Listing Standards Committee»<sup>1</sup>. New York, 6<sup>th</sup> June 2002.
- The USA Business Round Table<sup>2</sup> May 2002.
- The OECD Council. Governance Principles for Company Management. May 1999.
- «Special Commission to consider a Code of Ethics for Companies' Boards of Directors: Listed Companies' Governance»<sup>3</sup>. Madrid, 26<sup>th</sup> February 1998.
- The Committee on Corporate Governance<sup>4</sup>. UK, January 1998.
- The Committee on the Financial Aspects of Corporate Governance<sup>5</sup>. UK, December 1992.
- Director's Remuneration: Report of a Study Group. UK, 1995<sup>6</sup>.

Regarding the methodology used in this Report, it should be said that an end result approach was adopted when considering existing measures and recommendations, taking into account the spirit rather than the literal sense of such recommendations.

In summary, the main recommendations considered were the followings:

- Board of Directors' express assumption of the general supervisory function as its core and non delegable mission and the establishment of a catalogue of matters of its exclusive competence.
- Integration of a reasonable number of independent Directors.
- Non-executive Directors should be an ample majority over executive Directors.
- Multinational presence on the Board of Directors.
- Board size adjusted to the Company's characteristics but also being operative.
- Disclosure obligations (particularly on Corporate Governance matters).
- Existence of internal provisions regulating the Corporate Governance system.
- Relevance of the Secretary of the Board.
- Existence of an executive Committee similarly composed to the Board of Directors, being based the relationship of both bodies on the principle of transparency.
- Existence of Board sub-Committees exclusively composed of external Board Members, with particular responsibility for audit and control issues, appointments and remuneration.
- Measures to guarantee that the Board of Directors receive the necessary information properly and on time.
- Board Meetings: frequency, participation of all the Directors encouraged, carefully drafted minutes and an annual assessment of the efficiency of the Board.
- Formal transparent selection procedure of the Board of Directors based on the Nominating Committee.
- Establishment of an age limit to belong to the Board of Directors.
- The right of the members of the Board of Directors to obtain information and the establishment of the appropriate channels for the exercise of this right.
- An appropriate remuneration policy of the Directors, according to moderation criteria, assessed and reviewed by the Remuneration Committee. Furthermore, detailed and individualised information about them will be provided.
- Regulation of the Board of Directors obligations arising from their general loyalty and diligence duties, taking into account, in particular, their conflict of interests, confidentiality, exploitation of business opportunities and the use of business assets.
- Measures to extend the duty of loyalty to significant shareholders and senior executives.
- Measures to make more transparent the mechanism of delegation of votes thereby encouraging the Company's communication with shareholders.
- Precise, rapid and reliable information to be given to markets, therefore establishing informative state-

ment controls and procedures within the Company.

- Periodical financial information drafted pursuant to the same professional practices and principles of the annual accounts and verified by the Audit Committee.
- Approval of compensation plans linked to the share value and approved by the General Shareholders' Meeting.
- Establishment of measures to monitor the independence of external auditors.

Regarding its structure, this Report has been divided into six sections:

1. A brief introduction describing **Telefónica's Corporate Governance model and its general principles**, highlighting the main decisions and measures taken on these grounds from the Company's last General Shareholders' Meeting;
2. Analysis of the Company's **shareholding**;
3. Analysis of the **Board of Directors**, its placement within the Company, its composition, internal structure and functioning;
4. Analysis of the **Directors role**, considering mainly their rights and obligations within the Company, including detailed information on the compensation they have received in 2002 and on their participation on the Company's capital.
5. Analysis of the composition, responsibilities and

functioning of the Board of Directors' **Executive Committee and Board sub-Committees** including specific information on their functioning during the financial year 2002;

6. Description of the principles governing the **Company's relationship with its shareholders, markets and external auditors**.



[ *Telefónica's corporate governance principles* ]



The basic Telefónica's Corporate Governance principles are contained in the Articles of Association and in the Regulations of its Board of Directors approved on January 29<sup>th</sup>, 1997 and amended on July 22<sup>nd</sup>, 1998.

These Regulations determine the Board of Directors' action principles, regulate their organization and functioning and establish their members' code of conduct. It must be highlighted that mainly all the recommendations laid down at that time by the Olivencia Commission were already included in these Regulations. This meant that Corporate Governance principles were brought closer to the Company's memorandum of association, i.e., a significant example of the commitment of the Company to their shareholders.

Although these documents are available via the information provided by the Company to the Comisión Nacional del Mercado de Valores (Securities Markets National Commission, hereinafter, «CNMV»), they will also be available to shareholders, investors and to the public in general on the Company's Website, as stated below.

Regarding those principles inspiring Telefónica's Corporate Governance, these are exactly as established in its Board of Directors' Regulations:

- a. maximization of the Company's value in the interest of shareholders,
- b. the Board of Directors' essential role in the Company's management and administration,
- c. transparency of information in relations with employees, shareholders, investors and clients.

In accordance with the provisions laid down in its Regulations, the Board of Directors will adopt the necessary measures to ensure: (I) the Company's management team pursues the creation of value for shareholders, (II) the management team is effectively under their supervision, (III) that no other person or reduced group of people holds the power of decision or is subject to counterweights or controls, and (IV) that no shareholder receives privileged treatment vis-à-vis the others.

In accordance with these general principles, and in relation to the Company's entrepreneurial and financial strategies, the Board of Directors will ensure:

- a. company planning centres on obtaining long-lasting profits and maximizing long-term cash-flows.
- b. adoption of new investment projects aimed at obtaining an adequate yield.
- c. liquid assets not needed to finance new investment projects or to maintain the Company's financial solidity is distributed among its shareholders.
- d. company transactions are reviewed constantly to optimise their profitability.

These are the Corporate Governance principles that have guided the Board of Directors', its sub-committees' and Telefónica's management team's activity in recent years. Furthermore, the Chairman, César Alierta, expressly renewed them before the shareholders at the last Ordinary General Meeting held on April 12<sup>th</sup>, 2002. Pursuant to this com-

mitment, and since that date, the Company has adopted a list of measures in terms of Corporate Governance, amongst which we would like to highlight the following:

- **Renewal of the Board of Directors' sub-Committees.** At the meeting held on June 26<sup>th</sup>, 2002, the Board of Directors approved the re-organization of the Board's Committees, granting the Nominating and Compensation Committee new competencies in terms of Corporate Governance and giving the Human Resources Committee new competencies in the area of Corporate Reputation. In addition, their composition was renewed so from that time they have been almost entirely composed of external or non-executive Board Members.
- **Internal Code of Conduct for Securities Markets Issues.** These Regulations, which will be described in greater detail in chapter VII of this Report, lay down conduct guidelines for the so described affected personnel in matters related to the securities' markets, not only regarding the most stringent respect for current legislation, but also based on ethical criteria and professional liability. These Regulations are already adapted to a great extent to those conduct regulations subsequently stipulated in the «Law 44/2002 of November 22<sup>nd</sup>: Financial System Reform Measures» («Financial Law»).
- **Regulation regarding the Registration, Communication and Control of Financial-Accounting Information:** At the meeting held on November 28<sup>th</sup>, 2002, the Board of Directors, in line with their information commitment to the markets, appro-

ved the internal regulation of the Company's internal procedures and control mechanisms related to the preparation of financial-accounting information. They thereby guaranteed the application of homogenous accounting practices and policies within the entire Group and the establishing of periodical assessment on the functioning of this system. This regulation meets the requirements provided by recent legislation published on this matter in the USA.

- **Regulation of informative Statements to the Markets (*Design stage*).** This second internal regulation establishes the basic functioning principles of the Company's informative statement processes and control systems, aimed at guaranteeing priority, quality and control of the information notified to the regulating bodies of the securities' markets and to the market in general. Yet again, it is the consequence of the statutory requirements laid down in the legislations of the different markets where the Company's securities are listed. At the date of this Report, this internal regulation had received a favourable report from the Audit and Control Committee and, likewise, from the Nominating, Compensation and Corporate Governance Committee. However it is still pending approval by the Board of Directors.
- **Board of Directors' Retribution.** The Nominating, Compensation and Corporate Governance Committee decided to assess the Board Members' retribution in accordance with their obligations and engaged an external consultancy in order to prepare a report on this issue to this. Furthermore, in order to provide due transparency to the Board Members' retribution as such, the Com-

pany decided to provide individualised information pursuant to responsibilities or posts of the Board and their sub-Committees.

Finally, the Board of Directors has proposed to the General Shareholders' Meeting that article 28 of the Company's Articles of Association on Board Members' retribution be amended for two reasons: one, to redraft the first section entrusting the General Shareholders' Meeting specifically for setting the maximum retribution amount for the Board; and secondly, to add a new section stipulating how to make the Directors' retribution public in the Annual Report. This measure is described in greater detail in chapter V of this Report.

On the other hand, the drafting of this Corporate Governance Report is yet another initiative worthy of mention, essentially an exercise in the Company's transparency aimed at the markets, in line with recent recommendations by the Aldama Commission. In this sense, the Company's Board of Directors has undertaken to draft an annual report providing the information necessary on Telefónica's Corporate Governance practices and structure, analysed in a single piece of text for the knowledge of its shareholders and investors.

Furthermore, and also in line with the Aldama Commission recommendations, it is also worth highlighting a project to be launched within a section of the Company's Website in the second quarter of the year, exclusively aimed to Corporate Governance issues thus providing shareholders, investors and the general public with easy access to all the relevant information on this

matter.

To conclude, further to the analysis of Corporate Governance practices of all the listed companies within the Telefónica Group during 2002, it is planned to extend the best Corporate Governance practices to all companies belonging to the Group. This will enable the Group to present markets with a commitment as well as homogenous Corporate Governance practices adapted to the structure of the listed companies in each case and the markets where they quote.



[ *shareholder structure* ]

## Most significant shareholders

	Percentage	Total Shares	Direct Participation Percentage	Direct Participation Shares	Indirect Participation Percentage	Indirect Participation Shares
BBVA(*)	5.519	263,022,186	1.679	0,025,280	3.840**	182,996,906
«La Caixa»(***)	3.6%	-	-	-	-	-

(\*) As per information provided by this company in its Annual Accounts as at December 31<sup>st</sup>, 2002 the participation held per permanence criteria in Telefónica's capital is 5.28%.

(\*\*) Participation held via Corporación Industrial y de Servicios S.L., Argentaria Participaciones Financieras, S.A. and other companies. As per notification remitted to the CNMV on June 5<sup>th</sup>, 2002.

(\*\*\*) As per data provided by Caja de Ahorros y Pensiones de Barcelona, («La Caixa») on their Website, updated January 16<sup>th</sup>, 2003.

### 3.1 Most significant shareholders

Insofar as the Company shares are represented via accounts' entries, i.e. the Company itself does not keep a shareholder register, the ownership structure of the same cannot be known precisely, except for some basic data, obtained essentially via the X-25 form, which the Company is legally authorised to request where holding any General Shareholders' Meeting.

In this sense, and pursuant to the information existing in the Company, we can say there is no individual or corporate body which directly or indirectly, alone or jointly, exercises or may exercise any type of control over Telefónica. Nevertheless, there are certain shareholders whose participations may be considered significant and are those in tabular format above described.

Besides such shareholdings, as per notification remitted to the CNMV on January 8<sup>th</sup>, 2003, Chase Manhattan Nominees Ltd., had a 6.80% participation in Telefónica's capital as custodian, i.e. this participation is held on behalf of and under the responsibility of its clients.

Finally, the financial body, Citibank, NA was holder of 263,022,855 shares, i.e. 5.6% of Telefónica's share capital at February 1<sup>st</sup>, 2002 according to internal reports drafted by the Company itself. The said participation is held to the effects of that laid in the Depositary Agreement signed between the Company and Citibank NA on behalf of and under the responsibility of the ADR holders to the effects of the issuance and negotiation of the aforementioned securities on the New York Stock Exchange.

Pursuant to that laid down in the said contract, Citibank NA is obliged to exercise the corresponding political and economic rights as holder of the aforementioned actions following the instructions established by the ADR holders as stipulated in the depositary agreement terms and conditions.

### 3.2 Number of shareholders

Pursuant to the information obtained from the Servicio de Compensación y Liquidación de Valores (Securities Compensation and Settlement Service, hereinafter, «SCLV») on March 3<sup>rd</sup>, 2003<sup>7</sup> the number of Telefónica shareholders as per individualised registers of both individual and corporate entities, amounted to approximately 1,698,326 shareholders.

(7) Since there is no Company shareholder register, the latest data obtained by Telefónica are included in the X-25 form requested by the Securities Compensation and Settlement Service when the next Ordinary General Shareholders' Meeting is to be held.



[ *Board of Directors* ]



## 4.1 Functions

In line with the recommendations formulated by the Olivencia Commission, the Board of Directors' Regulations essentially define it as a Company control and supervisory body, delegating the Company's ordinary business management to the executive bodies (individual or collective) and to the management team.

Apart from the general function of supervision and control, the Board assumes specific responsibilities related to business management and strategy and the co-ordination of all the companies belonging to its Group. Furthermore, apart from the legal or statutory powers reserved for their exclusive knowledge, the Board is also obliged to directly exercise the following responsibilities:

1. Approval of the Company's general strategies;
2. Appointment, and where appropriate, dismissal of the most senior executives of the Company and other entities comprising the consolidated Group;
3. Appointment, and where appropriate, dismissal of the administrators in the different subsidiary companies;
4. Identification of the Company's main risks, implementation and follow-up of internal control and appropriate information systems;
5. Determination of shareholder, market and public opinion information and communication policies;
6. Establishing the repurchasing policy of the Company's own shares, which the General Shareholders' Meeting determines where appropriate.
7. Authorisation of Company operations with the Directors and significant shareholders which might present conflict of interests; and
8. In general, performing those entrepreneurial or financial operations of particular importance for the Company.

Along this same line of thinking, and bearing in mind that Telefónica is the head of an important and complex Group of companies, the Board of Directors exercises the responsibility of co-ordinating the Company's Group policy, respecting at all times the interests of any existing minority shareholders in any of these companies. Furthermore, where appropriate in each case, the adoption of agreements of specific relevance or significance by part of the subsidiary companies comprising the Telefónica Group are submitted to the Board of Directors of Telefónica for their knowledge, information or authorisation.

Pursuant to their responsibilities, in 2002 the Board took decisions on those matters of their exclusive

jurisdiction, such as the appointment or dismissal proposals of its members, the appointment or dismissal of the executives officers, the implementation and follow-up of internal control systems, the establishment of the repurchasing policy for the Company's own shares and the authorisation of Company operations with Board Members.

On the other hand, the Board of Directors has considered those operations and questions of most relevance for the Company, highlighting the following among others in 2002:

- Acquisition by «Telefónica Móviles, S.A.» of shares representing 65% of the share capital pertaining to the Mexican mobile telephone company «Pegaso Telecomunicaciones, S.A. de C.V.»
- Economic-financial situation of the Argentinian Republic, handling of Telefónica's risks in that country and management priorities in «Telefónica de Argentina, S.A.».
- Announcement of the Ordinary General Shareholders' Meeting, agenda and presentation, among other proposals, two new share capital increase operations charged to unrestricted reserves, share capital increase proposal in 2002 to attend (coverage of the referenced retribution system to Telefónica's share quotation value, destined to Endemol Group employees), likewise, to a proposal for the issuance of convertible or exchangeable fixed income securities, with the exclusion of the subscription preference right.
- Incorporation and development of a joint venture company set up between Telefónica and Portugal

Telecom, each with a 50% stake for the mobile telephone business in Brazil.

- Repositioning of the Emergia, Katalyx and Telefónica Data business lines and creation of the new Telefónica Group Business Solutions via the integration of the subsidiary companies Telefónica Sistemas, Katalyx, M-Solutions and Art-Media in the scope of Telefónica DataCorp.
- Integration of two satellite digital television platforms, Vía Digital and Canal Satélite Digital, via the exchange of Sogecable shares for Vía Digital shares.
- Restructuring of the Admira Media Group.
- Changes in the shareholder retribution policy, such as the proposal for the re-establishment of the Company dividend payments policy proposal in the 2002 Financial Year.
- The results of Telefónica and its Group for the first half of 2002, with special attention to recoveries due to value corrections in «Telefónica Móviles, S.A.» and in «Telefónica DataCorp, S.A.», regarding their investments and businesses in UMTS services in Europe, except Spain and the investment made in MediaWays, respectively.

## 4.2 Composition

### Size and Appointments

Telefónica's Articles of Association state that the Board of Directors will have at least five members with a maximum of twenty. The Board Members will be designated at the General Shareholders'

Meeting, or provisionally by the Board of Directors, as provided by the provisions laid down in the Public Limited Company Act and the Articles of Association.

Telefónica's Board of Directors has currently twenty board members which is within the limits set by the Articles of Association.

Given the complexity of the Telefónica Group, the significant number of companies comprising, the variety of sectors where it performs its business, its multinational format as well as its economic and commercial relevance, twenty members is reasonable for the Board of Directors of the Group's head Company.

The Directors' nominating proposals submitted by the Board of Directors for consideration at the General Shareholders' Meeting, as with the nomination agreements the latter adopts by virtue of the legally attributed co-option powers, must be respectful what is stipulated in the Regulations of its Board of Directors. Furthermore, they are to be preceded by the Nomination, Retribution and Corporate Governance Committee's corresponding favourable report which will not be binding.

In this sense, it should be said that, as a general rule in Telefónica, the Board Member appointments are subject to the decision taken at the General Shareholders' Meeting. Only on certain occasions, when absolutely necessary due to variations having taken place after the General Shareholders' Meeting, is an appointment made via co-option pursuant to the Public Limited Company Act, said decision being ratified, where

necessary, at the first subsequent General Shareholders' Meeting.

In relation to Board Member appointments made in 2002, the Board of Directors has, in each case, considered the reports presented by the Nominating, Compensation and Corporate Governance Committee which were in favour of all appointments. Furthermore, the appointments made in 2002 were mediated by the Board of Directors at the General Shareholders' Meeting.

#### **Board Member Profile**

The Board of Directors and the Nominating, Compensation and Corporate Governance Committee, within their respective jurisdiction, endeavour to ensure that the selection of external or non-executive Board Members falls upon persons of known solvency, responsibility and professional experience willing to dedicate a sufficient amount of their time to the Company. Extreme precision must be shown when electing those persons requested to cover the posts of independent Directors.

Furthermore, with regards to the appointment of independent Directors, the Board of Director's Regulations establish that they may neither propose nor designate a person to cover the post of an independent Member of the Board, who either has or has had a stable relationship of specific relevance with the Company management in the last two years, or who are bound by family, professional or commercial ties with any of the executive Board Members or other senior Company executives. Moreover, they are not permitted to have any firm link with shareholding company representative Board Members or the business entities or groups they represent.

In particular, the following may not be proposed or designated as independent Board Members:

- a. Those persons who hold or have held maximum level executive posts in the Company within the last two years.
- b. Relatives –up to the fourth level of kinship- of whomsoever is or has been a Company executive Board Member or senior executive within the last two years.
- c. Those persons, who either directly or indirectly, have made relevant payments to or received from the Company which might jeopardise their independence.
- d. Those persons who have or have had other relations with the Company, which in the opinion of the Nominating, Compensation and Corporate Governance Committee, may diminish their independence.

Pursuant to their knowledge, different professional backgrounds and expertise, the independent Board Members within the Company's Board of Directors provide the Board, and Telefónica's corporate management in general, with their own personal and professional experience, safeguarding business interests from an autonomous and free standpoint.

#### **Appointment Limitations**

Directors are appointed for a five (5) year period and may be re-elected once, or several times, for equal periods of maximum duration in accordance with current legislation.

Directors are to put their posts at the disposal of the Board of Directors and resign accordingly on becoming seventy (70) years old. Members of the Board in executive functions will cease to carry those out on becoming sixty-five (65), although they may continue as Board Members, provided the Board deems this as appropriate.

On the other hand, Directors are to place their posts at the disposal of the Board of Directors and resign accordingly, not only on reaching the aforementioned age, but when they cease to hold the executive post to which their appointment was associated, or those reasons for which they were appointed disappear, or when (I) they incur one of the legally envisaged incompatibilities, or (II) when they are severely admonished by the Audit and Control Committee for defaulting on one of their obligations as Board Members, or (III) when their permanence on the Board may affect the Company's credit or reputation on the markets or by any other means place its interests at risk.

#### **Current Composition of the Board of Directors**

Telefónica's Board of Directors comprises twenty (20) Board Members, whose names, posts, year of incorporation and the nature of their membership are set out below following the classification established by the Olivencia Report to that effect:

##### **Executive Board Members:**

- Mr. César Alierta Izuel, Esq., (1997), Chairman (2000)
- Mr. Fernando Abril-Martorell Hernández, Esq., Managing Director (2000)
- Mr. Antonio Jesús Alonso Ureba, Esq., Board Secretary (2001)

*(8) y (9) Luis Fernando Furlán, Esq., presented his resignation to the Company Board of Directors at their meeting held on 18th December 2002, due to his recent appointment as Minister for Industry of the Brazilian Government. The Board of Directors, at their meeting on February 26<sup>th</sup> 2003, approved the appointment of Fernando de Almansa Moreno-Barreda, Esq., by co-option as independent Board Member. See previous note.*

- Mr. Luis Lada Díaz, Esq., (2000)
- Mr. Antonio Viana-Baptista, Esq., (2000)

#### **Shareholding Company representative Board Members:**

- Mr. Isidro Fainé Casas, Esq., Vice-chairman (La Caixa, 1994)
- Mr. José Ignacio Goirigolzarri Tellaeché, Esq., Vice-chairman (Banco Bilbao Vizcaya Argentaria, 2000)
- Mr. José Antonio Fernández Rivero, Esq., (Banco Bilbao Vizcaya Argentaria, 2002)
- Mr. José Maldonado Ramos, Esq., (Banco Bilbao Vizcaya Argentaria, 1999)
- Mr. Antonio Massanell Lavilla, Esq., (La Caixa, 1995)
- Mr. Gregorio Villalabeitia Galarraga, Esq., (Banco Bilbao Vizcaya Argentaria, 2002)

#### **Independent Board Members:**

- Mr. Maximino Carpio García, Esq., (1997)
- Mr. Carlos Colomer Casellas, Esq., (2001)
- Mr. Alfonso Ferrari Herrero, Esq., (2001)
- Mr. Luis Fernando Furlán<sup>8</sup>, Esq., (2000)
- Mr. Gonzalo Hinojosa Fernández de Angulo, Esq., (2002)
- Mr. Miguel Horta e Costa, Esq., (1998)
- Mr. Pablo Isla Álvarez de Tejera, Esq., (2002)
- Mr. Enrique Used Aznar, Esq., (2002)
- Mr. Mario Eduardo Vázquez, Esq., (2000)

Telefónica's Board of Directors respects those recommendations generally accepted in matters of corporate governance, since it has a significant number of independent Board Members (nine), and the external Board Members (shareholding company representatives and independents) constitute the vast majority over the executive ones (fifteen against five). Finally, the independent

Board Members have the majority over the shareholding company representative ones (nine against six). This composition reasonably reflects the Company's share capital structure.

Given the multinational structure of the Telefónica Group, and pursuant to the recommendations formulated from some international forums on corporate governance, Telefónica considers the presence of international experience on its Board as particularly beneficial and, as such, deemed it opportune to include four foreign nationals as board members:

- Mr. Luiz Fernando Furlán<sup>9</sup>, Esq., (Brazilian)
- Mr. Miguel Horta e Costa, Esq., (Portuguese)
- Mr. Mario Eduardo Vázquez, Esq., (Argentinian)
- Mr. Antonio Viana-Baptista, Esq., (Portuguese)

### **4.3 Organisation of board meetings**

Both, the Company's Articles of Association and the Board Regulations lay down that the Board of Directors will meet once a month in ordinary session, and at the Chairman's initiative as often as he or she deems it necessary for the Company's good functioning. According to this, the Board of Directors sets an annual schedule of ordinary meetings. During 2002, Telefónica's Board of Directors held thirteen meetings, each of which was approximately three and half hours' long.

Almost all the Board of Directors' meetings held were attended by all Board Members, i.e. out of the thirteen Board sessions held in 2002, eleven of them were attended by all Board Members themselves or their representatives.

In order for directors to be adequately prepared for board meetings and to have access to all relevant information, the sessions have a pre-established agenda, notified at least three days prior to the meeting along with the session calling. For the same reason, the Directors receive the documentation relating to the meeting agenda sufficiently in advance.

To facilitate Directors having all the necessary information and explanations regarding some of the matters dealt within the meeting, the main executives of the Group have almost attended all Board meetings held in 2002 to expound on matters within their jurisdiction. Likewise, on certain occasions when the opinion of a specialised external counsel was deemed necessary, the presence of external advisors has been requested

All the meetings of the Board of Directors have dealt in depth with the different matters submitted for deliberation and/or decision. Board Members have participated in all debates and discussions, putting forth, where considered appropriate, their viewpoint in such matters. The Chairman organised debates ensuring and encouraging the participation of all Board Members in the deliberation process. Furthermore, it is a common practice for him to request the opinion of the Directors individually, particularly in questions of great importance for the Company.

#### **4.4 The Chairman of the Board**

The Regulations of the Board of Directors state that the Chairman will assume the chairmanship of all the Company's governing and administrati-

ve bodies and, as such, will act as the Company's Chief Executive Officer. Consequently, all the Board of Directors' legally and statutory delegable powers are delegated to him. At all times, his action must be in line with the standards and guidelines set by the Board of Directors and its sub-Committees. Likewise, all those agreements or decisions of particular importance to the Company must be subject to the prior approval of the Board of Directors' or of the relevant control Committee. It should be highlighted that the Chairman has no casting vote within the Board of Directors.

The fact that the Chairman of the Board of Directors also holds the position of the Company's Chief Executive Officer greatly facilitates the flow of information between the Company's management and its Board of Directors.

In order for a Director to be designated Chairman, he/she must have formed part of the Board of Directors for at least three years prior to his/her designation. Nevertheless, this prerequisite is not necessary provided that such designation has a favourable vote of at least 85% of the members of the Board of Directors.

#### **4.5 Executive Operating Officer**

All the Board of Directors' functions, except those which are legally or statutorily non-delegable, has been delegated to the Telefónica's Managing Director, as well as to the Executive Chairman. Besides being a member of the Board of Directors, the Managing Director is a member of the Board's sub-Committees.



The Managing Director is the Group's Chief Operating Officer, and all the Company's activity lines report to him, except those dedicated to the media and contents which are directly reported to the Executive Chairman. The Resources and Human Resources Corporate Departments also depend on the Managing Director.

#### **4.6 Secretary of the Board**

The Secretary of the Board, as laid down in the Regulations of the Board of Directors, must essentially safeguard the Board's good functioning, ensure the formal and material legality of its actions, guaranteeing that their procedures and governing rules are respected, provide Directors with the necessary advice and information, correctly reflect the Board debates and decisions in the form of minutes and certify its resolutions.

Pursuant to the Olivencia Commission recommendations, the Secretary of the Board of Telefónica is also a Director, thereby giving more importance to such role within the Board, strengthening his authority and endowing certain guarantees of independence and stability, likewise making his responsibility more demanding.



[ *Members of the Board* ]

The Regulations of the Board of Directors specifically dedicates a section to the same. It comprises 12 articles describing in detail the rights and obligations of the Directors, establishing as their main function that of orientating and controlling the Company's management to maximise the Company's value to the benefit of the shareholders. Likewise, they regulate, in detail, conflict of interest situations, non-public information, use of corporate assets and use of business opportunities which arise in connection with the director's position as such.

## 5.1 Rights

The Regulations of the Board of Directors acknowledge the individual right of each Director to gather and obtain all the information necessary to fulfil his/her supervisory functioning. These rules also expressly extend such right to the information regarding the different subsidiary Companies comprising the Telefónica's consolidated Group.

Furthermore, the external Board Members have the possibility, of hiring, when they deem it necessary, at the Company's expense, legal, accounting and financial advisors as well as other experts to aid them in performing their functions.

## 5.2 Obligations

As previously mentioned, the Regulations of the Board of Directors, set out in detail the main duties

arising out of their general obligations of diligence and loyalty so as to encourage Directors to become aware of the commitments they are assuming when taking office and to account for their actions.

The Directors' general obligations are those arising from their duty of diligence including, among others, the obligation to inform themselves and to prepare appropriately for the meetings of the Board and sub-Committees which they belong to and to attend meetings of such bodies. Likewise, they must participate actively in debates, accept responsibility for the decisions adopted, investigate any irregularity in the Company's management coming to their attention and monitor any situations of risk for the Company that may arise.

The basic obligations arising from the fundamental fiduciary duty contemplated in the Regulations of the Board of Directors are as follows:

- Duty of confidentiality, requiring Directors to keep in confidence the Board of Directors and Committees' deliberations which they belong to and generally to refrain from disclosing any information to which they might have had access in the course of their work. This obligation will continue even after resignation from their post.
- Obligation of non-competition, i.e. Directors are banned from performing professional services or those of any kind to any Company's competitors

and to any competitor of any of the Companies within the Group. Furthermore, prior to accepting any executive position in another Company or entity whose activity is directly or indirectly related to the one carried out by Telefónica or by any of the companies integrated in their consolidated Group, Directors must consult the Nominating, Compensation and Corporate Governance Committee.

- The handling conflict of interest situations. The Regulation of the Board of Directors establish that Members of the Board should abstain from participating in those debates affecting matters where they are directly or indirectly involved, or which affect a member of their family or a company where they hold an executive position or has a significant stake in the share capital. Likewise, Directors shall not directly or indirectly carry out professional or commercial transactions with Telefónica or any of the companies within the Group, unless the Board of Directors approves the same with a favourable vote of at least 90% of the attending Board Members and prior to a report from the Nominating, Compensation and Corporate Governance Committee.
- No misappropriation of the Company's assets. Directors shall not use the Company's assets or take advantage of their position in the Company to obtain patrimonial advantage, unless an appropriate consideration has been satisfied.
- No benefiting from business opportunities. Directors are banned from using for private purposes business opportunities which arise in connection with the director's position as such, unless they are offered by the Company and with the prior report

of the Nominating, Compensation and Corporate Governance Committee.

- Disclose their shareholdings in Telefónica. Directors are required to disclose the number of shares they or their closest relatives hold directly or indirectly in the Company, likewise they are required to disclose all the offices and activities at other companies or entities and, in general, any event or situation which might be material to their actions as directors of the Company.

#### **Extension of fiduciary duties**

##### **Significant Shareholders**

Pursuant to the Olivencia Report recommendation regarding the extension of fiduciary duties to significant shareholders, the Regulations of the Board of Directors state that the Board of Directors must formally reserve the right to authorise any transaction between the Company and any of its significant shareholders. Under no circumstances will it authorise the transaction if the Nominating, Compensation and Corporate Governance Committee has not previously issued a report assessing the transaction from the viewpoint of equal treatment for all shareholders and of market conditions.

Furthermore, as already mentioned, the Board Members are required to abstain from voting in those decisions of the Board in which they have a direct or indirect interest. In that respect, any matter affecting a company where board members hold an executive position or a significant shareholding will be deemed as being of the directors interest.

The Board of Directors disclose in the Company's annual report any transactions with significant

shareholders. Moreover, pursuant to the new requirements established by the new Spanish Financial Law, the Company must provide detailed information in their biannual reports of the operations carried out both, with Board Members and with significant shareholders.

#### **Senior Management**

The Internal Code of Conduct for Securities Markets Issues of Telefónica has extended compliance of certain obligations arising from the directors fiduciary duties to those persons carrying out senior management functions in the Company. In that respect, General Manager, Executive Officers and Deputy General Manager must report to the Regulatory Compliance Unit, created by the Internal Code of Conduct, those situations which could give rise to conflicts of interest due to their activities outside the Telefónica Group, their family relations, their patrimony or for any other reasons. Furthermore, it establishes the general principles of action to be observed in order to handle this kind of situations.

#### **Remuneration and other benefits**

The retribution of the Telefónica's Board Members consists of a monthly fixed allowance and of certain per diems for attending the Board of Directors' and its sub-Committees meetings. Besides, executive Board Members receive payments for carrying out their executive functions.

The Company's Board of Directors will, at the next Ordinary General Shareholders' Meeting, propose an amendment to the Company's Articles of Association on this matter, which has been granted with the favourable report of the

Nominating, Compensation and Corporate Governance Committee. This proposal for reform involves two brief but important amendments: the first one consists of a new wording for the first section of article 28 of the Company's Articles (retribution), which will entrust the General Shareholders' Meeting with the setting of the Board of Directors' retribution cap; the second, consists of adding a new fourth section to this same article which will establish how to disclose the Board members' retribution in the Annual Report.

Three important objectives are intended to achieve with the first measure:

1. **publicity**, since the amounts that the Board of Directors will receive will be established in a clear, direct and firm way.
2. **control**, provided that the General Shareholders Meeting which is the maximum representation body within the Company will determine those amounts; and
3. **efficiency**, since the retribution of the Members of the Board (especially that of the external Board members which is contemplated in the first section of article 28) should not be linked to objectives or results, according to the best practices in this field as recommended by the Aldama Commission among others, which point out the need to circumscribe the forms of variable retribution to the executive Board Members ( Indeed, this is the policy favoured and effectively implemented by this Board of Directors up until now).

On the other hand, article 28 of the Company's Articles of Association, currently in force, did not contain any provision on disclosure of the retribution of the Members of the Board. This loophole is expected to be eliminated with the inclusion of a new fourth section to this article that will intend to provide due transparency to the remuneration paid to the Board of Directors. The proposal –in line with the demands deriving from the Olivencia and Aldama Reports- responds to the need for making the retribution for Board Members public and individualised in the Annual Report, (i.e. by reference to the positions held by each member in the Board of Directors and its Executive Committee and sub-Committees). As to the retribution which might correspond to Directors for other reasons, and in particular for carrying out executive functions, it will be sufficient to indicate the same by way of aggregate in the Annual Report, with the appropriate breakdown of the different entries or retribution concepts.

The total amount of payments made to the Directors of Telefónica during 2002 was 11,907,088.40 Euros (3,312,042.31 Euros for fixed allowance; 76,416.29 Euros for expenses for attending the Board sub-Committees meetings; 8,405,975.34 Euros for salaries and variable remuneration to the executive Board Members; 69,537.84 Euros for retributions in kind to the executive Board Members, amongst these there are life insurance premiums; and 43,116.62 Euros for Company contributions to Board Members pensions schemes.)

The retributions and benefits received by Telefónica Board Members in the above-mentioned year are broken down in the following tables:



## Board of Directors

Annual amount of fixed allowance received  
by each Board Member (in euros)

Office	year 2002
Chairman .....	90,151.82
Vice-chairmen .....	150,253.03

### Members<sup>10</sup>:

Executives .....	90,151.82
Domanials .....	90,151.82
Independents .....	90,151.82

## Executive Committee

Annual amount of fixed remuneration received  
by each Director (in euros):

Office	year 2002
Chairman .....	60,101.21
Vice Chairman .....	60,101.21
Members .....	60,101.21

The Directors do not receive any class of per diems for attending the meetings of the Board of Directors and the Executive Committee.

## Other Committees of the Board of Directors

Overall figure of the total annual amount of fees received for attending the sub-Committees meetings.

Committees	Attendance fee per meeting	year 2002
Audit and Control	858.61	24,041.08
Nº. of meetings: 8		
Nominating, Compensation and Corporate Governance	858.61	26,616.91
Nº. of meetings: 8		

(10) Two independent Board Members of the Board of Directors, one of whom resigned office in December 2002, have an additional annual allowance of 60,101.21 euros each, because of their special interest for the Company, their experience and their dedication in relation to South America.

<b>Human Resources and Corporate Reputation</b> .....	858.61	10,303.32
Nº. of meetings: 3		
<b>Regulation</b> .....	858.61	11,161.93
Nº. of meetings: 4		
<b>Service and Commercial Quality</b> .....	858.61	4,293.05
Nº. of meetings: 2		

index-linked to the stock market value of the Company's shares.

Lastly, the Company does not grant, nor did grant in 2002, any advance payments, loans or credit of any class to Directors or executives officers, thus complying with the requirements in this regard contained in the Sarbanes-Oxley Act- enacted in the United States and applying to Telefónica as a listed Company in that market.

### Executive Directors

*Overall figure of the total amount of fees received by all the Executive Directors for each of the following items (in euros).*

Item	year 2002	
Salaries .....	4,096,718.56	
Variable remuneration .....	4,309,256.78	
Remuneration in kind .....	69,537.84	
Pension plan contributions .....	43,116.62	

The Executive Directors, in their capacity as directors of the Telefónica Group, receive remuneration under the «TOP» scheme which is index-linked to the listing value of the Telefónica shares and is addressed to all directors of the Group; the cost of the aforementioned remuneration with respect to the Executive Directors participating in the plan amounted to 1.2 million Euros in 2002.

It is also worth highlighting that non-executive Directors do not receive, nor have received in 2002 any remuneration from pension plans or life insurance policies, nor do they participate, as mentioned previously, in remuneration plans which are

### Participation of the Directors in the Company's capital

Name	Direct Ownership	Indirect Ownership	Number of Shares Held
Mr.César Alierta Izuel	471,959	–	471,959
Mr. Isidro Fainé Casas (1)	1,628	–	1,628
Mr. José Ignacio Goirigolzarri Tellaeché (2)	3,400	–	3,400
Mr. Fernando Abril-Martorell Hernández	31,513	–	31,513
Mr. Antonio Alonso Ureba	8,273	–	8,273
Mr. Maximino Carpio García	5,722	–	5,722
Mr. Carlos Colomer Casellas	532	–	532
Mr. José Antonio Fernández Rivero (2)	113	–	113
Mr. Alfonso Ferrari Herrero	1,776	–	1,776
Mr. Fernando de Almansa Moreno-Barreda	1,058	–	1,058
Mr. Gonzalo Hinojosa Fernández de Angulo	37,214	–	37,214
Mr. Miguel Horta e Costa	348	–	348
Mr. Pablo Isla Álvarez de Tejera	379	–	379
Mr. Luis Lada Díaz	29,172	–	29,172
Mr. José Maldonado Ramos (2)	30	–	30
Mr. Antonio Massanell Lavilla (1)	2,065	629 (3)	2,694
Mr. Enrique Useld Aznar	19,450	17,988 (4)	37,438
Mr. Mario E. Vázquez	10	–	10
Mr. Antonio Viana-Baptista	21,563	–	21,563
Mr. Gregorio Villalabeitia Galarraga (2)	52	–	52
<b>TOTAL</b>	<b>636,257</b>	<b>18,617</b>	<b>654,874</b>

According to the data in possession of the Regulatory Compliance Unit, the total number of Telefónica shares belonging directly or indirectly to the current Directors on an individual basis, and as at the date of presentation of this Report, amounts to 654,874 shares (0.013% of the capital stock).

- (1) Appointment proposed by La Caixa  
(2) Appointment proposed by BBVA  
(3) Participation held through next of kin relatives  
(4) Participation through a controlled company (93.96%)



[ *the Board of Directors' Committees* ]

Both the Company's Articles of Association and the Regulations of the Board of Directors provide for the existence of an Executive Committee, with overall decision-taking power and consequently with express delegated authority in all powers corresponding to the Board of Directors, except those which cannot be legally or statutorily delegated.

The Regulations empower the Board of Directors to create one or various consultative or sub-committees that are entrusted with the examination and monitoring, on a permanent basis, of certain areas of particular relevance for the Company's corporate governance, or with the performance of monographic analyses of specific aspects or matters when their degree of importance makes this advisable. These Committees do not have the status of corporate bodies. Instead, they are instruments at the service of the Board of Directors, to which they present their conclusions on matters or aspects that they have been asked to investigate.

In terms of these consultative or control committees, and as indicated previously, the Board of Directors, at its meeting on June 26, 2002, approved the reorganisation of this, assigning new jurisdictions to some Directors and renewing the Board's composition in order for this to be formed almost entirely by external or non-executive Directors.

After this reorganisation, Telefónica's Board of Directors has the following sub-committees: the

Audit and Control Committee, the Nominating, Compensation and Corporate Governance Committee, the Human Resources and Corporate Reputation Committee, the Regulation Committee and the Service and Commercial Quality Committee.

## 6.1 Executive Committee

The existence of an Executive Committee enhances the operativity and efficiency of the Board of Directors when exercising its functions, providing it with the necessary support through the work that it performs, particularly since it is formed by less Directors than the Board and meets more frequently than the latter.

Pursuant to the recommendations made in the Olivencia Report, and also in line with those recently published by the Aldama Commission, the relationship between both bodies are based on the principle of transparency, in the sense that the Board is fully aware of the decisions adopted by this Committee. Accordingly, matters considered and agreements adopted by the Executive Committee are always included as a point in the agenda to be discussed at the meetings of the Board of Directors.

As of the date of this Report, the Board of Directors Executive Committee is formed by the following persons:

- Mr. César Alierta Izuel (Chairman)
- Mr. Isidro Fainé Casas (Vice Chairman)
- Mr. Fernando Abril-Martorell Hernández
- Mr. Maximino Carpio García
- Mr. Carlos Colomer Casellas
- Mr. José Maldonado Ramos
- Mr. Antonio Viana-Baptista
- Mr. Gregorio Villalabeitia Galarraga
- Mr. Antonio Alonso Ureba (Secretary)

The Regulation of the Board of Directors provide that this Committee will meet every fortnight on a ordinary basis and as many times as it is called by its Chairman. In 2002, the Committee held twenty meetings, each with an average duration of more than 3 hours. Also noteworthy was the high level of attendance of its members.

As is the case with the meetings of the Board of Directors, they have a pre-established agenda, which is notified at least three days before the date envisaged for the meeting together with the notice of the meeting.

The Group's executive officers frequently attend the Executive Committee meetings in order to present information on matters relating to their respective areas of jurisdiction. Thus, some members of the Company's senior management attended practically all the meetings held during 2002. It is also worth highlighting that during 2002 External advisors gave twenty presentations at the. Executive Committee meetings addressing matters included on the agenda.

The Executive Committee dedicates a great deal of time at its meetings to develop and prepare

the issues that will be presented at the next Board meeting. Special consideration is given to certain issues on which the Executive Committee is informed, taking note of their content and scope and adopting, where appropriate, any necessary agreements.

## 6.2 Board sub-committees

### Audit and Control Committee

Article 24 of the Regulations of the Board of Directors establishes the working principles of the Audit and Control Committee as a consultancy or control Committee of the Board of Directors.

The main task of the Audit and Control Committee is to provide support to the Board of Directors in its supervisory functions having the following basic responsibilities:

1. Propose the appointment of the Auditor, the terms and conditions pursuant to which he/she is contracted, the scope of his/her professional mandate and, where appropriate, the revocation or extension of the appointment;
2. Review the Company's accounts, monitor compliance with legal requirements and the correct application of generally accepted accounting principles, and provide notification on proposals to modify the accounting principles and criteria suggested by management;
3. Serve as a communication channel between the Board of Directors and the Auditor, evaluate the results of each audit and the responses of management to the auditor's recommendations, and



mediate and arbitrate in disputes between the former and the latter in connection with applicable principles and criteria in the preparation of the financial statements;

4. Verify the suitability and integrity of the internal control systems adopted in the preparation of the individual and consolidated financial statements.
5. Monitor the fulfilment of the audit contract, taking all necessary steps to ensure that the opinion on the financial statements and the main contents of the auditor's report are drafted in a clear and precise manner.
6. Review the brochures and the periodical financial information that the Company must provide to markets and supervisory bodies; and
7. Ensure compliance with the Internal Code of Conduct for Securities Markets Issues and, in general, with the Company's own rules of governance and make the necessary proposals for their improvement. In particular, the Audit and Control Committee is responsible for receiving information, and, where appropriate, issuing a report on disciplinary measures to the members of the Company's management.

As of the date of the present Report, this Committee is formed by the following members:

- Mr. Antonio Massanell Lavilla (Chairman)
- Mr. Maximino Carpio García.
- Mr. Antonio Fernández Rivero
- Mr. Gonzalo Hinojosa Fernández de Angulo

In accordance with the recommendation contained in the Olivencia Report and corroborated by the Aldama Commission, all members of the Audit and Control Committee are non-executive Directors. Moreover, in compliance with the latest international recommendations in this regard, all the members of this Committee have financial experience and specifically its Chairman has extensive professional experience in finance and accountancy.

The Regulations of the Board of Directors establish that the Audit and Control Committee shall meet regularly according to needs and at least four times per year. During 2002, this Committee held eight (8) meetings, noteworthy for the high level of attendance of all of its members.

The meetings took place in accordance with a pre-established agenda, issued beforehand to the members of the Committee together with the notice of each meeting. The deliberations of this Committee and the agreements and decisions adopted are set forth at the corresponding minutes of each meeting.

The meetings of the Committee are normally attended by the members of the Company's management indicated below and who provide support and assistance to the Committee members in matters to be analysed at each of its meetings:

- General Secretary and Secretary of the Board of Directors of Telefónica.
- General Manager of Corporate Finance.
- General Manager of Audit and Communication.
- Deputy General Manager of Audit and Corporate Inspection.

- Deputy General Manager of Consolidated Financial Information and Accounting Policies.
- Deputy General Manager of Management Control.

Moreover, whenever requested by the Committee itself, other members of the management team of both the Company and its subsidiaries have participated in these meetings in order to provide information on specific matters affecting their respective areas of jurisdiction.

Lastly, the partner (assigned to Telefónica) of the Company's Accounts Auditor has regularly attended the Committee's meetings. Specifically, this person has intervened – only in relation to certain matters included on the agenda – in six of the eight meetings, at the request of this Committee, in order to explain and clarify aspects contained in the audit reports, provide information on his fees and deal with specific questions relating to the Group's information and accounting policies, in relation to the audit work performed.

During 2002, the main analysed questions by this Committee were as follows:

- The Company's internal control systems. During the meetings, this Committee was informed in detail of the actions performed by the Group's Internal Audit units.
- In order to verify the Company's accounts, this Committee reviewed the Company's audit system, consisting in the performance of quarterly reviews of the Company's financial statements in order to ensure the acceptability of the same and the verification of compliance with established legal requirements.

- After the Sarbanes-Oxley Act came into force in the United States, the Committee analysed and reported favourably on the «Regulation on the registration, communication and control of financial/accounting information for Telefónica Group», which was subsequently submitted for consideration and then approved by the Board of Directors.

- Other matters of interest analysed by this Committee were the following: the restructuring performed by virtue of the value adjustments by «Telefónica Móviles, S.A.» with respect to investments and its business in UTMS services in Europe and by «Telefónica DataCorp, S.A.» with respect to the investment in MediaWays; a general analysis of the Sarbanes-Oxley Act and its enacting regulations; accounting legislation applicable to pensions and other personnel commitments; impacts of the evolution of exchange rates on net worth.

In accordance with the provisions established in the new Spanish Financial Law, Telefónica's Board of Directors will propose at the next General Shareholders' Meeting the adoption of the modifications to the Articles of Association required in order to regulate the composition, jurisdictions and functioning of this Committee, based on the current regulations contained in the Regulations of the Board of Directors and incorporating the necessary modifications stipulated by the applicable legal provisions.

#### **Internal Audit**

The Company has a General Internal Audit Department responsible for internal audit matters and for ensuring the efficiency of the inter-

nal audit control of the different units of the Telefónica Group. This person has the following duties:

1. Guarantee the efficiency of the Group's internal control system.
2. Participate in the design of the control system according to risk evaluation and management.
3. Monitor the correct functioning of the system by reviewing the different processes which are critical for controlling business risks.
4. Review and notify control deficits that are detected in policies, methods, processes and procedures and which undermine business efficiency or increase the risk of undesired situations.
5. Review the security, control, efficiency, effectiveness and effective performance of information systems.
6. Any other functions which enhance the performance of the tasks entrusted to this person.

This General Internal Audit Department reports directly to the Audit and Control Committee, thus guaranteeing the adequate performance of all its functions and providing this Committee with continual and unlimited access to reports and work documents of the external auditors whenever it deems necessary.

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

Article 25 of the Regulations of the Board of Directors establishes the principles governing the func-

tioning of the Nominating, Compensation and Corporate Governance Committee as a sub-Committee of the Board of Directors. In July 2002, the name of this Committee was changed to the Nominating, Compensation and Corporate Governance Committee, assuming responsibilities in terms of corporate governance to support and inform the Board of Directors on matters relevant in this area.

The main function of the Nominating, Compensation and Corporate Governance Committee is to safeguard the integrity of the processes used to select the Company's Directors and senior executives, and to advise the Board of Directors on the determination and supervision of their remuneration.

Specifically, this Committee is assigned the following functions:

1. Provide information on proposed appointments of Company Directors and executive officers;
2. Approve the remuneration scales for the Company's senior directors;
3. Approve standard contracts for the Company's executive officers.
4. Determine the remuneration scale of the Executive Chairman or, in his absence, the Chief Operating Officer.
5. Establish the remuneration scale for Directors and review this on a regular basis in order to ensure that this complies with the duties performed by the Directors;

6. Provide information on incentive plans;

7. Prepare an annual report on the Director's and executive officers' remuneration policy.

8. Notify proposed appointments of members of the Executive Committee and other Committees of the Board of Directors; and

9. Prepare and keep a record of the situations of Company Directors and senior directors

The current composition of the Nominating, Compensation and Corporate Governance Committee is as follows:

- Mr. Alfonso Ferrari Herrero (Chairman)
- Mr. Maximino Carpio García
- Mr. Pablo Isla Álvarez de Tejera
- Mr. Gregorio Villalabeitia Galarraga

In accordance with the recommendations made in the Olivencia Report, all the members of this Committee are external or non-executive Directors.

The Nominating, Compensation and Corporate Governance Committee does not have a fixed number of meetings per year. It meets whenever the Board of Directors or its Chairman requests the issuance of a report or the approval of proposals within the scope of its responsibilities and provided that, in the opinion of the Committee's Chairman, this is necessary for the proper development of its functions.

In 2002, this Committee held eight (8) meetings. These were developed in accordance with a pre-esta-

blished agenda, issued beforehand to the Committee members together with the notice calling each meeting and the supporting documentation for each point on the aforementioned agenda for review and analysis by the Directors belonging to the Committee. This Committee's deliberations and the agreements and decisions adopted by it are recorded in the minutes corresponding to each session. A record was also taken of the documentation analysed at the meetings.

Throughout 2002, the Nomination, Compensation and Corporate Governance Committee had knowledge of all appointments of Company senior directors and changes in the management structure of both the Company and any of its subsidiaries, as well as proposed appointments of new members to the Boards of Directors of its Subsidiary companies and notified the abovementioned appointments and changes, in all cases favourably for subsequent approval by the Board of Directors.

This year Nominating, Compensation and Corporate Governance Committee has also reported and clarified possible conflict-of-interest situations affecting Company Board members or senior directors. In terms of remuneration, this Committee also agreed the Chairman's bonus and analysed the Chairman's remuneration. Similarly, the Stock Option plans of the different Group companies were examined and the Committee focused its analysis on companies which required such examination, accordingly.

Upon the request of the Chairman of Telefónica, during the first quarter of 2002, the Nominating, Compensation and Corporate Governance Committee provided information on the bonus of the Company's senior management for the year 2001,

as well as on the modification of the remuneration of senior directors.

In connection with its Corporate Governance new responsibilities, this Committee also began the task of examining the situation of the listed Companies of the Telefónica Group, in relation to the most relevant Corporate Governance recommendations, fostering the creation of sub-committees of the Board. At the end of year 2002, all the Group companies had set up and implemented consultative sub-Committees with responsibilities in the area of Audit and Control.

#### **Human Resources and Corporate Reputation Committee**

The Human Resources and Corporate Reputation Committee (originally the Human Resources Committee) was set up in accordance with the provision contained in Article 26 of the Regulations of the Board of Directors. Subsequently, the Board of Directors, at its meeting held on June 26th, 2002, agreed to assign new responsibilities to the Human Resources Committee in the area of Corporate Reputation, approving the new name of the aforementioned Committee as the Human Resources and Corporate Reputation Committee.

In terms of the object and functions of this Committee in the area of Human Resources, its fundamental mission, without prejudice to other functions that may be assigned to it by the Board of Directors, consists in analysing, informing and offering proposals to the Board for the adoption of appropriate agreements with respect to the Company's personnel policy.

In terms of Corporate Reputation, this Committee's functions include promoting both the development of the Telefónica Group's Corporate Reputation project and fostering the implementation of the Telefónica Group's core values.

This Committee is currently formed by the following Directors:

- Mr. Pablo Isla Alvarez de Tejera (Chairman)
- Mr. Alfonso Ferrari Herrero.
- Mr. Antonio Massanell Lavilla
- Mr. Enrique Used Aznar

In accordance with the recommendations made in the Olivencia Report, all the members which take part of this Committee are external or non-executive Directors.

Since June 2002, the Human Resources and Corporate Reputation Committee has held three (3) meetings, which have been attended by all its members. These meetings took place according to a pre-established Agenda issued beforehand to the Committee members. The meetings were attended by the members of the management team responsible for the corporate areas of Human Resources and Corporate Reputation. The deliberations during the Committee's meetings and the agreements or decisions adopted by it are documented in the minutes corresponding to each meeting.

In 2002 the matters discussed and analysed by this Committee included the following:

- development and implementation of the Telefónica Group's Corporate Reputation plan.

- development plans for Human Resources, directors and talented young employees with great potential; and
- analysis of the Telefónica Group Human Resources management report.

#### **Regulation Committee**

The main objective of the Regulation Committee, is to monitor, through the study, analysis and discussion on an on-going basis, of the main aspects on the regulatory agenda which affect the Telefónica Group at any time. Another mission of this Committee is to act as a communication and information channel between management and the Board of Directors in regulatory matters and, whenever necessary, to notify the Board of Directors of any matters that it deems to be of maximum priority for the Company and which require the taking of decisions or the establishment of a specific strategy.

The current composition of this Committee, following the reorganization approved by Board of Directors of Telefónica at its meeting of June 26<sup>th</sup>, 2002, is as follows:

- Mr. Enrique Used Aznar (Presidente)
- Mr. Jesús Maldonado Ramos
- Mr. José Antonio Fernández Rivero
- Mr. Antonio Alonso Ureba

This Committee is formed by an Executive Director and three non-executive Directors, two of whom are independent.

During 2002, this Committee met four (4) times and its meetings were attended by almost all its members.

The agenda of each meeting was issued beforehand to its members together with the notice calling each meeting and at least five days before the date of the meeting. The Secretary of the Committee recorded the minutes of each meeting.

This Committee's meetings were normally attended by the General Manager and the Deputy General Manager of Corporate Regulation, the Deputy General Secretary and Telefónica's Manager of Telecom Regulation Department.

Similarly, this Committee was attended by some of the most senior representatives of the Regulation divisions of Subsidiary companies domiciled abroad, as well as leading executives from the Group's business lines, in order to provide information on the situation and regulatory problems in their respective areas.

The most significant matters considered by the Regulation Committee in 2002 included the following:

- Regulatory situation of Telefónica de España;
- Regulatory situation of Telefónica Móviles España;
- Most important regulatory issues in Chile;
- Most important regulatory issues in Peru; and
- Implementation of the new European regulatory framework (Directives and Community Directives).

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

The fundamental mission of the Service Quality and Customer Service sub-Committee is the

examination, analysis and regular monitoring of the quality indices of the main services rendered by Telefónica Group companies, as well as the levels of commercial services offered to its clients.

In order for this Committee to confirm and analyse the fulfilment of the established objectives, its Chairman has requested each line of business of the Telefónica Group to provide a summary of their variable targets for 2003. A work method has also been envisaged which will enable the issuance of quarterly reports by each business line in connection with the evolution of its objectives based on established indicators and quality ratios for each of its businesses.

The current composition of this Committee is as follows:

- Mr. Gonzalo Hinojosa Fernández de Angulo (Chairman)
- Mr. Carlos Colomer Casellas
- Mr. José Maldonado Ramos
- Mr. Antonio Massanell Lavilla

In accordance with the recommendations made in the Olivencia Report, all members of this Committee are external or non-executive Directors.

Since June 2002, this Committee has met on two (2) occasions; these meetings lasted for approximately six hours each. The Committee meetings follow a pre-established agenda, which is sent together with the corresponding documentation, to its members fifteen days prior to the date of the meeting. The Secretary of the Com-



mittee records the minutes corresponding to each meeting.

The meetings of this Committee were attended by representatives of the business lines that have implemented quality procedures. Thus, the meetings of this Committee were attended by quality managers and executive directors of Telefónica de España, S.A., Telefónica Móviles España, S.A., Telefónica de Latinoamérica, Telefónica Data España, S.A., Terra Networks, S.A., Grupo Atento Servicios Corporativos, Vía Digital Distribuidora de Televisión Digital, S.A. (DTS), Telefónica Publicidad e Información, S.A. (TPI), as well as the Deputy General Manager of Corporate Reputation of Telefónica.

The main issues analysed in 2002 were as follows:

- Description of the existing Quality Plans;
- Achievement of the quality objectives in the year 2002;
- Projects and objectives for 2003; and
- Quality measurement tools or instruments.



[ *the markets* ]

## 7.1 Shareholders and investors

Several articles in the Telefónica's Board of Directors regulations deal with the channels through which the relationships between the Board of Directors and the Company's shareholders (both private shareholders and shareholders who are institutional investors) are organised, in order to ensure the greatest possible degree of transparency of such relations.

Moreover, it is expressly established that the Board of Directors commits to guarantee impartiality in its relations with shareholders.

The Company's actions in this area, based on the maximum standard of transparency, are aimed at distributing all public information produced by the Company and making it accessible to all its shareholders simultaneously and in a non-discriminatory basis, fulfilling their information needs and guaranteeing that the published information complies with the criteria of quality, clarity and veracity. The information is disseminated using a variety of media (official communications to markets, press releases, publications on the Company's Web Page, attendance at forums, staff and group meetings, ordinary and electronic mail, conference calls, Internet webcast, etc...).

### Shareholders' Office

In order to foster permanent contact with the Company's shareholders, in 1997 Telefónica created the

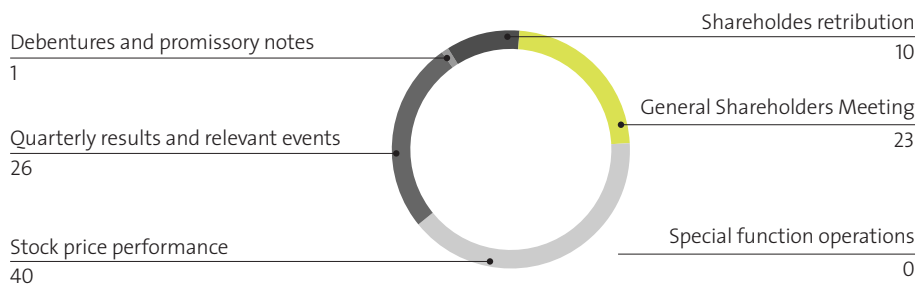
so-called «Servicio de Atención al Accionista» (Shareholder Service Area) with the aim of establishing a transparent and fluid communication with its private shareholders and allowing them to have access to the same information at the same time and in the same way as institutional investors.

The communication channels that Telefónica has established with these private shareholders have gradually evolved and strengthened with time. At present, it is worth highlighting the following aspects relating to the functioning of this Office:

- A Shareholder Freephone Service - 900 111 004 - operative from Monday to Friday from 9 to 19 hours. A total of 123,285 calls were made to this number in 2002, requesting different types of information.
- A Shareholders' Web Page, providing information on economic events and relevant incidents relating to the Company.
- Distribution of a quarterly publication which contains information on quarterly results and economic-financial events which may be relevant for shareholders. Today it is sent to more than 170,000 resident shareholder households.
- Personalised sending of documentation or information whenever requested (international mailing list, documentation relating to the General

## Distribution of total consultation made to the «Shareholder Service Area»

(data shown as percentages)



Shareholders' Meeting, etc.). In 2002, 2,360 personalised information mailings were sent, and 2,389 enquiries were received and handled through the Shareholder Service Website.

Telefónica also participates in specialised Forums in stock exchanges and other markets (Madrid, Barcelona and Valencia) addressed to private investors, where presentations are made on the management and prospects of Telefónica and its Group.

Lastly, and in order to improve the quality of information supplied by the Shareholders' Office, all the enquiries handled through the call centre, Web page and by ordinary post are processed by computer means. This enables the Company to perform a qualitative and quantitative analysis of the efficiency of these services and, thus, to improve the communication channels and to correct any existing deficiencies. Consequently, in 2002 the distribution of enquiries by Telefónica's shareholders per area of interest were as follows:

### Investor Relations Area

The Investor Relations Department, created at the same time that the Shareholders' Office, in order to provide support to shareholders and investors, began to operate in 1987, when the Company was admitted to listing on the New York Stock Exchange. The Investor Relations Area reports directly to General Manager of Corporate Finance of Telefónica, what shows the Company's commitment to offer its investors all the updated relevant information necessary for them to make their investment decisions.

This area's main task is the design and implementation of the Company's disclosure programme with respect to national and international financial markets, in order to present and explain the Company's main strategic, operative, organisational and business actions, thus, actively contributing to the proper pricing of the Company's securities.

In this way, the Company organises through this area regular informative meetings about the development of the Company and the Group's these meetings are attended by all Spanish and foreign shareholders and institutional investors, as well as by any executive officer that by reason of the nature of the matters to be presented should attend. In March 2002 Telefónica announced the celebration of the 2nd Investors Conference, which was attended by 275 investors and analysts. The presentations made at this Conference were sent to the different securities markets regulatory bodies and disclosed on the Investor Relations Web Page. There have been a total of 139,499 downloads from these files since then.

In 2002, more than 275 meetings were held with investors and analysts, including direct contacts and roadshows in Europe and in the United States.

Finally, the Investor Relations area performs a periodic analysis of the company's shareholders and analysts information needs, as well as the analysis of the shareholder and bondholder structure, with the aim of increasing the usefulness of the information that it has been distributed and making Telefónica the leader in the sector in terms of transparency.

### Disclosure Policy

The Regulations of the Board of Directors establish that the latter shall perform the following specific functions in relation to the securities markets:

- a. Supervising the periodic public financial information.
- b. Taking the necessary actions and steps in order to ensure the Company's transparency before the financial markets, specifically, the Board must inform these markets of any events, decisions or circumstances which may be relevant for the Company's shares listing.
- c. Taking the necessary actions and steps in order to foster the correct pricing of the Company's shares and, where appropriate, of those of its subsidiaries, avoiding, in particular, insider trading practices.

The Board of Directors expressly commits in its Regulations to adopt the necessary steps to ensure that any biannual, quarterly and any other information to be disclosed to the markets is prepared in accordance with the same principles, standards and professional practices with which the Financial Statements were prepared, and that it is as reliable as the latter. For this purpose, the Audit and Control Committee review such information in its capacity as a specialised Board of Directors sub-Committee.

Moreover, in compliance with the provisions contained in the applicable legislation, the Company provides all the regulatory market bodies where which its shares are traded, by issuing the necessary statements, with timely information on any material event

in relation to the Company and its Group. As a result, in 2002 the Company notified 33 Relevant Events and 27 press releases, as well as other less important information that was not classified as relevant.

In addition to this information supplied in real time, and beyond the scope of regulatory requirements, Telefónica is aware of the importance of periodic financial information on results. In this connection, the Investor Relations Area makes a special communication effort by organising quarterly audioconferences to present and analyse results, and which may be followed by telephone or over the Internet (webcast), guaranteeing universal and real-time access to information. Similarly, and with the same structure, specific audioconferences are organised to provide financial markets with information on relevant strategic decisions and operations, after notifying the corresponding regulatory bodies accordingly.

The Company also provides investors and shareholders with information contained in different Informative Prospectuses released either annually or more frequently and registered with the different regulatory bodies of the securities markets.

Moreover, all this information is available to the public on the Web Page of the Company. Special mention must be made of the design and implementation of a specific Web Page for the Investor Relations Area, which has developed into one of the most important tools for the achievement of the transparency objective in the distribution of updated information to the market, guaranteeing simultaneous and non-discriminatory access. At present, the Investor Relations Web Page has 10 main sections which provide access

to all official, financial, operative and strategic information released by the Company to the different regulatory bodies and to the markets in general. ([www.telefonica.es](http://www.telefonica.es) / [www.telefonica.com](http://www.telefonica.com) / [www.telefonica.com/ir](http://www.telefonica.com/ir)).

Lastly, it is important to mention that the Telefónica Group's policy of transparency and information has been granted with international recognition:

- 2<sup>nd</sup> best European company in terms of transparency (evaluated in early 2002 in a Reuters study and the «Institutional Investor» magazine) in which clarity, depth and speed of response to its investors were assessed.
- Best Investor Relations performance at European telecommunications level (July 2002, Thomson Exel Survey).
- 2<sup>nd</sup> position for the Telefónica Investor Relations wWeb site among all European companies and 3<sup>rd</sup> best European company in terms of use of virtual multiconferencing. («Investor Relations Magazine»).
- Best on-line annual report for Spain and Portugal, as well as 2<sup>nd</sup> best Investor Relations website (MZ Consult, Brazil).
- Telefónica CTC Chile was awarded a prize as one of the best investor relations websites in Latin America («Latin Finance» magazine).

#### **Disclosure Controls and Procedures Regulation**

Telefónica, as a Company whose securities are listed not just on the four Spanish Securities Mar-

kets but also on the stock markets in London, Paris, Frankfurt, Tokyo, New York, Buenos Aires, Lima and Sao Paulo and included on the Stock Exchange Automated Quotation System (SEAQ International), always bears in mind its commitment to each of these markets regarding compliance with their respective rules governing securities markets; one of its main duties is to comply with their disclosure obligations. And, despite the priority given to the regulatory body in its market of origin - the CNMV - and to Spanish legislation, the Company's internal regulation require compliance with the standards of those markets in which it trades.

However, in addition to its legal obligations, Telefónica has assumed a commitment to transparency with its shareholders, investors and with the market in general, and aims to place the Company at the forefront in terms of market transparency. Accordingly, the new legal requirements affecting Telefónica pursuant to both, current Spanish legislation and certain foreign regulations, as well as the recent developments in corporate governance issues, recommend the adoption of internal rules relating to disclosure to markets; as of the date of this Report, these rules have been granted with the favourable report of the Audit and Control Committee, and the Nominating, Compensation and Corporate Governance Committee, and they will be subject to the approval of the Board of Directors.

These rules govern the basic principles of the functioning of the processes and control systems for communicating information, through which the Company aims to guarantee that the relevant

corporate information is known by its senior executives and management and to establish the necessary mechanisms for performing regular assessments of the efficiency of these processes and systems.

## 7.2 Organisation of the General Shareholders' Meeting

In accordance with the provisions established in its Regulations, the Board of Directors must promote the informed participation of shareholders at the General Shareholders' Meetings and adopt any measures it deems appropriate to ensure that General Shareholders' Meeting effectively exercises the functions within the scope of its jurisdiction, pursuant to the provisions established in the Law and Articles of Association.

In order to provide the greatest transparency, the Company immediately informs all markets of any decision of the Board of Directors to call the General Shareholders' Meeting, including any information relating to points to be included on the Meeting agenda.

Appart from complying with the Spanish legal provisions governing the announcement of the call, and provided that Telefónica has shareholders in other jurisdictions, the notice of this call is published, in accordance with applicable provisions, in each of the following countries: Brazil, Peru, Argentina or Japan. As required by Spanish legislation, the official call notice must be published in one high circulation newspaper in the province. It must also be published in various national newspapers and normally also in a num-

ber of high circulation newspapers in Europe, in order to guarantee greater diffusion.

According to the provisions established in the Spanish mercantile legislation, all documentation relating to the points on the agenda must be made available to the shareholders at the Company's headquarters as from the moment of official publication of the call notice; shareholders must also be able to request that this information be sent to them free of charge. The Shareholders' Office collaborates in this task by providing information to shareholders through its call centre, Internet and mailing of documentation by ordinary post. For this purpose, the Company provides on call notices and help cards, the Shareholders' Office freephone number where shareholders can call to request information or documentation.

The Company also provides its shareholders with all documentation in the relevant language, either Spanish, English or Portuguese, where necessary in each one of the countries, in order to enable shareholders to reach a founded opinion on the proposals before participating in the Shareholders' Meeting or delegating their vote.

Hence, in terms of the General Shareholders' Meeting held in 2002, the Shareholders' Office handled:

- 20.000 calls on the Shareholder Telephone Help Line.
- 130 mailings of information on the General Shareholders' Meeting.

- 54.904 authorisations to delegate votes for representation at the General Shareholders' Meeting.

### 7.3 Internal Code of Conduct for Securities Markets Issues

Regarding the adoption of codes of conduct to avoid insider trading and similar irregularities, as mentioned before, the Company's Board of Directors' meeting of October 30th, 2002 approved a new Code of Conduct for Securities Markets Issues.

This regulation is meant to be addressed to all persons in contact with privileged information, including senior directors and members of the Board of Directors, as well as employees who, by virtue of their position, might have regular access to this type of information.

These Regulation do not only contain a general provision prohibiting operations with the Company's securities when in possession of privileged information. It goes further by establishing broad time restrictions. At times when there is objectively privileged information within the Company, such as in the month prior to the presentations of results or the month prior to the preparation of the financial statements by the Company's Board of Directors. Moreover, the Regulations impose the obligation to maintain acquired securities for a minimum period of six months in order to prevent speculation with the Company's securities.

The Regulation also establishes in detail the principles to be followed in conflict-of-interest situa-

tions, establishing the obligation to disclose such situations and any modifications which might arise from such circumstances.

Lastly, and in accordance with the provisions contained in the new Spanish Financial Law, the Internal Code of Conduct regulates the treatment of confidential information, and determines a series of obligations for individuals involved in these types of operations.

In addition to all these measures, the Company has launched a regulatory «Compliance Programme», by means of which it structures the technical and human means required to strengthen compliance with these new Regulation. With this purpose in mind, a Regulatory Compliance Committee has been set up. This Committee is formed by five of the Company's General Managers and is responsible for safeguarding the proper development of the programme. In addition to this Committee, a Regulatory Compliance Unit has also been established, and is responsible for ensuring the effective execution of the obligations contained in this Regulation.

### 7.4 The Company External Auditors

The basic responsibilities of the Audit and Control Committee include proposing the appointment of the Accounts Auditor, the terms and conditions of his/her contract, the scope of his/her professional mandate and, where appropriate, the rescission or extension of the appointment. In turn, it must act as a communication channel between the Board of Directors and the Accounts Auditor, evaluate the results of each audit and the responses to the



management team to its recommendations, and mediate and arbitrate in the event of discrepancies between management and the auditor in connection with principles and criteria applicable in preparing the financial statements.

According to the foregoing, the Board of Directors has established, through the Audit and Control Committee, a sound and professional relationship with the Company's Account Auditor, strictly respecting his/her independence, in order to comply with the recommendations made in the Olivencia Report.

The Board of Directors must also try to ensure that the financial statements are prepared without reservations on the part of the Auditor. However, if the Board considers that it must maintain its opinion, it shall offer a public explanation of its content and the scope of the discrepancies in question.

Lastly, the Company must disclose in detail the fees paid to the audit firm in both its Notes to the Financial Statements and Information Prospectus verified by the CNMV, specifying the fees received for professional audit services and for other non-audit services.

As regards the information corresponding to the year 2002, the Company will include detailed information on both Telefónica and the Spanish and foreign companies belonging to the Telefónica Group and consolidating by the global integration method.

## Telefónica S.A.

Corporate Governance Annual Report 2002

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Telefonica's Internet websites:  
[www.telefonica.es](http://www.telefonica.es) (Spanish),  
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Shareholders may request copies of this Report  
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by calling freephone **900 111 004** (in Spain),  
or by electronic mail to: [accion.telefonica@telefonica.es](mailto:accion.telefonica@telefonica.es)  
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