



Telefónica, S.A.

REPORT OF THE BOARD OF DIRECTORS OF TELEFONICA, S.A. ON THE PROPOSED AMENDMENTS TO ARTICLE 28 OF THE COMPANY'S BY-LAWS, THE DRAWING UP OF A NEW ARTICLE 31 BIS AND INSERTION OF A NEW ARTICLE 35.4., WHICH SHALL BE SUBMITTED TO THE ANNUAL GENERAL SHAREHOLDERS' MEETING FOR APPROVAL (POINT VII ON THE AGENDA).

The present report is prepared in accordance with the provisions of Article 144.1 a) of the Spanish Law of Corporations (*Ley de Sociedades Anónimas*) to justify the proposal for reform of the By-laws – the amendment of Article 28 of the Company's By-laws, the drawing up of a new Article 31 bis, and the insertion of a new section 4 of Article 35 – which are submitted for consideration and, as pertinent, approval by the Annual General Shareholders' Meeting called for April 10th and 11th, 2003, constituting Point VII of the Agenda thereof.

Although the first two reforms that are being proposed share the fact that they both respond to new developments and trends in terms of corporate governance, each of the three proposals for amendment of the By-laws that are being submitted to the General Meeting are justified for different reasons.

A) Reasons for amendment of article 28.

1. This Board's commitment to transparency, announced by its Chairman at the last Annual General Shareholders' Meeting, and the leading position of "Telefónica, S.A." in the financial markets, which means that it has to keep its corporate governance rules constantly under review and, as the case may be, revise them in line with any more exacting standards imposed from time to time, justify the alteration of the arrangements for Directors' remuneration contained in article 28 of the By-laws currently in force, which is submitted to the shareholders for approval. The proposed alteration takes the form of two short but very significant amendments: the first consists of rewording the first paragraph of article 28, giving the General Shareholders' Meeting responsibility for setting the maximum amount of the remuneration of the Board of Directors; the second consists of adding a new article 28.4, establishing how Directors' remuneration must be disclosed in the Annual Report.

2. The first paragraph of the aforementioned article 28, as currently worded, provides that the maximum remuneration of the Board of Directors is calculated as the profits of the preceding financial year multiplied by 0.5 percent. The new wording proposed for this paragraph embodies in the By-laws the policy of fixed remuneration which the Board of Directors has, in the interests of prudence, already been implementing, not availing itself of all its options under the arrangements currently in



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force, in conformity with the best practices of corporate governance. The overall remuneration of the Board of Directors - which is the essence of the alteration - must be set by the General Shareholders' Meeting and shall remain the same until the latter resolves to change it. This achieves three high-priority objectives:

- (i) a *disclosure objective*, since the sums available to the Board of Directors for its remuneration will be determined in a clear, direct manner and will not be subject to change;
- (ii) a *monitoring objective*, since it is the General Shareholders' Meeting itself, the highest representative body in the Company, which sets those sums; and
- (iii) an *efficiency objective*, since Directors' remuneration - in particular that of external Directors, which is the model of remuneration referred to in article 28.1 - should not be linked to targets or results. Accordingly, it bears pointing out - as highlighted recently in the "Aldama Report" - that the best practices in this field focus on the need to confine variable forms of remuneration to executive Directors, which has in fact been the policy promoted and actually followed by this Board.

3. Article 28 of the current By-laws make no provision whatsoever for disclosing Directors' remuneration. It is intended to rectify that omission now by adding a new paragraph four to that article, designed to make remuneration received by the Board of Directors properly transparent.

The proposal - in line with the requirements arising from the Olivencia and Aldama Reports - refers to the need to disclose the remuneration of the Directors qua Directors individually (that is, by reference to the office held by each member on the Board of Directors and on its Management or Consultative Committees). Any remuneration to which a Director is entitled on any other account, and specifically for the performance of executive functions, will only need to be stated in the Annual Report as a total, with the appropriate breakdown of the various items or heads of remuneration.

4. Therefore, the new wording of article 28 of the Company's By-laws submitted for the approval of the Annual General Shareholders' Meeting - which involves, in any event, keeping the current wording of the second and third paragraphs of that article unchanged - is as follows:

Article 28. - Remuneration



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1. *Directors' remuneration shall comprise a fixed set monthly allowance and expenses for attending meetings of the Board of Directors and its Management or Consultative Committees. Any remuneration the Company may pay its Directors collectively under either of the foregoing heads shall be that set for that purpose by the General Shareholders' Meeting, which remuneration shall remain in force until the latter resolves that it be changed. The Board of Directors shall set the exact amount to be paid within that ceiling and how it is divided between the various Directors.*
2. *Additionally and apart from such remuneration as is provided for under the above paragraph 1, other remuneration systems may be created that may, either be indexed to the listing value of the shares, or consist of the delivery of stock or of stock options to the Directors. The application of said remuneration systems must be authorized by the General Shareholders' Meeting, which shall fix the stock value which is to be taken as the term of reference thereof, the number of shares to be delivered to each Director, the exercise price of the stock options, the term of such remuneration system and such other terms and conditions as may be considered as fit.*
3. *Such remuneration systems as are provided for under the above paragraphs and which shall stem from the appurtenance to the Board of Directors, shall be deemed compatible with any and all other professional or work-based compensations to which the Directors may be entitled in consideration of whatever executive or advisory services which they may deliver to the Company, other than such supervisory and decision – making functions of a collecty nature as may pertain to them as such Directors, which functions shall be subject to the applicable legal provisions in force.*
4. *To ensure that the remuneration of the Directors qua Directors is duly transparent, the Annual Report shall specify the individualised remuneration relating to each of the offices or positions on the Board and its Committees (Chairman, Vice-Chairman, Member). The remuneration of executive Directors in respect of matters other than those referred to in paragraph 1 of this article shall be given as a total, with a breakdown of the various items or heads of remuneration.*

B) Reasons for insertion of a new article 31 bis.

1. Article 47 of Spanish Law on Measures to Reform the Financial System of 22 November, (*Ley 44/2002 , de 22 de noviembre, de Medidas de Reforma del Sistema Financiero*), referred to as the Financial Law (*Ley Financiera*), in its "Audit Committee" section, adds an additional provision eighteen to Spanish Stock Market Law of 28 July (*Ley 24/1988, de 28 de julio, del Mercado de Valores*), under which companies which have securities listed on official secondary markets have to set up an Audit Committee and establish its basic governing provisions in their By-laws.



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In compliance with that statutory requirement, the Board of Directors now submits for the approval of the shareholders a new article 31 bis to be inserted into the By-laws of "Telefónica, S.A.", acknowledging the above-referred Committee, which the Company set up some time ago and regulated in article 24 of its Rules of the Board of Directors (*Reglamento del Consejo de Administración*) with the name "Audit and Control Committee" as the Audit and Control Committee under the By-laws. In accordance with the Financial Law and in line with the existing provisions of the aforementioned Rules of the Board of Directors, the new article 31 bis establishes the composition of the Committee and its minimum powers and duties, and the basic aspects of its operation, in accordance with the recent legislative provision.

The proposed amendment also envisages that the provisions of the By-laws can be implemented and supplemented by the Rules of the Board of Directors, which would enable the detailed provisions currently contained in those Rules to be retained and, at the same time, allow the margin of flexibility necessary for those detailed rules to be adapted to prevailing circumstances from time to time.

2. Therefore, the Board of Directors submits for the approval of the General Shareholders' Meeting a new article 31 bis to be inserted into the text of the By-laws of the Company, worded as follows:

Article 31 bis - Audit and Control Committee

1. *An Audit and Control Committee shall be set up within the Board of Directors, comprising at least three and a maximum of five Directors appointed by the Board of Directors. All members of that Committee must be non-executive Directors.*
2. *The Chairman of the Audit and Control Committee shall be appointed by the Committee itself from amongst its members, must be replaced every four years, and may be re-elected on expiry of one year from ceasing to hold office.*
3. *The Audit and Control Committee shall have at least the following powers and duties:*
 - (i) *through its Chairman, to report to the Annual General Shareholders' Meeting on any matters within the competence of the Committee raised by shareholders at the Meeting.*



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- (ii) *to propose to the Board of Directors for submission to the General Shareholders' Meeting appointment of the Auditor referred to in article 204 of the Ley de Sociedades Anónimas and, where applicable, the terms on which the Auditor is engaged, extent of the Auditor's instructions and revocation or renewal of the Auditor's appointment.*
 - (iii) *to supervise internal auditing staff;*
 - (iv) *to be acquainted with the financial reporting and internal monitoring systems procedures; and*
 - (v) *to liaise with the Auditor to receive information on any matters which could jeopardise the Auditor's independence, and any other matters in connection with the process of carrying out the auditing of accounts, and to receive information and exchange with the Auditor the notifications referred to in legislation on the auditing of accounts and in technical auditing rules.*
4. *The Committee shall meet at least once a quarter and whenever appropriate, subject to notice of the meeting given by the Chairman, at its own initiative or in response to a request by two of its members or of the Management Committee.*
5. *The Audit and Control Committee shall be quorate when at least one half of its members, present or represented, are in attendance, and shall pass its resolutions by a majority of those present. In the case of an equality of votes, the Chairman shall have a casting vote.*
6. *The Board of Directors may issue implementing provisions and supplement the foregoing rules in its Rules, in accordance with its By-laws and the law.*

C) Justification of the insertion of a new section 4 to Article 35

1. The Board of Directors considers it expedient to decide on methods of distribution in kind of Company assets (whether through the distribution of dividends, or through distribution of the issue premium or through the return of contributions in cases



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of capital reduction), which, in accordance with standards extant on the international markets, would allow it to face the strategic challenges posed by managing the Company and which, in particular, would facilitate its execution of divestment transactions.

In view of these needs, the Board of Directors is proposing a By-laws reform to the General Shareholders' Meeting, which consists of adding a new section 4 to Article 35 of the Company's By-laws, wherein distributions in kind are authorized under the dual condition that the securities subject to distribution be homogenous (only thus can equal treatment of all shareholders be guaranteed) and liquid (for the purpose of facilitating their monetarization by those beneficiaries who have other investment preferences).

The proposal, which does not lack for precedents among our corporate practice, will facilitate transferring to shareholders the proportional share of the implicit value of those assets that the Company wishes to divest itself of for legal or strategic reasons.

2. By virtue of all of the foregoing, the Board of Directors is submitting a new section 4 of Article 35 of the Company's By-laws to the shareholders for approval with the following wording:

“The General Meeting may resolve to distribute dividends, or the issue premium, in kind, provided that the assets or securities subject to distribution are homogenous and are admitted for trading on an official market at the time the distribution resolution becomes effective. This latter requirement shall also be understood satisfied when the Company provides adequate guaranties of liquidity.

The rule contained in the previous paragraph shall also apply to the return of contributions in cases of capital reduction.”

3. Accordingly, Article 35 of the Company's By-laws will be drafted in the following manner:

“Article 35. Application of the Results.



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1. *The General Meeting will decide on the application of the Fiscal Year results in accordance with the Balance Sheet approved.*
2. *Once the items provided by Law or by these Bylaws have been covered, dividends may be distributed only by charging the Fiscal Year profit or the unrestricted reserves if the book value of Net worth is not lower than the capital stock or would not prove to be so as a result of the distribution.*
3. *The distribution of dividends to common shareholders will be executed proportionately to the capital that they have paid in.*
4. *The General Meeting may resolve to distribute dividends, or the issue premium, in kind, provided that the assets or securities subject to distribution are homogenous and are admitted for trading on an official market at the time the distribution resolution becomes effective. This latter requirement shall also be understood as satisfied when the Company provides adequate guaranties of liquidity.*

The rule contained in the previous paragraph shall also apply to the return of contributions in cases of capital reduction."