

**REPORT ON THE COMPENSATION POLICY OF THE
BOARD OF DIRECTORS OF
TELEFÓNICA, S.A.**

February 2008

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I. INTRODUCTION

As provided in Article 36 of the Regulations of the Board of Directors of Telefónica, S.A. (“**Telefónica**” or the “**Company**”), each year the Board must approve, at the proposal of the Nominating, Compensation and Corporate Governance Committee, a Report on the compensation policy of the Directors of the Company, which must set forth the standards and the basis for determining the compensation system for the Directors for the current year (in this case, for fiscal year 2008). Such Report must also include a summary of the compensation system applied during the prior year (i.e., 2007), describing the standards and general principles followed for the establishment and practical application thereof.

In compliance with such provisions, the Board of Directors of the Company has, at the proposal of the Nominating, Compensation and Corporate Governance Committee, prepared this Report, which was approved by the Board at its meeting held on February 27, 2007. To prepare this document, the Board drew on the advice and cooperation of the Company’s Directorate of Corporate Human Resources, as well as on the assistance of the human resources consulting firm Towers Perrin.

It is also stated for the record that this Report will be made available to the shareholders of the Company on the Company’s website (www.telefonica.es/accionistaseinversores) and will be submitted to the shareholders at the Ordinary General Shareholders’ Meeting of the Company, scheduled to be held on April 21 and 22 on first and second call, respectively.

II. PROCESS FOR THE PREPARATION OF THE COMPENSATION SYSTEM AND POLICY

The compensation system and policy of the Board of Directors of Telefónica and the process to be used in the preparation thereof are established in Article 28 of its By-Laws and in Article 35 of its Regulations of the Board of Directors. As provided in the above-mentioned regulations, the Board of Directors, upon the prior proposal and report of the Nominating, Compensation and Corporate Governance Committee,

determines, within the maximum limit established by the shareholders at the Ordinary General Shareholders' Meeting of the Company, the amount that the Directors are to receive for discharging their duties of collective supervision and decision-making inherent in such position. The By-Laws also provide, in addition to and independently of the compensation mentioned above, for the possibility of the shareholders at the General Shareholders' Meeting resolving to establish compensation systems for the Directors that are linked to the listing price of the shares or that entail the delivery of shares or of options on shares.

The above-mentioned compensation, deriving from membership on the Board of Directors of the Company, is compatible with the other compensation received by the Directors by reason of the executive duties that they perform for the Company.

To determine the amount to be paid to the Directors, the Board of Directors endeavors to ensure at all times that the compensation of the Directors is commensurate with the compensation paid at similarly-sized companies carrying on similar business in the market, which is also periodically reviewed by the Nominating, Compensation and Corporate Governance Committee, in order to propose to the Board of Directors, if required, the adoption of the resolutions deemed appropriate in connection with this matter.

In determining such amount, the Board of Directors of the Company also takes into account the responsibility and the level of commitment entailed by the role each Director is called upon to play and market requirements, using standards of moderation for such purpose that have been duly verified by the reports provided by professional experts on the matter.

The important role played by the Nominating, Compensation and Corporate Governance Committee in the determination of the compensation system and policy of the Directors is particularly worthy of mention. Thus, Article 22 of the Regulations of the Board of Directors of the Company provides that it shall fall upon such Committee, among other duties and powers: i) to propose to the Board of Directors the compensation of the Directors and to review it periodically to bring it into line with the duties discharged by them; and ii) to propose, within the framework established in the By-Laws, the extent and amount of the financial remuneration, rights and

compensation of the Chairman, executive Directors and senior Managers, including the basic terms of their contracts.

III. DESCRIPTION OF THE BASIC OBJECTIVES OF THE COMPENSATION SYSTEM AND POLICY

As regards the basic objectives of the compensation system and policy of the Directors of Telefónica, a distinction must be made between external directors (who do not perform any executive duties for the Telefónica Group), and executive directors, who perform executive or management duties within the organizational structure of the Company.

- External directors:

As far as external Directors are concerned, the aim of the compensation policy is to adequately compensate the directors for the dedication provided and the responsibility assumed, seeking to avoid such compensation compromising their independence.

- Executive directors:

The basic standard underlying Telefónica's compensation policy for executive Directors is to establish compensation packages that will make it possible to attract, retain and motivate the most distinguished professionals, so as to allow the Company to achieve its strategic aims within the ever more competitive and internationalized framework in which it operates.

From this viewpoint, Telefónica's compensation policy seeks to:

- (i) Ensure that the compensation package, in its structure and overall amount, is competitive with that of comparable international entities. In particular, given the size of the Telefónica Group and its multinational scope, the largest European multinational companies are taken as the main point of reference.
- (ii) Provide incentives for the sustained creation of value for the shareholders over time. To that end, the compensation includes significant short-, medium- and long-term variable components:

1. Annual variable compensation is linked to the achievement of specific and quantifiable business objectives that are in line with the interests of the Company and have an impact on the creation of value, as well as to the evaluation of individual performance. Objectives are adjusted to the strategic priorities of the business on an annual basis.
2. Medium/long-term compensation is linked to the creation of value for the shareholders.

Taking the foregoing considerations into account, the Company's Board of Directors, upon the prior proposal of the Nominating, Compensation and Corporate Governance Committee, in line with currently existing international good governance policies and practices on executive compensation (which show a growing trend for the compensation of executive Directors other than the Chairman to be basically linked to the performance of their executive duties), has resolved that, beginning in September 2007, executive Directors of the Company other than the Chairman are to receive only those amounts for the performance of their executive duties that are established in their respective contracts.

IV. STRUCTURE OF DIRECTORS' COMPENSATION

With respect to the structure established for the current compensation of Directors and as explained above, a distinction must be made between the compensation set for external Directors, on the one hand, and for executive Directors, on the other.

1. Structure of the compensation of Directors for their activities as external Directors

The compensation accruing to external Directors for their activities as such Directors is structured, within the framework established by the law and the by-laws, in accordance with the following standards and items of compensation, within the maximum limit determined for such purpose by the shareholders at a General Shareholders' Meeting, in accordance with the provisions of Article 28 of the By-Laws:

1.1. *Fixed amount*

Directors shall receive a fixed monthly amount, commensurate with market standards, according to the positions held on the Board and the Committees thereof. It is stated for the record that, as of the date hereof, provision is made for payment of a fixed amount for sitting on the Board of Directors, the Executive Committee and advisory or control Committees, on the terms and conditions described below.

1.2. *Attendance fees*

Directors shall be entitled to receive specified amounts as attendance fees. It is stated for the record that, as of the date hereof, it is established that the Directors will only receive fees for attending the meetings of the advisory or control Committees, as described below.

As of the date hereof, no provision is made for external Directors to receive any compensation as pension or life insurance, or to participate in compensation plans linked to the listing price of Telefónica shares, even though such form of compensation is contemplated in the By-Laws of the Company

In addition, it should be noted that certain Directors are members of the Boards of Directors of some subsidiaries and affiliates of Telefónica, and receive the compensation established by such companies for their directors.

2. Structure of the compensation of executive Directors

The compensation payable to executive Directors for the performance of executive duties for the Company is structured as follows:

2.1 *Fixed compensation*

This part of the compensation is determined according to the competitive level in the market taken as a reference, and the individual contribution of the executive Director.

2.2. *Variable short-term (annual) compensation*

A significant portion of the compensation of Directors performing executive duties for the Company shall be variable, in order to strengthen their commitment to Telefónica and motivate their performance. The parameters normally used as a reference for variable annual incentives are:

- Compliance with and achievement of the objectives established at the Group level.
- Evaluation of individual performance, according to the duties and objectives established for each executive, and
- The review and weighting of other elements and qualitative circumstances linked to the performance of the duties and the individual powers of each position.

2.3. *Long-term variable compensation:*

The Company also makes provision for the implementation of incentive schemes linked to the achievement of medium- or long-term objectives, in order to foster the retention and motivation of executive Directors and alignment with the sustained maximization of the value of Telefónica over time.

These schemes may include the delivery of Telefónica shares or of options thereon or compensation rights linked to the value thereof. The application of such compensation systems shall be approved by the shareholders at a General Shareholders' Meeting, who shall determine the value of the shares taken as a reference, the number of shares to be delivered to each Director, the exercise price of the option rights, the duration of such compensation system and such other terms as they deem appropriate.

Variable long-term compensation plans in effect during fiscal year 2007 are the Extraordinary Cash Incentive Plan and the Performance Share Plan, the basic terms of which are described in sub-section V below:

In any event, at the end of the fiscal year and depending on the level of compliance with the budget, the Nominating, Compensation and Corporate Governance Committee reviews the situation and, accordingly, proposes to the

Board of Directors the compensation solutions that best fit the new circumstances in each case.

2.4. *Benefits*

Executive Directors participate in benefit plans consisting of general health and dental insurance, life insurance and disability insurance. They are also participants in pension/retirement plans. These benefits are entirely in line with existing market practices.

2.5. *Basic terms of the contracts of executive Directors: termination; non-competition and exclusivity agreement*

The contracts of executive Directors and some of the members of the Company's management team in general provide that they shall be entitled to receive the financial compensation described below in the event of termination of the relationship for a reason attributable to the Company, and in some cases also due to the occurrence of objective circumstances, such as a change of control in the Company. Conversely, if the termination of the relationship occurs because of a breach attributable to the executive Director or manager, or results from his/her own free decision, s/he shall not be entitled to any compensation. However, it should be noted that, in certain cases, the compensation that executive Directors are entitled to receive under their contract does not result from the application of these general standards but from their personal and professional circumstances and the time when the contract was signed. The financial compensation agreed in the event of termination of the relationship, where appropriate, consists of three times annual salary and an additional payment according to the director's length of service for the Company. Annual salary amounts consist of the last fixed compensation and the arithmetical mean of the sum of the last two variable compensation payments received according to their contract.

As regards the agreement on non-competition and exclusivity, pursuant to the provisions of Section 8.3. of Royal Decree 1,382/85, which governs the employment relationship with senior management, contracts executed with executive Directors include a non-competition agreement that applies following the termination of the contract. Such agreement provides that, upon termination

of such senior management contract and for the term of the agreement, the executive Director may not render services, directly or indirectly, for his own account or on behalf of third parties, personally or through nominees, to Spanish or foreign companies whose business is the same or similar to that of the Telefónica Group.

The above-mentioned agreement not to compete has a duration of one year following the termination of the contract for any reason. There is an exception for events of dismissal that is improper or void by without reinstatement as declared by final judicial decision, arbitral award or administrative resolution (without the possibility of appeal), in which case the executive Director shall be released from the agreement not to compete.

The contracts of the executive Directors prohibit during the term thereof the signing (whether directly or through intermediaries) of other employment, or commercial or civil contracts with other companies or entities that engage in activities similar in nature to those of the Telefónica Group.

Their employment relationship continues to be and is declared to be compatible with the holding of other representative and management positions and with other professional situations s/he may attend to at other entities within the Telefónica Group or at any other entities unrelated to the Group, with the express knowledge of the Board of Directors of Telefónica S.A. or of the Chairman thereof.

V. CHANGES IN DIRECTORS' COMPENSATION

Below is a description of the changes in the compensation received by the Directors during the last two fiscal years, both as Directors and for the performance of executive duties, where applicable.

1. Changes in the compensation of the Directors for their activity as Directors

In fiscal year 2007, the Nominating, Compensation and Corporate Governance Committee, complying with the duties assigned to it and based on updated market information, conducted a review of the compensation established for the Directors of the Company for their mere status as such, and proposed to the Board of Directors that

the fixed annual amount corresponding to the Directors for sitting on the Board of Directors, the Executive Commission and the advisory or control Committees of the Board be reviewed, since until then there had been no change in the amount established in fiscal year 2004.

1.1 *Fixed amount*

As a result of the foregoing, the Board of Directors resolved to conduct such review beginning in March 2007.

The amounts paid to the Directors for the performance of the duties of collective supervision and decision-making inherent to their status during fiscal years 2006 and 2007, and the amounts expected to be paid for 2008, are as follows:

Board of Directors

<i>euros</i>	<i>2008</i>	<i>2007¹</i>	<i>from October 2004 to March 2007</i>
Chairman	300,000	290,000	240,000
Vice-Chairmen	250,000	241,667	200,000
Executive members	--	95,000	120,000
External members ²	150,000	145,000	120,000

(2) This category includes all non-executive members, i.e. proprietary, independent and other external directors.

Executive Commission

<i>euros</i>	<i>2008</i>	<i>2007¹</i>	<i>from October 2004 to March 2007</i>
Chairman	100,000	96,667	80,000
Vice-Chairman	100,000	96,667	80,000
Members	100,000	96,667	80,000

Committees	2007	2006
Audit and Control	Fee per meeting: 1,250 No. of meetings paid: 11 Total amount paid: 47,500	Fee per meeting: 1,250 No. of meetings paid: 11 Total amount paid: 46,250
Nominating, Compensation and Corporate Governance	Fee per meeting: 1,250 No. of meetings paid: 10 Total amount paid: 48,750	Fee per meeting: 1,250 No. of meetings paid: 11 Total amount paid: 53,750
Human Resources and Corporate Reputation	Fee per meeting: 1,250 No. of meetings paid: 4 Total amount paid: 20,000	Fee per meeting: 1,250 No. of meetings paid: 5 Total amount paid: 21,250
Regulation	Fee per meeting: 1,250 No. of meetings paid: 11 Total amount paid: 52,500	Fee per meeting: 1,250 No. of meetings paid: 10 Total amount paid: 45,000
Service Quality and Customer Service	Fee per meeting: 1,250 No. of meetings paid: 4 Total amount paid: 15,000	Fee per meeting: 1,250 No. of meetings paid: 4 Total amount paid: 12,500
International Affairs	Fee per meeting: 1,250 No. of meetings paid: 5 Total amount paid: 27,500	Fee per meeting: 1,250 No. of meetings paid: 3 Total amount paid: 18,750

As for the fees applicable for meetings as from January 1, 2008, the Board of Directors, with the prior report of the Nominating, Compensation and Corporate Governance Committee, resolved to maintain the current amount established for such item, i.e. 1,250 euros per meeting.

In addition to the foregoing, it is stated for the record that the compensation received by the Directors of the Company for sitting on the Boards of Directors of other companies belonging to the Telefónica Group was 405,192 euros in fiscal year 2007, and that the six Directors of the Company who sit on the Advisory Councils of Catalonia, Andalucía and Valencia received a aggregate total of 73,750 euros in fiscal year 2007.

1.3 Summary of the total compensation received by the Directors for their activity as Directors in fiscal year 2007.

* Figures stated in euros

Directors	Board	Executive Commission	Committees of the Board		TOTAL
			Fixed	Fees	
Chairman					
Mr. César Alierta Izuel	290,000	96,667	0	0	386,667
Vice-Chairmen					
Mr. Isidro Fainé Casas	241,667	96,667	0	0	338,333
Mr. Gregorio Villalabeitia Galarraga ⁽¹⁾	137,500	55,000	22,500	20,000	235,000
Mr. Vitalino Manuel Nafría Aznar	186,667	0	7,000	3,750	197,417
Members					
Mr. Julio Linares López	95,000	63,333	8,667	7,500	174,500
Mr. José María Abril Pérez ⁽²⁾	62,500	41,667	3,500	1,250	108,917
Mr. José Fernando de Almansa Moreno-Barreda	145,000	0	40,000	20,000	205,000
Mr. José María Álvarez-Pallete López	95,000	0	0	0	95,000
Mr. David Arculus	145,000	0	0	0	145,000
Mr. Maximino Carpio García ⁽³⁾	145,000	96,667	40,833	26,250	308,750
Mr. Carlos Colomer Casellas	145,000	96,667	13,333	2,500	257,500
Mr. Peter Erskine	95,000	63,333	0	0	158,333
Mr. Alfonso Ferrari Herrero	145,000	0	60,333	26,250	231,583
Mr. Gonzalo Hinojosa Fernández de Angulo	145,000	0	73,667	35,000	253,667
Mr. Pablo Isla Álvarez de Tejera	145,000	0	50,500	17,500	213,000
Mr. Antonio Massanell Lavilla	145,000	0	47,000	23,750	215,750
Mr. Enrique Used Aznar ⁽⁴⁾	145,000	0	60,333	27,500	232,833
Mr. Antonio Viana-Baptista	95,000	63,333	0	0	158,333

(1) Mr. Gregorio Villalabeitia Galarraga was a Director of Telefónica until July 25, 2007, being replaced as Vice-Chairman by Mr. Vitalino Manuel Nafría Aznar.

(2) Mr. José María Abril Pérez was appointed Director of Telefónica on July 25, 2007.

(3) Mr. Maximino Carpio García was a Director of Telefónica until December 19, 2007.

(4) Mr. Enrique Used Aznar was a Director of Telefónica until December 19, 2007.

2. Changes in the compensation of executive Directors

2.1 *Fixed and variable annual compensation*

The following table shows the changes in the fixed and variable annual compensation paid to executive Directors for the performance of their executive duties within the Company over the last two fiscal years:

<i>euros (except percentages)</i>	<i>2007 (2)</i>	<i>2006 (1)</i>	<i>%2007/2006</i>
Variable compensation	5,688,154 ⁽³⁾	5,408,437	5.17%
Fixed compensation	6,680,573 ⁽⁴⁾	5,236,697	27.57%
Total salary compensation	12,368,727	10,645,134	16.12%
Percentage of total salaries represented by variable compensation (%)	45.99%	50.81%	n/a

- (1) Includes the aggregate compensation of Messrs. Alierta, Álvarez-Pallete (since August 2006), Erskine, Lada (until August 2006), Linares, Vázquez (until July 2006) and Viana-Baptista.
- (2) Includes the aggregate compensation of Messrs. Alierta, Álvarez-Pallete, Erskine, Linares and Viana-Baptista.
- (3) It is stated, for the record, that, in addition, Mr. Peter Erskine received the following amounts:
 - i) Pursuant to the terms of the acquisition of O2 plc, 24,331,830.60 upon his ceasing to perform executive duties, for the following items: variable compensation for fiscal year 2007, a payment in lieu of notice as provided in his contract of employment, a payment for his permanence commitment complying with the provisions of the Master Agreement executed on the occasion of the Tender Offer for shares of O2 plc and the payment relating to the commitments previously acquired by O2 plc. in connection with his pension plan, which item is also reflected in the Document of the Offer. Most of such amount was paid in fiscal year 2007 and payment thereof was completed in January 2008; and
 - ii) 3.838.077 euros corresponding to payment under the “2005 O2 Share Plan” as is also reflected in the Document of the Tender Offer.
- (4) In addition, it is stated for the record that, in addition, Mr. Peter Erskine received the amount of 615,283 euros corresponding to the periodic payment in cash relating to the commitments then acquired by O2 plc with respect to its pension plan, which item is reflected in the Document of the Tender Offer.

As regards 2008, and as already mentioned, fixed and variable compensation will be determined according to the standards and principles mentioned above, i.e., following standards and parameters that will allow for the loyalty, motivation and commitment of the persons performing executive duties for the Group, thus achieving the strategic and business objectives established at any time for the Telefónica Group.

2.3 *Extraordinary Cash Incentive Plan*

In the first quarter of fiscal year 2008, the Executive Directors, together with the other Managers to whom the Extraordinary Cash Incentive Plan applies, received variable compensation in addition to their compensation for fiscal year 2007, the payment of which was linked to the achievement of operational and business objectives and metrics established at Group level for the 2005-2007 period. The Nominating, Compensation and Corporate Governance Committee determined that such objectives and Metrics had been achieved to a large extent.

2.4 *Performance Share Plan*

As mentioned above, as part of the compensation systems established to allow for the retention and loyalty of management talent in the medium and long term, the shareholders at the Ordinary General Shareholders' Meeting of Telefónica held on June 21, 2006, approved the application of a long-term incentive plan for executives and management personnel of Telefónica and of other companies belonging to the Telefónica Group, consisting of the delivery to the participants selected for such purposes, following compliance with the necessary requirements established therein, of a specified number of shares of Telefónica as variable compensation.

The total duration of the plan originally provided for is seven years. The Plan is divided into five cycles, with a duration of three years each, with each cycle beginning on July 1 ("Commencement Date") and ending on June 30 of the third year following the Commencement Date ("Conclusion Date"). The cycles are independent of each other, with the first cycle beginning on July 1, 2006 (with delivery of shares, if appropriate, starting on July 1, 2009) and the fifth cycle beginning on July 1, 2010 (with delivery of shares, if appropriate, starting on July 1, 2013).

The delivery of shares is contingent upon:

- Permanence in the company for the three-year duration of each cycle, although certain special conditions are established in connection with participants leaving the Company.

- The specific number of shares to be delivered at the end of each cycle will depend on the level of achievement and the maximum number of shares allocated to each Manager. The level of achievement is based on the comparison of the Total Shareholder Return (TSR), taking into account both listing price and dividends, of Telefónica shares with the TSR of a group of listed companies of the telecommunications industry which constitutes the Comparison Group (these are the companies making up the FTSE Global Telecoms Index, excluding Telefónica, at the beginning of the cycle). A maximum number of shares is allocated to each employee covered by the plan at the beginning of each cycle, and the specific number of shares that will be delivered to him/her at the end of the cycle is obtained by multiplying such maximum number by the level of achievement as of such date. Such level will be of 100% if Telefónica's TSR equals or exceeds that of the third quartile of the Comparison Group, and of 30% if such TSR equals the mean. If both amounts are the same, a linear interpolation will be made, and if it is lower than the mean, no shares will be delivered.

At the expiration of each cycle, Telefónica will deliver the shares, the specific number of which will have been determined in accordance with the conditions described above, to all the Managers of the Telefónica Group participating in the plan. The part of the cost to be borne by other companies belonging to the Group who are the employers of the affected Managers will be passed on to such companies.

In accordance with the foregoing, in fiscal years 2006 and 2007, shares were allocated to the executive Directors in respect of the first (2006-2009) and the second (2007-2010) cycles, which are therefore to be delivered beginning on July 1, 2009 and July 1, 2010. Thus, the maximum number of shares that will be delivered to each of the executive Directors of Telefónica, if they comply with the conditions established for such delivery, is as follows: Mr. César Alierta Izuel (129,183 shares in the first cycle and 116,239 shares in the second cycle); Mr. Julio Linares López (65,472 shares in the first cycle and 57,437 shares in the second cycle); Mr. José María Álvarez-Pallete López (62,354 shares in the first

cycle and 53,204 shares in the second cycle); and Mr. Antonio Viana-Baptista (62,354 shares in the first cycle and 53,204 shares in the second cycle). As regards Mr. Peter Erskine (to whom 181,762 shares were allocated in the first cycle and 151,863 shares in the second cycle), he will receive, within the first three months of 2008, the number of shares to which he is entitled, if any, according to the period of each cycle during which he was an executive of the Telefónica Group.

2.5 *Benefits*

In fiscal year 2006, the establishment of a Management Benefits Plan (Retirement Plan) was approved, in which executive Directors participate, funded solely by the Company, to supplement the current Pension Plan, which involves defined contributions equal to a specified percentage of Managers' fixed compensation, according to their professional levels within the organization of the Telefónica Group (annual regular contribution) and extraordinary contributions depending on the circumstances of each Manager, performed during 2006 and to be received in accordance with the conditions established in such Plan. In connection with the above-mentioned Benefits Plan, the total amount of the ordinary and extraordinary contributions made by Telefónica as of December 31, 2006 was 11,279,303 euros, and the total amount of ordinary contributions made by Telefónica as of December 31, 2007 was 1,707,237 euros, relating, in both years, to Messrs. Alierta, Alvarez-Pallete, Linares and Viana-Baptista.

Likewise, the executive Directors participate in the following benefits plans, which consist of general medical and dental insurance, as well as life insurance with disability coverage (hereinafter, "Other Insurance") and general pension plans for all Employees (hereinafter, the "Pension Plans"); all in line with the benefits for the other employees of the Telefónica Group. Set forth below are the annual costs of these benefits plans (the "Pension Plans" and "Other Insurance") with respect to executive Directors for fiscal years 2006 and 2007:

euros	2007	2006
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Pension Plan Contributions	33,018	59,062
Annual cost of Other Insurance	89,654	108,434

In addition, it is stated for the record that the executive Directors received cash compensation in the amount of 34,691.86 euros in fiscal year 2006 and 36,648.32 euros in fiscal year 2007.

2.6. *Advisors*

Finally, it should be noted that in all processes for the adoption of its respective decisions, as well as the preparation of this Report, the Nominating, Compensation and Corporate Governance Committee and the Board of Directors have drawn upon the information and advice of the internal services of the Company and the assistance of the human resources consulting firm *Towers Perrin*.

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