

REPORT BY THE SPECIAL COMMISSION TO
FOSTER TRANSPARENCY AND SECURITY IN
THE MARKETS AND IN LISTED COMPANIES

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MARKETS AND IN LISTED COMPANIES***

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I.- PREAMBLE.

1. The Commission's mandate.

On 19 July 2002, the Spanish Cabinet adopted a resolution whose operational section reads as follows:

"A Special Commission of a technical nature is hereby established to study the criteria and guidelines that should apply to companies which issue securities and instruments admitted to listing on organized markets in their relations with consultants, financial analysts and other companies, persons or entities which assist them or provide professional services to them, and those which should apply among the latter, in order to increase the transparency and security of the financial markets in the light of the structural changes, the current globalised economy and the trends in the international markets. The Commission must also analyse the current status and degree of application of the Code of Good Governance for Listed Companies."

This Commission understands that this mandate obliges it to study and propose "criteria and guidelines" as regards the governance of companies and their relations with various types of professional services firms, and to establish such criteria and guidelines with a view to increasing "transparency and security in the markets"; and it must do this after analyzing the current status of application of the Code of Good Governance for Listed Companies.

To comply with its mission, the Commission has met frequently; it has worked firstly in sub-committees and later in plenary sessions; it has requested considerable information from companies listed on the stock exchange and from providers of professional services, and it has set up an e-mail address to which the public could send suggestions and comments.

As a result of the foregoing, it drafted this Report, which begins with this preamble, continues with a reflection on the criteria of transparency and security in the markets and makes a number of recommendations about the relationship between listed companies and the aforementioned professional services firms and about improved corporate governance, in line with the mandate it received. The Commission is in agreement on the overall document presented as a Report, even if it does not reflect the individual opinion of each of its members about each of the matters which are discussed.

2. General diagnosis of the situation.

Modern market economies are immersed in an accelerated process of globalization, one of whose features is the integration of their capital markets. This integration process has created considerable pressure in favour of a degree of convergence among the institutional models of capital markets in the most advanced countries, in which the traditional system of the economies of continental Europe, based primarily on banks and similar financial institutions, is being replaced by one focused primarily on securities markets, in line with the traditional model in the English-speaking countries. This pressure is being fed by the need for access to greater sources of funding and the possibility of real-time worldwide communications afforded by changes in information technology, as well as by the effects of a complex process of cultural dissemination.

It is normally understood that the correct functioning of a capital market – such as the existing worldwide market, which attracts growing amounts of capital from a broad variety of sources, in conditions of great uncertainty – requires the application of a coherent philosophy as regards regulation or coordination of the economy around three criteria or principles: effective rule of law, self-regulation by the markets as far as possible, and maximum transparency.

Without the effective rule of law, through prompt, competent intervention through institutional instruments for monitoring, conflict resolution and application of justice, the system loses security and legitimacy in the eyes of broad strata of society. If the markets' scope for self-regulation is not exploited to the utmost, advanced countries will abandon the initiative towards liberal coordination of their economies. And if transparency does not receive special attention, i.e. if efforts are not made to disseminate, as broadly as possible, information that is as reliable as possible, then self-regulation by markets and the correction of their imperfections (which are logical and inevitable) will be more costly and more turbulent than need be.

Recent difficulties observed in the capital markets are due to a number of factors. They respond, to a great extent, to the process of collective learning that accompanies the shift in the institutional framework of the capital markets towards exchange-based systems. A number of features of that learning process observed in the US and other countries include partially defective working of the market in corporate control, strategic errors by companies which grossly increased their indebtedness or greatly underestimated the risks of their operations, and inappropriate actions by some companies, including accounting practices which distorted the picture of the situation (severely, on occasions), not to mention the responsibility of the regulatory authorities themselves, which may have created distorted incentive structures for market players.

Moreover, at times society's perception of the turbulence in the markets, and the sense of disquiet – even alarm – created by certain scandals can be amplified by such factors as the

impact those events have in the mass media, which often highlights the drama of the situation (this is not to dispute the key role played by the media in general in informing the public about such matters); the possible over-reaction to problems in the form of increased state regulation and intervention; and the understandable concern on the part of households increasingly involved in capital markets when faced with an economic downturn – people often lacking the ability to form their own opinion of the matter and who have long been receiving messages of excessive optimism.

Although all these difficulties and circumstances are important and require careful attention, if viewed from the appropriate standpoint it is found that they do not jeopardise the foundations of the market economy or the general orientation of the advanced economies towards exchange-based systems. Consequently, not only do the difficulties in these years not question the principles of rule of law, self-regulation and transparency; in fact, the solution can and must be found by applying those very criteria.

3. The Spanish tradition and the Olivencia code.

Spain has participated in the aforementioned process of transition towards an exchange-based system, and it has done so with particular intensity in recent years. However, this process is slow and complex and its culmination depends on changes in behaviour patterns, modes of perception and incentive frameworks which cannot be achieved merely by legislation or the establishment of a code of conduct.

Moreover, it is necessary to take account of Spain's initial position (which it shared with many other European countries): a long tradition of state dirigisme and coordination of the economy, a capital market centred around banks and financial institution, (very often with cross-holdings, concentrated capital ownership and stable hard cores of shareholders), and managers accustomed to having close relationships with the legislative power and little oversight by the Boards of Directors and much less by the Shareholders' Meetings.

This situation has been subjected to a process of very intense growth in financial activity, characterised by large companies resorting to the securities markets to support their expansion and consolidation initiatives, of small and mid-sized companies making the leap from traditional family firm to a more ambitious, modern company, and of household savings increasingly venturing into this field often for the first time. The structure of Spanish households' financial assets has changed substantially in the last ten years. At the end of 2001, close to 60% of those assets were in financial products directly or indirectly related to the securities markets (equities, bonds, mutual funds, pension funds and insurance), compared with 37% in 1995 and 23% in 1985. In fact, by the end of 2002, 28% of the capitalization of the

Madrid Stock Exchange was owned by households – more than at the majority of European stock exchanges.

In these circumstances – a rapid change set against a background of tradition from a previous era – it is not surprising that the transition to an exchange-based system with a notable degree of protagonism for the shareholder should prove complicated and stormy. For that reason, it is equally unsurprising that the attempt to make the transition should lead to a *de facto* maintenance of weak control over management by Boards and Shareholders' Meetings, a rhetoric about creating shareholder value (taken to be synonymous with the share price), the often purely formal adoption of codes of governance, the dissemination of the idea of independent directors, but not its actual implementation, and the first moves to greatly increase executive compensation plus certain reluctance to disclose that compensation. These are all signs that we are in a relatively early phase of the transition, in which cultural and institutional changes may have been mapped out and stated but they are still far from being fully implemented.

The Olivencia Commission's actions fall within this transition process. The Commission was created by the Spanish government in 1997 and it published a Report in February 1998 on the ongoing process in which it stated that it was probable and desirable that much of the Anglo-Saxon tradition of good governance should be taken on board by Spanish listed companies and capital markets; in this line of thinking, it developed an approach to corporate governance which emphasized the responsibility of management and Boards of Directors to the company's shareholders.

The Olivencia Commission's report led to a number of precise and carefully-considered recommendations that comprise the Code of Good Governance, whose adoption by companies is voluntary; companies adopting the Code should undertake to comply fully with the code or to explain why they do not; the expectation was that the markets receiving this information would reward good governance practices and punish non-compliance, unless the company's reasons for non-compliance were convincing or the markets attached more importance to the company's economic results than to its governance practices. Overall, the Olivencia Commission adopted an approach based squarely on the rule of law, self-regulation and transparency as referred to above.

4. The Olivencia Code four years on, and the role of this Commission.

The Olivencia Report and its Code of Good Governance were the subject of attention and comment by a strategic but nonetheless narrow sector of the population. Four years later, it is

not clear to what extent it has actually been applied, although there is interesting but partial evidence on the matter. The CNMV has published what listed companies say about their compliance with the code, but this is aggregated information which has not been cross-checked.

A second Olivencia Commission, established precisely to monitor compliance with the Code, conducted two surveys in 2002: among a strategic sample of about 200 experts and a representative sample of 800 shareholders. The surveys showed that although the experts were conversant with the Olivencia Report and Code and had a positive opinion of them, shareholders were barely aware of them. All parties appeared to favour the Report's characteristic approach involving voluntary application of the Code and self-regulation by the markets.

However, it is worth highlighting that, according to the surveys, the majority opinion of experts and shareholders is that, in practice, the information which listed companies provide to the markets and their shareholders is grossly insufficient, and this is particularly the case of the information provided on the occasion of the Shareholders' Meeting. Both groups (experts and shareholders) took it for granted that this lack of transparency conceals conflicts of interest and the use of inside information by executives and directors, to the detriment of the company. They expressed some interest in the idea of independent directors, but doubted that they would really be independent in practice; this doubt probably reflects the scant real experience with independent directors in Spanish business and society.

In these circumstances, and in view of the fragmented information available about the situation of governance in listed companies, the next move was that taken by this Commission in application of the mandate described in the Preamble.

This is yet another step in the process of transformation of Spain's capital markets, in continuation of the Olivencia tradition, since it assumes the basic philosophy of the rule of law, self-regulation and transparency. Like its predecessor, this Commission also considers that its function is not to take the place of the legislature nor to curtail companies' capacity for self-regulation. On the contrary, it understands that its style of intervention is appropriate to its mission of reflecting on the situation, clarifying the direction of the process of change in which we are immersed, and making a number of suggestions, identifying problems and suggesting possible solutions, without dogmatism, in the tone and manner of prudent guidelines in an area of considerable and growing complexity that is subject to constant change.

5. Parties to whom this Report is addressed.

The reflections and recommendations in this Report are addressed primarily to the companies themselves and the participants in the capital markets, evidently without prejudice to the use which the public authorities make or consider it necessary to make thereof, or to the contribution by these reflections to the public debate and the deliberation in society at large about these matters.

Specifically, the Report focuses on listed companies, which are the centre of the capital markets and of the process of raising funds from the public, but its recommendations may also apply to any company resorting to the primary securities market (issue market) for the first time with the aim of placing its securities with the public, whether or not those securities are subsequently listed in a secondary market.

The Report also envisages, albeit indirectly, the relationship between certain specialised operators and parties with the listed companies, and some of the recommendations are also directed at them.

6.- Content and structure of the Report.

Taking account of the Olivencia Commission Report, the experience obtained with its application and the challenges faced today, this report addresses several of the problems which were covered in the previous Report and some new ones. This Report's approach to the regulation of capital markets is coherent with that of the previous Report, but it also elaborates upon certain principles and criteria.

This Report is a response to the search for a balance between, on the one hand, regulations to provide legal protection of shareholders' ownership rights, which, in the final instance, are the cornerstone of the capital markets system, and, on the other hand, as much self-regulation as possible for listed companies. This philosophy could be summarised in an affirmation of the principle of freedom, understood in a double dimension: freedom of shareholders and freedom of companies to regulate themselves when deciding on and applying strategies, but also the freedom to organise their own corporate governance.

From this principle of freedom derive the principles of transparency and loyalty, duly balanced with that of diligence, to which this Report devotes considerable attention, as it does to the functioning of corporate organs and to the relationships with service providers and consulting companies.

The problems addressed in this report include the specification of the duties of loyalty and diligence, the definition of conflicts of interest, the workings of boards of directors and shareholders' meetings, and the relationships between listed companies and other companies with which they have relations of a commercial or advisory nature.

Consequently, the Report is structured as follows. Sections II and III are devoted to analysing the problems arising in the application of the principles of transparency and the duty of loyalty. Section IV discusses the "Company organs " and section V discusses "Professional services providers". Section VI contains a number of reflections on the scope and application of the recommendations.

II.- THE PRINCIPLE OF TRANSPARENCY AND THE DUTY OF DISCLOSURE.

1.- Transparency.

In financial markets, information is the cornerstone underpinning the entire system to ensure that prices are formed appropriately and that the market players' positions can be appropriately monitored. For this purpose, the regulation of financial markets and the market players must ensure the correct and necessary disclosure of information so that all those participating in the markets may form sound and reasonable judgements for their investment or divestment decisions, and transparency is therefore a fundamental principle whereby:

All the information that is relevant to investors is disclosed to the market.

The information that is disclosed is correct and truthful.

The information is disclosed in a symmetrical and equitable fashion .

The information is disclosed on a timely basis.

When these conditions are met, market players can form appropriate judgements of the listed companies and take the appropriate decisions, assuming the risks that are inherent to the market.

Therefore, it is necessary to examine the regime of transparency in the financial markets and listed companies in order to correct any defects that might be detected in an analysis of the current situation. The Commission considers that our system of transparency is oriented particularly towards quantitative information (economic and accounting information) and information with a more immediate impact (significant events), but that it needs further development with regard to qualitative information, specifically in the area of corporate governance.

The recommendation in this area is that the disclosure duty with regard to corporate governance structures and practices should be extended and, in general, that measures should be adopted to ensure greater information quality. The establishment of transparency obligations is particularly appropriate since (i) it provides information about a dimension of companies which is increasingly important for evaluating them and adopting investment decisions as a result; (ii) it enables market forces to impose their discipline, thereby creating incentives to ensure that self-regulation is used not to preserve vested interests but to increase organisational efficiency; (iii) in short, it constitutes a measure that is relatively non-aggressive and non-interventionist while providing a superior alternative to other measures that limit the freedom of organization. Accordingly, the Commission sees the obligation of transparency as a

complementary component of self-regulation which provides the conditions under which many other matters may be left to the sphere of private autonomy, which provides greater flexibility and adaptability.

1. 1. Full disclosure.

Because of the development of markets and societies, investors now need more information of greater quality in order to form a "true and fair view" of a listed company. It is not sufficient merely to have access to the company's accounting information; it is also necessary to have access to information that is increasingly of relevance in today's markets, including most notably information about corporate governance. Regardless of the equilibrium between regulation and self-regulation mechanisms for listed companies, investors are entitled to be informed of key information regarding the decision-making processes in listed companies and any other information which reveals important features of corporate governance.

1. 2. Correct disclosure.

Full disclosure is useless if it is not possible to ensure that the information is also correct. The procedures to guarantee its correctness must extend to any aspect of the information to be disclosed by listed companies, particularly that relating to corporate governance (since, as stated above, this has also acquired considerable relevance for investors) and accounting information.

Recent experience in the United States has shown that accounting, the financial language of companies, must serve to provide correct information to the market, not to conceal or distort that information.

In connection with the important task of drafting a basic set of accounting rules that will be accepted in the international financial markets, the Commission wishes to highlight the praiseworthy work being done in the European Union which made it possible recently to approve European Regulation on International Accounting Standards, which will come into force in 2005. The Commission believes, nevertheless, that the traditional accounting principles based on prudence in valuation should not be abandoned in order to adopt market or fair values, which are always subjective and subject to major oscillations. Events in the United States reveal that financial statements drafted in accordance with the new criteria may not be effective guides for managers or reliable indicators for investors.

The Commission bases its concern on the proven fact that European companies have, to a great extent, remained immune to the financial problems in the US precisely because they had not adopted the new accounting principles now being imposed in the European Union. Moreover, the volatility inherent to the market values, or fair values, may be incompatible with the security, clarity and confidence which corporate balance sheets should provide to the markets. Finally, the accounting standards in force already allow companies to inform shareholders of the market value of the main assets at a given date, in the notes to financial statements. These practices should not erode the traditional principle of prudence that should apply to any accounting valuation.

It is appropriate to reflect on the advisability of extending the guarantee of correctness to any other matters of obligatory disclosure by listed companies, particularly corporate governance, since, as stated above, it has also acquired relevance for investors.

1. 3. Equitable, symmetrical and timely disclosure.

Finally, the information must be disclosed to the market in an equitable and symmetric manner: all market participants must have access to substantially the same information in the same timescale, so companies must send shareholders and investors in general the content of presentations provided to investment banks, analysts, rating agencies, significant shareholders and to all depositories of price-sensitive information once that information becomes known to the company.

The timing of market disclosure is also very important. Correct, equitable and symmetric information is useless if it is not disclosed at the same time as it becomes known to the company.

The amendments in the Law of Measures to Reform the Financial System (Law 44/2002, dated 22 November) represent a move towards a more demanding regime for disclosure of relevant information to the market (articles 37 *et seq.*). It would be advisable to extend this reporting regime to the area of good governance, and the requirements as to equitable treatment in the distribution of information should also apply to the other parties which are involved in the market and have relations with the companies.

2.- The duty to disclose.

In connection with the foregoing, companies must acknowledge and comply with the aforementioned duties of transparency: disclosure of information to the market must not be merely voluntary, regardless of whether the corporate governance rules or criteria are binding or not. And, companies must be required at least to disclose to the market which of those rules and criteria they adopt and the degree to which they apply them in each case, so that investors can form a fair opinion of those companies. In listed companies, compliance with these duties depends on management, under the control and ultimate responsibility of the Board and its delegated or specialised bodies.

2. 1.- Content of the information to be disclosed by listed companies about their governance structure.

Accordingly, the Commission recommends the establishment of duties of transparency regarding the following aspects of governance structures and practices:

- a) *The company's ownership structure.*- Information on this matter should go beyond the current system of disclosing significant stakes and should provide an updated accurate picture of the powers which control the company, revealing the capital structure and, within that structure, the percentages of significant shareholdings and any family, commercial, contractual or corporate relations that exist. The Commission considers that it is vital for markets to be aware of pacts between shareholders and of the control structure of companies or groups of companies that own stakes in the company or in its subsidiaries, particularly when they are also owned by the core shareholders, as well as the representation held by these companies, directly or indirectly, on the Board, and any form of "poison pill" or similar mechanism in place at the company.
- b) *The company's management structure.*- The markets should also be informed about the composition, rules of organisation and workings of the Board of Directors and its Commissions; the identity, track record, stake in the company and remuneration of their members, the functions and posts held by each director within the company, the relations between the directors and the core shareholders, cross-directorships or tied directorships and the procedures for appointment, removal and re-appointment. The information should not be confined to formal aspects but should be rounded out with an explanation and assessment of the practices that are in place.
- c) *Related-party and intra-group transactions.*- The Law of Measures to Reform the Financial System, dated 22 November 2002 (Law 44/2002) took a major step forward by establishing the duty to report on transactions between a company and its core shareholders, directors or senior executives (article 37). Transactions with subsidiaries and, generally, any matters needed to provide a picture of the degree of effectiveness and

compliance with the duties of loyalty referred to in section III of this Report must also be disclosed.

- d) *Risk control systems.*- Mechanisms of control established to assess, mitigate or reduce the company's main risks should also be disclosed.
- e) *Functioning of the Shareholders' Meeting.*- Public disclosure should also cover the rules governing the functioning of the Shareholders' Meeting and the relationship channels between the company and its shareholders. In this connection, it is vital that the company's policies in the area of proxies, conduct of meetings (direct attendance, information, questions, complaints) be disclosed, and that their function and contribution be assessed.

2. 2.- The instruments of disclosure on corporate governance.

There are numerous ways in which transparency can be attained on the foregoing points, from press releases to disclosures regulated by the supervisory authorities (significant stakes, significant events, annual or directors' reports and specific reports on corporate governance, etc.). Nevertheless, this should not hamper the provision of unified, structure information about corporate governance.

To this end, the Commission recommends, firstly, that the provisions on corporate governance at each company (principles of action of the directors, definition of their duties, functions and incompatibilities, rules of working of the Board of Directors and Shareholders' Meeting) be combined into a single text to be published for the general knowledge of shareholders and investors. In any event, all the relevant information on this matter should be consolidated periodically into a special document which could be called "annual report on corporate governance" and kept up to date via the Internet so as to facilitate dissemination of that information or any other information of relevance so that the market can assess each company's guidelines and practices in the area of corporate governance.

a) The annual report on corporate governance.

It is of the utmost importance that the Board of Directors – based on a report by the Audit and Control Commission or, as appropriate, the Appointments and Remuneration Commission – draft an annual report on the company's corporate governance structure and practices, setting out in an orderly fashion the matters referred to in section 2.1 above. The structure of this report – like that of annual reports – could be regulated to provide a uniform basis of presentation to enable investors to evaluate and monitor this area.

b) The company's website.

In order to comply with the disclosure duty, the mechanisms which the information society places at companies' disposal – namely the Internet – should be used appropriately and regularly. The Internet should gradually and effectively replace more traditional disclosure mechanisms while ensuring that the information is disseminated more widely and effectively.

Every listed company should have a website through which it informs its shareholders, investors and the market in general about economic events and any other significant events that take place in connection with the company, as well as enabling shareholders to exercise their right to information and any other shareholder rights.

In particular, the corporate website should enable shareholders to propose alternative motions to those on the agenda and to make requests for information, and the company should, by the same avenue, make those proposals known to the other shareholders sufficiently in advance of the time when, if appropriate, they must be laid before the Shareholders' Meeting.

In any event, it is the duty of the Board of Directors to establish the standard content of the information to be disclosed, which must comprise at least the following:

- i. Company Bylaws.
- ii. Regulation of the Shareholders' Meeting and the Board of Directors and any other rules of corporate governance.
- iii. Quarterly reports for the current year and annual reports for the last two years, plus the external auditors' reports.
- iv. Composition of the Board of Directors and of its Commissions.
- v. Identification of the shareholders with stable holdings, both direct and indirect, and their representation on the board, and any pacts between shareholders that have been disclosed to the company or the market in any way.
- vi. Direct or indirect shareholdings owned by the members of the Board, which they must notify to the company within at most 48 hours. The company must also disclose treasury stock and any significant variations in it.
- vii. Information contained in the presentations given to market players and to significant shareholders.
- viii. Notices of Shareholders' Meeting and the information contained in them, as referred to later.
- ix. Resolutions adopted at the most recent Shareholders' Meeting.

The company's website must also be the place for disclosing any significant event which the Board considers it advisable to disclose, particularly any significant related-party transactions between the company and its directors, administrators or shareholders that are approved.

The Commission also recommends that, for the sake of symmetry of information, the website contain a summary of the reports issued by the main analysts, investment banks and rating agencies that cover the company on a regular basis.

2. 3.- Guarantees of information quality: the "comply or explain" principle.

In order to ensure optimum information quality, it is also necessary to establish measures based particularly on the requirement that the chosen rules of governance and their degree of effective compliance be justified and explained.

In the final instance, the aim is to introduce the "comply or explain" principle into Spanish practice. Companies have a broad degree of autonomy to structure their organization and the working of their governing bodies and to adapt them to their specific needs, circumstances and preferences. Nevertheless, when they depart from the standards of good governance, either those established or recommended on a general basis (e.g. those contained in this Report) or those adopted and published by the company itself, they must offer a detailed explanation and justification for the decisions so that the market can assess them appropriately.

Moreover, in connection with the practices that are actually followed, the need to provide a justification means that a company must regularly review its governance practices and offer a judgment about its degree of compliance, and, where possible, provide data and evidence to support it.

III.- THE PRINCIPLE OF SECURITY AND THE DUTY OF LOYALTY. DIRECTORS' RESPONSIBILITIES.

1.- Security.

As stated earlier, it is necessary to establish a regime of transparency for markets and listed companies which also increases their security at the same time. Accordingly, because of the specific nature of the financial markets, transparency (subject to the conditions described above) is the primary instrument for investor protection.

However, the scope of the principle of security is relatively diverse and broader: although security in a financial market and in listed companies is attained primarily through transparency, it is necessary to recognise certain duties and responsibilities which enhance security on those occasions where transparency is insufficient to protect investors because of the existence of serious conflicts of interest on the part of the persons who must make or execute the decisions.

This is the fundamental reason for demanding security in the markets: investors must be able to trust that the value produced by the company is distributed correctly and that the directors and controlling shareholders do not obtain benefits that are disproportionate to their work or interest in capital. The most appropriate treatment is to regulate situations of conflict of interest. The Olivencia Report took a fundamental step in this direction by drawing attention to the importance of the duty of loyalty on the part of directors and significant shareholders, but its guidelines need to be rounded out and included in company law. Self-regulation would appear to be insufficient for dealing with situations where there are serious conflicts of interest.

This Commission is of the opinion that legislation would be advisable in this area to compensate for the weakness of the discipline provided by market forces in cases of an outright clash between the company's interests and the interests of the parties involved in managing it. The basic instrument would be an orderly drafting of the cases and the regime of liabilities for directors in the event of breach of the duty of loyalty.

2.- Directors' responsibilities: duties of loyalty and diligence

2. 1. The duty of loyalty in conflicts of interest.

Legal systems in continental Europe – and Spain is no exception – are silent and even tolerant on the question of conflicts of interest and other practices which are doubtful from the

standpoint of the duty of loyalty: very little attention has been devoted to these matters and any such attention has been accompanied by a certain degree of naivety. The problem lies in the fact that the rules on directors' responsibilities were designed from a unitary standpoint taking the problem of negligence as the paradigm. This approach meant that the problem of disloyalty was not appropriately addressed; this defect must be corrected by establishing a regime governing the duty of loyalty.

To address directors' duties and responsibilities appropriately, the Commission considers it necessary to establish a clear separation between the creation of value and profits in the company, on the one hand, and the distribution of that value, on the other hand, so as to distinguish similarly between the duty of diligence and the duty of loyalty, within the directors' fiduciary duties. In short, directors are bound by two imperatives: to maximise value creation (which should not be understood solely or primarily as the share market price at a given time) and to distribute that value or profit correctly.

The regime governing directors' liability must address breaches of the duty of loyalty with the appropriate rigour, without prejudice to appropriately addressing the duty of diligence. The requirements arising from the duty of diligence (obtainment of information, dedication, participation in collective decision-making) must not preclude the technical discretionality or competence in the business decisions inherent to the company's management.

2. 2. Specification of the duty of loyalty.

Spain's company law has traditionally confined itself to establishing a very generic or abstract duty of loyalty. Article 127 of Spain's Companies Law (*Ley de Sociedades Anónimas*) is typically laconic, in line with the general trend elsewhere in continental Europe: all it says is that directors must act as loyal representatives. It is true that the legal coverage provided by this generic loyalty clause could have been sufficient for the doctrine and case law to develop abundant criteria and clear rules of guidance in this area down through the year. However, in practice very little has been achieved in this direction, whatever the reasons.

Accordingly, the first measure to be adopted to enhance the efficacy of the duty of loyalty would consist of detailing, at least to an intermediate level of specification, the basic duties deriving from the general principle, as the Olivencia Report suggested at the time. The definition of specific patterns of action increases the observability and verifiability of improper conduct and guides directors' conduct while facilitating the work of the persons charged with overseeing compliance, particularly the courts; it provides support to enable persons to resist improper pressure, and it contributes to creating an appropriate corporate culture – the most important outcome in the final instance.

The following duties of loyalty for directors should be addressed:

- i. Conflicts of interest between directors or their closest relatives and the company; if they cannot be avoided, they must be notified to the Board of Directors.
- ii. Directors must not hold positions in competitors of the company or its group.
- iii. Directors must not use confidential company information for personal purposes.
- iv. Directors must not make improper use of the company's assets or take advantage of their position in the company to obtain patrimonial advantages without the appropriate consideration. In any event, the Board of Directors should be informed of any economic or commercial relationship between the director and the company.
- v. Directors should not take advantage of business opportunities of which they become aware by virtue of their position as director.
- vi. Even after they cease to hold office, Directors must keep secret any data or information received in the course of their duties, and may not use them for their own benefit nor provide them to third parties, without prejudice to the obligations of transparency and disclosure imposed by the mercantile and securities market legislation. If the director is a legal person, the duty of secrecy must apply to the latter's directors.
- vii. Directors must refrain from intervening in debates and votes on proposals for appointment, re-appointment or removal which relate to them or in any other matter in which they have a personal interest.
- viii. Directors must notify to the company any significant change in their professional situation and any change affecting the character or condition by virtue of which they were appointed to the board, or which might entail a conflict of interest.
- ix. Directors must inform the company about company shares, options on shares or derivatives referenced to the company's share which they own, directly or via companies in which they have a significant interest, and of any changes which occur in such shareholding or the related rights, independently of compliance with the securities market regulations.
- x. Directors must inform the company of any legal, administrative or any other type of action which, because of its importance, might have a serious impact on the company's reputation.

Regulations must be based on the principle that the foregoing duties of loyalty are obligatory, but in principle this is not necessarily incompatible with a principle of *ad hoc* dispensations whereby certain transactions could be authorised. Even though this increases the possibilities of evading effective compliance with the duty of loyalty, a blanket prohibition might prevent transactions that are potentially beneficial to the company and might be less advisable. In any event, the dispensations must be relatively easy to administer while also being difficult to evade, under a procedure which ensures the independence of the body granting them – the Board of Directors or even the Shareholders' Meeting, depending on the importance of the decision – from the director involved and guarantees that the transaction is equitable and performed on an arm's-length basis; there should also be a rule of transparency in similar terms to that contained in the Law of Measures to Reform the Financial System (article 37 of Law 44/2002, dated 22 November).

The Commission considers that it would not be operational to specify the duties of loyalty if there were legal difficulties for proceeding in practice against persons who breached those duties. Consequently, this matter should be covered by legislation to clarify the matter and define a policy of rigour in line with our legal tradition, one that is capable of interpreting the dissuasive efficacy of the liability for breach of the duty of loyalty and providing the procedures and requirements for shareholders to bring actions to claim such liability.

Finally, it should be noted that cases of violation of the duties of loyalty lead to situations that are particularly frustrating for investors and the public at large when the legal measures adopted against the director at fault fail to recover the amounts by which he/she enriched him/herself illicitly. The Commission considers that this matter is outside its mandate but it feels bound to express its concern in this connection and its wish that this matter be handled appropriately.

2. 3. Extending the range of parties bound by duties of loyalty.

Another decisive factor for increasing the security of the markets via liability for breach of the duties of loyalty would be through the subjective extension of those duties whose nature enables persons who, though not formally occupying the position of director, hold a post of similar nature in the company. Such an extension might even be more justified than the original rule for directors, since the greater opacity surrounding the actions of such parties, who often act in the shadows behind the formal decision-making bodies, implies that the disciplinary instruments provided by market forces are less effective in these cases.

The rules should be extended to cover at least the following parties:

- (i) individuals who represent directors that are legal persons:

- (ii) senior executives of the company who are not directors;
- (iii) de facto directors, i.e. persons who actually perform the functions of director without being appointed as such, or whose appointment is invalid or has expired;
- (iv) “hidden directors”, whose instructions are implemented by the company's directors;
- (v) the controlling shareholders.

2. 4. The duties of diligence.

The Commission has analysed the current situation of judicial application of the duty of diligence and, as a result, proposes that it is necessary to establish the clearest possible separation between the consequences of decisions adopted by the members of the Board in the company's interests, with due consideration and advice, and others which directors take for personal interests or in conflict with the company's interests, as discussed in previous sections. In any event, the Commission stresses that it is important for all members of the Board of Directors, both executives and non-executives, to discharge their duties in good faith and with the necessary diligence in pursuit of the company's interests; they should participate effectively in meetings of the Board and of any commissions to which they are appointed. We believe it is essential to cast off passive concepts of directorship, which are incompatible with the current requirements of professionalism, efficacy and responsibility.

In any case, the duties of diligence should include:

- i. Devoting, on a continuous basis, the time and effort required to follow regularly the matters raised by the company's management, obtaining the necessary information for this purpose and the collaboration or assistance that is considered necessary.
- ii. Participating actively in the governing body and in its commissions or assigned tasks, obtaining information, expressing an opinion and urging the other directors to opt for the decision which is deemed to be most favourable for the company's interests. If a director is unable to attend meetings for a justified reason, he/she should provide proxy instructions.
- iii. Opposing resolutions that are contrary to the law, the Bylaws or the company's interests, and requesting that his/her position be entered in the minutes when he/she deems it advisable to safeguard the company's interests.

- iv. Soliciting the call of Board meetings when he/she considers it advisable, or to include in the agenda items which he/she consider advisable, in accordance with the law and the Bylaws.
- v.- Requesting the information he/she deems necessary to complement that which has been supplied to him/her so as to be able to form an objective and totally independent opinion on the general workings of the company's management. Each member of the Board of Directors must have access to all the information notified to that body and may also request, through the President, any other information that may be necessary to carry out his/her mission.

In conclusion, the Commission wishes to highlight the considerable liability resting on the director's shoulders and, therefore, the obligation to select directors appropriately and to define their duties, rights and obligations in relation to the general interest of the company and the shareholders.

3. The ethical framework of corporate governance.

Laws and codes of good governance and the principles of transparency and security are necessary to ensure that economic activity takes place in the climate of confidence required for corporate efficiency and social progress. However, experience has shown that even the strictest laws and the best-drafted codes are not sufficient to ensure good corporate governance. To achieve the latter, it is also necessary to have professional competence and ethical behaviour on the part of directors and managers, who must always seek the long-term good of the company above their own short-term personal interests. Respect for ethical values in professional life is essential; without it, the rules and practices for corporate governance are ineffectual. In the final instance, directors and managers must set an example so as to create a culture of good governance.

Some companies define their own code of ethics and other corporate principles which they wish to exalt and respect. In any event, the professional relationships in any company must be based on compliance with the law, the dignity of the human being and the traditional ethical values (particularly justice) that are vital for human society.

A company's first obligation is to pursue its mission within the general framework of the law. Nevertheless, beyond the strict compliance with the law and with the duties imposed by its mission, it has recently been argued that companies have other social responsibilities. International bodies such as the UN and the European Union and many international

companies concur and urge companies to accept and comply with other social responsibilities. Consequently, we can distinguish two levels within a company's responsibilities.

The first level refers to the company's long-term continuity, which entails generating sufficient profits through a good competitive position in the markets, complying with the laws and avoiding any unjust actions, even beyond what the law regulates. This also makes it necessary to minimise negative side effects caused by business activity (restructuring, pollution, etc.).

The second level, which is broader and more contingent, entails positive actions with all the parties directly or indirectly involved with the company, including society as a whole, in each particular situation as far as possible. This second level of responsibilities is, by its nature, variable over time and very dependent on the social and cultural situation in each country; consequently, it is clear that it should be voluntary.

Corporate governance of the company and executive management should take account of the various interests at stake in a decision, but the supreme criterion in resolving disputes and moving forward is the good of the company as a whole and its long-term continuity.

In the context of the company's social responsibility in managing its business and in its relations with the parties with which it has dealings, each company can freely adopt the additional ethical or social obligations or commitments which it wishes to assume within a general framework of sustainable development, such as presenting the triple balance sheet (economic, social and environmental) that is discussed in some quarters to disclose those obligations and commitments to shareholders, employees and society in general, on the basis of the principles of voluntariness and transparency.

IV.- GOVERNING BODIES.

1.-Shareholders' Meeting.

The Commission considers that one of the main objectives of corporate governance is to enhance the role of the Shareholders' Meeting as the company's basic decision-making and oversight body and as the guardian of shareholders' interests.

As the sovereign corporate body which instruments shareholders' rights to participate in the vital decisions made by the company, the Shareholders' Meeting must provide the most efficient vehicle for such participation, enabling shareholders who do not attend the meeting to be represented and to voice their interests through proxies.

1. 1. Information provided to shareholders on the occasion of Shareholders' Meetings.

On the occasion of Shareholders' Meetings, and from the time they are convened, the company must disclose the full content of all the motions to be submitted to the Meeting on its own web site, regardless of other procedures for this purpose established by law or implemented voluntarily by the company.

Each motion must include a justification whose terms must be accurate, clear, intelligible and useful for assessing the proposed decision and forming an opinion in order to define the corporate intention.

The preceding points and, generally, all those regarding the procedures of disclosing information to shareholders, whether at their request or at the company's initiative, must be contained in the Shareholders' Meeting Regulation referred to below.

1. 2. Information about corporate governance criteria and their compliance.

As stated above, it is of the utmost importance that the Board, based on a report by the Audit and Control Commission, or the Appointment and Remuneration Commission, or an *ad hoc* Commission, draft an annual report about the company's structure and practices of corporate governance which explains in an orderly manner the matters referred to in section II.2.1.

1. 3. Shareholders' Meeting Regulation.

In order to adapt corporate governance criteria to the new guidelines recommended in this Report, it is recommended that companies should draft and disseminate specific regulations for Shareholders' Meetings, that they should be submitted for the Shareholders' Meeting's approval and that they regulate the convening, preparation, notification, attendance, conduct and exercise of the political rights, provided that the Meeting itself does not amend them, in accordance with the law and Bylaws.

The Shareholders' Meeting Regulation should be posted on the company's website, thereby disclosing to shareholders and investors the legal framework in which the Shareholders' Meetings will take place.

It is recommended that each company regulate the need for some duly delimited business decisions that are material for the company's future and for shareholder and investor interests to be submitted to the Shareholders' Meeting.

The adoption of protective measures aimed at preventing takeovers or the removal of specific officers should also require the approval of the Shareholders' Meeting. The Commission believes that the possibility of requiring a reinforced majority or of prohibiting some protective measures should even be considered, in accordance with the Bylaw provisions on this matter. The Commission considers that, when such measures are being voted on, any parties involved in a possible conflict of interest should abstain.

In any case, the Commission believes that the Shareholders' Meeting Regulation should include at least the following factors, and elaborate, if appropriate, upon the provisions of the law and Bylaws:

1. 4. Notice, agenda, motions and information to shareholders during the preparations for the Shareholders' Meeting.

The notice of the meeting must be disclosed sufficiently in advance to enable shareholders to request and obtain complementary information about the agenda items or to give voting instructions.

Moreover, the text of all the motions, with sufficient information about their justification and advisability, should be made available in advance via the website.

Companies should facilitate the dissemination of any alternative motions regarding the items on the agenda of the Meeting in the terms stated in this Report about the duty of transparency.

1. 5. Conduct of the Shareholders' Meeting.

The Commission recommends the adoption of any measure that facilitates shareholder participation at the Shareholders' Meetings, ensuring that their votes are cast in accordance with their wishes.

Facilities should be provided to institutional investors (mutual funds, financial institutions, other intermediaries) which represent the interests of numerous shareholders and investors to enable them to contribute more actively in corporate decisions. In any case, because of the growing importance of institutional investors' participation in companies' ownership structures, it is recommended that they define and disclose their policy on participation in the decisions of the companies in which they have invested and that this definition be made known and notified to final investors.

The Shareholders' Meeting Regulation should also regulate the conduct of the Meeting in the most appropriate way for each company's interests and characteristics: the chair; information available at the Meeting and answers to questions submitted in writing; duration, order and number of speakers; attendance and intervention, if appropriate, of the external auditor and the Chairs of the specialized Commissions of the Board, and the format of the Minutes, among other aspects.

The attendance cards or documentary certificates that are delivered to shareholders to enable them to attend the Meeting and the proxy forms should be standardized.

1. 6. Other measures.

The aforementioned measures, which can be adopted via self-regulation, do not exclude others that also facilitate or ensure shareholders' representation and access to the Meeting, such as those aimed at extending the period of advance notice of the Meeting and at enabling shareholders, subject to the legitimisation requirements that are considered appropriate, to apply to include items in the agenda of the convened Meeting and propose alternative motions sufficiently in advance of the Shareholders' Meeting so that the Board can define its position about whether or not they should be included in the agenda to be published, stating the reasons for non-inclusion; or implement the necessary systems for an electronic calculation of the quorum, and the granting of proxies and voting by post or electronic means.

2.-Board of Directors.

The current requirements of professionalism and efficacy in the governing bodies of companies that are present in the capital markets and the need to establish rigorous management and control mechanisms that safeguard shareholder and investor interests grant the Board of Directors a predominant role.

The Commission insists that the mission of all the members of the Board is to defend the company's long-term viability, that all the Board should act together to protect the company's general interests and that the obligation of all the directors is to cooperate to that end.

The governing body's unitary structure in Spanish law does not prevent that, through a functional division of the Board itself plus internal control, suitable corporate governance guidelines are implemented in order to promote security and transparency in companies and the market. For this purpose, the possibility should be considered of creating and regulating specialised commissions and distinguishing different types of directors who, without prejudice to the equal obligations and duties of all the directors, safeguard the interests of the shareholders not represented on the Board.

On that basis, and in view of the special degree of dedication, activity and responsibility, the Board of Directors must have a reasonable number of members to ensure its viability and the work of each director, who must have access to the necessary resources to improve and make their functions more efficient, including the ability to communicate with the parties responsible for the different business and services areas and, if appropriate, to be assisted by professionals and external experts.

The Board and the persons that comprise it must have the necessary information in order to improve their functions and make them more efficient; it is their responsibility to identify and request that information. For that purpose, all the directors are entitled to request and compile any such information; unless the Bylaws or regulations state otherwise, their requests must be made to the Board Secretary and they must record in the minutes any defects they observe in the compliance with their requests for information.

The Boards of Directors of listed companies must hold ordinary meetings periodically, usually once per month, in order to monitor the actions of the executives and Delegate Commission, if any, and adopt the appropriate decisions relating to same. Moreover, the Board should meet when the Chairman or a sufficient number of directors request this, in accordance with the Bylaws and Regulation. Throughout the year, the Board must specifically analyze the budget and the performance of the strategic plan, if any, and its degree of compliance, plus the quarterly accounts that the company must file with the markets' regulatory or supervisory bodies for publication.

Below are some recommendations for improving the efficiency of the Board of Directors organization.

2. 1. Directors.

The Commission decided to proceed further in the definition of the members of the Board of Directors, based on their relationship with the company, since they are the basic elements of the Board's composition, on the basis that there are not different classes of directors but that they must all cooperate effectively so that the Board can comply, as a unit, with the functions attributed to it.

When establishing those definitions, the Commission believes it is necessary to specify some of the usual names in order to avoid the interpretation that there is a group of directors, called "independent", whose function appears to be only that of monitoring the other Board members or representing minority shareholders. For that purpose, we made a basic distinction between internal or executive directors and external directors and, among the latter, we defined the categories of "domanial" and independent directors to balance the Board composition, without prejudice to the fact that there may be external directors who do not belong to either of those two categories.

a. - Internal or executive directors.

These are directors who have executive or management functions in the company or in one of its investee companies and, in any case, have an employment, mercantile or other type of relationship with the company apart from their status as directors. Executive directors are also those who have some capacity to decide about some parts of the company's or group's business through a stable delegation or proxy granted by the Board of Directors or the company, respectively.

Conversely, directors who receive special powers from the Shareholders' Meeting or Board of Directors through delegation, authorization or proxy for a specific act should not be considered executive or internal directors.

b. - Domanial external directors.

These are directors appointed by shareholders who, individually or collectively, own a stable participation in share capital which, regardless of whether or not this entitles them to a seat on

the governing body, the Board has estimated to be sufficiently significant, considering the company's floating capital, to propose their appointment to the Shareholders' Meeting.

The system of incompatibility regarding commercial or professional relations with the company and its group should be similar to that for independent directors, and should envisage what incompatibilities may affect the shareholders whom these directors actually represent.

They must notify the Board of any conflict of interest between the company and the shareholder who proposed their appointment when this affects matters that are submitted to the Board; in that case, they must obligatorily abstain from debating or voting on the related resolutions.

c- Independent external directors.

These are persons of acknowledged professional prestige who can contribute their experience and knowledge to governing the company and, although they are not executive or domanical, are appointed to the Board and satisfy the conditions that ensure impartiality and objectivity, such as:

- i) Not having, at present or in the recent past, an unemployment, commercial or contractual relation, direct or indirect, of a significant nature, with the company, its managers, domanical directors or group companies whose interests the latter represent, credit institutions with a significant position in the company's finances or organizations that receive significant subsidies from the company.
- ii) Not being a director of another listed company that has domanical directors in the company in question.
- iii) Not being a close relative of the company's executive or domanical directors or senior managers.

Any of the aforementioned relationships must be disclosed to and evaluated by the Board based on a report by the Appointment and Remuneration Commission, and must be disclosed in the annual report.

2. 2. Protection of external directors from removal and term of office.

One of the major factors in the objective to improve market transparency and security is ensuring that external directors comply with their functions adequately.

For that purpose, once the Shareholders' Meeting has appointed the domanian and independent external directors, the Board should not propose their removal before they comply with the period of office as provided in the Bylaws, except for exceptional and justified causes approved by the Board of Directors, based on a report by the Appointment and Remuneration Commission.

The Commission has thought about the advantages and disadvantages that setting a maximum number of mandates may have for maintaining the reasons for the appointment of the directors, especially independent ones. Although it might be argued that the limitation on the reappointment of independent directors would guarantee their independence, the Commission concludes that it does not appear to be reasonable that the company should have to dispense with the services of a director who is making a positive contribution. Accordingly, the Commission does not recommend term limits and suggests that this decision should be left to the company, and stated in the Bylaws. Proposals for reappointment should be made by the Board of Directors, based on the Appointment and Remuneration Commission's report on compliance with the conditions in place at the time the reappointment is proposed.

2. 3. Directors' age.

The Commission has also extensively discussed an age limit for directors. Even though an age limit for directors would facilitate the smooth, automatic replacement of the directors who reach the limit, the Commission concludes, in contrast with the Olivencia Report, that, because of the increase in life expectancy, the liberal or private nature of the office and the Board's responsibilities in the selection process, there are no substantive reasons in terms of good governance to warrant a recommendation on this matter. The only qualification is that the company which adopts a policy on this matter must state it clearly in its internal regulations (Bylaws or Regulation).

3.-Composition of the Board of Directors.

The establishment of rules, criteria or recommendations on corporate governance and, particularly, on the composition of the Board of Directors and its Commissions must take account of the ownership structure in order to comply with the general objective of protecting minority shareholders.

The Commission recommends that the Board of Directors, through its members, represent as large a percentage of the company's capital as possible.

The Commission has also considered the difficulty of establishing a general rule to define the number and proportion of independent external directors: a valid approach, updating that of the Olivencia Report, would be to have an ample majority of external directors on the Board and, among them, a very significant number of independent directors, considering the company's ownership structure and the capital represented on the Board.

4.- The Chairperson of the Board of Directors.

One of the items to which the Commission has paid closest attention during its meetings is whether or not it should recommend separating the position of Board Chair from the function of chief executive of the company. This is because of the intense controversy arising on this matter in debates about corporate governance in recent times. It appears that public opinion (according to some of the most recent opinion surveys) is predominantly in favour of separating those positions or functions because this would make the Board more independent of the management team and would, therefore, increase its predisposition towards performing an efficient supervisory function. The Commission is very sensitive to this argument but, at the same time, it also considered the disadvantages of the alternative dual solution: namely, it might deprive the company of strong leadership; it might considerably hinder the transmission of information between the management and the Board; and it might generate coordination costs in the organization. Consequently, the Commission finally considers that it should not recommend separating the positions and that it should reiterate the Olivencia Commission's position, including its provisos. In the final instance, that position is justified by the conviction that the choice of one leadership structure or another (dual or unitary) cannot be formulated as a general rule but that it depends vitally on each company's circumstances.

5.- Board of Directors commissions.

The Board's performance of its functions is strengthened and, in particular, made more efficient by the creation of specialised commissions within it in order to diversify the work and ensure that, in specific relevant matters which are not so pressing or important as to require direct referral to the full Board, the motions and resolutions by the Board have first been submitted to a specialist body that can filter and inform its decisions in order to strengthen the guarantee that the Boards' decisions are objective and are based on due consideration.

The Board of Directors must appoint such commission's members, approve their Regulations, if any, and consider their proposals and reports; such commissions report to the Board and are answerable to it.

The Commissions that should be created in order to improve corporate governance are as follows, although companies may create additional commissions and split the functions of those listed below:

- i. Executive or Delegate Commission, with executive functions for adopting decisions that are binding on the company within the scope of its powers.
- ii. Audit and Control Commission, Appointment and Remuneration Commission and, if appropriate, Strategy and Investment Commission, whose functions are to inform and make proposals to the Board of Directors plus other functions granted by the law, Bylaws or the Board Regulation, within the scope of their powers.

5. 1.- Executive or Delegate Commission.

Under current regulations, it is not obligatory to establish this commission, to which the Board can delegate, in a stable, permanent way, some or all of its functions, so that the commission can adopt resolutions about the company's administration and management.

The Board of Directors decides the composition of this Commission and it is recommended that, when the Executive Commission assumes all or most of the Board's powers, its composition should be similar to that of the Board itself in terms of the percentage of the different types of directors.

5. 2.- Audit and Control Commission.

The Law of Measures to Reform the Financial System requires listed companies to have an Audit Commission (article 47 of Law 44/2002, dated 22 November).

This Commission considers that the appointment of the Audit and Control Commission's members corresponds to the Board of Directors, in the exercise of its self-regulation function, and that it should take account of their knowledge and professional experience. Those members should all be external directors and the proportion of domanial and independent directors should be similar to that on the Board itself. The Audit Commission's chairman should be an independent director.

Within the Board's regulation, the Audit Commission should have its own regulation, drafted and approved by the Board of Directors. The Regulation should cover the following matters:

- Expressing its opinion on the annual accounts and quarterly and half-yearly accounts that must be delivered to the markets' regulatory or supervisory bodies, disclosing the internal control systems, the monitoring and compliance through internal audits and, if appropriate, the accounting criteria applied. The Commission must also inform the Board about changes in accounting criteria and about on- and off-balance sheet risks.
- Full access to the internal audit and the ability to express its opinion about the selection, appointment, reappointment and removal of the internal audit manager, and participate in setting his/her remuneration, and the ability to express its opinion about this department's budget.
- The power to report on and propose the selection, appointment, reappointment and removal of the external auditor, and the conditions of his/her engagement. That power cannot be delegated to the management or to any other company body.
- Preparation of an annual report on the activities of the Audit and Control Commission which must be included in the directors' report.

Executive directors cannot be members of this Audit and Control Commission, although they can attend its meetings to report at the Commission's request.

5. 3. Appointment and Remuneration Commission.

This Commission believes that all companies should have an Appointment and Remuneration Commission whose functions are to inform the Board of Directors about the appointments, reappointments, removals, remuneration and offices of directors and the general remuneration and incentive policy for directors and senior management.

In particular, that commission has the function of informing beforehand all the proposals that the Board of Directors makes to the Shareholders' Meeting regarding the appointment or removal of directors, including cases of co-option by the Board of Directors itself.

The Commission's members are appointed by the Board of Directors among from external directors in the same proportion as on the Board itself. The Board must draft and approve, as part of the Board Regulation, the specific rules for this Commission, of which executive directors cannot form part.

5. 4.- Strategy and Investment Commission.

Companies should consider the need to have a Strategy and Investment Commission, whose functions would be to propose or inform the Board about all the strategic decisions, investments and divestments that are material for the company or the group, assessing whether they fit in with the budget and strategic plans. In general, this Commission is in charge of analyzing and monitoring business risks.

The Board is in charge of appointing the members of this Commission and approving its regulation, if any. Executive and external directors can be members.

6.- Remuneration of the Board and senior management.

Although the Board's remuneration is a decision to be taken by each company, it is recommended, in general, that remuneration comprising shares of the company or group companies, stock options or options referenced to the share price be limited to executive or internal directors. If directors' remuneration is based on company earnings, regard should be had to any qualifications in the external auditor's report that have a material effect on the income statement.

One of the basic recommendations of the Olivencia Report in order to attain adequate transparency was for companies to disclose the individual remuneration of each director in as much detail as possible. The Commission is aware that this recommendation is being implemented at a slow pace and has deliberated on the matter, considering that this area is a clear indicator of the quality of corporate governance and that it fulfils a function of exemplarity for listed companies; accordingly, this Commission reminds companies that it is advisable to implement it.

The Commission believes firstly that the amount of remuneration received by each director should be disclosed in the notes to the accounts, and that all the items of this remuneration should be broken down, including the delivery or assignment of shares, stock options or systems referenced to the share price, which must be approved by the Shareholders' Meeting. Regarding executive directors, the Commission believes that, provisionally and without detriment to the final objective, the remuneration corresponding to them as directors, which is disclosed in the notes to the accounts individually, could be separated from that corresponding to them as company managers, which is not disclosed individually but would be included in the information referred to in the next paragraph.

In any case, it is recommended that the remuneration and total cost of senior management (management committee or similar) and the number and identification of the positions comprising it should be disclosed in the annual report, with a breakdown of the items that correspond to them: salary in cash and in kind, stock options, bonuses, pension funds, provisions for indemnities and any other compensation.

Regarding the implementation of golden handshake or protection clauses in favour of companies' senior management in the event of dismissal or changes in control, although the Commission does not agree with any of those actions, it understands that they are difficult to regulate on a general basis and it recommends that each Board of Directors should self-regulate in order to avoid abusive or unjustifiable situations. In any case, it is considered necessary that any contract of this type should have the formal approval of the Board of Directors.

Once the Board has approved the amount of compensation that was agreed upon, if the amount exceeds two years' salary, the surplus must be booked as a provision in the balance sheet of the same year of the approval and the amount must be disclosed separately.

7.- Drafting of the annual accounts and half-yearly and quarterly reports.

The accuracy and integrity of the annual accounts presented to the Board of Directors for drafting must be previously certified by the Chairman (where the Chairman has executive functions), the managing director, the chief financial officer or the person responsible for the corresponding department and it must be disclosed that the consolidated annual accounts include the accounts of all the consolidated domestic and foreign subsidiaries, in accordance with the applicable mercantile and accounting regulations. Certifying the accounts entails a specific liability for the parties who have a direct relation with the company's performance but this does not eliminate the joint and several liability of all the directors for drafting the annual accounts.

Based on the certified accounts and the Audit and Control Commission's reports, having made any queries it considers necessary to the external auditor, and having obtained all the necessary information, the Board of Directors must draft the annual accounts and directors' report in clear and accurate terms in order to facilitate an adequate understanding of their contents.

Within the strictest compliance with the applicable mercantile and accounting regulations where the company's shares are listed, the annual accounts and half-yearly and quarterly

reports to be filed with the markets' regulatory or supervisory bodies should be drafted in accordance with internationally recognized principles.

Regarding companies listed in foreign markets, the results that would be reported in the accounts filed with such foreign markets if those companies applied the corresponding accounting criteria should be disclosed.

Drafting the accounts cannot be considered as an isolated resolution by the Board; rather, the latter must also monitor the accounts, at least quarterly, with the corresponding reports from the Audit Commission and the participation of the company's auditor.

8.- Compliance with corporate governance criteria. Board Regulation.

All companies should have a number of corporate governance rules or criteria that include at least the Regulations of the Shareholders' Meeting and of the Board of Directors.

The preparation of the annual corporate governance report referred to in section II of this Report should also be reviewed and approved, if appropriate, by a full Board meeting, and must be made available to all the shareholders on the occasion of the Ordinary Shareholders' Meeting.

The items included in the various sections of this Report about the governing body and any other items that the Board itself believes should be included could form part of the Board of Directors Regulation, which should be registered at the Mercantile Register, filed with the CNMV and made available to shareholders and investors through the company's web site.

In addition to the duty to attend to the formal and material legality of the Board's actions, the Board of Directors Secretary should also be expressly granted the duty to oversee compliance with the Bylaws and with the provisions of the regulatory bodies and the consideration, if appropriate, of their recommendations, and to ensure compliance with the company's corporate governance principles or criteria and the rules of the Board Regulation.

V.-PROFESSIONAL SERVICE PROVIDERS.

The reliability of external professionals' reports is a key question in the protection of investors and shareholders: specifically, the reliability and accuracy of audit reports and the objectivity of the recommendations and analyses made by financial analysts, investment banks and rating agencies.

That requirement of reliability and accuracy should be matched by a liability for those parties in the case of negligence in the information they provide to the market or in verifying that information, if it proves to be inaccurate or incorrect.

1.-Auditors.

The Law of Measures to Reform the Financial System contains a number of limitations on auditors with which this Special Commission is in agreement (particularly, article 51 of Law 44/2002, dated 22 November), although it considers that, in the corporate governance provisions, companies should specify control systems for overseeing the contracts with audit firms for non-audit services and they should be approved by the Audit and Control Commission and disclosed in the annual report.

2.-Financial analysts and investment banks.

Financial analysts perform research and make recommendations about listed securities that may be used by current and potential investors to guide their investment decisions. The main problem raised by the actions of such analysts is their relationship with financial institutions that participate in financial and strategic advisory transactions for the companies being analysed, which may influence the analysts' opinion.

Consequently, it is necessary to regulate analysts' activities and the access to the profession in order to guarantee the transparency and independence of their opinions and recommendations.

Regarding transparency, the Commission recommends including an explicit statement in research reports that includes, but is not limited to, the following:

- That the points of view expressed in research reports reflect the analyst's personal opinion about the company and its securities;

- That the analyst's remuneration does not depend on the recommendation contained in the research;
- Any participation by the financial institution that employs the analyst in underwriting and/or offering of securities of the company covered by the report in the twelve months prior to the publication of same;
- The remuneration, if any, that the financial institution has received for providing financial consultancy services to the company covered by the research in the twelve months prior to the publication of the report;
- The financial institution's direct or indirect stakes and representation on the governing bodies of the company covered by the research;
- Within the universe of securities covered by that financial analyst, the percentage of recommendations to overweight, hold and underweight.

Regarding independence, the recommendation is to adopt measures, including but not limited to the following, with regard to the relations between analysts and the financial institutions for which they work:

- The research and consultancy departments should be separated physically and in terms of information flows. To all intents and purposes, those departments should belong to different divisions;
- Neither the financial institution's consultancy department nor the company covered by the report should review the report prior to publication;
- Restrictions should be imposed on trading by the analyst in shares of the company covered by his research;
- The financial analyst's remuneration should be based only on the activities performed by his/her department and should not be related to the activities performed by other departments of the financial institution.

Financial institutions should have rules of conduct covering the following:

- Periods and situations during which reports cannot be published about specific companies;

- Situations in which the financial institution must impose restrictions on department activities about specific securities;
- Restrictions on share trading by certain professionals in specific cases and the imposition of internal approval procedures for those transactions;
- The non-participation of the financial analyst in meetings between the financial institution and the governing bodies of the companies he/she covers.

In any case, since most investment banks are international, the measures adopted in other countries should be examined.

Investment banks should approve and disclose their own codes of conduct aimed at delimiting as far as possible their research and consultancy services, and revealing and quantifying, to the market, any circumstances related to the company in question that might interfere with their independence.

3.- Rating agencies.

Rating agencies enable market operators and supervisory authorities to assess the solvency of potential debtors and the securities of different issuers. The ratings provided by specialist agencies overcome information asymmetries and spare market operators the cost of analysing large volumes of financial information. The supply of accurate, reliable ratings has become very important for the market and a matter of interest for economic policy. Consequently, among other factors, it is necessary to:

- Identify the professional activities that might jeopardise the analyst's independence.
- Identify incompatible activities.
- Prevent researched companies from hiring the analyst who wrote the report within two years from its publication.
- Provide a breakdown of the fees received under all headings.
- Establish a penalty regime, insofar as analysts' conduct is not already covered by the securities market regulations.

As in the case of investment banks, and with even greater justification, the essentially multinational nature of companies dedicated to rating risks means that the effort to subject those companies to rules of conduct may be ineffective since the regulations are not harmonised internationally.

VI.- SCOPE OF THESE RECOMMENDATIONS

1.-Self-regulation principle.

By formulating all the aforementioned measures, the Commission wished to express them as recommendations aimed, above all, at the companies addressed by this Report within the scope of self-regulation.

- Firstly, they are aimed at faithfully complying with the mandate with which this Commission was created, namely to study the “criteria and guidelines” (in short, recommendations) which “companies which issue securities instruments admitted to listing on organized markets in their relations with consultants, financial analysts and other companies” that assist them or provide services and intervene in the markets, in accordance with the stated technical nature of this Commission, which has no power to legislate, regulate or propose provisions of such nature.
- Secondly, they are aimed at continuing with the recommendations of the Olivencia Code, which played a key role in creating a pioneering model of corporate governance in the past, most of whose principles are still in force and inform these recommendations, which elaborate upon, specify and complement them, except in specific cases in which the current needs of the companies and markets, plus the experience in observing that Code, warrant different solutions.
- Thirdly, the conviction that the variety of problems arising in the corporate governance of companies with an increasingly complex structure and the growing need for specialisation and professionalism in a competitive environment is best managed within the flexibility of self-regulation, under the constitutional principle of corporate freedom, and exposed to the market's judgment of the self-governance regime chosen by each company under conditions of transparency.

The basic principles of corporate governance (such as those described above) may have a broad scope. However, their expression in specific measures may be appropriate in some cases and inappropriate in others, and it is not possible to generalise. Measures that are valid for one company in a specific country may not be valid for another company, even one in the same country or sector. Each company's history, origin, ownership structure and corporate values play a role in determining its governance codes. What matters is that each company makes a decision on how to embody those principles in specific measures and explains the reasons for its decision to investors. Consequently, this Commission is in favour of requiring that

companies provide the utmost transparency in the use and dissemination of information, and of promoting self-regulation when drafting corporate governance provisions. Self-regulation is based on two cornerstones: the ethical framework of company management and the transparency principle. Consequently, self-regulation means that companies have the duty to constantly disclose the way in which they approach corporate governance matters and their reasons for doing so.

By virtue of their self-regulatory abilities within the current legal framework, companies may include in their corporate governance regime the recommendations they see fit and in the way they consider to be most appropriate, i.e. by including them in their Bylaws or by drafting a Code or principles of governance, or by establishing specific regulations for Shareholders' Meetings or the Board of Directors.

The public authorities may use the recommendations contained in this Report as they see fit by formulating the legislative or regulatory proposals they consider to be appropriate.

Naturally, market participants may also take note of the proposed measures when making decisions regarding the companies that operate in the market.

2.- Appropriateness of additional regulatory support.

Notwithstanding the foregoing, this Commission notes that, as stated in the actual text of this Report, some of its recommendations would be supported more appropriately with regulation including mandates whose compliance would not depend solely on the companies' free will. Among others, we highlight the following:

- i. The basic duties of disclosure and transparency regarding corporate governance, comprising the duty to give a reasoned explanation for any departure from the recommendations of good governance or from the criteria adopted and published by the company itself, and regarding financial and management information.
- ii. The definition and regime of the duties of loyalty and diligence beyond the current “diligence of an orderly entrepreneur and loyal representative” (article 127 of the Spanish Corporations Law), especially in the area of conflict of interests, in both listed companies and other market players covered by this Report.

- iii. The duty to have corporate governance provisions that include at least what this Report considers should be part of a Board of Directors Regulation and a Shareholders' Meeting Regulation, which integrate or complement the Bylaws, as the case may be.

The Commission does not wish to conclude without drawing attention to the need for ethical behaviour by all the parties referred to in this Report in orienting the self-regulation of their conduct and in observing the regulations applicable at any given time or in following the recommendations. Within the framework of principles and values contained in the Spanish Constitution, that is the only way to achieve a balance and effective protection of the different interests involved in the financial markets.