

ESPAÑA

Versión en inglés del Código de Buen Gobierno

The Governance of Listed Companies

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Madrid, 26 February 1998**Special Commission to Consider a Code of Ethics for Companies' Boards of Directors****C O N T E N T S****I. INTRODUCTION**

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III. CODE OF GOOD GOVERNANCE

I. INTRODUCTION

1. THE SPECIAL COMMISSION: ORIGIN AND PURPOSE

On 28 February 1997, the Cabinet, at the proposal of the Second Vice-President of Government and Minister of Economy and Finance, resolved to create a Special Commission to Consider a Code of Ethics for Companies' Boards of Directors.

By means of a Ministerial Order dated 24 March 1997, in compliance with the Cabinet's decision, the Second Vice-President of Government and Minister of Economy and Finance designated the members of the Special Commission as follows:

Chairman:	Mr. Manuel Olivencia Ruíz
Vice-Chairman:	Mr. Luis Ramallo García
Members:	Mr. Pedro Ballvé Lantero
	Mr. Eduardo Bueno Campos
	Mr. José María López de Letona y Núñez del Pino
	Mr. Cándido Paz-Ares Rodríguez
	Mr. Víctor Pérez Díaz
	Mr. Enrique Piñel López
	Mr. Jesús Platero Paz
Secretary:	Mr. Antonio J. Alonso Ureba

On 30 June 1997, the Special Commission came into being.

The Government's resolution entrusted the Special Commission with two tasks: to draft a Report on the problems of

the Boards of Directors of companies which tap the capital markets, and to draw up an Ethical Code of Good Governance which could be followed voluntarily by those companies.

This mission was in response to one of the measures announced by the Cabinet on 21 February 1997, in the framework of structural forms of the business world, namely the initiative to tackle the workings of Boards of Directors.

The Government understood that, in this way, it was responding to widespread demands from professional sectors and the markets themselves for greater efficiency, agility, accountability and transparency in the governance of companies which obtain finance from the capital markets with a view, in short, to boosting their credibility and better defending the interests of all shareholders.

Moreover, the Government stated in the preamble to the Resolution creating the Commission that the need for this type of measure is all the more urgent due to the policy of privatisation and divestment of State-owned companies, which will considerably increase the number of shareholders, who are entitled to a greater voice in the administration of the companies.

2. THE DEMAND FOR REFORM

The Special Commission granted priority to reflecting on the reasons underlying the remit from the Government. The great demand, in the expression of the Cabinet's Resolution, for better governance of companies which seek finance in the capital markets defines a movement for reform which has arisen in recent years in broad sectors of public opinion and can be traced back to the English-speaking countries but whose expansion to many other countries can be attributed to the phenomenon of globalization of the economy and internationalisation of markets.

The reform movement proposes changes in the way in which companies are governed, basically those companies whose shares are listed on the securities markets. The aspiration to change denotes dissatisfaction with pre-existing practices, which it is sought to improve, but the demand is directed not so much at the public authorities, with a view to legislative reform, as at the companies themselves, so that, making use of their freedom of action and the self-governing powers of their governing bodies, they may adopt decisions which are conducive to improved governance.

Underlying this reformist tendency is a factor which can be considered as a constant in companies which seek finance in the capital markets: namely, the separation between ownership and management. Although this separation can have its advantages, such as specialisation in the financial and management functions, it has an inherent risk of conflicts of interest. This is in addition to the risk deriving from the existence of various groups of shareholders. In addition to the major shareholders, the increasing number of small investors and the rising importance of institutional investors are factors which introduce internal tensions within a company's ownership. Consequently, the wider the gap between ownership and management and the more important the small and institutional investors become, the greater is the need for new formulae for balance within the governing bodies of listed companies. The shareholders as a whole are the company's owners, but the different roles of each shareholder group requires the adoption of checks and balances in order to ensure that no one group monopolises power to the detriment of the interests of the others.

The need to avoid or correct abuses has been highlighted most acutely by excesses committed by managers or controlling groups which have triggered financial crises. However, it is not necessary to reach such extremes in order to perceive that the true problem lies in the causes and that these arise from the imbalance produced when companies concentrate too much management power in governing bodies which do not duly represent all interests and from the lack of transparency and of a ready flow of information (not to mention when there is concealment or distortion of information). Consequently, the demand that those who govern a company should render accounts and explanations of their conduct is a constant throughout the reform movement. This principle of good governance, though valuable in itself, is not sufficient if it is not combined with efficiency (which it may not oppose) in the functions and at the service of the company.

Inspired by these principles and oriented towards the latter objective, measures for good corporate governance must focus, as the fundamental core, on the Board of Directors, its workings and the conduct of its members. The Special Commission considers that its *raison d'être* lies in reflecting on these matters and in proposing criteria and measures which may contribute to improve the governance of our companies.

3. DRAFTING THE REPORT

The original Cabinet Resolution established certain guidelines for the Special Commission's work: it must first hold broad consultations with all the agents and institutions operating in the market, or with their most representative organisations, and it had the power to demand from agencies and bodies of the Administration such data, background information, information, support and assistance as might be necessary to discharge its duties. Under

these provisions, even before the Special Commission was formally constituted, the members of Commission commenced preparatory work involving compiling, analysing and systematising the reports and surveys conducted on the subject both in Spain and in other countries, monitoring the application of the Codes of better practice or good governance and the doctrinal treatment of the reform movements in the area of corporate governance.

Aware that the task must commence precisely from the actual economic realities to be addressed, in the first phase of the work the members of the Special Commission conducted a study of the structure of the ownership and Boards of Directors of Spain's listed companies and a survey regarding knowledge of the current status of a broad range of matters which must necessarily form part of the Report commissioned by the Government. The Survey was distributed to the thirty-five most liquid companies on the stock market (which comprise the IBEX-35 index). All the surveyed companies responded to the questionnaire, providing for a very broad analysis of the problems and trends observed in practice in Spain.

This survey on the state of the matter was followed by one regarding opinions and suggestions on the content of the Report and of the Ethical Code of Good Governance entrusted to the Commission. The questionnaire was distributed among many sectors of business and the stock markets, organisations representing economic interests, professional associations, academic bodies and other private and public institutions whose opinion the Commission felt it necessary to obtain in order to draft the Report. The examination of the replies was very valuable in providing information on the currents of opinion existing in Spain regarding corporate governance and for drafting the criteria which inspired the Special Commission's Report.

The Commission worked basically by drafting a proposed general outline, distributing its content in the form of position papers commissioned from the members; submitting each position paper to critical analysis, comments and amendments from the other members; examining the texts at Commission meetings and discussing each subject until final approval by consensus. A total of forty-two plenary sessions of the Commission were held involving over two hundred hours of debates, not counting the meetings of the drafting group.

From the initial phase, by providing invaluable services, the Comisión Nacional del Mercado de Valores supported this work and all the activities of the Special Commission, as required of it under the Cabinet Resolution.

An evaluation of the data obtained using this methodology led the Commission to establish the characteristics of the companies listed on the Spanish bourses which distinguish them from those of other countries and, consequently, must be taken into account when formulating recommendations on good governance. Very particularly, the analysis of the shareholder structure of our companies revealed that the bulk of the companies listed on the continuous market are controlled by a majority shareholder or a significant group of shareholders. Nevertheless, although the companies with a free float of over 75% of their capital stock were numerically in the minority, in terms of market capitalisation they accounted for close to half of the market's total.

However, neither the analysis of the Spanish situation nor the conclusions drawn therefrom regarding the characteristics of the Spanish market eliminated the need to examine the situation in other countries, and the Commission took this matter carefully into account in its work. In fact, even those features which are peculiar to the Spanish situation in this connection must be examined by comparing and, where appropriate, contrasting them against the situation in other countries. In effect, it is impossible to view the Spanish model in isolation since the increasing globalization of the economy and internationalisation of markets are clearly imposing a trend towards convergence in capital structures and governance systems.

Lastly, it should be noted that one advantage of this Report is its timing: it was drafted in a phase of economic expansion, which facilitated the climate of serenity which work of this nature requires. The timing of the work enabled the Commission to draw upon a large volume of historical data, texts, experiences, results and critical evaluations with respect to other countries which have already been through this process, and made it possible to draft the Report in the appropriate tone.

4. NATURE OF THE WORK.

The Special Commission interpreted the term "Code of Ethics", which the Government used to refer to its mission, in the sense which it considered most in keeping with the nature and purpose of the mandate which it had received.

Although the term "Code" can be understood as meaning a body of law, this is not the sense in which it is used in this document. The aim here is not to impose duties whose breach would trigger liabilities, nor to establish obligations. This "Code" is not imposed by the public authorities by exercise of their legislative or regulatory powers and, consequently, contains no rules of imperative or normative law.

Moreover, the word "ethics" should be construed in its broadest sense, relating to rules, principles and models of conduct which respond to the criteria of what is proper and rational. Because of the customary connotations of the word (i.e. referring to permanent moral values) which are not applicable in the case at hand, the Commission prefers to use the term "Code of Good Governance".

The Commission wishes to expressly highlight the relative nature of its formulations which, though inspired by the aim of synthesising practices of good governance and relating to specific situations in space and time, should be

interpreted in each case in terms of their appropriateness to the circumstances of each society and viewed within a dynamic process which will constantly adapt them to changing circumstances. In this way, the broad autonomy which companies enjoy under the related legislation and the powers of self-government granted to their Boards of Directors are respected. The recommendations contained in the Code will only come into force if, by use of that freedom, they are included in the bylaws, when referring to the structure of the governing body and its rules of action, or adopted by the Board of Directors, when regulating its own workings, and not as rules of positive law but as conventional or transactional rules.

It is precisely the framework of free will which allows companies to specify and adapt their characteristics to the system of corporate legislation established generically in the law, which does not distinguish between the very varied situations which can arise within a company, ranging from the family firm to the open company listed on the stock market. This Code is addressed primarily to companies which obtain capital on these markets, with their special circumstances deriving from the plurality of interests represented within their ownership. These companies need appropriate organisation for their governing bodies, not because of their size but, rather, because of the presence among their shareholders of numerous private savers or investors who, with the majority or significant shareholders, represent interests which are worthy of specific protection.

However, the fact that the Code's recommendations are directed primarily at listed companies and, particularly, those with higher free floats, does not mean that they are of use only to those companies. These recommendations are also appropriate for all companies which obtain finance on the capital markets, even if their shares are not listed on the stock exchange. And other companies which do not fall into those categories can undoubtedly also elect, by exercise of their free will, to use this Code to inspire the configuration of their governing bodies.

5. THE REFORM MOVEMENT IN SPAIN

An examination of practices in Spain reveals that the measures propounded by the modern corporate governance movement have begun to be applied voluntarily by some companies which followed known developments in other countries even before there was any indication or recommendation by the public powers in this connection. In their replies to the Commission's survey, some companies (precisely those with the largest free float) stated that they already had codes of ethics of conduct, director's statutes and other internal rules for the workings of their governing bodies.

The initiatives of some of the principal professional associations and companies led to the adoption in Spanish practice of specific measures associated with the movement for the reform of governing bodies, such as the inclusion of independent directors, the reduction in the number of directors, the creation of commissions on directorship, remuneration, auditing and other internal control matters, plus the disclosure of more than the minimum legally required information.

This evolution in companies' governing structure is not imposed by law but comes from society, in response to demands from the various sectors of the economy themselves and actual experience. As such, it is a phenomenon which materialises in new models of organisation whose observance or otherwise (apart from any legal consequence) is valued by the markets and has increasingly notable repercussions on the credibility of companies which seeks finance from the markets.

This trend towards open markets and free competition, which is responsive to the dynamics of the modern economy, should not meet with an immobilistic refusal to change.

II. REPORT ON THE BOARD OF DIRECTORS

1. THE BOARD OF DIRECTORS' MISSION

1.1. The general supervisory function.

The Board of Directors is often seen as a true body of management whose primary function is to conduct the

company's ordinary business. However, in companies above a certain size (and this is the case with all listed companies), the management functions are basically in the hands of a management team working under the immediate authority of the company's chief executive officer. And this must necessarily be so as the Board, because of its discontinuous functioning, its collegiate structure and its deliberating character, is not the appropriate organ for managing such companies.

However, this does not mean that the Board has become, much less should become, devoid of content or relegated to a merely decorative or representative function. On the contrary, it is an invitation to enhance the Board's role in connection with the tasks which it is best suited to perform and which can add most value to the company's governance. Debates in other countries about reforming the Board of Directors and the sensitivity beginning to develop in Spain indicate that these tasks all relate to the same goal: control of management. This is only logical since, in the current phase of development of our capital markets (characterised by spectacular growth in investment by the public and an influx of institutional investors, both domestic and foreign), governing structures are needed which are capable of dealing with the increased risk of divergence between the interests of owners and managers as a result of the increase in floating capital.

In this context, the Board of Directors should be configured basically as an instrument of control and supervision which aims at aligning the plans of the company's managers with the interests of those providing the funds and bearing the business risk. This Commission believes that the general supervisory function is the most genuine function of the Board of Directors in listed companies, and it identifies three basic responsibilities within that function: to guide the company's policy, control its management echelons and liaise with the shareholders. The emphasis on the supervisory function should, however, lead to the relations between the Board and the executive team being expressed in constructive and not in antagonistic terms. Mutual trust and loyal collaboration between the Board and senior management will always be of incalculable value for good corporate governance.

1.2. Indelegable core powers.

Good corporate governance should commence with an awareness on the part of the Board of Directors that the heart of its institutional mission is the general supervisory function and, for that purpose, this Commission recommends that the Board expressly assume the following commitments: (a) approval of the company's general strategies; (b) appointment, remuneration and, where appropriate, removal of the company's senior executives; (c) control of the management activity and evaluation of executives; (d) identification of the company's main risks and implementation and follow-up of appropriate internal control and reporting systems; (e) determination of the policies governing information and communications with the shareholders, the markets and public opinion.

The Commission considers that the Board should assume the foregoing functions as indelegable. Their importance from the standpoint of management control in effect makes it necessary that the decisions in those spheres should be taken only by a plenary meeting of the Board of Directors. Delegation to other instances of decision-making powers in these matters might jeopardise the effectiveness and credibility of the general supervisory function and the Board's very mission. Naturally, this should not prevent the Board from entrusting informational, consultative or merely executive tasks in these areas to other persons or bodies in the company.

1.3. Creating shareholder value.

Good corporate governance requires a clear definition of the goals to be pursued by company administration. The Commission has reached the conviction that the so-called "financial" solution is the most appropriate one for effective, accurate exercise of the principle of accountability and the one which best responds to the expectations of investors who, in the final instance, are those to whom accounts and explanations on management must be rendered. Consequently, we recommend establishing that the company's ultimate goal and, accordingly, the principle presiding over the Board's operations, is to maximise the company's value, i.e. to employ a term used widely in financial circles, to "create shareholder value". We feel this definition is preferable to other broader (but also vaguer) definitions or interpretations of the "corporate interest" for several reasons: firstly, because it provides the Board and the executive levels under its supervision with a clear guideline which facilitates decision-making and performance evaluation; secondly, because, in competitive markets, it favours the formation of capital and the most appropriate allocation of resources; and thirdly, because it efficiently brings the organisation's design into line with the incentives and risks of all the parties involved in the company.

However, this does not mean that the Board and company management must pursue the shareholders' interests at any price while ignoring or paying insufficient attention to those of other groups with interests in the company and of the community in which the company is located. In this connection, the shareholders' interest provides a guide for action, which must take place while necessarily respecting the legal requirements (e.g. tax and environmental legislation), complying with the good faith contractual obligations (both explicit and implicit) arranged with other stakeholders (employees, suppliers, creditors, customers) and, generally, discharging the ethical duties which are reasonably appropriate for the responsible conduct of business.

2. COMPOSITION OF THE BOARD OF DIRECTORS

2.1. Independent directors.

From the standpoint of the effectiveness and credibility of the general supervisory function, an analysis of the composition patterns of our Boards of Directors reveals the advisability of introducing some innovations. The most important of them relate to the qualitative composition of the Board and, in short, to the provenance and profile of the directors. Our main recommendation in this connection relates to independent directors, whose primordial mission is to ensure that the interests of the floating capital are heard in the Board of Directors.

The Commission uses the term independent director since it is the conventional term in this area although it does not accurately express the idea of a director it seeks to identify nor his differences from other groups. In reality, the term refers to those directors not related to the management team or to the controlling core of shareholders which have most influence over the former. Naturally, this does not mean that an independent director must not be a shareholder, or that the absence of the aforementioned links should suffice to define his profile. Moreover, these features must be complemented with the experience, competence and professional prestige which should always characterise the independent director.

The Commission trusts that the appointment of such independent directors with sufficient strength in the company's governing body will increase its representativeness, broaden its viewpoints and, above all, increase the Board's willingness and ability to efficiently discharge the supervisory function.

Some respondents to our survey expressed certain reservations about the role and value of independent directors: they felt that they might lack motivation to discharge their duties and held doubts about the actual independence of those seeking such appointments. The Commission feels that this opinion is of great interest in that it highlights real risks which merit consideration; however, it cannot accept that this should lead to the elimination of a figure which is supported by the most prestigious working groups and forums of debate world-wide and by accumulated empirical evidence in the most developed capital markets. In effect, studies in this field confirm the existence of positive results associated with the announcement of the appointment or increase in number of independent directors. And such favourable reactions by the markets can only be interpreted in the sense that investors are willing to trust in the independence of this category of director. Naturally, the greater the reputation of the appointees, the greater will be this reliance: markets normally measure independence in terms of what is to be lost by he who breaches it.

Overall, however, the Commission is aware that the process of including the figure of the independent director in corporate practice should be managed with prudence. On the one hand, it is impossible to ignore the highly concentrated ownership structure of our stock market. On the other hand, the process should be implemented gradually while avoiding sharp changes in the composition of the boards of our listed companies and in step with the development of what has been referred to as the "market in independents". If we really aspire to independence being more than just a label, it will be necessary to build a tradition (as yet only incipient in Spain) that highly qualified professionals serve and acquire responsibilities in companies to which their sole link may be share ownership. Companies must provide the necessary guarantees to ensure that the process of selection is carried out correctly and that the candidates who are chosen match the profile of the position (some guidelines for this purpose are given in 5.2). Our impression is that financial circles are adopting a somewhat light interpretation of the figure of independent director, based more on the letter than the spirit of the name.

2.2. Types of director and balance in the Board of Directors.

Having introduced the figure of independent director, it is necessary to identify the various groups of directors which should be present in the Board of Directors and to determine how to strike a reasonable balance among them. The goal is to prevent the process of decision-making in the board from being concentrated in the hands of one person or a small group of persons.

It is clear that the Board should be informed of the company's business and co-ordinate with the executive levels which manage the company. For this reason, we feel that it is very advisable that the leading members of the management team, particularly the chief executive, should be members of the Board. However, at the same time, the Board must maintain the ability to examine the work of the company's executives with some distance and impartiality. Otherwise, the general supervisory function will be jeopardised. This is precisely the reason why it is recommended that the broad majority of the Board members should be non-executive directors (i.e. not executives), particularly in companies which are not majority owned by one person, a family group or a group of companies.

Within the category of non-executive director it is necessary to distinguish between independent directors, as discussed above, and what might be termed, more graphically than accurately, "domanial directors". The former, as

stated before, are appointed to the Board of Directors on the basis of their high professional qualifications, regardless of whether or not they are shareholders; the latter are appointed to the Board because they hold or represent the holders of blocks of shares which can control the company, either alone or in concert with others. The former have the mission of representing the floating capital (ordinary shareholders); the latter are linked to the controlling shareholder or group of shareholders (significant shareholders). And even though all are expected to provide distance when considering the management team, it is impossible to ignore the fact that they are not in equivalent positions in terms of incentives, interests and links. Consequently, this Commission believes it is advisable that the composition of the group of non-executive directors should be subject to certain rules to ensure the appropriate equilibrium between independent and domanial directors.

It is well known that the proportional system provided in corporate law for the appointment of directors has encountered insurmountable difficulties in listed companies due to the impossibility of grouping the shares of scattered investors. However, the proportional system contains a regulatory principle which is clearly of value in guiding corporate governance, and this principle inspires our proposal for determining the composition of the group of non-executive directors. The Commission's position is that the ratio between the independent and domanial directors should be based on the ratio in the company's shareholders between the floating capital (in the hands of ordinary investors) and the stable capital (held by significant investors). Evidently, this is not a mathematical rule but, rather, a recommendation which aims to ensure that independent directors carry sufficient weight in the Board's decisions. The reasonable and flexible nature of the rule allows it to be adapted to each company's individual circumstances. Accordingly, it is clear that as the market capitalisation or the number of significant shareholders increases, there will be more justification for relaxing the demand for strict proportionality.

2.3. The size of the Board.

In addition to the qualitative aspect, there is also a quantitative aspect of the composition of the Board of Directors which merits some reflection. The number of directors is undoubtedly a factor when assessing the Board's efficiency and the quality of its decisions. A minimum number of directors is required in order for the Board to be able to debate and to enrich its points of view, but it is also advisable not to exceed an upper limit. In practice, Spanish Boards are often too large, which impairs their efficacy and, occasionally, their cohesion, both of which are desirable traits. Very large Boards encourage non-involvement by individual directors, dilute the sense of accountability and foster passivity. Insofar as this is the case, they do not foster debate and tend to behave in a routine or formulaic manner.

Consequently, the Commission considers that Boards should analyse their size in order to adjust their composition. Authoritative opinion favours a drastic reduction to the ideal size which, according to modern studies on teams and joint decision-making processes, is between five and seven. Against this thesis, the Commission feels that it is not possible to be so categorical in this area. Firstly, because the general category of listed company encompasses a great diversity of ownership structures, combinations of forces and circumstantial situations (e.g. mergers). Additionally, because the decision-making efficiency of the Board should not be the only criteria to consider when deciding on the optimum size, which depends on a variety of circumstances such as the complexity of the business organisation and the number and composition of the Board sub-committees. Consequently, it would apparently be prudent to recommend a broader range between the minimum and maximum number of directors and to recommend that companies whose boards are currently oversized should gradually adjust them to the size which they feel is appropriate to their characteristics.

3. STRUCTURE OF THE BOARD OF DIRECTORS

3.1. Preliminary consideration.

The reflection on the various components in the structure of the Board of Directors (the Chairman, Secretary, Directors and sub-committees) must also be based on the Board's priority mission, namely its general supervisory function. This matter is of considerable interest here since the Board organisation patterns which are most widespread among Spanish companies do not always match the goals which are pursued. The companies to which the Report is addressed that wish to adhere to the recommendations for good governance contained herein must necessarily introduce certain guarantees (balancing of powers, creation of ancillary bodies, etc.) to facilitate attainment of the proposed objectives of control and transparency.

3.2. Chairman of the Board.

The Board of Directors is headed by the Chairman, a figure of extraordinary importance since, in the final instance, the operational efficacy of the Board depends on him. In effect, the Chairman must not only call meetings, draft the agenda and manage the meetings, but he must also ensure that the members of the Board receive the necessary information, participate actively and commit themselves to their work. The chairman is responsible for promoting the good working of the Board. Experience has shown that when the Chairman fails to duly exercise its functions of encouragement and leadership, Boards of Directors falter in their true functions and become relegated to a secondary role within the organisation.

The most delicate of the problems arising in this sphere is the question of whether it is advisable for the same person to hold the positions of Chairman of the Board and Chief Executive Officer or whether they should be kept separate. The Commission is aware that either alternative has its advantages and drawbacks. The accumulation or combination of offices can provide listed companies with clear leadership both internally and externally and facilitate the recruitment of more competent personnel to head them. However, this course has two major disadvantages, namely: it concentrates too much power in the hands of a single person, and it can blur the distinction between two types of task and responsibility which are qualitatively different, i.e. governing the Board and managing the company; consequently, combining their functions may hinder the Board as a whole from effectively carrying out its supervisory function.

In these circumstances, considering also that the combination of offices is the general pattern in Spain and in neighbouring countries, the Commission recognises that this is not the appropriate time to offer a general guideline. Nevertheless, the concern for preserving optimum conditions for the good discharge of the general supervisory function leads us to recommend the adoption of some cautionary measures if it is decided that the two offices be held by the same person. The idea is to create counterbalances to enable the Board to function more independently of the management team and conserve its ability to oversee the latter. The measures we refer to can be implemented in many ways, although the most effective way is probably to appoint one of the directors to the post of co-ordinating Deputy Chairman with subsidiary powers to call Board meetings, add new items to the agenda, remit information to the directors and, generally, respond to their concerns. In any event, it would appear to be advisable to supplement these measures by establishing the policy that the Board review the Chairman's performance as such and as CEO once per year.

3.3. Secretary of the Board.

Another important player within the structure of the Board of Directors is the Secretary, who is responsible for much of Board's housekeeping and order. In effect, the Secretary must facilitate successful Board meetings by taking particular care to provide directors with the necessary advice and information, conserve documentation, enter the proceedings in the minutes books and certify the Board's resolutions. At the same time, the Secretary must devote particular attention to the formal and material legality of the Board's actions and ensure that its governing rules and procedures are observed and regularly revised.

Accordingly, it would appear to be advisable to highlight the role of the Secretary within the Board and provide him with certain guarantees of independence and stability. In this connection, measures could include making the Secretary hierarchically dependent on one of the sub-committees or appointing him as a director, in order to strengthen his authority within the Board and apply a more stringent system of accountability. The foregoing are merely examples and they can be replaced or expanded by the companies to which this Report is addressed using other analogous formulae.

3.4. Ordinary directors.

The ordinary directors as such have no specific function within the structure of the Board. They must all participate in debates and collegiate decisions and accept liability for them. However, each director's individual contribution will undoubtedly be different. The comments above on the qualitative composition of the Board reflect this difference in contributions. Directors appointed from the executive line are expected, above all, to provide information, strategic evaluations and proposals for decisions, whereas non-executive directors are expected basically to provide independent judgement, capacity to evaluate and authority to resolve conflicts of interest. In any event, the Commission wishes to draw attention to the risk that these differences in contributions might lead to a split in the Board which, as a sole body, ought to operate with one will and shared accountability.

3.5. The Executive Committee.

The Companies Law gives Boards of Directors broad powers to create delegate bodies to substitute for them and

assist them in the discharge of their duties, and experience has shown that companies (particularly listed companies) make ample use of these powers. This phenomenon is observed particularly in connection with Managing Directors and Executive Committees.

This Commission's concerns focus particularly on Executive Committees and their manifest protagonism in the day-to-day life of many companies, which can occasionally overshadow and even annul the leadership and oversight role which the Board of Directors should play. This naturally does not mean that the existence of Executive Committees should be discouraged, since they are an invaluable instrument within more complex organisations, but the need for them should tend to decline as the recommendations contained in this Report are implemented, particularly those relating to the size of Boards and the frequency of their meetings. In any event, in order to avoid a reduction in the weight which non-executive directors (particularly independents) should have in the governing structures of listed companies, it is recommended that the composition of the Executive Committee should faithfully match that of the Board and should contain the same balance between different director types.

The existence of an Executive Committee does not reduce or eliminate the responsibility of the Board and its members in carrying out the aforementioned supervisory functions. Relations between the two bodies should be governed by the principle of transparency and, in this connection, the Commission recommends adopting the necessary measures to ensure that the Board has full knowledge of the matters discussed and the decisions adopted by the Executive Committee.

3.6. Board sub-committees.

The traditional structure of Boards of Directors needs to be complemented with other delegate bodies which are beginning to appear in Spanish corporate practice. The Commission feels, in effect, that the Board's general supervisory function depends to a great extent on the creation of certain supporting bodies to which the examination and permanent oversight of certain areas which are of particular relevance for good corporate governance can be entrusted; these areas are: accounting information and control, appointment of directors and senior executives, determination and review of remuneration policies, and evaluation of the governance system and the observance of its rules.

For this reason, it is recommended that the related sub-committees be formed. The Board is responsible for determining their functions and powers, and in this task it should be guided by the criteria developed in the form of best practices in both Spain and other countries. In any event, it would be appropriate to note the basic missions of the various committees. The mission of the Audit Committee is basically to evaluate the company's accounting verification system, ensure the independence of the external auditor and review the internal control system. The Nomination Committee's mission is to protect the integrity of the process of selecting directors and senior executives, ensuring that candidates match the profile of the vacancy. The Remuneration Committee's mission is to assist the Board in setting and supervising the remuneration policy for directors and senior executives. The Compliance Committee's role is to oversee the observance of the rules comprising the company's governance system, periodically review its results and make proposals for reform to the Board.

In general, these committees' role is basically informative and consultative, although they may exceptionally be given decision-making powers. The idea is not that they should supplant the Board's decisions but, rather, that they should provide it with material (information, advice and proposals) with which it can effectively develop its supervisory function and improve the quality of its performance in this area.

The efficacy of these committees depends on the quality of the information they produce and, since this depends on the rigour and reliability with which it is elaborated, they need a degree of regularity in their operation and independence in their composition. With regard to this latter aspect, we believe that sub-Committees should comprise only non-executive directors and that their composition should reasonably reflect the ratio in the Board between domanial and independent directors. The presence of executives in these committees might impair the credibility of their information since their mission consists, to a great extent, of evaluating the executives' performance. However, this should not prevent members of the management team from attending sub-committee meetings for information purposes.

The Board of Directors is responsible for determining the number of sub-committees and the directors who should comprise them, depending on needs and availability. In this connection, it should be noted that a separate Committee need not be created for each area of responsibility (Audit, Nomination, Remuneration and Compliance), nor is it necessary that the directors comprising them should be different in each case. Nevertheless, barring special circumstances, we feel that it is not advisable to combine all responsibilities in a single body, since this might reduce the latter's efficiency due to overwork, lead to an excessive concentration of power and detract from the importance of the Board of Directors. It would apparently be advisable to have at least two sub-committees, one in charge of Auditing and Compliance and the other responsible for Nomination and Remuneration. In order to ensure collegiate operation, it is also recommended that any committees which are established should have at least three members.

4. THE WORKING OF THE BOARD OF DIRECTORS

4.1. Organisation of Board meetings.

The Board must undoubtedly meet with a certain frequency in order to maintain a constant presence in the life of the Company. It is not easy for it to discharge its duties if it does not regularly devote at least a minimum period of time to its activities. From the data available, it would appear that our Boards are far from complying with the "one hundred hours per year" rule suggested by some students of the matter or even with the more modest target of one meeting per month. Aware of the difficulty of offering general guidelines in this area, these proposals are made not with the recommendation that some of them be adopted but merely to draw the attention of the readers of this Report to the need to reflect on this area and to set objectives which are more demanding than current practice.

The level of demand should also be raised in connection with planning the Board's tasks. In this connection, the Commission considers that the Board should draft an annual plan of ordinary activities and have a formal catalogue of matters reserved to it in order to ensure that the government and control of the company do not slip from its grasp. It is not easy to draft a general inventory of these matters, since their relevance varies depending on the characteristics of the company and of the sector in which it operates. The preparation of the inventory is a formal task of the Board, which should ensure that all the matters with a relevant impact on the company's progress are duly reflected in it.

The Chairman of the Board has a particular responsibility for achieving these objectives since he is the one who calls the meeting and sets the agenda, although this does not inhibit or prevent initiatives by the other directors in this area. The Commission recommends, in this connection, that companies adopt the appropriate instruments to facilitate participation by all the Board members in determining these aspects which are so important for the efficacy of Board meetings. In particular, as already suggested, it might be appropriate to endow the Deputy Chairman who co-ordinates the non-executive directors with the subsidiary power to call meetings and, of course, to provide that requests from directors to call a meeting or include other items on the agenda that be binding on the Chairman.

4.2. Preparation of meetings.

Two essential factors are needed in order for directors to prepare adequately for Board meetings: information and time. Without them, the Board will scarcely be able to make a significant contribution to corporate governance, with the resulting risk that the management team will assume a protagonism which does not correspond to it. The data obtained by this Commission reveal that Board meetings are occasionally called without sufficient information and at short notice. Consequently, it recommends that the necessary measures be adopted to ensure that directors have access to the relevant information sufficiently in advance of the meeting.

In connection with the first point above, regard must be had to the amount and the quality of the information. Regarding quantity, the information should be neither scant nor excessive. The information distributed to directors should be appropriately elaborated and oriented towards the relevant matters, towards the core of the question. Regarding quality, it is important that directors not receive historical and financial information only (as is often the case) but that they should also be given qualitative information and projections. The Board should have information to help it value the company's intangible assets, and ascertain market trends, customer satisfaction, product quality and all other matters which will enable it to guide the strategy and appropriately frame the prospects of the company's business.

The policy of informing the Board is a primary responsibility of the Chairman, assisted by the Secretary. Each of them must exercise the utmost zeal in attaining the aforementioned objectives and ensure that the information reaches its addressees reasonably in advance so that they may become familiar with it and make use of it to enhance the quality of their contribution to the Board's deliberations. The importance and confidential nature of the information cannot be used as a pretext (save in exceptional circumstances) for breaching this rule, since a director's first duty is that of confidentiality.

4.3. Conduct of meetings.

Another essential aspect of the working of the Board is the conduct of its meetings. The efficacy of Board meetings depends on the richness of the viewpoints put forth and the vitality of the deliberation process, which in practice often suffers from an excess of "presidentialism." Consequently, the Commission considers it is appropriate to reiterate the advisability that all members should attend, participate and maintain their independence, and it proposes some guidelines to this end.

The first relates to the use of proxies by directors, which the Commission believes should be restricted to cases

where it is indispensable. It is not a good practice in general since it encourages absenteeism and disinvolvement and can impair the quality of Board debates. In any event, if a proxy must be granted, instructions should be given as to its use and it should be held by a director belonging to the same group.

Another matter requiring attention in order to avoid passivity and routine is that all the directors should speak and adopt positions on the matters submitted to the meeting. In this connection, the Chairman's work is of singular importance since it is he who is ultimately responsible for organising the debate and fostering the participation of the directors.

4.4. Board minutes.

In common with all the collegiate bodies, the Board of Directors is legally obliged to appropriately reflect its debates and decisions in the form of minutes. However, experience shows that this duty, which falls on the Board as a whole although internally it may be assigned to the Secretary, is not always satisfactorily discharged. The consequences can occasionally be severe, since the minutes constitute the history of governance of the company and are an element of primary importance in evaluating the directors' activity and, where appropriate, their liability. Consequently, the Commission, which is also aware of the extraordinary importance of this matter for legal and probative purposes, recommends in the strongest terms that care should be taken in drafting the minutes and that every effort should be expended to avoid falling into a routine in this connection.

4.5. Evaluation of operation.

The Board must be alert to avoid any risk of routine or inertia. It is therefore advisable to adopt rules for self-control and, in this connection, it is recommended that the Board reflect on its own workings at least once per year, if possible in a monographic meeting. The goal would be to assess the quality of its work, evaluate the efficiency of its rules and, where appropriate, correct any aspects which are found not to be fully functional. In this task, whose final objective is to ensure the effectiveness of Board and, in short, its ability to supervise the management of the company, very careful consideration should be given to the Compliance Committee's reports.

5. APPOINTMENT AND REMOVAL OF DIRECTORS

5.1. The process of appointment and the Nomination Committee.

Even though the Shareholders' Meeting is the body with the power to appoint directors, the Board of Directors evidently plays a leading role within this process. The power to temporarily fill vacancies by co-option and to submit proposed appointments to the Shareholders' Meeting for approval, coupled with the scant participation by the floating capital in the Shareholders' Meeting, gives the Board of listed companies a decisive influence in the appointment of directors, which should be offset with the express assumption of the related liability and the implementation of the appropriate control systems. The goal is to ensure that the rules of good governance which the Board establishes in this area (particularly those relating to the qualitative composition of the Board and the balance within it between the different types of director) are complied with not only in form but also in substance. To better attain this goal, the Commission recommends the implementation of formal procedures to encourage transparency and scrutiny by all Board members of the selection of candidates, with particular protagonism going to the Nomination Committee.

The mission of the Nomination Committee is to oversee the integrity of the process of appointment of directors and, for this purpose, it is advisable to assign it the following functions: (a) formulate and review the criteria to be followed in the composition of the Board of Directors and the selection of candidates; (b) make proposals to the Board for the appointment of directors so that it may designate (co-opt) them directly or approve the proposals for submission to the Shareholders' Meeting; (c) propose to the Board the members which should belong to each of the Committees. Naturally, in discharging these duties and, particularly, in making proposals for appointments, the Committee must take account of the suggestions made to it by the Chairman, the other directors, the executives and the shareholders of the company. Their function is to examine these suggestions, and to evaluate and report on them objectively and impartially so that the Board may make its decisions on sound bases. The Committee's function is not to take the place of the Board but it is advisable that the Board should state its motives whenever it decides to depart from the Committee's suggestions.

The entire appointment process should be aimed at ensuring the proper representativeness of the Board and the competence, soundness and experience of the selected candidates.

5.2. Special reference to the selection of independent directors.

The rigour which should preside the selection process should, if anything, be heightened when choosing candidates for the post of independent director, whose importance for the good governance of listed companies has already been suitably highlighted (see 2.1). We provide the following guidelines to orient the work of Nomination Committees and, generally, of Boards of Directors in this delicate task.

The first point is the professional background of the independent directors. The basic idea here is pluralism: there is no single profile for the independent director. Consequently, it is advisable not to select only persons who are or have been senior executives at other companies, although this background may qualify them particularly well for guiding the strategy and effectively performing the supervisory function. It is also advisable to include people from other professional backgrounds. This, in addition to avoiding the risk of "cross directorships", enriches the Board with different points of view and varied experiences, including experience from outside the business world.

The second recommendation relates to independence. Care should be taken to ensure that the independent director is not affected by relations or interests which might compromise his ability to exercise judgement impartially and objectively. Accordingly, the first point is to check the candidate's independence of the executive team, for which purpose it is necessary to examine any significant link (whether family, professional, commercial or similar) with persons in executive positions. The idea of "significant link" is ambiguous, but it does appear to be sufficiently expressive. Based on well-established international practice which has already been accepted by our largest firms, the following can be classified as having significant links: former executives of the company, immediate relatives of persons who are currently senior executives or who have occupied such positions in recent years, persons who, directly or indirectly (through companies in which they have a significant ownership interest or at which they have executive functions), have or have recently had significant commercial or professional relations with the company. Naturally, these recommendations are merely guidelines and do not rule out further investigation. The final responsibility for ensuring effective independence lies with the Nomination Committee and the Board of Directors itself.

Our final recommendation relates to the independent director's participation in the company's capital stock. The parties in charge of candidate selection must also examine candidates' independence with respect to the controlling shareholder groups which can have an influence on the management team. Only by avoiding candidates with substantial links to those groups is it possible to ensure the desired balance between independent directors and domanial directors.

However, none of the foregoing should be interpreted as discouraging independent directors from acquiring stakes in the capital stock. On the contrary, the Commission considers that it is desirable that they should own shares in the company in order to increase the directors' motivation and strengthen their alignment with investor interests. However, there is a limit which should not be exceeded, namely the point where one ceases to be an ordinary shareholder and becomes a significant shareholder, and, it should be reiterated, this occurs when, considering the company's ownership structure, the shareholder, alone or by agreement with others, is in a position to influence the control of the company. In this case, the nature of the director's relationship with the company would be substantially altered. The Commission recognises that there are cases where it is not possible to determine whether a person owning a shareholding of some size is an ordinary shareholder or a significant shareholder. The responsibility of choosing him as an independent director again falls on the Nomination Committee and on the Board itself, and they must make every endeavour to preserve the integrity of the appointments system.

5.3. Orientation programmes for new directors.

Reflecting patterns already existing in practice, the Commission considers that the companies to which this Report is addressed should have an orientation programme for newly-appointed directors as a form of concluding the appointment process. The programme would aim to inform them of their legal liabilities and the company's rules of governance and to familiarise them with the company's characteristics, situation and environment. In the framework of this programme it would be very useful to offer new directors the opportunity of directly getting to know the organisation and meeting with its main executives.

5.4. Re-election of directors.

The available information reveals that the director appointment process is not always as carefully meditated as might be desirable. Inertia and the natural tendency to avoid personal questions are risks for which solutions should be found. The Commission believes that the establishment of some formal procedure could contribute to improving the situation and, in this connection, it recommends that companies provide that, as an integral part of the process of re-appointment, the Nomination Committee evaluate the director's performance and actual dedication to the office during the previous mandate and issue a report on the matter. This method can be expected to reduce the risk of automatism often attributed to Board decisions in this connection.

A particularly problematic aspect is the question of term limits. This Commission considers that the debate should clearly refer only to the independent directors. The re-election of executive directors and domanial directors should be subject to no more restrictions than their evaluation and whether they still have the confidence of their supporting group. In fact, if these conditions are met, the re-appointment of such directors should be encouraged as the experience and company-specific knowledge they have accumulated over time makes them more valuable as directors.

The problem arises with the independent directors. It is often argued that although a certain period of service increases the quality of the human capital placed at the company's service, it also debilitates its independence. It is claimed that the passage of time breeds familiarity and the forging of personal links with the parties under supervision. It is precisely for this reason that term limits are proposed. However, this Commission does not feel it is appropriate to make such a drastic recommendation. The scant empirical data available indicate that the possible costs of lower independence do not justify dispensing with the accumulated experience. In fact, the mere existence of a term limit may discourage a director from dedicating himself to Board work and, generally, from becoming involved with and committing himself to the company's future. Consequently, the Commission considers that other types of measures should be used to minimise the risks which it is sought to palliate here; specifically, one possibility is to rotate directors to different areas of control within the Board. The aim is basically to prevent directors from belonging permanently to the same sub-committee.

5.5. Removal of directors.

The decision regarding a director's removal may only be taken formally by the Shareholders' Meeting (dismissal) or by the director himself (resignation), and in those cases where the law or the bylaws provide for automatic removal. Consequently, it is advisable for companies to reflect on this matter and for their internal regulations to include bylaw provisions regarding removal or, at least, certain obligations to resign in cases which might affect the working of the Board or the company's prestige and reputation in the market. Additionally, it should be borne in mind that a director's general duties of loyalty oblige him to resign whenever his permanence on the Board might jeopardise the interest of the company or where the reasons for his appointment cease to exist (e.g. when a domanial director disposes of his stake in the company or when an independent director joins the executive line).

A director's decision to resign should generally be respected since there are many reasons (health, family commitments, overwork, etc.) which may justify it, but it is desirable that such processes and their causes should be transparent.

It is also advisable to establish an age limit for directors. The Commission's position in this connection is that certain measures should be implemented to enable the older directors to be replaced, while giving the company some scope to make use of the experience of certain directors. Accordingly, it would appear advisable to establish a prudent age for retirement, probably between sixty-five and seventy, for executives directors and the Chairman, while allowing greater flexibility for the other directors (for example, a percentage limit might be established for the number of directors who may stay in office above the reference retirement age).

6. DIRECTORS' POWERS REGARDING INFORMATION

6.1. Information and examination.

In addition to the responsibility of the Chairman and Secretary to develop a good policy of informing directors, it is important to highlight the individual directors' power and duty to request and obtain any information required to discharge their supervisory duties. Consequently, it is recommendable that the company's internal rules formally recognise every director's right to examine the books, records and documents of all types, to contact the heads of departments and divisions and to visit the company's facilities and premises.

In order not to perturb the ordinary course of company business, it will generally be necessary to establish channels

within the Board structure to ensure a degree of order in requesting, producing and channelling information. The normal method should be for directors to remit requests for information via the Chairman or Secretary, who should receive the request and directly provide the information or facilitate contacts with the appropriate interlocutors or establish measures to enable them to conduct examinations *in situ*. The Commission recommends the establishment of measures to overcome conflicts which may arise when information requests are denied, delayed or incompletely attended to. An appropriate course might be to assign the resolution of conflicts to one of the sub-committees.

6.2. Resources and expert assistance.

The Commission considers that, in order to facilitate the work of the directors, the company should guarantee their access to the company's in-house experts and, where necessary, engage external experts to advise them in connection with the problems arising in the discharge of their duties.

In order to avoid undue use of this power to the detriment of the company, the latter may establish limits on the exercise of these rights. It is considered perfectly acceptable for a request for the engagement of external experts to be submitted for approval by the majority of the independent directors or by one of the sub-committees, be notified to the company Chairman and be open to veto by the Board where there is just cause (e.g. where it is unnecessary or excessively costly).

7. DIRECTOR REMUNERATION

7.1. Control of remuneration policies.

Director remuneration is a matter of capital importance in corporate governance and is consequently a legitimate concern for shareholders, as evidenced in our opinion survey. The available information suggests that much remains to be done in this area. Shareholders expect directors' remuneration should not exceed the level required to attract competent persons, that it should bear some relationship to the individual and corporate performance, and that it should be disclosed for public scrutiny. And these are precisely the guidelines which this Commission feels should apply to the policies adopted by companies in this area. To facilitate implementation and control, we insist that it is advisable that the Board create a Remuneration Committee with the characteristics already detailed in 3.6 and formally give it the following powers: (a) to propose to the Board of Directors the amount of the directors' annual remuneration; (b) to periodically review the remuneration programs and consider their appropriateness and results; and (c) oversee to ensure transparency in remuneration.

7.2. The amount of remuneration.

Although the company is free to establish the remuneration, it should proceed cautiously, allowing itself to be guided by market demands and having regard to the responsibility and commitment of the role which each director is called upon to play. Moderation should be the rule presiding over decisions in this area. Director remuneration should be set so as to offer sufficient incentives to dedication by the director while not compromising his independence.

7.3 Remuneration structure.

In this respect, the Commission believes that it is better to use formulae which link a significant portion of director remuneration, particularly that of executive directors, to the company's results, since this will bring the directors' interests more into line with those of the shareholder, which it is sought to maximise. We will not consider the advantages or disadvantages of the various forms of remuneration (incentives, payments in stock, stock options, etc.), some of which face tax obstacles in Spain which do not exist in other countries. It is the responsibility of the Remuneration Committee to consider the possibilities for configuring the remuneration and adjusting them to each company's individual circumstances. However, it should be noted that the most widespread remuneration systems in Spanish companies do not meet the above recommendation. As this Commission has discovered, the norm is for a percentage of earnings to be earmarked for director remuneration. The problem is that this percentage acts only as

an upper limit and, consequently, cannot strictly be viewed as a share in profits nor, therefore, does it achieve the desired effect.

In any event, it is important to review remuneration policies periodically in order to ensure that the amounts and structure are commensurate with the directors' responsibilities, risks and duties. Accordingly, it is advisable for the Board itself, with the help of reports drafted for this purpose by the Remuneration Committee, to evaluate these matters at least once per year and disclose information on this area in the annual report.

7.4. Transparency in remuneration.

Because of its importance and delicacy, the matter of transparency in director remuneration received special consideration on the part of the Commission, and it is a matter of great interest in assuring the confidence of investors and the markets in the Board of Directors.

There is a long tradition of opacity in this area in Spain, which our laws have made no effort to remove. The law requires disclosure in the annual report of the salaries, per diems and any other form of remuneration earned by the Board members and any pension or insurance premium payment obligations to former or serving directors, but it does not impose overall disclosure of director remuneration and, in practice, fails to fully satisfy the interest of shareholders and markets in this connection and can, in fact, create a distorted picture of the situation and give rise to frequent misinterpretations.

The Commission notes that the widespread expectations in this area and the reforming tendencies observed in Spanish corporate governance practices are tending unequivocally towards exceeding the minimum disclosure requirements, i.e. towards increasing transparency. Consequently, the Commission recommends that the policy of disclosing director remuneration should be inspired by the principle of maximum transparency.

Application of this principle requires advancing as fast as possible from the current situation to full and detailed disclosure of the directors' remuneration, including that arising from their positions as directors (fixed fees, per diems, profit-sharing, bonuses, incentives, pensions, insurance premiums, payments in kind, etc.) and those other payments made by the company under other relationships (professional services, management or executive posts).

The Commission recommends that the companies to which this Report is addressed that choose not to apply full transparency immediately but, rather, implement it in stages, as well as companies which decide to apply it partially should publicly disclose their reasons in the company's annual report. In either case, companies should at least disclose each individual director's remuneration, for his position as such, under each of the headings listed above, and any fees collected for professional services. The remuneration of the executive directors can be disclosed as an overall figure, indicating the number of directors collecting them under each of the remuneration headings. All this information should be included in the annual report.

8. THE DIRECTOR'S DUTY OF LOYALTY

8.1. Generic duties.

Substantive law establishes that a director must discharge his duties with the diligence of an orderly businessman and loyal representative. The highly abstract and generic nature of this precept makes it advisable, in our opinion, for the company's internal rules of operation to detail the main duties arising out of the general obligations of diligence and loyalty so as to encourage directors to take cognisance of the commitments they are assuming when taking office and to facilitate the evaluation of their performance.

The following sections discuss the duty of loyalty. It is worth recalling here the main obligations arising from the duty of diligence, which include, inter alia, the directors' duty to inform themselves and prepare appropriately for the meetings of the Board and the sub-committees to which they belong; to attend meetings and participate actively in debates, so that their opinion makes an effective contribution to the decision-making process; to undertake any specific task assigned to them by the Board within their commitment of dedication; to notify company management any irregularity coming to their attention; and to monitor any situations of risk which may arise and, for this purpose, to move to call extraordinary Board meetings or include the appropriate items on the agenda of the next meeting to be held.

8.2. Conflicts of interest.

One of the items which receives the least attention in Spanish corporate practice yet which is, at the same time, one of the most relevant in fostering good governance in companies which obtain capital on the financial markets is the establishment of clear rules for handling conflicts of interest, i.e. those cases where the company's interests clash with the director's (direct or indirect) personal interests. The Commission considers that at least two fundamental rules should be established in order to deal clearly with this matter.

The first is that directors should abstain from attending and from participating in debates affecting matters in which they have an interest, including most particularly all discussions regarding their re-appointment or removal.

The second is based on the need to limit professional or commercial transactions between the director and the company, and to surround any such transactions (whether direct or indirect) with the maximum safeguards, since they may be very dangerous for the company's interests. To this end, the Commission considers that the company's internal regulations should formally establish the director's duty to provide advance notice of any conflict of interest and establish a control mechanism which could consist (in line with best practices) of the requirement that such transactions be approved by the Board based on a report by the appropriate sub-committee. It would also be advisable for such transactions to be disclosed publicly.

8.3. Non-public information.

With regard to company information to which the directors have access, the Commission recommends that the company's internal rules expressly impose obligations of confidentiality and passivity.

The obligation of confidentiality requires the director not only to keep in confidence the debates of the Board and any sub-committees of which he is a member but also to refrain from disclosing any information to which he has had access in the course of his work.

The obligation of passivity obliges directors not to make use of the company's confidential information for private purposes. This is evidently not an absolute obligation since, if the use of the information will have no effect on the company, there is no reason to deprive the director of the opportunity of using it; however, the companies to which this report is addressed are advised to regulate the procedures to follow in case of doubt as to whether or not the use of the information is detrimental to the company. In no event may such information be used to acquire or sell company securities or engage in any type of speculation with such securities.

8.4. Use of corporate assets and business opportunities.

The duty of loyalty has ramifications on many other planes which are not always duly clarified in Spanish corporate practice and in connection with which a certain relaxation of good practices is sometimes observed. The first item which the Commission recommends companies to address and to expressly regulate is the use by the directors of the company's assets, the aim being to prevent them from being used exclusively for private purposes and to prevent directors from obtaining patrimonial advantages.

The second matter relates to what are termed "business opportunities". The Commission includes under this heading any possibility of making an investment or a commercial transaction which arises in connection with the director's position as such. We recommend companies to adopt clear rules preventing directors from using a business opportunity corresponding to the company for their own benefit or that of their circle. As always, exceptions will be admitted. In this connection, we feel it is satisfactory if the rule allows a director to exploit a business opportunity of the company provided that the company has had first refusal on the opportunity and rejected it and the corresponding sub-committee has given its approval.

8.5. Duty to notify.

The duty of loyalty also implies the obligation on directors to disclose personal situations and those of their closest relatives and of companies in which they play a significant role, regarding shareholdings, offices and activities at other companies and entities, syndication agreements to which they are party and, generally, any fact, situation or link which might be material to their loyal actions as directors of the company. The Commission recommends that these obligations, some of which are already contained in the securities market legislation, should be formally reflected in the company's internal regulations.

8.6. Extension of fiduciary duties to significant shareholders.

As stated before, the ownership structure of the companies in our stock market is characterised by a considerable concentration of capital and, therefore, a strong presence of significant shareholders (i.e. shareholders which, either individually or jointly, are capable of influencing the control of the company). Recognition of this reality led us to encourage the participation of these shareholders in the Board (domanial directors) and leads us now to recommend the adoption of measures to eliminate or, at least, attenuate the risk that they may make use of their privileged position to obtain special advantages, be they informational, contractual or patrimonial. These measures should be based on the duty of fidelity, which also applies to significant shareholders because of their special position in a listed company. Consequently, the Commission recommends that the Boards of Directors of the companies to which this Report is addressed should adopt or encourage the adoption of safeguards or guarantees similar to those obtaining for directors, particularly in connection with conflicts of interest and the use of non-public information. For guidance, the Commission suggests three basic rules.

The first is a rule of competence, under which the Board of Directors formally reserves the right to clear any direct or indirect transaction between the company and a significant shareholders, with the provision that in no event will it approve such a transaction without first considering the opinion of the sub-committee which is deemed most appropriate, and that such sub-committee must evaluate the transaction from the standpoint of equal treatment for all shareholders and of market conditions. In the case of ordinary transactions, a generic authorisation of the line of transactions and their conditions of execution should be sufficient.

The second rule relates to transparency, whereby the Board of Directors is obliged to disclose in the company's annual report any transactions with significant shareholders (volume of transactions and nature of the principal ones) so that all parties may know their scope and importance.

The third rule relates to abstention, and would oblige significant shareholders to abstain from voting in decisions of the Board in which they have a direct or indirect interest (e.g. defensive measures against a hostile take-over bid).

Regarding the use of non-public information, the Commission has detected concern in the markets regarding the asymmetrical distribution of information among shareholders and the access to confidential company information by significant shareholders. The Board of Directors should be watchful for this type of situation in order to determine whether there have been anomalies or leaks and to claim the related liabilities. In any event, it might be recommendable to extend to significant shareholders the duty of confidentiality and the duty not to make use of privileged information.

9. THE BOARD OF DIRECTORS AND THE SHAREHOLDERS

9.1. Limitations of the Shareholders' Meeting.

Although an examination of the role of the Shareholders' Meeting, as the shareholders' forum for expressing their views and passing judgement on the conduct of the company's business, goes beyond this Commission's brief, it cannot be ignored that the efficacy of the Shareholders' Meeting as an instrument of control and decision-making in listed companies is subject to many structural limitations. Experience shows that the bulk of ordinary shareholders take no part in the Shareholders' Meeting; and science also teaches that this attitude is economically comprehensible on the grounds of "rational apathy" (the cost of participating in the meeting is often greater than the benefit to be obtained) and "collective action" (it is not possible to co-ordinate the individual initiatives of scattered shareholders and there is no incentive to expend efforts from which mainly others will benefit). Consequently, it is not surprising that the Shareholders' Meeting is often reduced to a mere formality or a routine affair.

The reform movement of which this Report is a part, whose aim is to promote the Board as a supervisory body, arises to a great extent from the realisation of the Shareholders' Meeting's scant disciplinary efficacy. This being the case, this Commission has its doubts as to the effectiveness of certain policies aimed at reactivating the Shareholders' Meeting by stimulating shareholder participation (creation of shareholder committees, ability of shareholders to call Shareholders' Meetings, payment of meeting attendance fees, etc.). This does not mean, however, that no steps should be taken to make shareholder control more effective, and this is an area where this Commission feels there is ample scope for action. We refer basically to measures which provide greater transparency in the mechanism of proxies; enhancement of corporate communications to shareholders; and stimulation of activity by those investors which can contribute most to management control, namely the institutional investors.

9.2. Proxies.

It is incontestable that the floating capital's participation in Shareholders' Meetings is channelled through proxies in the vast majority of cases. It is also known that the protagonism in this area is split between the share depositories and the company's management, which has the resources required to obtain proxies (publication of proxy forms, propaganda, postal services, etc.). Consequently, it is not surprising that fears have arisen regarding the possibility that the agent which controls this process can also control the Shareholders' Meeting. Thus, there is an understandable concern which has often led to the implementation of very drastic measures, such as transferring the management of proxies in listed companies to a government agency or a committee of shareholders (formed, for example, of the company's fifteen or twenty largest shareholders, each with one vote).

The Commission places little reliance on the usefulness or advisability of this type of measures, which may lead to further bureaucratisation of management and generate new conflicts. However, this does not mean that we recommend resigned acceptance of the *statu quo*. In fact, we are of the opinion that the most widespread proxy systems in place in Spain could be improved substantially, and we invite Boards of Directors to reflect on this area. There are numerous models for inspiration in the more developed markets. In our opinion, efforts should be directed basically at improving transparency and, in this connection, we believe that it would be very positive for voting proposals in proxy forms to be justified in much greater detail (at least in connection with the adoption of agreements where proxies are of some importance) and for any conflicts of interest to be disclosed. It is clear, for example, that where there is a proposal to implement defensive measures against hostile take-over bids, it should be indicated if the Board of Directors is split on the subject. Additionally, it might be desirable to promote measures which facilitate the obtaining of proxies by significant groups of shareholders.

9.3. Communications with the shareholders.

Shareholders' frequent absenteeism plus the limitations of the Shareholders' Meeting as a forum of communication between the company and its shareholders may justify additional efforts to create other more flexible communication channels or instruments. Very varied recommendations have been made by the institutions and committees which are most active in this area. Some have suggested that the Board should write to all shareholders after each Shareholders' Meeting to summarise the debates and describe the results. It has also been suggested that companies hold decentralised information seminars (e.g. at regional or provincial level) for shareholders, or that they should issue periodical circulars informing shareholders of the company's progress, its plans and, very particularly, matters relating to corporate governance. To the same end, it has also been suggested that, in addition to the standard information provided by the company in its annual, half-yearly and quarterly disclosures, it should arrange meetings with stock market analysts, who can relay these experiences to investors. We also consider any proposals aimed at creating "Shareholder information offices" to be very interesting. The aim pursued by these measures would be to create channels for ongoing communications with shareholders which complement those the legal right to ask questions at the Shareholders' Meeting, so that the desired information can be obtained from the company at any time. This system is also advantageous for the Board since it provides it with an additional instrument for gauging its shareholders' concerns.

The Commission is aware that any of the measures listed above have a very limited scope. In this connection, we do not propose to issue a precise recommendation but merely to inform the persons in charge of listed companies of the need to experiment and develop new formulae for communication and cohesion which can boost shareholder confidence in the companies in which they have invested. The Board of Directors must naturally consider the costs to the company of implementing such initiatives and judge whether they are justified from the standpoint of their usefulness in achieving good governance.

9.4. Institutional investors.

This chapter on relations between the Board of Directors and the shareholders would not be complete without a reference, however brief, to institutional investors (investment funds, pension funds, insurance companies, etc.) since, although they have not attained the same prominence in Spain as they have in other countries, they have been increasing spectacularly in importance and accounted for around 25% of investment in the stock market last year. Institutional investors play a very important role in the governance of listed companies since the interests of their policyholders, unit-holders, investors, etc. coincide with those of ordinary shareholders to a great extent.

It is well known that institutional investors, both domestic and foreign, have traditionally not evidenced much interest in playing an active role in companies either through representation on the Board or through participation in the debates and votes at Shareholders' Meetings. They often prefer to keep their options open so as to be able to divest the company when they see fit. In short, they prefer liquidity to control. Nevertheless, as the volume of their investments increases and, consequently, a quick divestment becomes more difficult (particularly in relatively shallow markets like Spain's), these passive policies will foreseeably change, and there are already signs of this development.

It is beyond the scope of our brief to guide the policies of institutional investors by recommending greater involvement in corporate governance, although we do feel that such active policies should be welcomed by the Boards of listed companies. In any event, it is recommendable for Boards to adopt policies of communication with institutional investors. Specifically, this Commission believes that the Board should foster regular contacts with institutional investors to exchange opinions and establish a channel to enable them to provide valuable information to company management for the purpose of developing business and governance strategies. We are not unaware that implementing these initiatives always involves the risk of access to sensitive information, and this may reduce the freedom to divest of institutional investors which do not plan to maintain their investment. Nevertheless, these are minor risks which can always be palliated by drafting some rules of conduct.

In any event, regardless of the policy for participation which is adopted in each individual case, the Commission relies on an increasing commitment by institutional investors with the promotion of rules for good governance and, in this connection, it invites them to disclose their preferences regarding the workings of Boards of Directors and to make use of their influence to promote or favour their adoption by the companies in which they invest.

10. RELATIONS BETWEEN BOARDS AND MARKETS

10.1. Transparency.

The principle of transparency and the need to safeguard investors' interests require special attention from the Boards of Directors of the companies to which this Report is addressed. The policy of informational transparency imposes on these companies the obligation to provide the market with accurate, reliable information about their activities and results. The Board of Directors of a listed company should be aware of this responsibility and, consequently, of its obligation to play an active role in this connection.

The reporting obligations of listed companies are regulated, often in great detail. In other cases, the rules confine themselves to establishing generic duties whose compliance entails greater demands and more responsibility. In any event, this Commission recommends that Boards of Directors exercise the utmost zeal in offering immediate and sufficient information not only on events which are capable of significantly affecting the formation of prices on the stock market but also on those which affect the company's ownership structure (particularly variations in significant holdings and syndication pacts and other forms of coalition); on those which entail a substantial modification of the rules of governance (this is in addition to that whose provision is recommended in point 12.2); on related-party transactions of particular importance (transfers within the group and with parties related to members of the Board of Directors); and on transactions affecting the company's equity. In connection with the latter point, the Commission wishes to underscore the need for extreme rigour with respect to the matter of own shares. Transactions with own shares are widespread in practice and, in fact, may be advisable on many occasions. Nevertheless, given the inherent dangers, they should be subject to the maximum transparency. When a company proposes to conduct a major operation in this area, whether through one or a series of transactions, it should disclose its plans so that the orders reaching the market will not be misinterpreted.

From the procedural standpoint, the application of the principle of transparency makes it advisable that Boards of Directors take responsibility for the full content of all material information conveyed to the markets.

10.2. Regular financial reporting.

The annual financial information is a fundamental element in the policy of transparency and, consequently, the law surrounds its preparation with all types of safeguards, including verification by an external auditor. Nevertheless, capital markets need more frequent flows of information, hence the obligation imposed by capital market regulations to provide information at half-yearly and even quarterly intervals; moreover, prudence often requires financial information to be disclosed at more frequently still. In all these cases, the maximum homogeneity and reliability should be the guiding principles. Consequently, we recommend that the financial information released to the markets should be drafted under the same principles, criteria and professional practices as used for the annual accounts so as to ensure transparency when conveying to markets and investors the "picture of the activity, results and reasonable continuity" of the company. Experience shows that quarterly or half-yearly reports may suddenly be contradicted by the annual accounts, which can be very detrimental to investors who previously placed reliance on interim information which was not rigorously drafted. Without going so far as to recommend that interim information be subjected to external audit (not even a less rigorous audit), it would be advisable that such information be reviewed beforehand by the Audit Committee.

11. RELATIONS BETWEEN THE BOARD AND THE AUDITORS

11.1. The role of the Audit Committee.

The audit of the annual accounts is an element of capital importance within the system of controls over limited companies. Auditors are called upon to verify the financial statements prepared by the management team and, in this connection, they acquire important obligations. The Board of Directors must take the necessary measures to ensure that the auditors discharge their duties correctly and, particularly, that they are free from interference by the executive line. One of the principal measures in this connection is the establishment of an Audit Committee with the features and powers discussed above (3.6). To discharge its duties, the Committee must be given at least the power: (a) to propose the appointment of the auditor, the conditions of his contract, the scope of his professional mandate and, where appropriate, the rescission or non-renewal of the appointment; (b) to review the company's accounts, to oversee compliance with the legal requirements and the correct application of generally accepted accounting principles, and to issue opinions on proposals by management to modify the accounting principles and criteria; (c) to serve as a channel of communication between the Board of Directors and the auditors, to evaluate the results of each audit and the responses from the management team to its recommendations, and to mediate and arbitrate in the event of discrepancies between management and the auditor in connection with the principles and criteria which are applicable in preparing the financial statements; (d) to check the suitability and integrity of the internal control systems and to review the designation and replacement of the persons in charge of them; (e) to supervise compliance with the audit contract and to procure that the auditor's opinion on the financial statements and the main contents of the auditor's report are drafted clearly and precisely.

11.2. Auditor independence.

Shareholders' and markets' main concerns in this area focus on the auditor's effective independence. It is beyond our brief to examine the propriety of adopting new regulations in this area and to determine their orientation and content. However, it is our impression that, in general terms, the best guarantee of independence lies in the reputation of the audit firms, since they all have strong commercial reasons for preserving and increasing that reputation. Nevertheless, it cannot be ignored that auditors are occasionally subjected to pressure to relax their standards and, consequently, it would appear advisable to recommend Boards of Directors and Audit Commissions to be vigilant for such situations in audit firms which might be indicative of a situation of risk. It is recommended specifically that they check the auditor's degree of diversification and refrain from hiring audit firms where the fees they would collect from the company would amount to a significant percentage (e.g. over 10%) of their total revenues. It is also frequent for audit firms to provide other professional services to companies (e.g. consulting, legal advice, etc.). Although this Commission considers such practices to be perfectly legitimate, it recommends the adoption of certain safeguards, such as the inclusion of the revenues from those other services when calculating the auditor's degree of diversification, and the disclosure of the fees paid by the company to its audit firm for services other than auditing.

11.3. Audit exceptions.

The evidence available to us reveals that a large number of the opinions issued by the external auditors of the companies listed in our markets contain reservations or qualifications regarding the financial statements subjected to verification (an average of 27% were qualified in the last three years). The Commission considers that this is an anomalous situation without parallel in other developed markets and which must necessarily be remedied. It is expected that the greater rigour in the preparation of the accounts attained through the creation of Audit Committees will help to overcome this problem. However, in any case, we would urge Boards of Directors to avoid these situations, which cause a considerable degree of perplexity among investors. Where the situation is insurmountable, the Audit Committee should seek to ensure that both the Board of Directors and the auditors report clearly on the discrepancies and explain their content and scope to the shareholders and the markets.

12. ADOPTION AND PUBLICATION OF THE RULES OF GOVERNANCE

12.1. Voluntary nature.

The reflections and recommendations contained in this Report are basically for guidance purposes. The Commission considers that they should not be included in legislative regulation nor imposed upon the parties to which they are addressed, not even indirectly through systems controlling their adoption which might distort the voluntary nature of the Code of Good Governance. In our opinion, companies' freedom and autonomy must be fully guaranteed, since our companies' capacity to adapt to the internal and external situations which they must face depend greatly on those two factors. Additionally, each company is unique and, as such, should not be deprived of its sovereignty to design its own structures of governance in accordance with its preferences, circumstances and idiosyncrasies. Imagination and innovation are forces which should also be encouraged in this area, rather than merely establishing limitations against the risk of immobility.

However, we trust that our recommendations may be useful in general in raising the standards of corporate governance in Spain. Based on best practices while also taking account of the distinguishing features of Spanish corporate practice, they will be particularly useful for companies which feel that the value of the organisation increases if it raises its level of control, transparency and, in short, its willingness to explain and justify its decisions. Moreover, the criteria and rules contained in this Report have been designed with a view to being applied flexibly and imaginatively rather than mechanically, as an onerous formality. Good governance is not assured with the mere external appearance of formalities and procedures; rather, it requires the will to accept the philosophy and principles inspiring its rules.

12.2. Publicity.

The question of corporate governance is undoubtedly very relevant, as shown by the available experience. Experts in the area, analysts and fund managers generally feel that the standards of corporate governance are very important when considering investment decisions, and this impression is confirmed by opinion polls. Companies should be transparent in order to facilitate evaluation by the markets of their governance systems. Consequently, we advise listed companies to report publicly on such systems, and to ensure that the Board's Compliance Committee, whose basic purpose is to evaluate the efficiency of the rules for control and decision-making and to oversee their compliance, should participate in preparing that information.

The goal is to ensure that the Board of Directors includes its rules of governance in the information which it discloses annually. It is very advisable for companies to justify any decision not to follow the recommendations of the Code of Good Governance which is the result of our Report. This requirement for justification will also encourage companies to reflect regularly on their governance structures and will stimulate them to adapt to market demands, with the resulting improvement in their credibility.

III. CODE OF GOOD GOVERNANCE

GENERAL CONSIDERATIONS

1. This Code is based on the considerations contained in the preceding report on the Board of Directors, which are a reflection (and, at the same time, an invitation to readers to reflect) on the most important questions arising today in the sphere of corporate governance.
2. The Code is addressed principally to Spanish companies which are listed on the stock markets and, particularly, to those where floating capital comprises a majority of their capital stock.
3. The Code formulates recommendations which seek to synthesise measures or practices of good governance in the current stage of development of Spanish companies. The aim is not to propose rules of objective law but to offer for consideration by the companies to which this Report is addressed a catalogue of measures which companies, using the free will and power of self-governance provided to them under our legislation, may incorporate into their bylaws or rules of operation. Given the relativity and flexibility with which the recommendations are drafted, the companies which choose to accept them may also adapt them to their own characteristics and circumstances.
4. The recommendations focus on Boards of Directors and are inspired by principles of accountability (including Board transparency and accountability) and efficacy, in the service of the corporate interest defined in line with the rule of creating shareholder value.

RECOMMENDATIONS

The companies to which this report is addressed are recommended to consider the following measures:

1. The Board of Directors should expressly assume the general supervisory function as its core mission, exercise the corresponding responsibilities exclusively and indelegably and establish a catalogue of the matters which are its exclusive competence.
2. The Board of Directors should include a reasonable number of independent directors who are prestigious professionals with no links to the management team or the significant shareholders.
3. In the composition of the Board of Directors, the non-executive directors (both domanial directors and independent directors) should have an ample majority over executive directors, and the proportion between domanial directors and independent directors should take account of the ratio between the significant holdings in capital and the other shareholders.
4. The Board of Directors should adjust its size to achieve more efficiency and participation. In principle, the size could range from five to fifteen members.
5. If the Board chooses to combine the offices of Chairman and CEO in the same person, it should adopt the necessary safeguards to mitigate the risks of concentrating power in a single person.
6. The figure of Secretary of the Board should be made more important and given more independence and stability, and his function of ensuring the formal and material legality of the Board's actions should be highlighted.
7. The composition of the Executive Committee, if there is one, should reflect the same balance as in the Board between the various classes of director, and the relations between the two bodies should be inspired by the principle of transparency so that the Board of Directors has full knowledge of the matters discussed and the decisions made in the Executive Committee.
8. The Board of Directors should create sub-Committees for control purposes, composed exclusively of non-executive directors, to deal with matters of accounting information and control (Audit Committee), the selection of directors and senior executives (Nomination Committee), the determination and review of remuneration policies (Remuneration Committee) and the evaluation of the governance system (Compliance Committee).
9. The necessary measures should be adopted to ensure that directors have sufficient specifically-prepared and oriented information sufficiently in advance to prepare for Board meetings, and the importance or confidentiality of the information may not justify breaches of this recommendation except in exceptional circumstances.
10. To ensure the good working of the Board, it should meet as often as necessary to fulfil its mission; the Chairman should encourage all directors to participate and take positions; particular care should be taken in drafting the minutes; and the quality and efficiency of the Board's work should be evaluated at least once per year.
11. The Board's participation in the selection and re-election of its members should conform to a formal, transparent procedure based on reasoned proposals from the Nomination Committee.
12. Companies should establish in their regulations the obligation for directors to resign where they may have a detrimental impact on the working of the Board of Directors or on the company's prestige and reputation.
13. An age limit should be established for the position of director, which could be sixty-five to seventy for executive directors and the Chairman and somewhat more flexible for other members.
14. The right of every director to request and obtain the necessary information and advice to enable him to fulfil his supervisory functions should be formally recognised, and the appropriate channels for exercising this right should be established, including the possibility of engaging external experts in special circumstances.
15. The director remuneration policy, whose proposal, evaluation and review should be assigned to the Remuneration Committee, should conform to criteria of moderation, be commensurate with the company's performance and be disclosed in detail on an individual basis.

16. The company's internal regulations should detail the obligations arising from the directors' general duties of diligence and loyalty, with particular attention being given to conflicts of interest, the duty of confidentiality, and the use of the company's business opportunities and assets.
17. The Board of Directors should foster the adoption of appropriate measures to extend the duties of loyalty to the significant shareholders and, in particular, establish safeguards covering transactions between significant shareholders and the company.
18. Measures should be taken to provide greater transparency in the mechanism of proxies and to promote communication between the company and its shareholders, particularly institutional investors.
19. The Board of Directors should go beyond the reporting requirements of the current legislation and undertake to provide the markets with fast, accurate and reliable information, particularly with regard to the shareholder structure, substantial modifications in the rules of governance, related-party transactions of particular importance and transactions with own shares.
20. All the periodical financial information, in addition to the annual report, which is released to the markets should be drafted under the same professional principles and practices as the annual accounts and should be verified by the Audit Committee before release.
21. The Board of Directors and the Audit Committee should monitor situations which might jeopardise the independence of the company's external auditors and, specifically, they should verify the percentage of the audit firm's total revenues represented by the fees paid to it under all headings, and professional services other than auditing should be publicly disclosed.
22. The Board of Directors should endeavour to ensure that the accounts drafted by it and submitted to the Shareholders' Meeting should be free of audit qualifications and, where this is not possible, both the Board and the auditors should explain clearly the content and scope of the discrepancies to the shareholders and the markets.
23. The Board of Directors should include information about its rules of governance in the annual report, and justify any departures from the recommendations of this Code.