

## CORPORATE GOVERNANCE REPORT FOR 2011

The Third Swedish National Pension Fund (AP3) is part of the national pension system. Our mission is to invest our assets to achieve the best possible benefit for the pension system by achieving high returns at a low level of risk. We use our influence as an investor to help us achieve that goal. The legislation<sup>1</sup> regulating AP3's operations requires us to disregard economic and business policy considerations in our investment decisions. We are, however, required to observe high standards of environmental and social responsibility in our investment activities, without compromising the goal of securing high returns. Our mandate gives us a unique opportunity to exercise influence as an independent institutional shareholder in the equity market. As part of the national pension system, we are fully autonomous from other investors and business interests. This independence makes us well placed to earn respect for our role as an investor and underpins our credibility and ability to advocate our stance in specific issues.

AP3 is required by Parliament to publish a corporate governance policy. The policy is approved by the Board of Directors and communicates our positions on corporate stewardship and related issues. The policy is updated regularly and published on the AP3 website at [www.ap3.se](http://www.ap3.se). In April 2011 we updated the policy with a clarification on our core values.

It is not always practicable to provide detailed reports of our discussions with other investors, nomination committees, corporate managements and boards, primarily because we believe confidential dialogue is often the most effective way to communicate our views. We aim to exert influence at an early stage in the process, usually ahead of the AGM season. Only if a company board or nomination committee has not responded to our comments do we consider raising the issue at the AGM or voting against a resolution. AP3 believes that active stewardship makes a positive contribution over the longer term to our primary goal of obtaining high investment returns. We also believe that it helps to build trust and confidence in AP3 – an important factor, especially in times of instability on financial markets.

Our aim is to report, as openly as possible, our governance engagements and focus areas during the year. To that end, we are pleased to present our annual governance report for the 12 months ended 30 June 2011.

### CORPORATE GOVERNANCE AT AP3

We aim at all times to adjust our stewardship to the conditions dictated by our overall strategy. AP3 manages a highly diversified listed equity portfolio of SEK 110 billion,<sup>2</sup> invested in more than 4,000 companies worldwide. Our foreign equity holdings are small and we rarely control more than 0.05 percent of the voting rights in any one company.

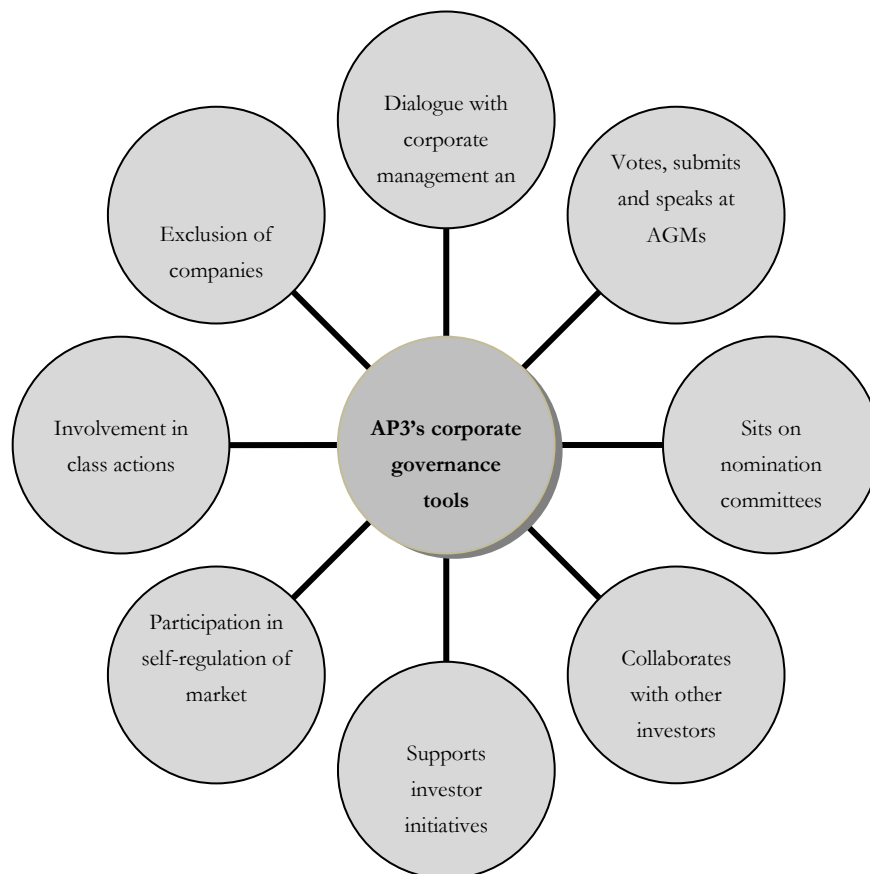
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<sup>1</sup> Swedish Pension Funds Act of 2000

<sup>2</sup> As of 30 June 2011.

We have gradually altered the structure of the Swedish equity portfolio, which formerly included small and mid cap equities and now primarily invests in the larger companies listed on the Stockholm Stock Exchange. This change has reduced the size of individual equity interests in the Swedish portfolio, though the holdings remain considerably larger than in the foreign equity portfolio. In the Swedish equity portfolio, we hold more than 0.5 percent of the voting rights in over 60 companies. In half of these, our share of ownership exceeds 1 percent. Only in five companies does our share of the voting rights exceed 3 percent. We are a mid-sized Swedish institutional investor with a Swedish equity portfolio worth approximately SEK 32 billion at 30 June 2011.

AP3 prioritises active governance in entities where our equity holdings are relatively large, which for us means mainly Swedish companies. We also prioritise taking an active role in the debate on corporate governance guidelines in Sweden's equity market.



**AP3'S MAIN GOVERNANCE TOOLS ARE:**

- The Swedish system of shareholder-appointed **nomination committees** is unique internationally. In most other countries, the nomination committee is a sub-committee of the board. The Swedish model has attracted growing international interest in recent times. Nomination committees are arguably best placed to influence governance because they nominate board members. Nomination committees in Sweden are usually composed of representatives of the three to five largest shareholders. However, the relatively small size of most of AP3's portfolio holdings means AP3 generally exercises stewardship through other

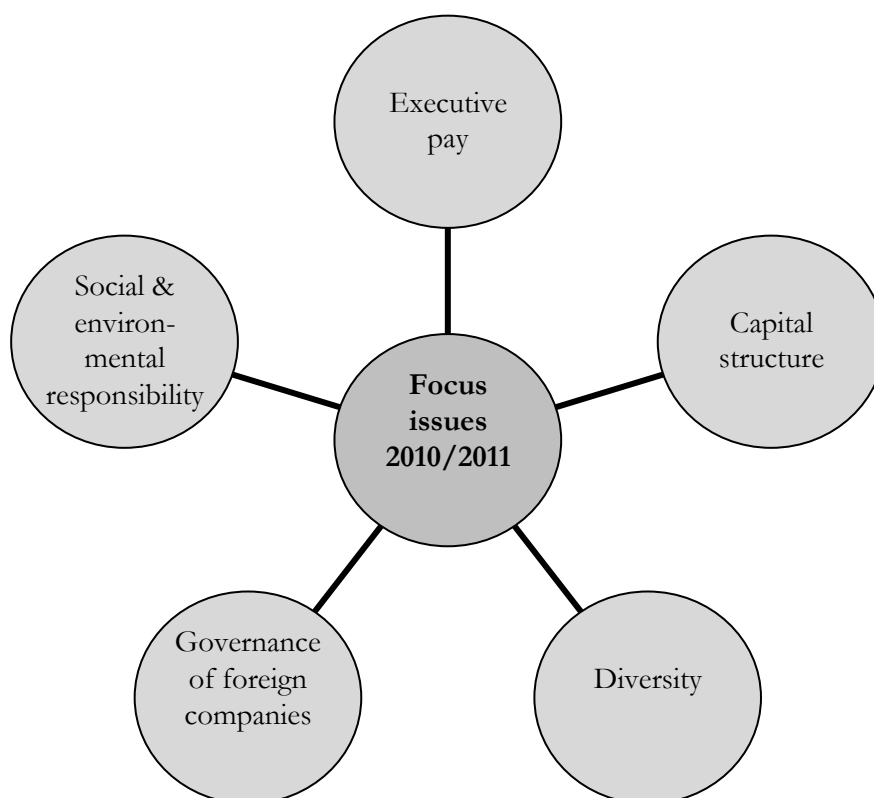
channels. At the start of the 2011 AGM season we had seats on eight nomination committees: the Norwegian medical technology company Diagenic, Swedish medical technology companies Karolinska Development, Orexo, BioInvent and Cellavision, Arise Windpower, Alpcot Agro, and private equity timberland company Bergvik Skog.

- **Dialogue with corporate managements and boards** is a constructive way to communicate our views on corporate governance. Companies often contact institutional investors like AP3 before the AGM to discuss proposed resolutions, particularly in respect of remuneration schemes. On occasion, we also initiate dialogue with the companies themselves when important issues need to be discussed.
- We seek to exercise our **voting rights at AGMs** in such a way as to generate higher portfolio returns. Going into this year's AGM season, we chose to focus our stewardship on a group of 50 or so companies. We also voted at the AGMs of around 400 companies in the foreign equity portfolio.
- **Raising issues at AGMs** is a key governance mechanism. We are always prepared to speak at AGMs to explain our position on specific issues, ask questions and – where appropriate – express criticism.
- **Contacts with foreign shareholders** are gaining in importance as these investors become increasingly active voters at Swedish AGMs. Working alongside other institutional investors, AP3 operates a proactive communications strategy to promote understanding of the Swedish governance model abroad.
- **Environmental and social responsibility** is a key focus area for AP3 in a governance context and we engage continuously with Swedish companies in this context. We also hold dialogues with foreign companies alongside AP1, AP2 and AP4 under the auspices of our joint Ethical Council.
- **Cooperating with other investors** on issues of environmental and social responsibility has become increasingly important as a way to make our stewardship more effective and obtain maximum impact. We channel much of our cooperation with other investors through the Ethical Council.
- **Playing an active role in developing the self-regulatory system** for the Swedish equity market is natural for AP3 and we do so through our membership of the Institutional Owners Association for Regulatory Issues in the Stock Market, where we join other institutional investors in discussing issues relevant to the Swedish corporate governance model. AP3 also supports a range of initiatives to make it easier for investors to make their voice heard abroad, for instance via our membership of the ICGN.<sup>3</sup> The ICGN issues guidelines on responsible investment to protect investors' rights.

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<sup>3</sup> International Corporate Governance Network.

- AP3 also supports **investor initiatives** to increase corporate transparency, improve environmental reporting and promote corporate social and environmental responsibility, primarily via the Ethical Council.
- **Participating in and monitoring class actions** is becoming increasingly common, especially in the United States. Class actions are lawsuits in which people collectively bring a claim to court and where the court's judgement is binding on all parties. Class actions are brought most frequently in consumer-related matters but are also becoming more widespread in the financial market. Most class actions are settled before reaching court and settlements often involve defendant companies taking steps to improve governance. Thus, investors can use class actions to improve the stewardship of companies that violate rules or standards. AP3's custodian bank keeps track of settlements payable to us through class actions. In 2006-2010 AP3 received payouts of SEK 92 million from various lawsuits. SEK 9.5 million of this was paid to us in 2010.



### **FOCUS ISSUES AT AGMS IN 2011**

AP3's corporate governance strategy prioritises initiatives most likely to contribute to our primary goal of achieving high investment returns and our secondary goal of ensuring public confidence in us as a pension fund. For the 2011 AGM season we focused on five areas:

## **Executive pay**

Remuneration is a major and important part of AP3's governance work. Since inception in 2001 we have taken a conservative line on executive pay and placed clear demands on share-based incentive programmes. The corporate governance policy states clearly that variable remuneration should be linked to predetermined and measurable performance criteria and should be limited in scope and subject to defined ceilings. The policy also calls for regular evaluation of variable remuneration systems, principles and distributions. We share the same interests as the companies in which we invest, namely creating conditions for optimal returns over time on our investments. Remuneration plans for senior executives should therefore be structured as a cost-effective reward for long-term value creation. AP3 believes corporate boards should be responsible for setting executive pay levels and guidelines. As an investor, it is always important that we base our approach on the company's best interests as this is the optimum way to create long-term value for shareholders. We believe dialogue with company representatives and other shareholders is the best route to make our voice heard. Over the years we have written to companies in our portfolio on a number of occasions to make clear our views on remuneration policy and also engaged companies in direct dialogue.

## **Board diversity**

AP3 promotes diversity on the boards of listed companies. We believe that boards should possess a broad spectrum of experience. We push for companies to offer directorships to candidates from beyond the established networks and for directors to be selected from a wide range of potential candidates. Women currently hold 24 percent of the seats on the boards of listed Swedish companies, a 300 percent increase in eight years and confirmation that the process of change is advancing, albeit slowly. It is noteworthy that the percentage of female directors in the seven companies that have made initial public offerings in the past 12 months is 32 percent, indicating a willingness to embrace change. This willingness is needed, especially because 23 out of the 229 companies listed on the Stockholm stock exchange have no female directors. Equality may not be one of AP3's focus issues, but we are keen to see an increase in female board representation as we believe this would have a positive impact on corporate performance. The pace of change naturally depends on how women fare in other areas of society. There is a pressing need, for instance, for more senior female managers at Swedish companies to broaden the base for board recruitment. The prime responsibility here rests on the companies and their shareholders. Nomination committees should be tasked with handling the issue of increased female board representation. AP3 does not consider quotas as an optimal solution to the problem on free market grounds. It is up to shareholders, who bear the risks of the business, to choose the people to lead the company. The threat of quotas has nevertheless created pressure for change, which is to be welcomed.

## **Capital structure of Swedish companies**

The issue of corporate capital structure is always high on AP3's agenda. Considerations here include the appropriate level of profit distribution to shareholders, how new share issues should be structured, and the feasibility of share buybacks. Buybacks are today a common and widely accepted method of transferring capital to shareholders. Companies often recommend buybacks as an effective way to optimise the capital structure, create shareholder value, guarantee incentive programmes, use equity capital to fund acquisitions or transfer excess liquidity more tax-efficiently compared to traditional dividends. Most companies typically seek a buyback mandate (usually for a maximum of 10 percent of the outstanding shares) whether or not they have used such a mandate in the past or plan to in future. AP3 generally makes little comment on buyback mandates, other than to point out that they should focus on buying back the cheapest equity class.

## **Environmental and social responsibility**

AP3 believes there is a connection between corporate ethics and the capacity to deliver long-term shareholder value. We apply environmental and social responsibility mainly by screening companies to ensure they are not in breach of international conventions. We also engage companies in dialogue and support joint investor initiatives.

## **Corporate governance in the foreign equity portfolio**

Demands are steadily growing for institutional investors to take an active role in the stewardship of companies in which they own shares. Last year the UK introduced the *UK Stewardship Code* in an attempt to promote increased commitment to governance among institutional investors and thereby improve the governance of listed UK companies. The increased commitment involves shareholders publishing a governance policy, voting at AGMs and communicating their views on various topics to the companies concerned. The code is based on adherence to general principles rather than detailed regulations and for this reason AP3 intends to follow the code. An initiative to harmonise corporate governance in Europe is also under way at European Union level. Last year the European Commission published a *Green Paper on Corporate Governance in Financial Institutions* and this year the Commission distributed a questionnaire that may be used to draft a more general code covering all listed companies. AP3 has joined other Swedish institutional investors via the Institutional Owners Association for Regulatory Issues in the Stock Market in submitting a response to the Commission in which we question the need and motivation for such an expensive regulatory structure.

Most of our foreign equity portfolio is managed by external managers, to whom we used to delegate our voting rights in the past. However, we are expanding our direct voting in the global equity portfolio as part of our extended commitment to corporate governance. Direct voting builds trust in AP3's governance and will help us in the long run to achieve higher returns in the equity portfolio. Our current target is to vote at the AGMs of 500 of our foreign portfolio companies. This figure is likely to rise over time. In the first half of 2011 we voted at 400 foreign AGMs.

## **VOTING AT SWEDISH AGMS IN 2011**

AP3's equity holdings vary over time and this year the portfolio held investments in 118 Swedish companies with an average size of 0.9 percent of the equity and voting rights. Our holdings differ in size from company to company and in some cases are much higher. For instance, we hold stakes of 5 percent in several life science companies. It is not possible for practical reasons to attend and vote at the AGM of every company in our Swedish portfolio and we therefore have identified a group of 50 or so companies where we are active and exercise our voting rights. We use several criteria when selecting this group:

- Our 25 largest portfolio holdings.
- Companies with market capitalisation above SEK 100 million and where our equity interest exceeds 1 percent.
- Life science companies with market capitalisation above SEK 10 million and where our equity interest exceeds 2 percent.
- Companies with contentious agenda items or which we have engaged in dialogue.
- Investment companies.

In the 2011 AGM season AP3 attended and voted at 48 AGMs and voted remotely at a further six. We also attended four EGMs, at which capital procurement was the main agenda item as companies including Industrivärden, Orexo and Alpcot Agro sought approval for new share issues.

### **Focus on executive pay**

As usual, remuneration was the most time-consuming agenda item. More and more companies are introducing long-term share-based incentive schemes for their employees and virtually all this year's proposals met AP3's requirements for such programmes. Today's incentive schemes are almost always performance-based and contain a fixed limit on benefits. They generally also include an element of risk on the part of the beneficiary in the form of a financial investment and usually represent a known and limited cost to shareholders. Companies nowadays present their proposals professionally and often provide shareholders with an evaluation of past programmes.

### **Dialogue on share matching**

Many incentive programmes that require a financial investment from the beneficiary contain an element of share matching, which results in the actual risk to the beneficiary being very limited or even non-existent. In many cases, the share price can fall by 50 percent without the participants losing money, meaning that their only link with other shareholders is in a rising market. AP3 therefore takes the view that boards should carefully consider share matching structures when drafting proposed plans. What is an optimal level of matching? Naturally, there is a balance between making a plan as attractive as possible to attract participants to invest their money and in ensuring maximum benefit to shareholders. One aspect that can be considered is whether participants in a highly geared performance-based programme should have the same matching as those taking part in an equity saving plan. Perhaps those with a greater upside should be required to take a higher level of risk. AP3 advanced its views on a number of occasions and intends to maintain its dialogue with companies in this area.

### **Increased board remuneration**

Many nomination committees proposed increased remuneration for board members 2011. Around 30 of the 50 AGMs at which AP3 voted approved increased fees to directors. The figures varied from increases of 5-10 percent to more extreme hikes of 50 percent. Board remuneration levels have remained unchanged at many companies for a few years, reflecting a general desire to show restraint amid the recent financial crisis. AP3 feels this restraint was vital to regain some of the confidence that many corporate boards (especially in the financial services sector) lost during the crisis. Many nomination committees justified the increases on the grounds that remuneration had remained unchanged for some time. AP3 is not against warranted adjustments in board remuneration but, in our opinion, this line of reasoning is open to question. However, we hope that higher fees will lead to a reduction in the average number of board assignments that directors undertake, and we believe this would be beneficial for companies.

Number of general meetings <sup>4</sup> at which AP3 voted in Sweden, July 2010 – June 2011	52 (48 AGMs and 4 EGMs)
Ratio of companies in the listed equity portfolio in which AP3 voted, July 2010 – June 2011	42 percent
Number of agenda items that AP3 voted on in Sweden, July 2010 – June 2011	Approx. 800
Number of nomination committees on which AP3 had a seat in 2010/2011	8

## **CORPORATE GOVERNANCE IN THE FOREIGN EQUITY PORTFOLIO**

Most of the Fund's foreign equity portfolio is passively managed by external managers to whom we used to delegate our voting rights. As part of our increased commitment to good governance in recent years we have become more active in the global equity portfolio and in the past years have reassumed direct responsibility for all our voting rights. Direct voting builds trust in AP3's governance and will help us to achieve higher returns in the equity portfolio over time. The Fund has a diversified equity portfolio with relatively small holdings in a wide range of companies, so the extent to which we vote actively involves striking a balance between the costs involved and the value added that our interventions can create. Initially, we restricted our voting to a small number of companies in the global portfolio but gradually increased this figure and in 2011 we voted at around 400 foreign AGMs.

For reasons of cost and practicality it is not possible to attend foreign AGMs and we therefore vote by proxy at these meetings. As last year, we used an electronic voting system supplied by UK consultants Manifest. Swedish corporate governance consultancy Nordic Investor Services (NIS) monitors the AGMs on our behalf, analysing paperwork and informing us of any controversial issues that might arise. NIS also handles the voting process, though we always decide ourselves how we will vote.

### **Global voting policy**

In addition to a corporate governance policy for Swedish companies, AP3 also has a global corporate governance policy and a global voting policy to facilitate voting procedures and engagements. The latter policy is based on internationally accepted corporate stewardship principles, namely the OECD's Principles of Corporate Governance and Multinational Enterprises and the United Nations Global Compact (which is also one of the cornerstone for the AP funds' Ethical Council). The global voting policy is on similar lines to the policy of Norway's NBIM. It is general in nature and it should be borne in mind that local codes and regulations, industrial

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<sup>4</sup> Some of the resolutions put to Swedish AGMs are included in an appendix of the Swedish version of this corporate governance report. The appendix include AP3's views on issues on the AGMs and a disclosure on how we voted on executive pay. However the appendix has not been translated into English

standards and market-specific conditions can necessitate small deviations in individual cases. A fundamental principle when exercising our voting rights is that we will not take a definitive stance on AGM resolutions unless the information provided by the company is sufficient to enable us to make an informed decision. Where such information is not forthcoming we abstain from voting.

### **Voting mix based on equity index weights**

AP3 voted at AGMs in the United States, Canada, Japan, the UK, Switzerland, France, Germany, Spain, Italy, the Netherlands and Australia, basing our selections largely on relative weights in the global MSCI equity index. We also prioritised voting at the AGMs of foreign entities where we support international initiatives on a specific topic and at companies where we submitted an AGM resolution.

### **Many "no" votes**

AP3 voted on approximately 7,000 resolutions at some 400 foreign AGMs. We voted against or abstained from voting for the resolution in about one quarter of cases – slightly more cases than last year. This is a much higher ratio of "no" votes than for Swedish companies, which normally notify investors of proposed resolutions prior to the AGM. On executive pay, we also abstained or voted against board proposals in more than 75 percent of cases, reflecting the fact that foreign companies find it considerably more difficult to meet AP3's requirements on remuneration packages for senior executives. On many occasions we voted against board resolutions due to inadequate information. Last year we voted against in approximately 60 percent of executive pay agenda items, which indicates that the remuneration packages for senior executives is not developing in the direction we aim for. It should also be noted that we voted in favour of four out of ten resolutions submitted by shareholders. This was because many institutional investors submitted their own resolutions to the AGMs of foreign entities and these were often of a high standard.

Number of agenda items on which AP3 voted in Sweden, July 2010 – June 2011	399 AGMs
Ratio of companies in the listed equity portfolio at which AP3 voted, July 2010 – June 2011	Approx. 10 percent
Number of agenda items on which AP3 voted in Sweden, July 2010 – June 2011	7,085
Ratio of agenda items on which AP3 abstained or voted against a board resolution, July 2010 – June 2011	28 percent

### **Agenda items on environmental and social responsibility**

Especially in the US and Canada, investors often submit resolutions to AGMs on environmental and social responsibility. AP3 has done so itself in previous years, submitting resolutions to companies such as Freeport McMoran, Goldcorp and Walmart. These resolutions often seek to encourage companies to be more transparent, appoint environmental experts to the board of directors or address their environmental impact.

During the 2011 AGM season AP3 voted on 85 resolutions at 48 companies. The same investor or group of investors often submits the same type of resolution to multiple firms. AP3 weighs up all resolutions to see if they can create positive benefits for the company and its shareholders. Sometimes the submissions are not sufficiently tailored to the company in question, and this may lead us to vote in favour of a resolution in one case and against the same resolution in another. An example of this concerned the appointment of a board-level environmental affairs specialist at Chevron Corp and Occidental Petroleum. We supported the resolution at Chevron but voted against the same proposal at Occidental. Appendix 1 presents our reasoning for voting in favour of or against some of the resolutions, including the Chevron and Occidental examples.

	<b>Number of agenda resolutions</b>
Resolutions regarding environmental issues	44
Resolutions regarding social responsibility issues	41
<b>Total no. of resolutions that AP3 voted on</b>	<b>85</b>

## **ENVIRONMENTAL AND SOCIAL RESPONSIBILITY**

AP3 has a mandate from Parliament to practise environmentally and socially responsible investment without compromising our overriding goal of high investment returns.

### **Incorporating international conventions in business values**

AP3 is part of the Swedish pension system and bases its principles on commitment, action and driving change on the values of the Swedish government. The Instrument of Government defines the state's core values as democracy, the equal value of all people, the right to human freedom and dignity, and sustainable development. Sweden's core values are also reflected in the international conventions signed by Sweden (including on the environment, human rights, labour protection, corruption and inhumane weapons) and through the government's support of initiatives such as the UN Global Compact<sup>5</sup> and the OECD Guidelines for Multinational Enterprises.<sup>6</sup> For AP3, international conventions and the Swedish government's core values are key instruments in our pursuit of high standards of environmental and social responsibility.

As an investor, AP3 bases its ethical and environmental standards on the assumption that all the conventions signed by Sweden are important and should be complied with. This approach is also built on decisions and statements from United Nations agencies affirming human rights as universal, indivisible, interdependent, interrelated and inalienable. By linking our standards to international conventions and by working with others who share our aims we can be part of an

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<sup>5</sup> The Global Compact is a voluntary UN initiative encouraging companies to operate in compliance with ten universal principles based on the UN conventions on human rights, labour standards, the environment and corruption.

<sup>6</sup> The OECD guidelines are joint recommendations to business from 40 governments, including Sweden's, and cover human rights, corruption, employment, competition, taxation and disclosure.

international coalition on the financial markets to ensure that any treaty breaches are brought to light.

AP3 believes there is a connection between corporate ethics and the capacity to deliver long-term shareholder value. We believe that companies which are well governed offer a better long-term investment. We screen companies to make sure they are not violating international conventions, we engage in active dialogue to encourage them to act responsibly and we support investor initiatives aimed at specific companies or industries. Environmental and social responsibility is a core part of our governance policy.

### **Proactive dialogues with companies on environmental and social issues**

At AP3 we take a proactive approach to social and environmental responsibility, focusing primarily on Swedish companies with substantial production or purchasing in countries governed by non-democratic regimes or with weak labour and environmental laws (primarily developing countries and emerging markets). We work to ensure that the managements of companies in which we invest identify and manage social and environmental risks so as to create shareholder value. We urge enterprises to abide by the principles of the UN Global Compact and other guidelines for specific industries, such as the ICMM<sup>7</sup> guidelines for mining and extractive companies.

Our primary approach is dialogue with companies as we believe this provides the best opportunity to exert influence. As a long-term investor, we are aware that change can take time and we therefore monitor how companies respond to our views and requirements until we achieve our objectives in each particular case.

Through dialogue we aim to ensure that companies have risk management systems and codes of conduct in place and that they have managers in charge of environmental and social affairs to reduce the risk of the organisation breaching international conventions. We communicate a number of core requirements during the dialogue process:

- **Risk analysis and systems**

We expect companies to work systematically to identify the social and environmental risks to which their businesses are exposed. We also expect them to have risk management systems in place.

- **Code of conduct**

We expect companies to have group-wide codes of conduct covering human rights, working conditions and environmental protection. The codes should be based on the UN Global Compact and the ILO's<sup>8</sup> core conventions. They should also be publicly disclosed and subject to compliance monitoring.

- **Reporting**

Companies should disclose social and environmental activities either in the annual report or

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<sup>7</sup> International Council on Mining and Metals

<sup>8</sup> International Labour Organisation, the UN body for labour protection and working conditions. The eight core conventions concern freedom of association, forced labour, discrimination and child labour.

sustainability report and publish them on their websites. The guidelines of the Global Reporting Initiative (GRI)<sup>9</sup> are an appropriate framework for such reports.

### **Sustainability an increasingly key part of corporate business models**

During the year we held discussions on social and environmental responsibility with 11 Swedish corporations and our impression is that these issues are often raised at group level and increasingly form part of operating and strategic risk analyses. We welcome this. Many companies treat social and environmental responsibility as just another requirement they have to meet; equally, many see it as a business opportunity. As environmental issues have come increasingly to the fore, more and more enterprises are realising that it is a cost where there is scope for savings. On the one hand, companies are under pressure to reduce their environmental footprint; on the other, many firms have identified a strong business case for developing eco-friendly products and reducing their environmental impact.

### **Life cycle approach gains ground throughout the product chain**

More and more companies take a life cycle approach to their products, focusing strongly on environmental impact throughout the chain – from product concept to choice of material through manufacture and use to final disposal. Many firms train their customers in how to use and look after their products to minimise environmental impact. These areas often give rise to major environmental impacts and thus create considerable scope for cost savings.

### **More structured approach to supplier risk**

In recent years, companies have put increasing demands on suppliers to comply with their codes of conduct, and many enterprises now recruit personnel to perform supplier audits. Some companies also use third-party auditors to audit their suppliers – sometimes in addition to their in-house audits. The consumer industry has taken the lead in auditing suppliers' compliance with environmental and ethical standards, but firms in many other sectors have also realised the importance of maintaining control over their supply chain – a change that AP3 has been advocating in corporate dialogues for a number of years now.

### **AP3 engages in wide-ranging discussions on sustainability with companies and external asset managers**

In our discussions with companies we address a wide range of issues including: working conditions and work environments; human rights; risk analysis and risk systems; sector and country risk; employee and supplier codes of conduct and training, and compliance monitoring of these codes; supplier audits; corruption risk; sustainability reporting; and third-party audits. We encourage businesses to analyse and review their environmental impact and implement targets to reduce emissions and other adverse impacts.

AP3 also holds ongoing discussions with external asset managers to encourage them to conduct social and environmentally responsible investment and abide by the PRI.<sup>10</sup>

### **Governance via the Ethical Council**

AP1, AP2, AP3 and AP4 have since 2007 coordinated their screening and dialogue processes

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<sup>9</sup> United Nations initiative to create a global standard for corporate sustainability reporting.

<sup>10</sup> The United Nations Principles for Responsible Investment.

through a joint Ethical Council. By pooling our resources and voting rights, we are better able to influence foreign companies in which we invest and encourage them to refrain from breaches of international conventions ratified by Sweden.

An external expert screens the funds' equity holdings to determine whether any company in our portfolios is acting in violation of international treaties. If a company is accused of breaching a convention, the Council investigates the facts, contacts the company concerned and encourages it to take action to address the breach and prevent any recurrence.

Infringements of international conventions often indicate a company's failure to understand its responsibility for incidents or to focus on acting proactively in environmental protection and social issues.

### **Dialogue and collaboration the key tools**

Corporate dialogues and collaboration with other investors are the Council's main tool for achieving positive change. The Council's main objective is to ensure change and believes this is best achieved through investor governance and seeking to influence companies through dialogue.

In 2010 the Council concluded dialogue with one company after it complied with our demands. Eleven companies were on the Council's dialogue list as of 31 December 2010. The Ethical Council also engages in indirect dialogue with companies via its environmental and social responsibility consultant. A total of 195 indirect dialogues took place in 2010. AP3 had excluded 11 holdings from its investment universe as of 30 June 2011.<sup>11</sup> AP3 treats exclusion as a last resort in cases where dialogue does not lead to progress.

### **Annual report on the Ethical Councils work**

The Ethical Council publishes an annual report that includes information on its corporate dialogues and investor initiatives. The report and further information about the Council is available at [www.ethicalcouncil.com](http://www.ethicalcouncil.com).

### **Collaboration with other investors**

AP3 has a diversified portfolio of investments in more than 4,000 equities worldwide. Many of our equity holdings are under passive index management, which means that instead of actively investing in a specific company we invest in exposure to a market and share index. AP3 is a relatively small investor by international standards and we rarely own more than 0.05 percent of the voting rights in foreign entities or 1 percent of Swedish companies. The diverse nature and small size of our holdings limits our ability to influence foreign companies in our portfolio and we therefore seek to work with other investors to make our voice heard. The Ethical Council is the vehicle for much of this work. Around 6,000 companies were contacted in 2010 as part of initiatives supported by the Ethical Council.

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<sup>11</sup> As of 30 June 2011 AP3 had excluded the following companies from its portfolio: Alliant Techsystems, Elbit Systems, GenCorp, General Dynamics, Hanwha Corporation, L-3 Communications, Lockheed Martin, Poongsan, Raytheon, Singapore Technologies and Textron.

## Joint investor initiatives to exercise influence

AP3 has joined the Ethical Council in numerous investor actions initiated either by ourselves or other PRI members.<sup>12</sup>

In 2010 AP3 and its fellow Ethical Council members joined the **Institutional Investors Group on Climate Change** (IIGCC), a European investors' forum for collaboration on climate change. The IIGCC aims to use investors' collective voice on climate change and engage companies, policymakers and investors in addressing the long-term risks and opportunities in this area. The IIGCC called on governments to introduce price mechanisms to promote climate-friendly investments and agree transparent emissions targets ahead of the Cancun climate talks in Mexico in December 2010.

The Ethical Council also supports the **Extractive Industries Transparency Initiative (EITI)**. Transparency and good governance are crucial in countries rich in minerals but have weak governments. This is especially true in the oil industry. Clear disclosure of incomes in host countries and payment levels increases transparency and creates better conditions for financial governance. The Ethical Council has joined forces with 70 other investors in supporting the EITI, sending a signal to extractive companies and nations with mineral assets that shareholders value transparent accounting.

AP3 has since 2006 supported the **Carbon Disclosure Project (CDP)**, which aims to encourage increased corporate awareness of climate change. The project urges companies to adopt greater transparency in reporting their climate change strategies and developing key metrics to measure improvements. The CDP aims to make the data collection process more effective through a joint request for data and emissions reporting signed by a large number of investors. The seventh edition of this document, co-authored by 551 investors with combined capital of US\$71 trillion, was sent to 5,906 enterprises in 2010. The response rate has been 80-90 percent in recent years and feedback is published on a website for investors.

The Ethical Council has also joined 44 other investors in supporting an initiative to address **oil sands mining** in Canada, an environmentally deleterious industry. The initiative calls for increased transparency, encourages mining companies to conduct environmental impact assessments and recommends measures to reduce environmental effects.

After the BP oil spill in the Gulf of Mexico in 2010, the Ethical Council and a group of other investors contacted 15 oil companies to inquire about safety measures undertaken during **deep-sea drilling**.

The Ethical Council also joined several large funds in an initiative to tackle corruption and conducted an overview of preventive **anti-corruption** measures undertaken by a group of companies. The overview led the Council to contact around 20 companies.

AP3 is among 15 Swedish investors behind the **Sustainable Value Creation** project that has polled Sweden's 100 largest companies on the measures they are taking to promote sustainability, encouraging them to take a structured approach in this field as part of long-term value creation. By

providing reliable information on how they integrate environmental and social responsibility in their operations, businesses can achieve enhanced transparency – and the Sustainable Value Creation project thus helps investors to make informed investment decisions.<sup>13</sup> Investors and the 100 largest companies were invited to attend a seminar in 2010 at which BP chairman Carl-Henric Svanberg discussed his company's sustainability work at board level and those present joined investors in roundtable discussions. A new survey has been sent to the 100 largest companies in 2011.

Number of corporate dialogues <sup>14</sup> through AP3 on issues of corporate governance, environmental and social responsibility (ESG).	72
Number of corporate dialogues <sup>15</sup> through the Ethical Council in 2010	270
Number of corporate dialogues via consultant in 2010	195
Number of companies excluded from AP3s portfolio at 30 June 2011	11

## UN PRINCIPLES FOR RESPONSIBLE INVESTMENT

As of 2006 AP3 is a signatory to the Principles for Responsible Investment (PRI), which encourage investors to integrate environmental social and governance issues (ESG) in their financial analysis and decision-making processes.<sup>16</sup> Signing the PRI signalled our support for the initiative and our intention to comply with the principles in our business activities.

The PRI	How does AP3 comply?
<b>Principle 1. We will integrate ESG<sup>15</sup> in our investment analysis and decision-making processes.</b>	<ul style="list-style-type: none"> <li>- Makes ESG-related investments.</li> <li>- Ongoing internal initiative to analyse how ESG might be integrated across the portfolio.</li> <li>- Participates in academic studies focusing on ESG and that have helped to develop tools to integrate and measure ESG.</li> <li>- Screens the equity portfolio.</li> <li>- Trains staff in ESG.</li> <li>- Incorporates ESG in due diligence process and requests for proposals.</li> <li>- Discusses ESG with external managers.</li> </ul>
<b>Principle 2. We will be active owners and integrate ESG in our corporate governance policy and asset</b>	<ul style="list-style-type: none"> <li>- Since 2001 has integrated ESG in the corporate governance policy and in direct engagements with companies, for instance through active dialogue and by voting and submitting resolutions at AGMs.</li> <li>- Has a voting policy.</li> <li>- Engages companies in active dialogue on ESG-related risks and</li> </ul>

<sup>13</sup> For further information about the project see [www.svcinitiative.com](http://www.svcinitiative.com)

<sup>14</sup> The figures do not include the investor initiative headed by CDP on behalf of AP3 and 550 other investors and which targeted 5,906 companies in 2010. The term "dialogue" is as defined in the PRI's annual signatory questionnaire. It involves active discourse at three levels: extensive, moderate and small engagement.

<sup>15</sup> As above.

<sup>16</sup>

<b>management.</b>	<p>opportunities.</p> <ul style="list-style-type: none"> <li>- Frequently supports investor resolutions on ESG.</li> <li>- Engages in dialogue with external managers to encourage them to focus on ESG-related issues.</li> <li>- Takes part in developing self-regulation systems and seeks to influence decision-makers.</li> </ul>
<b>Principle 3. We will seek appropriate disclosure on ESG matters by the entities in which we invest.</b>	<ul style="list-style-type: none"> <li>- Engages regularly with companies on ESG.</li> <li>- Expects companies to report externally on ESG.</li> <li>- Supports initiatives (such as the CDP, Eiti, IIGCC, Global Compact, GRI and Sustainable Value Creation) and shareholder resolutions promoting increased transparency, improved environmental reporting and corporate environmental and social responsibility.</li> <li>- Engages in dialogue with external managers on ESG.</li> </ul>
<b>Principle 4. We will promote acceptance and implementation of the principles within the investment industry.</b>	<ul style="list-style-type: none"> <li>- Engages in regular dialogue with other investors and stakeholders in the investment industry on ESG.</li> <li>- Attends conferences and round-table meetings to share knowledge on ESG implementation.</li> <li>- Encourages external managers to sign the PRI.</li> <li>- Includes ESG-related requirements in requests for proposals.</li> <li>- Supports academic research on ESG.</li> </ul>
<b>Principle 5. We will work together to enhance effectiveness in implementing the principles.</b>	<ul style="list-style-type: none"> <li>- Cooperates with AP1, AP2 and AP4 through the Ethical Council.</li> <li>- Participates independently and via the Ethical Council in networks and collaborative initiatives with Swedish and international investors.</li> <li>- Uses the PRI's clearing house (extranet) as a source of best practice and to support investor initiatives.</li> </ul>
<b>Principle 6. We will report on our activities and progress towards implementing the principles.</b>	<ul style="list-style-type: none"> <li>- Discloses ESG engagements in this annual corporate governance report and in the Ethical Council's annual report. The reports are available on the AP3 website.</li> <li>- The AP3 corporate governance policy is published on our website.</li> <li>- AP3's responses to the annual PRI questionnaire are published on the PRI website.</li> </ul>

## STAKEHOLDER DIALOGUE

AP3 holds regular discussions both independently and via the Ethical Council on environmental and social responsibility. Stakeholders include politicians, the media, NGOs, investors, companies, researchers and students. We seek to share knowledge and insights through dialogue, questions, interviews and written reports and by speaking at conferences and participating in round-table discussions.

## DIVISION OF RESPONSIBILITY

AP3's Board of Directors reviews the corporate governance policy every year. The CEO has overall responsibility for ensuring that the policy is implemented. The Fund has a corporate governance committee consisting of a senior asset allocation and corporate governance specialist, the Chief Legal Officer and the Head of Communication and Sustainable Investments. The Head of Communication and Sustainable Investments is also AP3's representative on the Ethical Council and is a member of AP3's executive management committee. The corporate governance committee reports to the CEO and Board of Directors. The corporate governance policy and a document on

how AP3 implements environmental and social responsibility in its operations are available on our website.

## **APPENDIX 1**

### **Presentation of how AP3 voted at foreign AGMs on shareholder resolutions in ESG in 2011.**

Almost half of the shareholder resolutions on environmental and social governance that AP3 supported required the company to write a report or perform a review in a specific area. Resolutions of this kind are often aimed at drawing attention to an issue that the company in question is perceived as having neglected or to highlight contentious business operations. The company's reporting practices are critical to whether a resolution can be seen as an effective tool to pressure it into improving its reporting or whether further disclosure is likely merely to replicate already-published information.

Environmental resolutions are often used to drive change at companies active in extractive industries, which have a major impact on the environment and communities and thus carry significant business risks.

Here is how AP3 voted on some of the resolutions.

#### **Boston Properties Inc – Reporting of sustainability performance and policies**

*Resolution:* To prepare a report on the company's sustainability policies and performance and to base the report on the Global Reporting Initiative (GRI) guidelines.

*Why AP3 voted in favour of the resolution:* The company is part of an energy-saving programme but declined membership of the Carbon Disclosure Project in 2010. The company does not use the GRI guidelines in its CSR reporting, meaning it lags behind in this area. AP3 therefore voted in support of the resolution.

#### **Ryland Group Inc – Targets for reduced greenhouse gas emissions**

*Resolution:* That the board of directors adopts quantitative goals, based on available technologies, for reducing total greenhouse gas emissions and produces a report on its plan and implementation.

*The company:* As a major house builder, the company agreed it had responsibility to reduce carbon emissions but said this was the wrong strategy.

*Why AP3 voted in favour of the resolution:* This type of resolution can be seen as a way to voice concern over the impact of part of the company's business operations or policies. The company had not signed the UN Global Compact and publishes no CSR report (either as part of the annual report or in a standalone format). The company is a slow mover in this area. AP3 therefore voted in support of the resolution.

#### **Exxon Mobil Corporation – Report on hydraulic fracturing**

*Resolution:* To approve a shareholder proposal regarding a report on natural gas production. The proposal, from the Park Foundation, asked the company to produce a report on its operations in

hydraulic fracturing (also known as fracking). Fracking is a process of oil or natural gas extraction from deep below the surface of the earth by using fluid under high pressure to fracture the rock. *The company:* Maintains it is environmentally responsible in its operations and uses safe techniques that are subject to regular control and oversight at local and national level. It says the risk of groundwater interference is exaggerated because fracking takes place hundreds of metres below the water table.

*Why AP3 voted in favour of the resolution:* The fracking process has the potential to cause significant adverse environmental impact and the questions were thus relevant. The company's comprehensive CSR report names and describes the process but is short on detail, though the general information provided on risk management processes could naturally be applied to fracking. AP3 voted in favour of the resolution to encourage the company to be more active in disclosing information to investors and the general public on fracking.

### **Exxon Mobil Corporation – Report on oil sands extraction**

*Resolution:* To approve a shareholder proposal regarding a report on Canadian oil sands. The resolution, from Green Century Capital Management, called on the company to disclose the risks associated with its oil sands extraction activities in Canada and the financial risks relating to the company's dependence on this business. Canadian oil sands account for 11 percent of the company's reported reserves.

*The company:* The company has co-authored a report, "Canada's Oil Sands: Responsible Development, Innovation, and Opportunity", with its part-owned subsidiary Imperial Oil. The report is published on the websites of both companies:

[www.exxonmobil.com/Corporate/Files/iol\\_oilsands\\_brochure.pdf](http://www.exxonmobil.com/Corporate/Files/iol_oilsands_brochure.pdf).

*Why AP3 voted against the resolution:* The company provides extensive information about this business operation on its website ([www.exxonmobil.com/Corporate/energy\\_production\\_oilsands.aspx](http://www.exxonmobil.com/Corporate/energy_production_oilsands.aspx)) and reported all significant financial risks in its annual financial statements as required by law. The resolution offered no obvious benefit as the company's reporting was already sufficient.

### **Chevron Corporation – Appointment of environmental specialist to the board of directors**

*Resolution:* To approve a shareholder proposal regarding the appointment of an independent director with environmental expertise to the board of directors to guard against future environmental scandals.

*The company:* Rejected the resolution on the grounds that directors should possess wide-ranging expertise rather than specialist know-how.

*Why AP3 voted in favour of the resolution:* Specialist skills are needed at board level and not all directors can be generalists, especially as the definition of relevant background can be skewed. AP3 voted in favour of the resolution. An almost identical resolution was also submitted to the AGM of Occidental Petroleum, but in this case AP3 voted against.

### **Occidental Petroleum Corporation – Appointment of environmental specialist to the board of directors**

*Resolution:* To approve the nomination of a director with environmental expertise.

*The company:* The company said it already had an environmental expert on the board.

*Why AP3 voted against the resolution:* John Feick, a director since 1998, holds a doctorate in chemistry and is in charge of environmental affairs at board level. He has participated in government reports relating to environmental protection and the energy sector. The resolution did not appear to offer tangible benefit so AP3 voted against it.

## **Goldcorp – Proposal to suspend mining operations**

*Resolution:* Proposal to suspend operations at the Marlin mine in Guatemala until the mine “no longer contravenes international law and human rights”.

*Why AP3 voted against the resolution:* The company's operations in Guatemala have attracted attention and strong criticism. Through the Ethical Council, AP3 was part of an investor group that demanded an independent review into the human rights situation around the mine. The review, published in early 2010, contained a raft of recommendations for improvements in health, environment and safety for mine employees and local people. Goldcorp responded with an action plan and responded to every point listed in the review. In October 2010 the company presented an initial progress report and said most of the remedial measures were due to be completed in the first half of 2011. Goldcorp's response to the review and its subsequent action plan demonstrated an active commitment to improving conditions at the Marlin mine. It also set out its strategy in this area, including implementation of a sustainability policy and a human rights policy. The Ethical Council has an on-going dialogue with Goldcorp and review the progress of actions taken by the company continuously. The company now manages these issues at top level. It is fair to allow the company the opportunity to implement these changes and for this reason AP3 voted in favour of the proposal.

## **Appendix 2**

### **Presentation of how AP3 voted at Swedish AGMs in 2011**

This appendix is available only in Swedish.