

Environmental and ethical compliance – the AP3 approach

Approved by the CEO April 2011

This memo provides a closer look at AP3's approach to environmental and ethical compliance and supplements the corporate governance policy approved by the Board of Directors.

Environmental and ethical compliance

The preparatory drafts of the Swedish National Pension Funds Act (2000:192) state that AP3's overriding objective is to achieve high returns at a low level of risk. The Fund must take account of environmental and ethical considerations account in its investment operations but without compromising this goal.

In this context, AP3's policy is to encourage companies in which we invest to take responsibility for the environmental and social impact of their business activities.

Observance of sound environmental and ethical practices is vital if companies are to be run in shareholders' best interests over the long term. These aspects therefore form an integral part of AP3's corporate governance work. AP3 works to ensure that the managements of companies in which we invest identify and manage social and environmental risks so as to create shareholder value.

AP3's core values

As part of the Swedish pension system, AP3 rest on the same principles of commitment, action and demand for change as those that form the core values of the Swedish state. Central tenets of these values include democracy, the equal value of all people, the freedom and dignity of the individual and sustainable development, in accordance with the wording of the Instrument of Government.

The Swedish Government's core values also find expression in those international conventions that Sweden has signed, which include conventions on environment, human rights, labor rights, corruption and inhumane weapons, as well as through support given to initiatives such as the United Nations Global Compact and OECD guidelines for multinational companies, in addition to Sweden's own stance on international public law issues. In tandem with the Swedish Government's value system, international conventions constitute essential instruments for AP3 in its efforts

to take environmental and ethical issues into account.

As an investor, AP3 bases its ethical and environmental standards on the assumption that all the conventions signed by Sweden are equally 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 international coalition on the financial markets to ensure that any treaty breaches are brought to light – an approach that strengthens the conventions in question.

AP3 bases its approach on the assumption that companies in which it holds shares abide by international conventions and agreements ratified by Sweden. We also assume that companies with operations in Sweden comply with Swedish law. Our view is that companies have a responsibility to follow international conventions, irrespective of whether they are aimed at states, individuals, businesses or organisations. This responsibility also applies regardless of whether the countries in which the companies operate have signed the conventions or have weak rights protection frameworks.

Active governance is AP3's primary tool for taking environmentally and ethically considerations in its investments. In rare cases, the Fund may exclude companies from the portfolio if they fail to meet the standards required under AP3's corporate governance policy.

Integrating environmental and ethical compliance into the investment process

AP3 has a two-step system for incorporating environmental and ethical considerations in our investment activities.

1. Ethical screening to establish if any of the companies in the portfolio are acting in contravention of international conventions.

2. Ethical risk analysis to establish the environmental and social risks to which portfolio companies are exposed and how the companies manage these

risks.

This process is designed a) to ensure that AP3 has no investments in companies that contravene international conventions, and b) to guarantee that the Fund is aware of the environmental and social risks pertaining to companies in which we are a major shareholder. AP3 will initiate discussions with a company if a deficiency comes to light.

Ethical screening and exclusion

AP3 screens the listed equity portfolio to examine whether any company is in breach of international conventions. If there is reason to suspect that a company has seriously infringed an international convention we investigate the facts. If our inquiries reveal any such breaches we urge the company to act to prevent a recurrence. By using our ownership to engage in an issue, take actions against violations of conventions and make demands regarding change, we are able to make a difference. However, if these contacts do not result in progress and there is reason to believe that contravention will continue then AP3 may divest its holding.

Serious breaches of international conventions can include:

- Systematic human rights abuses, such as manslaughter, torture, unlawful detention, forced labour, the worst forms of child labour and child trafficking.
- Serious violations of individuals' rights in war or conflict zones
- Infringements of international environmental treaties
- Companies that manufacture weapons in contravention of the Nuclear Non-Proliferation Treaty, the Ottawa Convention on anti-personnel landmines or conventions on chemical and biological weapons.

In cases where Sweden has signaled its intention to sign a convention, AP3 may decide to act as if the convention has already been signed.

Ethical risk analysis

AP3 uses active governance to ensure that the companies in which it invests have proper procedures to identify the ethical and environmental risks to which their businesses are exposed. We work to ensure that companies have risk management systems in place to manage potential incidents and that they also have a corporate code of conduct. This applies especially to companies whose business operations have a substantial environmental impact or that have production and/or purchasing in countries where there is a lack of government will or ability to ensure compliance with

basic international rules and regulations on human rights, worker rights, corruption and environmental protection.

A corporate code of conduct means a group-wide framework of rules and systems to handle environmental and social issues. It should meet the following requirements:

1. *Transparency.* The basic principles of the code should be communicated openly to shareholders and other stakeholders, though AP3 respects the fact that in certain cases it may be inappropriate to publish detailed guidelines externally. It is also important that guidelines are clearly communicated to all employees within the group.
2. *Compliance and control.* Compliance must be monitored regularly for a code of conduct to be effective and credible.
3. *Reporting.* Proper evaluation of the code by shareholders and other stakeholders requires that the company demonstrates satisfactory external reporting of the code and of compliance procedures and appropriate data. The Global Reporting Initiative (GRI), a United Nations initiative to develop an international environmental and social reporting standard, is a good model on which to base this reporting.

AP3's ethical risk analysis focuses on companies in which we hold relatively large shareholdings. These are primarily businesses based in Sweden.

Joint Ethical Council of the AP funds

AP1, AP2, AP3 and AP4 have a joint Ethical Council that handles issues of environmental and ethical compliance at foreign companies in which they hold shares. AP3's screening of its listed equity portfolio takes place largely through the Ethical Council. Each fund has a representative on the Council.

Efforts are based on systematic screening of the AP funds' equity portfolios to identify and analyse breaches of international conventions. The Ethical Council seeks to persuade companies to refrain from infringing conventions and to introduce group-wide preventive measures to prevent future breaches.

Working closely with other investors leads to more effective governance and the Council tries to do so when feasible and appropriate. This approach also makes it possible for international investors to work with a major partner in Sweden on active governance in ethical and environmental issues.

Sustainable investments

AP3 invests in companies we deem capable of contributing to our overall goal of achieving a high return on capital. A comprehensive strategy for environmental and social responsibility is often essential for building a strong brand and preserving a company's reputation,

which in turn is vital to guarantee long-term access to capital. We believe that well-run companies are better longterm investments. For many businesses, environmental and ethical responsibility creates opportunities (such as developing sustainable products and services) and promotes competitive advantages.

AP3 acts to encourage listed companies and private equity managers to apply the principles of the UN Global Compact.

UN Principles for Responsible Investment

AP3 has signed the UN Principles for Responsible Investment, which encourage investors to integrate environmental, social and corporate governance issues in their financial analysis and decision-making processes. We are gradually incorporating these principles in our investment operations and encourage other investors to adopt them.

Reporting

AP3 believes transparency is essential for building trust in what we do. We inform stakeholders about our governance work in an annual corporate governance report and also in the annual report. The Ethical Council also publishes an annual report.