



# CORPORATE GOVERNANCE REPORT FOR THE AGM SEASON 2007-2008

The Third Swedish National Pension Fund (AP3) aims to generate maximum returns on fund capital at a low level of risk, and we use our investor influence to help us attain that goal. By law, our investments must be independent of economic or business policy considerations. As part of the national pension system, we are independent of other investors and business interests. This autonomy makes us well placed to win respect for our role as a shareholder and is a key factor underpinning our credibility and ability to gain support for our views on key issues.

AP3 communicates its standpoints on governance issues via the corporate governance policy adopted by the Fund's Board of Directors. The policy is updated regularly and published on the AP3 website at [www.ap3.se](http://www.ap3.se). However, it is not always practicable to provide detailed reports of our discussions with other investors, nomination committees, corporate managements and boards. This is primarily because we believe confidential dialogue is often the most effective way to get our views across. We aim to exert influence at an early stage in the process, usually ahead of the AGM season. Only if we feel that 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.

Active governance can make a positive contribution to our primary goal of high investment returns, especially in the long term, and the goal of building trust in AP3 and the pension system. Our aim is to report, as openly as possible, our active engagement as a shareholder and the primary areas that we have focused on during the year. To that end, we are pleased to present our annual governance report for the 12 months ended 30 June 2008.

## **Corporate governance at AP3**

We aim at all times to adjust the level of our governance activities to the conditions dictated by our over-

all strategy. AP3 has a highly diversified portfolio of around SEK 108 billion invested in 2,500 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.

In 2006 we reduced the weight in Swedish equities in AP3's long-term portfolio from 16 percent to 12 percent. Prior to 2006, about half of the Swedish equity portfolio was actively managed. In the last few years we have reviewed the portfolio structure as part of a strategic drive to make decisions on long term market exposure (beta) independent from decisions on active positions (alpha). The outcome is that the entire Swedish equity portfolio is now under index management. Active positions in individual equities or various types of derivative instruments are now via separate absolute return mandates.

We have also gradually altered the management structure of the Swedish equity portfolio, which formerly included small and mid cap equities. The portfolio now includes only the larger companies listed on the Stockholm Stock Exchange. The number of equities under index management has increased because AP3 now holds shares in nearly all companies in the SBX index (approximately 80). Although the overall impact of the change has been to reduce the size of individual equity interests in the Swedish portfolio, the holdings are considerably larger than in the global equity portfolio. AP3's equity interests in more than 50 companies in the Swedish equity portfolio range from 0.5 percent to just over 1 percent of the voting rights, but we are still a small to medium-sized player compared to other Swedish institutional investors. As of 31 December 2007, our Swedish equity portfolio had a market value of SEK 24 billion, making AP3 the 13th largest institutional investor on the Stockholm Stock Exchange.

AP3 prioritises active governance in the companies where we have relatively large equity holdings,

which at present applies almost exclusively to Swedish stocks. We also strongly emphasise active participation in the debate on corporate governance guidelines in the Swedish equity market.

AP3's main instruments for exercising governance are:

**Nomination committees.** AP's policy is always to accept a nomination committee seat when asked. Nomination committees in Sweden are usually composed of representatives of the three to five largest shareholders. Because most of AP3's portfolio holdings are relatively small, we generally exercise governance through channels other than nomination committees. At the start of this year's AGM season, AP3 had seats on two nomination committees – Bio-Invent and Enea – compared to one in 2007, five in 2006, eight in 2005 and ten in 2004.

**Dialogue with corporate managements and boards** is an excellent way to communicate our standpoints on corporate governance matters. Companies are increasingly inclined to contact institutional investors like AP3 before the AGM to discuss proposed resolutions, particularly concerning different forms of remuneration schemes. On occasion, we also initiate dialogue with the companies themselves to discuss important issues.

**The right to vote at the AGM.** AP3 makes every effort to exercise its voting rights in such a way as to generate higher portfolio returns. Going into this year's AGM season, we chose to focus our corporate governance activities on a manageable number of companies. We also voted remotely in our 70 largest internally managed European holdings. In addition, we voted on issues of social and environmental responsibility in a number of North American companies.

**Raising issues at AGMs** is a key governance mechanism. We are always prepared to speak at AGMs to explain our position on individual questions, ask questions and express criticism, where this is warranted.

**Contacts with foreign shareholders** are becoming increasingly important as these investors become more active and exercise their voting rights at Swedish AGMs. Foreign investors usually follow the recommendations of corporate governance consultants when voting but tend to look askance at Swedish

corporate governance and, regrettably, are often distrustful of the nomination process. AP3 has helped to market the Swedish governance model abroad, including joining a working group appointed by the Council for Swedish Corporate Governance. This effort to improve dialogue appeared to have an effect this year as there was less discontent among foreign investors than in previous AGM seasons.

**Environmental and socially responsible investment** is a key focus area for our corporate governance activities and we engage actively in dialogue with Swedish companies in these matters. We also hold discussions with foreign companies with regard to breaches of international conventions. Our dialogues with foreign companies are conducted jointly with AP1, AP2 and AP4 via the joint Ethical Council.

**Active role in self regulation.** As a member of Institutionella Ägares Förening (IÄF), an association of institutional investors, AP3 is actively involved in shaping self-regulation in the Swedish equity market. Working through the association, AP3 clarified its stance on the pricing of class A and class B shares in public offers – an issue that came under the microscope during the takeover bid for Swedish company Invik by Icelandic company Milestone in late 2007. The deal involved holders of class A shares in Kinnevik being offered a 10 percent premium to Kinnevik's class B shareholders. Alecta, AP4, Nordea Fonder and Swedbank Robur Fonder responded by demanding action against Racon Holdings, the Milestone company behind the acquisition. IÄF classed the bid as falling short of generally accepted equity market standards and wrote to the Swedish Industry and Commerce Stock Exchange Committee (NBK) asking for the rules to be clarified so that offers do not discriminate on price between class A and B shares. AP3 was among a large number of Swedish and foreign investors (including The Norwegian Government Pension Fund Global, CalPers and Hermes) that signed the letter. However, the content was misinterpreted in some quarters as an attack on the Swedish system of differential voting rights, rather than an issue of best practice in takeovers.

The debate gained renewed intensity when Investor sold its multi-vote class A shares in Scania to Volkswagen at a high premium. Industrivärden and Investor representatives spoke at many AGMs during the spring, strongly defending differential voting rights and rejecting all criticism of price differences between class A and B shares.

IÄF has for some time been calling for an overhaul of NBK's takeover rules and this review has finally begun. A team of lawyers completely re-drafted the takeover rules a few years ago and the same team will now review the rules and consult with a reference group that includes institutional investors. The review findings will be presented to NBK in September 2008. The legal team will also analyse the contentious issue of class A and class B share pricing in takeover bids.

With AP3 CEO Kerstin Hessius and Deputy Chairman Lars Otterbeck as members of the Council for Swedish Corporate Governance, the Fund aims to help raise general standards of corporate governance in Sweden.

### **Focus issues in 2007-2008**

AP3's corporate governance strategy involves prioritising initiatives most likely to contribute to our primary goal of achieving high investment returns of high priority and that help underpin public confidence in pension fund generally and the overall pension system. For the 2008 AGM season we focused on the following four areas:

#### **Executive pay**

Executive pay takes up a major part of AP3's corporate governance work. We share the same interests as the companies in which we invest, namely creating conditions for optimal returns on our investments. Remuneration plans for senior executives should for this reason be structured as a cost-effective reward for long-term value creation.

AP3 regards correctly structured share-based incentives as an effective way to unite the interests of management and shareholders. We have since 2002 been working to promote incentive plans that are transparent, reasonable and contain a link between performance and reward. We are pleased, therefore, to see that incentive schemes are moving in the right direction and increasingly are linked to performance or require an investment by the beneficiary. In recent years we have pushed for performance criteria to be made measurable in absolute terms (for example via the share price) as well as in relative terms (for example by benchmarking earnings against those of competitors). We have also pointed out that incentive plans should always be subject to review to determine if they are in shareholders' best interests.

Prior to this year's AGMs, we wrote to the largest Swedish corporations stating our viewpoint and also engaged them in direct dialogue.

#### **Board diversity**

AP3 promotes diversity on the boards of directors of listed companies. We believe that corporate boards should possess a broad spectrum of experience and that directors should have sufficient time for the job. For a board to function effectively the directors must possess a wide range of experience and expertise. AP3 works to ensure that directors are chosen from a wider range of candidates than in the past. For instance, we actively promote increased representation of female board members.

#### **Environmental and socially responsible investment**

AP3 firmly believes there is a connection between corporate ethics and capacity to deliver long-term shareholder value. We apply standards of environmental and socially responsible investment in two ways: by screening companies to ensure they are not in breach of international conventions, and by maintaining ongoing dialogue with corporate managements.

As of 2007, we operate via a joint Ethical Council with AP1, AP2 and AP4 whereby we work together to drive positive change in foreign companies implicated in violations of international environmental and human rights conventions.

AP3 also develop proactive dialogues with Swedish companies on codes of conduct, risk analysis and risk management systems.

#### **Foreign listed companies**

AP3 adopted a global corporate governance policy in 2006 to supplement our corporate governance policy for Swedish companies. The foreign equity portfolio is managed mainly by external managers to whom we delegate our voting rights. We review their actions in this area through regular dialogue.

As part of our extended commitment to corporate governance we will be expanding our direct voting in the global equity portfolio. We believe that a stronger commitment to good governance in the long run help us to achieve higher returns in the equity portfolio. AP3 uses remote voting for a limited part of the global portfolio, namely the 70 largest internally managed companies in the European equity portfolio. We have also voted in 12 North American com-

panies on issues of environmental and social responsibility. A review of the voting process will be held after the end of this year's AGM season.

AP3 continues to be active in the international corporate governance debate. For example, the Ethical Council joined with other investors in 2007 in signing a letter to the US Securities and Exchange Commission on the SEC's proposed changes in the rules governing submission of shareholder resolutions to AGMs. Resolutions on issues relating to environmental and social issues are an important mechanism that allows investors to comment at American AGMs. The SEC's proposals would limit the scope for shareholders to submit resolutions.

## THE 2008 AGM SEASON

During this year's AGM season AP3 continued the policy of prioritising quality rather than quantity in the governance of our Swedish holdings, choosing to focus on a manageable number of companies across five different categories:

- Our 20 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 20 million and where our equity interest exceeds 2 percent
- Companies with a controversial agenda item or with which AP3 had held discussions on an important governance-related issue prior to the AGM
- Investment companies

AP3 attended and voted at 36 AGMs during the spring and voted remotely at a further six AGMs. We also attended four extraordinary general meetings in the second half of 2007.

Prior to the 2008 AGM season, the nomination committees of several companies (including Investor, Atlas Copco and Electrolux) proposed resolutions asking for shareholders to authorise payments of synthetic shares to directors. Synthetic shares enable the beneficiary to receive future dividends equal to the company's share price. The proponents argued that a stronger link between directors' pay and the company's share price would be beneficial to shareholders. AP3 has not stated a strong view either way on

this issue, but we believe the idea is worth trying in a limited number of companies and the outcome then reviewed. In fact, we advocate an easier solution whereby directors simply invest part of their pay in the company's shares. This is an approach that Investor has taken in the past.

Many managements, boards and nomination committees of listed companies have increased their contacts with investors to explain the merits of their remuneration programmes, which has made voting decisions easier. In our dialogues this year, we stressed to companies the importance of a performance-reward link in share-based incentive schemes and the need to review schemes to establish if and how they have enhanced shareholder value.

Some of the resolutions put to corporate AGMs are shown below, along with AP3's approach to the issues involved. For instance, we explain why we voted one way or the other on share-based incentive schemes.

For AP3, the AGM season got underway on 27 March with real estate company **Castellum**. Although there were no controversial issues on the agenda we still wanted to demonstrate good governance by exercising our voting rights, so we were represented by AP2.

The **SKF** AGM approved the introduction of a performance-based share plan for up to 310 senior managers and key people. The scheme enables beneficiaries to receive SKF shares without having to make a financial investment, though distributions are related to the achievement of financial targets set by the board of directors. The plan is also long-term and involves an acceptable level of dilution for shareholders. By replacing a long-term variable cash element in place since 2005, the plan increases transparency and forges a stronger link to shareholder value, which AP3 supports. The AGM also approved a resolution for directors' fees to be part-fixed and part-linked to the performance of the SKF share in 2008. AP3 has no specific objections to board pay being part-linked to the share price, though we would like to see the variable component based on the creation of shareholder value over the longer term.

**Nordea** attaches high priority to providing information to institutional investors in due time before the AGM to enable them to comment on proposed incentive plans. The long-term incentive scheme for 2008 was based on the same principles as last year's plan and aimed at 400 senior managers and other key people. AP3 voted in favour of the proposal because it included an

element of risk in form of an investment by the beneficiary, clear performance conditions vis-à-vis Nordea's main competitors, and reasonable costs to shareholders. However, we felt that the lock-in period of two years could have been longer and we expressed this view to Nordea. We also asked for the plan to be subject to review, which is something we pressed for at all this year's AGMs and which we believe should apply at all listed companies.

**SSAB** issued around SEK 10 billion of new shares in conjunction with its acquisition of US steel company IPSCO, which was incorporated as a division of SSAB in July 2007. The share issue was approved at an extraordinary general meeting last summer and was supported by AP3. Shortly before the AGM, SSAB announced the sale of IPSCO's pipe division, which will heavily reduce the company's debt. SSAB has a clear and straightforward policy on principles for pay and benefits to senior executives and other key people: it does not use incentive plans. The board of directors submitted no resolutions to this year's AGM in this regard.

**TeliaSonera's** remuneration policy is brief and continues to offer scope for defined benefit pensions plans for some staff, which is unsatisfactory. After criticism from shareholders, including AP3, the TeliaSonera board of directors withdrew a resolution on a long-term incentive plan for senior managers. The resolution was presented to investors in due time before the AGM but was unacceptable due to an insufficient link between performance and reward. The company intends to present a new and improved proposal at next year's AGM. For the interim, the board of directors proposed that senior executives be entitled to a variable incentive of up to 50 percent of basic salary – the same level as the CEO. AP3 voted in favour of the resolution.

**Electrolux** operates an incentive plan that in some respects falls short of AP3's requirements. The scheme contains a link to performance, but should also incorporate an element of risk for beneficiaries. AP3 contacted Electrolux before the AGM to ask why the CEO's salary had been raised from SEK 3.6 million to SEK 5 million with no real explanation. The company said the increase was justified based on a pay analysis showing that the long-term variable component should be given greater weight to strengthen the link between the interests of the CEO and shareholders. In 2008 Electrolux will work with an external consultant to analyse the effects of the current long-term incentive scheme in terms of beneficiaries' per-

formance and motivation levels. This review will form the basis for future plans. AP3 presupposes that the board of directors will present the findings at the next AGM. The Electrolux nomination committee also proposed that directors be entitled to part-payment in synthetic shares.

Despite having a small staff, investment company **Öresund** has a large board of ten directors. A point worth noting is that the deputy chairman receives a higher fee than the chairman. The company has a clear and straightforward remuneration policy that entitles senior executives to a maximum bonus of six months' salary. Bonus levels are set each year by the board of directors. The board submitted a resolution to the AGM to set up an activist fund in which Öresund would be among the principal shareholders.

**Investor's** nominating committee submitted a resolution to the AGM asking for a portion of salary to be payable in synthetic shares. The resolution involved no significant change in the status quo because the board has previously required directors to invest part of their board fees in Investor shares. The board of directors recommended adoption of an incentive scheme that was fundamentally on the lines of previous years' plans, featuring a share savings programme for all employees and a performance-based share scheme for the CEO and management. The scheme incorporates investment by beneficiaries and the lock-in period is of adequate length. It also has a clear performance link for senior managers and a payout ceiling, as well as offering shareholders a limited cost that is known in advance. We voted in favour of the resolution. AP3 had been informed of the details at an investors' briefing prior to the AGM and made our comments known to management at that time. In addition to the conditions of growth in net asset value and total return that already apply, we take the view that future performance conditions should be benchmarked against competitors. The plan should also be subject to a performance review, and we look forward to the results of such a study.

Prior to **Skanska's** AGM we contacted the company to clarify a couple of matters regarding the board of directors' proposals on salary and other remuneration to senior executives. Skanska's remuneration policy requires variable incentives to be in the interests of shareholders and based on performance against set (but unspecified) targets. The company explained that variable incentives are linked to certain financial and non-financial targets that are well described in the annual report. An extraordinary general meeting in No-

vember 2007 approved a share savings scheme for all Skanska's 47,000 employees. AP3 voted in favour of the plan.

**Carnegie** held two extraordinary general meetings in 2007. The extraordinary general meeting in August 2007 was held to approve allocations in Carnegie's profit-sharing system following a re-evaluation during the spring of certain trading positions. AP3 found the situation – involving large deficits and write-offs, combined with the fact that investors were required to pay for a substantially higher portion of the losses than Carnegie employees – to be unsatisfactory and we voted against the board's resolution. Taking a stance was made difficult because shareholders lacked full and complete information. We were also keen to await the results of the review by the Swedish Financial Supervisory Authority, due the following month.

The review strongly criticised the board of directors and management for serious shortcomings in the management and control of Carnegie's business affairs. The Financial Supervisory Authority issued a warning and imposed its maximum fine of SEK 50 million. It also demanded the resignation of Carnegie's CEO and ordered the company to call an extraordinary general meeting to appoint a new board. Carnegie's CEO stood down with immediate effect and a second EGM in November elected a new board of directors headed by the CEO of Invik. The new board was smaller than planned after one nominee withdrew at the last minute. Nomination committee representatives from Swedbank Robur Fonder and AP1 had earlier resigned from the committee and dissented from the choice of chairman, stressing the importance of having a chairman who was independent of the company. AP3 also took the view that an independent chairman would be preferable, but we voted in favour of the resolution in the absence of any alternative proposal.

The meeting also authorised the newly elected board of directors to examine how the previously approved share-based incentive scheme for 2008 should be adjusted in the context of the write-downs in profit for 2007. This was because the scheme targets were tied to Carnegie's earnings per share for the 2008 financial year and the write-down in 2007 profits had rendered the basis for the targets inadequate. A long discussion followed on the decision relating to profit-sharing allocations that was taken at the August meeting. One shareholder submitted a motion proposing the decision be rescinded in the light of the extensive information presented in the Financial Supervisory Authority's report. The board of directors nevertheless submitted

a resolution proposing that the decision from the August meeting be allowed to stand. AP3 voted against the board's resolution, as we did at the August meeting.

The AGM in April this year approved the winding up of the share-based incentive scheme for 2008 and its replacement with a new plan on which the board would provide details later in the year. The auditors were unable either to recommend or advise against discharge from liability for the former board. The AGM voted not to grant discharge from liability for the former directors and for the former CEO. AP3 supported this decision, along with many large institutional investors. In the absence of guidance from the auditors in this matter, our view was that we lacked sufficient information to grant discharge from liability. This decision closed no doors and left it to Carnegie's current board to complete ongoing investigations and establish, where possible, the links between cause and effect. However, the new board decided not to take matters further after taking a balanced view of the prospects for the success of legal action process and the interests of shareholders. In addition, Carnegie said it would not seek damages from any member of the former board or appeal against the SEK 50 million fine imposed by the Financial Supervisory Authority.

**SCA** is one of the companies without an incentive plan for employees. However, senior executives at SCA, as at most other listed companies, can augment their basic salaries with a variable incentive. In AP3's view, SCA's variable remuneration model is very well structured and capable of serving as a blueprint for other companies. The variable component has a ceiling and is related to fixed salary. It is based on performance against set targets and, in so far as is possible, is based on the performance of the SCA share. In addition, it is not included in pension-entitled income.

**SEB** had reviewed the long-term incentive plan it adopted in 2005 and which had been in place for three years. It proposed a new scheme in three parts, the first two of which were effectively the same as before. The scheme is based on a share savings plan open to all employees. Beneficiaries must invest up to 5 per cent of their basic salary in the plan, creating an element of personal financial risk. If the shares are held for three years and the beneficiary still works for SEB, he or she receives one new share for every share saved. The plan also includes a performance share scheme for 480 senior executives and key individuals. The element of subsidy is quite high because the share price is fixed at a low level. On the other hand, it runs for a long time – seven years – and has an initial

performance period of three years and a strong link between performance and reward. A new component was a share matching plan for 140 key individuals, under which 25 percent of the individual's cash bonus is allocated to a pool with various ownership rights. After three years, each participant receives one share for each ownership right and a maximum of four "matching shares", depending on the extent to which performance targets have been met. Performance targets are based on annual average nominal profit growth over three years. AP3 provided input on the proposal prior to the AGM, pointing out that the plan should be monitored and the performance requirements raised, both in absolute terms and by introducing benchmarking against competitors in those parts of the plan where this was lacking. SEB responded by amending the plan to limit it to fewer beneficiaries and include higher performance targets. These changes meant lower dilution for shareholders and a stronger link between performance and reward. AP3 voted in favour of the resolution.

When the notice to attend the **Volvo** AGM was sent out, the nomination committee had not finalised its proposals for a new board of directors and remuneration guidelines. This was a peculiar omission for such a large and public company. The nomination committee's proposal for the ninth member of the board did finally arrive just before the AGM. The board of directors proposed a share-based incentive plan for senior executives similar to Volvo's 2007 scheme. The plan lacked a financial downside for the beneficiaries and was far too short in duration – one year – to achieve a significant lock-in effect. However, it met many of AP3's basic requirements for such plans. It had an uncomplicated structure, was performance-based, linked to employment and contained a payout ceiling. AP3 voted in favour of the resolution. Nevertheless, we would like to see future plans being of longer duration and containing a stronger performance link (preferably benchmarked against competitors).

**Ericsson** was among the companies whose nomination committees recommended that a portion of directors' board fees be payable in synthetic shares. Ericsson is also one of the few companies to have reviewed previous share-based incentive plans. At this year's AGM the company recommended a one-year extension of its current programme (comprising three plans: a share savings plan for all employees, a plan for key individuals, and a profit-based share plan for senior managers) rather than introduce a new scheme. However, the company intends to present a resolution for a new incentive scheme to next year's

AGM. AP3 informed Ericsson that we would like to see a better performance link in the new programme, ideally benchmarked against the company's closest competitors.

**Ratos's** board of directors submitted a resolution to the AGM proposing pay guidelines for senior executives. Regrettably, the guidelines did not specify who was covered and said nothing about benefits, pensions, notice of termination, severance pay or decision-making processes. We contacted the company and made our views known. The rationale behind the incentive scheme is, however, presented in detail in the remuneration policy. Ratos offers two share options plans to a group of around 30 people. These are partly options to buy Ratos shares and partly synthetic options based on the performance of Ratos's investment portfolios. In AP3's view, the performance link is strong because the plans pay out only if the company achieves a return of 15 percent per year. The synthetic options are freely transferable and not locked in, but Ratos does have a right of first refusal, which protects the portfolio companies. There is also a clear distribution ceiling, though the distributions themselves are not specified. On the other hand, there is no ceiling on profit, which is questionable as disproportionate outcomes can damage the company's reputation. Participants are required to pay a market-based premium on the options, which means there is a potential financial downside for beneficiaries. AP3 voted in favour of the proposed scheme, as we did in 2007.

**BioInvent** is a relatively small and research-intensive company with few employees and in which AP3 is one of the main institutional shareholders. We also have a seat on the nomination committee. The board of directors asked the AGM to approve a staff share options scheme for all employees. The plan imposes requirements on employees before they can cash in their options. Combined with a long duration, this offers staff a strong incentive to stay with the company. There is no financial downside because beneficiaries do not pay for the options, but the scheme is linked to performance. In the past, the company has lacked an incentive plan that unites the interests of employees and shareholders, and it is AP3's view that BioInvent as a staff-intensive business will benefit from the new scheme. AP3 voted in favour of the resolution.

The **Industrivärden** nomination committee initially proposed no changes in the board of directors. However, the announcement that one of the directors, Lars Grönstedt, was stepping down from the board of Handelsbanken meant that he was ineligible for re-election

to the Industrivärden board. In the event, Industrivärden decide not to replace Grönstedt and merely withdrew his name from the resolution. The board also proposed the introduction of a share-based incentive scheme, a new step for the company. The plan enables all employees to purchase call options at market price that entitle them to purchase shares on condition that the individual remains an employee of the company for three years afterwards. Industrivärden partly subsidises purchases of share options through cash compensation to the employee for three years after the purchases, provided that the individual still works for the company and retains all acquired options. The scheme is financed by swap agreements with banks, which means there is no direct dilution for shareholders. AP3 notes that the plan lacks a link between performance and reward but that it is uncomplicated and limited in scope, covering all 22 employees and offering a clear lock-in because the incentive is not paid for three years. There is an element of financial risk for beneficiaries, who must use their after-tax income to purchase share options at today's market price and then receive 75 percent of the paid option premium in three years. The plan falls outside the optimal structure outlined in AP3's incentive scheme policy but is probably appropriate for an investment company of Industrivärden's size.

**Securitas** was demerged in 2006 into three independent listed companies: Securitas, Niscayah (formerly Securitas Systems) and Securitas Direct. Much of Securitas's AGM was taken up with the heavy losses of SEK 1.7 billion sustained at the company's Loomis Cash Management subsidiary in the UK. Securitas is one of only a few companies that elect their nomination committees at the AGM. In most cases, the AGM approves principles for the appointment of a new nomination committee.

The board of directors of **Swedish Match** is entitled to circumvent its guidelines for remuneration of senior executives and did so in 2007 by agreeing maximum severance pay of SEK 18 million to the outgoing CEO. This was despite the fact that the CEO resigned voluntarily, which should have disqualified him from severance pay under Swedish Match's own guidelines. The board justified its decision by saying that the CEO would remain at the company's disposal during the handover period. Swedish Match has a profit-sharing scheme for employees and this year the board asked the AGM to approve a share options plan for a maximum of 75 employees. This plan has been in existence since 1999 and is, in AP3's view, deficient because the options are not tied to the employee remain-

ing with the company and can be freely transferred to third parties. On the other hand, it contains a clear link between performance and reward, which is an important asset, and distributions are based on the same independent criteria as the 2007 scheme. Maximum dilution in 2003-2007 was 1.7 percent. The new plan creates further dilution of up to 1.4 percent, giving a total of just over 3 percent. AP3 voted in favour of the board's resolution.

**Handelsbanken's** AGM was preceded by the announcement that Lars Grönstedt would not be standing for re-election as chairman. This was a little strange given that the nomination committee had only a short time earlier presented a proposed new board including Grönstedt. The nomination committee responded by reducing the number of directors by one. Hans Larsson was proposed to replace Grönstedt as chairman, breaking the bank's tradition of having a former chief executive officer in this role. In the past, Handelsbanken's chairman has received a fee from the bank for his board work and a salary paid by the Handelsbanken foundations. The nomination committee proposed a resolution altering this structure and under which the AGM would authorise all remuneration paid to the chairman. The committee also proposed a sharp increase in the chairman's salary and benefits. Though the overall sum was lower than previously, the change brought Handelsbanken into line with the packages paid to the chairmen of SEB and Nordea banks. At Swedbank, the chairman's remuneration package remains similar to Handelsbanken's former structure. AP3 supports Handelsbanken's new remuneration structure, though we question the lack of disclosure on the issue.

Handelsbanken has no bonus or share-based incentive schemes. Since 1973 it has relied exclusively on a profit-sharing system called the Octagon Fund to reward employees. This fund is not subject to AGM decisions, however. At this year's AGM, Handelsbanken proposed the introduction of a convertible warrants plan for all employees. The warrants require beneficiaries to invest a portion of their salary, with finance provided by Handelsbanken at market rates. The plan contains no link between performance and reward and is more reminiscent of the share savings plans at Ericsson and SEB. Maximum dilution is 2 percent. This might be seen as high for a single-year plan, but the scheme is a one-off. Also included is a three-year lock-in, which creates an incentive for employees to remain with the bank. Given this context, AP3 voted in favour of the plan.

Prior to pharmaceuticals company **Medivir's** AGM this year, several of the Board's seven directors announced they would be stepping down from the board at the 2009 AGM. In an effort to maintain continuity, the nomination committee proposed changing the articles of association to allow the board to be expanded from eight members to ten. It did so on the assumption that next year's nominating committee would recommend a return to a smaller number of directors. The resolution was approved and Medivir currently has ten board members. The company has a staff share options programme dating back to 2007 and which runs to 2012. No new programmes were submitted to this year's AGM.

**Atlas Copco's** nomination committee presented a resolution recommending that directors be able to choose between being paid partly in synthetic shares and partly in cash, or being paid entirely in cash. The board of directors proposed a performance-based share options scheme for 245 key individuals structured on similar lines to the previous year's plan. Beneficiaries do not pay for the share options and therefore do not assume any financial risk, which AP3 regards as a key ingredient. AP3 criticised the absence of a link to continued employment, as we did last year. On a positive note, distributions are performance-related and depend on Atlas Copco meeting its economic value added targets in 2008. The plan is of relatively short duration, with one third of options being redeemable after the first 12 months. AP3 voted, as last year, in favour of the resolution. However, we did so on the basis that the company will modify any future incentive schemes to address our criticisms.

A strong balance sheet, solid cash flow and real estate sales resulted in **JM's** board of directors proposing a major capital transfer to shareholders. The transfer took the form of a redemption programme that handed back about SEK 1 billion to shareholders. The board put three resolutions to the AGM: a SEK 110 million convertible debentures programme for all employees and two long-term incentive schemes in the shape of a share savings plan and a performance share plan. The convertible debentures programme stipulates a pre-conversion qualifying period of two years, which creates a lock-in effect. The two incentive schemes are aimed at 50 senior managers and run for seven years, including an initial three-year qualifying period. The share savings plan presupposes a financial contribution from the beneficiary. Share allocations are linked to the beneficiary's after-tax salary (which, in turn, is linked to the attainment of operating and financial targets for pre-tax operating profit, earnings per

share and a customer satisfaction index). The performance share plan is linked to growth in the company's profits over a three-year period. The maximum dilution from the three plans is specifiable and limited. AP3 voted in favour of the resolutions.

The chairman of **Swedbank** earns a fee of SEK 1.35 million approved by the AGM and draws a salary of SEK 3.1 million as an employee of the bank. Following the changes in chairman's remuneration at Handelsbanken, Swedbank is the only major bank that pays its chairman both a board fee and salary. Swedbank's rules on remuneration of senior executives allow it to offer short-term and long-term incentive schemes, with board approval required for short-term schemes and AGM approval for long-term schemes. The company proposed no long-term incentive schemes for 2008.

**Sandvik's** pay guidelines for senior executives state that members of group management receive a fixed salary, annual variable salary and long-term variable salary. The qualification requirements for annual variable salary are that the company reaches annual profit targets and meets quantifiable goals in the individual's area of competence. The maximum annual variable salary payment is 50-75 percent of fixed salary. The qualification requirements for long-term variable salary are fulfilment of quantifiable targets set by the board of directors. These include creation of shareholder value allied to the company's growth, profits and capital efficiency over a three-year period. The maximum long-term variable salary payment is 45-50 percent of fixed salary. In the past, Sandvik has paid long-term variable salary in the form of share options, though only share options from 2004 remain usable. There are 20,000 share options outstanding and the company estimates the cost of these at SEK 2.5 million. The AGM was not asked to approve any new incentive schemes.

The incentive scheme approved at the **Scania** AGM is, in effect, a variable component of salary. It is divided into two parts, consisting of cash amounts measured as percentages of annual fixed salary based on the beneficiary's job. The percentages are, in turn, measured on residual net income (RNI) and change in RNI and are set by the remuneration committee. Scania defines RNI as net profit minus the cost of equity. RNI and change in RNI are 45-150 percent and 35-80 percent of fixed salary respectively. Half of the combined total for the two components is paid out in cash, with the remainder (less tax) invested in shares distributed over three-year periods, with one third being distributed each year. Payments and distri-

butions are conditional on the beneficiary being employed at the end of the relevant financial year or having agreed retirement terms. AP3 voted in favour of the resolution because the plan is tied to employment, contains a link between performance and reward and locks beneficiaries in for three-year periods.

**Eniro's** nomination committee submitted an AGM resolution asking shareholders to authorise the board of directors to set the principles for directors' ownership of shares in the company. The resolution, which was approved, requires directors to purchase Eniro shares for a minimum of SEK 180,000 kronor prior to next year's AGM. For the chairman, the minimum amount was set at SEK 350,000. Directors must hold the shares for at least six months after leaving the board. AP3 actively encourages share ownership by board members and we voted in favour of the resolution. Eniro's remuneration policy entitles senior executives to a maximum bonus of 35-70 percent of fixed salary. Some of the bonus is paid in cash; the remainder is converted into synthetic shares with a two-term term (according to the share-based incentive plan approved by the AGM in April 2006). The exact amount payable is conditional on the beneficiary's performance against set targets. The company also has a long-term share savings plan, approved by the 2006 AGM. No new programmes were put before the AGM.

At the **Boliden** AGM the nomination committee proposed the re-election of the new CEO as a member of the board. The company has no share-based incentive plans and no resolutions on this subject were raised at the AGM. Boliden is one of only a few large companies listed on the Stockholm Stock Exchange whose nomination committee members are appointed at the AGM. As of 2009, small shareholders are represented on the nomination committee by Lars-Erik Forsgårdh, former CEO of the Swedish Shareholders' Association.

The **H&M** AGM voted in favour of the nomination committee's recommendation that Mia Brunell Livfors be elected to the board of directors, a move that increased female representation on the H&M board from 25 percent to 30 percent. AP3 has been a consistent advocate of increased diversity and equality in Swedish boardrooms and was positive to Livfors' appointment. We also note that H&M, one of the world's largest clothing companies, has a relatively modest remuneration policy that limits bonuses to a net maximum of SEK 300,000 after tax for members of group management and SEK 900,000 for the CEO. The remuneration policy also requires all bonuses to be in-

vested in H&M shares that must be held for a minimum of five years. The AGM also approved a resolution that future appointments of nomination committee members will be made by the AGM.

At **Lundin Petroleum's** AGM, AP3 voted against the resolution on remuneration and other employment conditions for group management. The issue was dealt with in two resolutions: one on principles (which we supported) and one on long-term variable salary (which we voted against). We voted against the second resolution because long-term variable salary should be a separate agenda item under the terms of the Swedish Code of Corporate Governance. The plan adopted by the AGM included share-based remuneration, which meant it should have been treated as an incentive scheme and dealt with separately from the rest of the remuneration scheme. Moreover, the long-term variable incentive scheme was deficient in that it lacked targets and defined grounds, was unclear on payment amounts and contained no information on the total estimated cost and how the plan would be reviewed. AP1, AP2, AFA, Swedbank Robur Fonder, a number of foreign institutions and the Swedish Shareholders' Association also voted against the resolution.

**Alpcot Agro** is a Swedish limited company that acquires and farms agricultural land in Russia. Its board of directors asked the AGM to authorise the issue of 20 million new shares on one or more occasions up to the next AGM, with or without derogation from shareholders' pre-emption rights. The issue(s) would increase share capital by up to SEK 100 million and entail dilution of 48 percent. Any derogation from shareholders' pre-emption rights would be to facilitate mergers and acquisitions, to stimulate the company's growth and, if necessary, to strengthen the group financially and enable its shares to be listed on a regulated market or trading platform. AP3 believes it is important to safeguard the pre-emption rights of existing shareholders to participate in new issues of shares, but we consider that directed issues can be acceptable in special cases. AP3 voted in favour of the board's proposal in this instance. We also spoke at the AGM to underline the importance of the company observing social and environmental responsibility standards and regularly disclosing its activities in this area, as well as to ask the CEO to explain how the company is addressing these issues at present.

The board of directors of **Kinnevik** asked the AGM to approve a performance-based incentive plan for around 20 senior executives. Beneficiaries must be existing owners of shares in Kinnevik or purchase Kin-

nevik shares in the market when registering participation in the plan. For each share owned, beneficiaries receive a free allocation of target-based and/or performance-based retention rights, provided that certain conditions are met over a three-year period, that the beneficiary remains an employee of the group at the end of the three-year period and that the beneficiary still owns the original shares. Retention rights are allocated in four different series for Kinnevik employees and five series for Korsnäs employees. Performance conditions consist of absolute targets, such as positive total return, and relative targets, such as annual total return in relation to the total return on the Stockholm Stock Exchange. The plan requires a personal investment by beneficiaries, is performance-based, incorporates a lock-in period of three years and entails maximum dilution of 0.04 percent, making it inexpensive for shareholders. AP3 voted in favour of the resolution.

Telecom operator **Tele2** deviated from its own executive pay guidelines on two occasions in 2007. In conjunction with the appointment of the company's director of M&A operations as CEO of the Russian organisation and market area manager, Tele2 granted her a maximum variable incentive equal to her fixed salary. This doubled her variable remuneration. The board of directors also amended the components of the CEO's total remuneration package by reducing his annual basic salary and raising the maximum short-term incentive. The AGM approved a performance-based incentive scheme for 80 senior executives and other key individuals. Beneficiaries, who must already own shares in Tele2 or purchase them in the stock market, receive a free distribution of target-based and/or performance-based retention rights under the same principles as apply at Kinnevik. The plan requires a personal investment by beneficiaries, contains a strong link between performance and reward and has a lock-in period of three years. Maximum dilution of 0.19 percent means the cost to shareholders is low. AP3 supported the resolution.

AP3 has a seat on the nomination committee of **Enea**. The board of directors asked the AGM to approve a new three-year share options scheme for employees of the wholly owned US subsidiary, Enea Embedded Technology. A similar scheme was introduced in 2007 and this year's proposal was straightforward, linked to employment during a lock-in period of three years and did not involve major costs for shareholders. It was share options-based, a structure that we usually have reservations about. However, in this case we decided it was justified because it was tailored to the US market.

**RaySearch Laboratories** has no nomination committee and most AGM resolutions are proposed by the board of directors (though this year's resolutions on the election of the chairman and directors and on remuneration issues were proposed by shareholders representing around 70 percent of the voting rights). The company has no incentive scheme specifically for senior executives and did not propose any such programme to the AGM. However, the remuneration policy approved by the AGM entitles senior managers (except the CEO) and other employees to participate in proposed share options and profit-sharing schemes.

The board of directors of medical technology company **Aerocrine** submitted an AGM resolution requesting authorisation for an increase in share capital through the issue of new shares, warrants and convertible debentures with a total dilutive effect not exceeding 20 percent. According to the proposal, securities would be issued on one or more occasions up to the next AGM and with or without derogation from shareholders' pre-emption rights. AP3's corporate governance policy states that the pre-emption rights of existing shareholders should be safeguarded. However, directed issues are acceptable in special cases and we considered Aerocrine to be one of these. In AP3's view, it is vital that the company is in a position to raise external capital, broaden the shareholder base and increase liquidity in its shares as and when needed. Increasing the share capital would significantly dilute shareholders' equity holdings in the short term, but would probably be in the company's best long-term interests. For this reason we voted in favour of the board's resolution.

In addition to attending and voting at the 36 AGMs listed above, AP3 also voted by proxy at various other AGMs. We are strongly in favour of remote voting and encourage listed companies to offer this service to shareholders, whether by post or electronically.

Gaming company **Unibet** is domiciled in Malta, where national law requires at least half of all the outstanding shares be represented at the AGM for the meeting to constitute a quorum. AP3 voted by proxy, as we did in 2007.

**ABB** held its AGM in Zurich and AP3 voted remotely. ABB follows the European model, whereby the board of directors – not the nomination committee – submits all AGM resolutions, including its own re-election resolution. Directors are elected individually, which allows shareholders to withhold support from specific candidates if they wish. Directors' pay, remuneration guide-

lines for senior executives and share-based benefits are not subject to AGM approval.

**AstraZeneca** is domiciled in the UK and is therefore not subject to the same rules as companies listed in Stockholm. For example, allocations of shares or share options under incentive plans are approved by a remuneration committee rather than the AGM. AstraZeneca sought authorisation to make limited party-political contributions. Such contributions are not unusual among foreign companies and are used for lobbying purposes. The company's 2007 annual report disclosed contributions last year to local and national party-political committees and local campaign committees for candidates of the major political parties. AP3 is obliged as a government agency to refrain from political partisanship, and for this reason we voted against the resolution.

**Oriflame Cosmetics**, domiciled in Luxembourg, offered shareholders the option of voting remotely at its AGM. The meeting authorised the board of directors to allocate 6.5 percent of any increase in annual operating profit to a profit-sharing scheme for senior managers, with individuals entitled to receive distributions of up to 12 months' salary. In line with past practice at Oriflame, only a limited number of beneficiaries were included in the scheme. This is also why only 6.5 percent of the increase in operating profit was made available for distribution, as opposed to 16 percent previously.

At the AGM, Oriflame held a simultaneous extraordinary general meeting to approve an incentive plan for around 150 senior managers. The plan involves beneficiaries being invited annually to purchase shares at market price and then receiving up to four free shares over a three-year period, depending on growth in group operating profit. The plan involves maximum equity dilution of 3 percent, which might seem high for a single incentive plan. Nevertheless, AP3 voted in favour of the resolution because the plan requires an investment by the beneficiary and has a multi-year structure and because the company also reduced allocations to the profit-sharing scheme.

Two other companies, **Old Mutual** and **Autoliv**, have also made it easy for shareholders to vote by proxy, and AP3 did so at both AGMs. Neither company had any controversial issues on their agendas and we voted in support of all resolutions.

### **Governance in the global equity portfolio**

AP3 adopted a global corporate governance policy in

2006 that complements the governance policy for Swedish equities and focuses on our foreign equity holdings. The bulk of the foreign equity portfolio is managed by external managers, to whom we delegate AP3's voting rights. Managers – especially active managers – are devoting greater internal resources to governance issues. Managers that provide passive management usually exercise voting rights in line with advice from corporate governance specialists, such as RiskMetrics Group of the US and Manifest in the UK. AP3 talks regularly to managers to find out how they deal with governance issues.

In the past, AP3 (unlike some other Swedish institutional investors) has chosen not to participate in class actions against foreign companies. However, our custodian bank, Northern Trust, has monitored our interests in this area to ensure we claim our share of any damages awarded. Such awards are usually agreed in a settlement between the parties.

The US courts have ruled that only investors from certain countries outside the US are entitled to participate in an ongoing class action against Vivendi Universal, a French company partly managed from the US. Swedish investors are among those excluded from the lawsuit. It is, however, possible for other investors to sue the company via a direct action and many of the institutions that have been excluded from the class action are preparing, or have already initiated, direct actions. Most of Sweden's large pension funds, including AP3, intend to pursue direct actions and AP3 has hired an American law firm in this regard.

### **Environmental and social responsibility**

AP3's parliamentary mandate is to practise environmentally and socially responsible investment without compromising the overriding goal of high investment returns. Environmental and social responsibility form part of the governance policy. AP3's social and ethical standards are based on international conventions and agreements ratified by Sweden, such as the ILO's core conventions, the UN Declaration on Human Rights and the OECD's guidelines for multinational corporations.

We use two methods to implement social and environmental responsibility. The first involves screening companies that we invest in to make sure they are not violating international conventions. The second method is to engage in active dialogue with companies to promote adequate policies and procedures for managing social and environmental risks.

## **The Ethical Council**

AP1, AP2, AP3 and AP4 in early 2007 established a joint Ethical Council for ethical screening and dialogue with foreign companies. The purpose of the Council is to deal more effectively with social and environmental violations and work together to influence the companies in which the funds invest.

An external expert screens the funds' Swedish and global equity portfolios twice a year to determine whether any of them violate international conventions. If a company is accused of breaching international conventions, the Council investigates the facts, contacts the company and tries to initiate dialogue to encourage action to prevent any recurrence.

During 2007 the Council held dialogues with 14 companies worldwide. The Council also participates in various international initiatives to underline the AP funds' commitment to responsible investment and encourage companies to be more engaged in this area.

In addition to company dialogues and investor initiatives, the Council also published its 2007 annual report in April this year. The report is available for download from the AP funds' websites.

## **Proactive dialogue on social and environmental responsibility**

AP3 focuses its proactive initiatives on social and environmental responsibility primarily on Swedish companies with substantial production or purchasing in countries governed by non-democratic regimes or with weak labour and environmental laws (the latter applies primarily to developing countries and newly industrialised nations).

We make the following demands on such companies:

- **Risk analysis and systems**  
Companies should work systematically to identify the social and environmental risks to which their businesses are exposed. They should also have risk management systems in place.
- **Code of conduct**  
Companies should have group-wide codes of conduct covering human rights, working conditions and environmental protection. Codes should be based on the UN Declaration on Human Rights and the ILO's core conventions. They should be publicly available and subject to compliance monitoring.
- **Reporting**  
Companies should publish external social and environmental reports either in their annual report or

in a separate sustainability report and make them available on their websites. The guidelines of the Global Reporting Initiative, a UN initiative to create a global standard for corporate sustainability reporting, are an appropriate framework for such reports.

## **Dialogues with companies**

AP3's primary approach is dialogue with companies. We believe this provides the best opportunity to exert influence. As a long-term investor we realise that change can take time and we therefore work systematically to monitor company responses to our views and requirements until we have achieved our objectives in each specific dialogue.

In late 2007 we undertook a systematic review with the help of our responsible-investment adviser, GES, to identify which Swedish companies are least prepared for social and environmental risks in their businesses. We already have ongoing dialogues with many of the companies identified. However, a couple of new firms were identified and we have already started or will be starting dialogues with them. The dialogues aim to ensure that companies have risk management systems, codes of conduct and managers for social issues and/or environmental protection to limit the risk of the organisation breaching international conventions.

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 analysis. The global debate on climate change has resulted in green issues once again coming into the spotlight.

Our dialogues during the year focused on a wide range of areas: working conditions; occupational health and safety; human rights; risk management analysis and systems; industry and country risks; codes of conduct for own personnel and suppliers, including training and compliance monitoring; supplier audits; environmental protection, including risks and opportunities; corruption risks, sustainability reporting; and external audit.

## **International initiatives for social and environmental development**

AP3 has been a member of **Amnesty Business Group (ABG)** since 2005. ABG trains and lobbies Swedish companies to respect and promote human rights in their markets. The aim of our membership is to acquire knowledge and promote action to prevent human rights violations. ABG was one of the main

sponsors of an annual survey, published in March 2008, on risk exposure and risk management at Swedish companies in relation to human rights.

In mid-2006 we signed **the UN Principles for Responsible Investment**, an initiative to encourage investors to integrate environmental, social and governance considerations in their financial analysis and decision-making processes. By signing the PRI, we declared our support for the initiative and intent to comply with the principles within the framework of our mandate.

Also in 2006, we became a signatory investor in the international **Carbon Disclosure Project**. The CDP aims to encourage increased transparency in corporate reporting of climate change strategies and improved documentation of key metrics used to measure progress. The CDP compiles information in a common database that investors can use to identify the risks and opportunities associated with specific companies. Questionnaires were sent to 2,400 companies in 2007. CDP has the backing of 385 investors with assets of \$53 billion and this was one reason for the high response rate of 80-90 percent. Early in 2008 AP3 contacted a number of Swedish companies that had not returned the questionnaire, urging them to do so.

AP3 also supports the **Extractive Industries Transparency Initiative**, which promotes increased transparency in revenue reporting – a much needed development in countries that are rich in minerals but have weak governments.