



30 August 2006

Report on AGM Season 2006

Purpose of a governance report

AP3's position as a manager of Sweden's national pension capital and an institutional investor requires high transparency across our operations. We are very clear when it comes to communicating the Fund's position on issues of corporate governance. We do so through the corporate governance policy approved by the Board and published and updated regularly on our website.

However, it is not always possible to disclose detailed information about our discussions with other shareholders and corporate managements and boards. This is mainly because confidential dialogue is often the most effective way to get AP3's point of view across.

In the United States it is much commoner for pension funds to exercise influence through publicity campaigns. This reflects the dispersed ownership structures of US companies and the fact that US commercial law imposes a weak protection of shareholders' rights. The rights of shareholders to file resolutions to general meetings are strongly circumscribed, while some of the decisions of such meetings on key issues are advisory rather than legally binding, as in Sweden.

AP3 has a parliamentary mandate to exercise its influence as a shareholder to help secure its overriding goal high investment returns. Hence, we prioritise concrete results. Our strategy is to exert influence at an early stage in the process of negotiating proposals to the

AGM. Only in cases where a positive response to our key demands is not forthcoming do we consider raising the issue at the AGM or voting against the board's proposal.

Research shows that, even in the US, pension funds that have focused on confidential dialogue have been more effective in getting their views across than those which have pursued media campaigns. AP3's strategy of prioritising engagement through dialogue as a means to exert influence means that we cannot always reveal everything about the discussions and negotiations to which we are party. At the same time, we have a strong desire to openly disclose the ways in which we exercise the fund's ownership rights and the issues we have highlighted during the preceding 12 months. That is our motive for publishing this annual governance report. Since most AGMs are held during the first half of the year, we have timed publication of this report to coincide with our interim statement for the first six months, though the report covers the 12-month period ended 30 June 2006.

AP3's corporate governance activities

The AP3 equity portfolio of SEK 100 billion is invested in 3,500 companies around the world. The Fund's equity in foreign companies is very low, varying from 0.02% to 0.06% of the voting rights. In Sweden, however, our share of the voting rights is much larger. In 55 companies we have more than 0.4% of the voting rights, and in five of

these our share exceeds 1%. Compared to other Swedish institutions, AP3 is a small to mid-sized player. At the start of 2006 we were the 11th largest institutional investor on the Stockholm Stock Exchange.

In corporate governance, as in other areas of our operations, AP3 allocates resources to give priority to areas where the greatest results can be achieved. As a result, AP3 prioritises active governance in companies where we have a relatively large share of capital. These are limited at present to Swedish corporations. We also attach great importance to participating actively in the debate on governance issues in the Swedish equity market.

The Fund's foreign equity portfolio is managed primarily by external managers, to whom AP3 delegates its voting rights. We talk regularly to the managers to find out how they have approached various governance issues. In recent years, many active management firms have opted to devote more resources to governance matters, for instance by recruiting experts in the field. For index management, managers often opt to exercise their voting rights on the lines of advice provided by special proxy voting consultants, such as Institutions Shareholder Services (ISS) of the US.

In June 2006, the AP3 Board approved a global corporate governance policy to cover its foreign equity holdings and to supplement its governance policy for Swedish equities. The policy is available for download at www.ap3.se.

AP3 is a member of Institutional Corporate Governance Network (ICGN), a global network for institutional investors active in the governance field. The network has 400 members from 30 countries with combined assets of US\$10,000 billion. Being a member

of the network enables AP3 to influence the development of international governance practices. ICGN responds to consultation papers and conducts campaigns to protect investor interests in legislation, listing requirements and corporate governance codes.

AP3's Swedish equity portfolio is managed by our internal managers and included 75 companies as of 1 January 2006. We have restructured our Swedish equity management strategy to reduce risk and generate higher returns. The changes, initiated in autumn 2005, have increased the number of companies in the portfolio and reduced the average size of our holdings in individual companies.

AP3's main tools for exercising governance are:

Nomination committees. AP3's policy is always to accept a nomination committee seat when we are asked. In Sweden, nomination committee members consist of the three to five largest shareholders. AP3's relatively small shareholdings in most companies mean that we generally exercise governance without having a seat on the nomination committee. This makes it important to establish a dialogue with the institutional investors represented on the nomination committee in instances when we wish to play a role. Our experience is that strong arguments often weigh more heavily than the investor's share of the voting rights.

Dialogue with board of directors/ executive management. AP3 uses a variety of ways to communicate its standpoint to the corporate bodies that have greatest influence over governance matters, namely the board of directors and executive management. We are increasingly contacted by boards wishing to hear our views, for instance in relation to

share-based incentive schemes. On occasion, we also initiate dialogue with managements and boards when we wish to discuss a particular governance issue.

The right to vote at an AGM is an important asset that AP3 seeks to use in such a way as to generate higher portfolio returns. Since the Fund's inception in 2001, our policy has been to exercise our vote at the AGMs of all companies in our Swedish equity portfolio.

Raising issues at AGMs. AP3 strives to be an active participant in AGM debates, which means that we are prepared to raise specific issues, ask questions and, when necessary, voice criticism.

Active role in self-regulation. AP3 is a member of Institutionella Ägares Förening, an association of institutional investors and an important player in the Swedish equity market's system of self-regulation. AP3's CEO Kerstin Hessius and Deputy Chairman Lars Otterbeck are members of the Council for Swedish Corporate Governance. We aim to use our involvement in these organisations to foster the development of improved corporate governance practices in the Swedish equity market.

Contacts with foreign shareholders. Foreign institutions have emerged as increasingly active owners in Swedish companies and now exercise their voting rights at AGMs much more extensively than in the past. Hence, discussions between shareholders often include foreign investors. Unfortunately, foreign shareholders tend to have a negative image of Swedish governance and view our nomination system with suspicion. In the last year AP3 has helped to market the Swedish governance model abroad and took an active role in a working group set up by the Council for Swedish Corporate Governance. AP3's CEO Kerstin

Hessius visited US corporate governance consultancy Institutions Shareholder Services (ISS) in July 2006 to discuss why ISS had assigned Swedish companies a low rating in its global governance rating. AP3 also made presentations to a number of conferences, including the International Corporate Governance Networks annual global conference.

Dialogue prior to AGMS in 2006

AP3 has a not-inconsiderable stake (defined as more than 0.4% of the equity) in 56 Swedish corporations and had contacts with 35 of these on 64 different governance matters from July 2005 to June 2006.

Focus issues in 2005-2006

AP3 selects a number of focus areas and issues prior to each AGM season. For the 2006 season, we prioritised the following areas:

Share-based incentive schemes

Share-based incentive schemes are among the most important issues on which AP3 has to vote at an AGM. We have worked for many years to promote options programmes that are reasonable, transparent and performance-linked. Since we voted against the Skandia options scheme in 2002 we have noted a significant improvement in the structure of options and share-based incentive schemes in the Swedish equity market. A couple of years ago, more than half of such programmes lacked performance conditions or any required investment by the beneficiary. This figure had fallen to 20% for the schemes proposed in 2006.

In October 2005 we published a document that discussed the pros and cons of share-based incentive schemes (see www.ap3.se). Our analysis was based on studies of the international corporate governance debate

and research by leading academics in the field. The document contains a checklist that we use when examining and deciding our approach to individual options schemes. In autumn 2005 AP3 arranged a workshop with leading representatives from Swedish institutional investors to discuss the issues raised in the document.

In advance of this year's AGMs, we used the document to convey our approach on options programmes for boards and executive managements. Our hope is that by raising effective arguments we will help to ensure that the options schemes proposed by Swedish corporations are reasonable and balanced. We are concerned about developments in the US, where inadequate transparency and the absence of a link to performance have allowed many corporate managements to manipulate options schemes to generate unjustifiably large benefits to participants. Some 50 corporations are currently under investigation by the US financial inspectorate for option backdating. At the same time, we often hear the argument that Swedish corporations should mirror US remuneration systems for competitiveness reasons. AP3 is committed to efforts to prevent adoption of the US remuneration model by Swedish businesses.

Twenty-three of the 56 Swedish companies in which we hold more than 0.4% of the equity held votes on proposed share-based incentive programmes at their 2006 AGMs. In 17 cases, we discussed the proposed schemes with company representatives beforehand. We voiced criticism in four instances, and in three of these cases our views were accepted. In the case of one company, Lundin Petroleum, we voted against the board's proposal. AP3's representative, Pernilla Klein, made the following statement at the AGM:

"The Third Swedish National Pension Fund is positive to share-based benefits. We think they can be an effective way to align the interests of management and shareholders. But at the same time, we want these programmes to be structured so they are in shareholders' best interests – and a basic requirement in this context is a link to performance. A simple rise in the share price should not be enough to trigger a capital gain. After reading the options scheme proposed by the board, it is AP3's view that it does not meet our basic requirements. The link to performance is far too weak. The Lundin Petroleum share price is strongly dependent on one factor that is beyond the influence of management, namely oil prices. I would like to urge the board to study the benefits of schemes operated by competitors.

Let me give a few examples:

Royal Dutch Shell: Decided this year to cease all awards of options with no link to performance. The company has adopted a new system that introduces vesting conditions relating to how its share price and dividend perform in comparison to those of competitors (defined as integrated oil companies).

BP: Has a more or less identical performance-based programme.

Kerr McGee: Has introduced a system of synthetic shares that makes payouts conditional on favourable share price and dividend performance compared to those of competitors.

Premier Oil: Has also introduced performance criteria. The fact is that it is difficult to find a European oil company that continues to operate the type of nonperformance-based scheme that the board is proposing. Regrettably, I must observe that the proposal does not meet the requirements that AP3 places on share-based incentives and that we will therefore be voting against it."

In response, the Lundin Petroleum board said the remuneration committee would initiate a

review of the company's option schemes ahead of the 2007 AGM. AP3 was invited to participate in these discussions.

Proxy voting

Sweden is one of the world's most difficult and expensive countries when it comes to proxy voting since the practice has not been allowed under the Swedish Companies Act. With foreign institutional investors increasingly keen to exercise their voting rights, the Swedish rules have attracted growing international criticism. There is no doubt at all that obstacles to proxy voting have contributed to the negative international image of Swedish corporate governance.

Increasingly integrated global financial markets have led to a high proportion of foreign ownership on the Swedish equity market. In the longer term, it is unsustainable for Swedish corporations to maintain barriers for these shareholders to exercise their voting rights. If we continue on the current path the risk is that international investors will demand a higher risk premium.

The new Swedish Companies Act that came into force this year scraps the ban on proxy voting, though the practice is only possible if the AGM votes to amend the articles of association. AP3 wrote to 25 Swedish corporations with a large base of foreign investors prior to their 2006 AGMs to press for the introduction of proxy voting. Four of these companies (Swedish Match, Telia, Nordea and Castellum) amended their articles of association to allow distance voting. AP3 has contacted four of the remaining 21 corporations to further clarify our views and arguments on this issue. These initiatives will continue during 2006, and AP3 intends to submit a proposal motion to amend the articles of association of at least one company in 2007.

Code of Corporate Governance

A key feature of the 2006 AGM season was the Swedish Code of Corporate Governance ("the Code"), which came into force in mid-2005. AP3 welcomes the Code because it helps to make Swedish corporate governance more transparent. Though a formal code serves as the reference point for what constitutes best practice, it is important to realise that all companies are unique. What practises are in the best interests of shareholders vary from company to company and here the Code provides important flexibility through its "comply or explain" principle, which allows the market to judge whether a company's explanation for its deviation from the Code is acceptable or not.

AP3 works to promote straightforward and readily comprehensible corporate governance reports that are not overly complex or legalistic. It is important for companies to inform the market if they have deviated from the Code and to explain what alternative model they have chosen to follow.

One of the Code's most important achievements is the nomination committees that have been introduced by all major listed corporations. This system, whereby the committee members are investor nominees, operates only in Sweden and, to a degree, in Norway and Denmark and is therefore unique internationally. By contrast, the nomination committees of foreign corporations are appointed by the board of directors. The Swedish model has created a natural interface between the board, principal shareholders and institutional investors. This has helped to improve the climate of debate and made boards more inclined to listen to the views of investors.

The Code has also clarified the role of the nomination committee, which in turn has

made the nomination committee's work more structured and removed the need to discuss its scope and remit. At the same time, the amount of work entrusted to nomination committees has increased.

A new Code rule, introduced this year, was that the AGM must approve a remuneration policy for senior executives. These policies were invariably passed without a much debate and their content was in most cases highly generalised, which AP3 sees as desirable in order to avoid any risk of the AGM wresting responsibility for remuneration from the board of directors. Recruiting and setting the remuneration of a CEO is one of the board's core tasks.

AP3's involvement in nomination committees

Prior to the 2006 AGM season, AP3 was a member of the nomination committees of Ratos (Pernilla Klein, chairman), Nobia (Kerstin Hessius), Swedish Match (Pernilla Klein), Haldex (Pernilla Klein) and Castellum (Pernilla Klein).

On these committees we worked to promote the adoption of board performance reviews and to improve the quality of such reviews. We also think it is appropriate to commission external assessments at regular intervals. Questionnaire-based reviews may also need to be supplemented by conversations with individual board members. The latter approach is often an effective way to gain insight into the board's workings.

AP3 believes new directors should be selected from a broad range of potential candidates. It is particularly important to identify potential female candidates. A selection process of this nature is often best performed by an external recruitment specialist. AP3 attempts to ensure that people

from outside established networks are elected to serve on corporate boards. The aim should be to make sure that the company has a board whose members have high integrity and who form a balanced team with different career backgrounds and experience.

One of the nomination committee's primary tasks is to ensure that proposals have the support of shareholders not represented on the committee. However, this role is under threat from the increasingly prevalent practice of corporations requiring nomination committee members to sign confidentiality agreements requiring them not to disclose information to third parties. AP3 has declined to sign any such far-reaching agreements and has instead suggested a less rigid text. Up to now, companies have agreed to use our formulation instead.

Trend of rising board fees

Fee increases for directors remains a clear trend. Companies often cite the greater workload arising from the Code as justification for the increases. For companies in the Investor business sphere, directors' fees have risen by 25% and the increases have been accompanied by requirements for board members to purchase shares. At the same time, Swedish board fees remain far below international levels. The remuneration of non-executive directors of Swedish companies are only half the level paid to directors of UK corporations.

Opinion differs among institutional investors on whether it is appropriate to increase fees, but AP3's view is that in many cases it is necessary to do so. Membership of a corporate board should not be seen as a titular position but as a role requiring high competence and responsibility. It is therefore natural that the remuneration reflects the director's workload and responsibilities. It

must be sufficiently high to attract and retain suitably qualified and independent directors, and competitive enough to attract foreign nationals to accept directorships in Swedish corporations. In 2006, AP3 representatives have in a variety of cases initiated proposals efforts to raise directors' fees.

AGM voting

AP3's Swedish equity portfolio totalled 75 companies at the start of 2006 and our ambition has been to vote at the AGMs of all these firms. Our policy is to send a member of our own staff to attend the AGMs of companies in which our shareholding exceeds 1%, with which we have held discussions on an important matter, or which have a controversial issue on the AGM agenda. For other companies, we use the proxy service provided by our custodian bank. In all cases where we voted by proxy, our votes were cast in favour of all board proposals included in the AGM agenda.

We used a system to examine the AGM agendas of all 75 companies and identify controversial issues. We attended the AGMs of 22 companies by sending our own representatives. In nine of these companies AP3 controlled more than 1% of the equity. In the other 13 companies we attended the AGM for other reasons. At 49 AGMs we voted through the voting platform provided by our custodian bank.

Using our custodian bank for this purpose was a pilot project that began at the start of 2006 and will be reviewed, along with the entire AGM voting policy, prior to the 2007 season.

Issues raised by AP3 at AGMs

AP3 raised matters at five of the 23 AGMs that we attended during the year.

Haldex: Pernilla Klein raised the issue of the took the view that the offer, representing a Amnesty Business Group's demand that the CEO report on efforts to implement the company's corporate code of practice. Pernilla thanked the CEO for responding and said AP3 would follow with interest the company's efforts to live up to the code's requirements in all respects.

MTG: Pernilla Klein advocated the introduction of proxy voting and asked the company chairman to respond on behalf of the board.

Eniro: Christina Kusoffsky Hillesöy asked the above question.

Enea: Pernilla Klein asked the chairman of the board if the company (which changed its articles of association) planned to introduce proxy voting the following year.

Lundin Petroleum: Pernilla Klein criticised the proposed options scheme and said AP3 would vote against it. The Fund also asked for its dissenting opinion to be recorded in the minutes.

Lundin Petroleum (general meeting): Christina Kusoffsky Hillesöy informed the meeting that AP3 was voting no to the decision to extend the options scheme proposed at the AGM.

Issues in the spotlight

Gambro

One of the major corporate events in Sweden of the first half of the year was the bid by Investor and EQT for Gambro. A number of institutional investors, led by Robur, rejected the initial offer as inadequate, though AP3 took the view that the offer, representing a premium of 29% over the average share price in the preceding three months, was acceptable. After Robur's rejection, the offer

premium was increased to 33%.

The Gambro offer also raised the question of whether private equity buyouts are undermining the public equity market. Our position is that the capital markets are in good shape and that company ownership comes in a variety of forms. Different ownership structures can suit companies at different stages in their development. In some circumstances it may be an advantage to be outside the public equity market and thereby avoid the pressure of quarterly reporting in order to pursue a longer-term investment and restructuring strategy.

Private equity is not a threat to the public stock market – quite the reverse. Countries such as the US and US, which like Sweden have a highly developed market for private equity (measured as the private equity market's share of GDP), also have a dynamic public equity market.

Husqvarna

The Second Swedish National Pension Fund (AP2) submitted a counter-proposal to the Electrolux AGM in respect of the proposed distribution to shareholders of Husqvarna. The Electrolux board had proposed that series A shareholders in Electrolux should receive series A shares in Husqvarna, with the same principle applying to holders of B shares. AP2's proposal called for only one series of shares to be distributed, in part because AP2 opposes the system of differentiated voting rights and also because the fund regarded the transaction as being in breach of the principle of equal treatment enshrined in the Companies Act.

AP3's corporate governance policy contains no general reservations about differentiated voting rights so we approached this issue on the basis of whether it infringed the equal treatment principle. We were not entirely

convinced by the legal arguments suggesting that the distribution did infringe the principle, but we welcomed Investor's suggested compromise of reviewing the Husqvarna share structure with the intention of striking a better balance between equity and ownership by increasing the number of series A shares relative to series B shares.

AP2 withdrew its counter-motion at the AGM and all institutional investors, including AP3, voted in support of the board's proposal (apart from SEB Fonder, which abstained).

Environmental and social considerations

AP3's mandate from parliament is to take environmental and social issues into account without detracting from the overriding goal of high investment returns. Environmental and social responsibility form part of the Fund's corporate governance policy. AP3's social and ethical standards are based on international conventions signed by Sweden.

In the field of environmental and social responsibility AP3 has chosen to focus primarily on Swedish corporations that conduct substantial manufacturing or purchasing in countries led by undemocratic regimes or that have weak employment and environmental laws (which relates chiefly to emerging markets or newly industrialised nations).

We make the following demands on such companies:

Risk analysis and systems. The companies should have systems to identify the social and environmental risks to which their businesses are exposed. They should also have systems to manage and monitor risks.

Code of conduct. Companies should have group-wide codes of conduct for human rights and environmental issues. These codes should be published and made subject to compliance monitoring.

Reporting. The company should publish an external social and environmental audit, either in the annual report or in a special sustainability report. The guidelines of the Global Reporting Initiative, a UN programme to create a global standard for corporate sustainability reporting, are an appropriate framework for such reports.

AP3's main approach is dialogue with companies. We believe this provides the best opportunity to exert influence. In the last 12 months we have held discussions with eight Swedish corporations and gained the impression that they have begun taking environmental and social issues more seriously. We see that these questions are rising up the corporate agenda and increasingly being considered at group level. Corporations are also including social risks to a greater degree in their operational and strategic risk analysis.

If it comes to our notice that a company in which we hold shares has been accused of breaching international conventions we investigate the facts, contact the company and, when necessary, urge it to take action to prevent any recurrence.

In 2005 AP3 commissioned external specialists to examine whether certain US defence companies had infringed the Ottawa Convention ban on production, storage and development of a specific type of anti-personnel landmine. We also held discussions with one of the companies concerned. Our conclusion was that there was no adequate basis for excluding the companies from our portfolio.

The US Internet company Yahoo! was accused of having allegedly cooperated with authorities in China in events that led to the imprisonment of a Chinese journalist. AP3 wrote to Yahoo! in June 2006 to state that we take the accusations seriously and wish to see the company develop a policy to avoid similar incidents in future.

AP3 has since 2005 been a member of Amnesty Business Group (ABG), which trains and influences Swedish corporations to respect and promote human rights in their respective markets. The aim of our membership is to acquire knowledge and to contribute to measures to prevent human rights violations.

AP3 was one of the main sponsors of an ABG survey, published in March 2006, which addressed the risk exposure and risk management of Swedish companies in relation to human rights.

In July 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 principles we signalled our support for the initiative and our intention to comply with it in our investment activities.