



Corporate Governance 2007

Published 29 August 2007

The aim of the Third Swedish National Pension Fund (AP3) is to generate maximum returns on fund capital at a low level of risk, and we must use our investor influence to promote attainment of 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 enables us to earn respect for our actions as a shareholder and gain support for our views on key issues.

Guided by the corporate governance policy adopted by the Board of Directors, AP3 aims to communicate clearly the Fund's standpoints on governance issues. The policy is regularly updated and published on AP3's website. However, it is not always practicable to provide detailed reports of the discussions we hold with other shareholders, corporate managements and boards. These processes are a main channel for exerting investor influence based on our policy, and confidential dialogues are often the most effective way to get our views across. We strive to exert influence at an early stage in the process, usually before the AGM season. Only when we receive no response to our key demands do we consider raising the issue at the AGM or voting against the proposal.

Our governance strategy is to prioritise the initiatives we believe will most effectively advance the overriding goal of high returns and the supporting goal of building trust in AP3. There is no guarantee that we will always be able – or willing – to fully disclose our discus-

sions and negotiations with other shareholders. But we do want to report, as openly as possible, how AP3 practised shareholder responsibility and approached its focus issues in the past year. Towards that end, we are pleased to present the annual governance report, which covers the 12-month period ended 30 June 2007.

Corporate governance at AP3

We aim to continually adjust the level of AP3's governance activities to the conditions imposed by our general strategy. The AP3 equity portfolio of approximately SEK 120 billion is invested in 2,500 companies worldwide. Our foreign equity holdings are very small and we rarely control more than 0.05% of the voting rights.

Weighting in Swedish equities was reduced for the 2006 strategic portfolio from 16% to 12%, which slightly reduced equity holdings in Swedish companies. Up to 2006, about half of the Swedish equity portfolio was actively managed, with the remainder under passive management. In the past year, AP3 reviewed the portfolio structure with the ambition of making decisions on market exposure (beta) independent from decisions on active positions (alpha). The outcome is that the entire Swedish equity portfolio is now under passive management. Alpha exposure in individual equities or various types of derivative instruments will be primarily through overlay mandates.

We have also gradually restructured management of the Swedish equity portfolio, which

formerly included small and medium cap equities. The portfolio now includes only the larger companies listed on the Stockholm Stock Exchange. The number of equities under passive management has increased since AP3 now holds shares in nearly all companies on the SBX index (a total of 80), which lowered the level of risk. While the overall impact of the change has been a reduction in the size of individual equity interests in the Swedish portfolio, our stakes are significantly larger in the global equity portfolio. AP3's equity interests in more than 50 companies in the Swedish equity portfolio are between 0.5% and 1% of the voting rights, or slightly higher, but AP3 is still a small to medium-sized player compared to other Swedish institutional investors. As of 31 December 2006, the market value of the Fund's Swedish equity portfolio was SEK 26.8 billion, making AP3 the 13th largest institutional investor on the Stockholm Stock Exchange.

AP3 prioritises active governance in relation to companies in which we have a relatively large equity holding, which presently applies almost exclusively to Swedish companies. We also strongly emphasise active participation in the debate on corporate governance practices in the Swedish equity market.

AP3's main instruments for exercising corporate governance are:

- **Nomination committees.** AP3's policy is always to accept a nomination committee seat when we are asked. Nomination committees in Sweden are usually composed of representatives of the three to five largest shareholders. Because AP3's equity in most companies in the portfolio is relatively minor, we generally exercise governance by means other than nomination committees. At the start of this year's AGM season, AP3 was represented on only
- one nomination committee, Karo Bio, compared to five in 2006, eight in 2005 and ten in 2004.
- **Dialogue with boards of directors and executive management.** This is a highly prioritised avenue for communicating our positions on matters of corporate governance. Companies are increasingly contacting institutional owners like AP3 prior to the AGM to discuss proposals on share-based incentive schemes, for instance. 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 this right so as to generate higher portfolio returns. Going into the 2007 AGM season, we chose to prioritise a manageable number of companies as the main focus for our corporate governance activities.
- **Raising issues at AGMs** is a key instrument of governance. We are always prepared to raise issues in order to explain AP3's position on individual questions, ask questions and – where justified – express criticism.
- **Active role in self-regulation.** As a member of *Institutionella Ägares Förening*, an association of institutional investors, AP3 is actively involved in shaping the Swedish equity market's self-regulation system. AP3's CEO Kerstin Hessius and Deputy Chairman Lars Otterbeck are also members of the Council for Swedish Corporate Governance. The objective of our involvement in these organisations is to improve general standards of Swedish corporate governance.

- **Contacts with foreign shareholders** are becoming increasingly important as these investors become more active and exercise their voting rights at Swedish AGMs. Unfortunately, the foreign investors tend to look askance at Swedish corporate governance and there is, regrettably, widespread distrust of the nomination system. AP3 has helped to market the Swedish governance model abroad, including through participation in a working group appointed by the Council for Swedish Corporate Governance. AP3's CEO has also visited the headquarters of Institutional Shareholder Services, a US provider of corporate governance solutions, to discuss governance issues.

Focus issues in 2006-2007

AP3 selects a number of focus areas and issues prior to each AGM season. For the 2007 season, we prioritised four areas:

Performance links in share-based incentive schemes

AP3 has for several years now applied several fundamental standards for share-based incentive schemes, which we believe must be reasonable, transparent and performance-linked. The standards are presented in detail in an analysis report we published in 2005 and which is available on our website. We are pleased to note improvements in the structure of share-based incentive schemes, which are increasingly being linked to performance conditions and required investments by beneficiaries.

Most listed companies now discuss proposed incentive schemes with major shareholders well before the AGM. AP3 is frequently invited to participate in these advance discussions and we appreciate the opportunity. As in previous years, we expressed our opinions of proposed schemes to several companies

prior to the 2007 AGMs. For the first time, this year's corporate governance report includes an explanation of AP3's votes related to share-based incentive schemes.

Board diversity at listed companies

AP3 supports diversity on the boards of directors of listed companies and we believe board composition should reflect a broad spectrum of experience. AP3 is making efforts to ensure that board seats are offered to people outside the established networks and encouraging companies to carry out a wide-ranging inventory of potential candidates. We believe it is particularly important to identify women candidates.

The outcome of this year's AGM season was that women's representation on the boards of listed companies increased slightly, from 17.7% last year to 19.3%. While quite a few women were elected to boards of directors at AGMs in 2007, several companies also enlarged their boards by electing additional male directors. Volvo's board was increased from eight to nine directors and Electrolux added two additional male directors to its board. Several women also left their directorships; three women left the board of Nordea, while only two were elected.

It seems to be relatively difficult to recruit women directors, in part because the recruitment base is limited. There are few women in other executive positions at Swedish listed companies, as shown by a study of women in executive management conducted by AP3 and Nordic Investor Services. The study, which covered all 266 companies traded on the Stockholm Stock Exchange, should be considered an attempt to broaden the debate on underrepresentation of women on corporate boards to include the question of why there are so few women executives at these companies. The study shows that as of 2006, only 12.1% of executives in group manage-

ment were women and half the surveyed companies had no women executives in group management. The percentage of women executives at listed companies declined slightly in the last year to 11.4%. The percentage of women in executive management is thus considerably lower than the percentage of women on boards of directors.

Proxy voting

More foreign shareholders have started voting at Swedish AGMs in response to stricter foreign regulations requiring institutional shareholders to exercise voting rights in the companies in which they hold shares. In today's integrated global equity market, it is unrealistic to expect shareholders to physically attend AGMs all over the world. It is reasonable to presume it would be in the best interests of listed companies to make it easier for shareholders to voice their opinions. The current proxy voting procedure is complicated and expensive. The advantage of proxy voting, a procedure in which shareholders personally fill out and submit proxy forms, is that all shareholders are allowed to vote without being physically present. This would improve transparency with respect to how shareholders vote, as each shareholder casts individual votes and groups are not represented by a single proxy.

Proxy voting has been a priority issue for AP3 for some time. We carried out a letter-writing campaign in 2006 and pressed 25 Swedish listed companies to implement proxy voting. Several took the opportunity to act before this year's AGM season and amended their articles of association to abolish the prohibition of organised voting by proxy. But only a few companies have instituted proxy voting and the listed companies with the largest percentage of foreign ownership and lowest attendance at AGMs (Eniro, Atlas Copco and Ericsson) have thus far elected not to implement proxy voting.

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 environmentally and socially responsible investment in two ways: we screen companies for compliance with international conventions and we maintain ongoing dialogue with the companies.

The First, Second, Third and Fourth Swedish National Pension Funds formed a joint Ethical Council in early 2007 to coordinate efforts related to environmental and social issues at companies outside Sweden in which the Funds' invest. The Ethical Council examines the fund portfolios to identify violations of international conventions, performs analysis and maintains ongoing discussions with companies. The Ethical Council does not cover Swedish companies; as before, the buffer funds will maintain separate dialogues with companies in Sweden.

The 2007 AGM season

From 2001 to 2005, AP3's express ambition was to attend and vote at all AGMs in the Swedish equity portfolio. After we restructured our Swedish equity management in autumn 2005, resulting in a more diversified equity portfolio, the goal was clearly no longer practicable. Accordingly, during 2006, AP3 tested voting via the Fund's custodian, Northern Trust, for companies in which we hold an equity interest of less than 1% of the voting rights and capital. Voting was managed through a chain of proxies. AP3 was represented at the AGMs by attorneys retained by SEB, Northern Trust's local partner. Prior to this year's AGM season, we decided to discontinue the practice of voting at the AGMs of all companies in the Swedish equity portfolio. The main reason for not continuing to vote via the custodian was that we were

not content to be associated with foreign institutions that vote against proposals without explaining their positions. For instance, many US institutions voted against discharging boards of directors from liability, a source of some confusion at the AGMs. As the number of equities in the Swedish portfolio increased, it also became difficult in our judgement to maintain acceptable quality in the process of reviewing all AGM agenda proposals.

Going into the 2007 AGM season, AP3 continued shifting corporate governance priorities in the interest of promoting quality over quantity. We selected a manageable number of companies which became the primary focus of corporate governance activities. The list of companies was composed based on a few simple guidelines:

- The 15 largest investments in the portfolio
- Companies with an equity interest above 1% and market capitalisation above SEK 100 million
- Life science companies above 2% of equity and market capitalisation above SEK 20 million
- Companies where we believe there is a controversial issue on the agenda or where AP3 has engaged in dialogue with the company on an important shareholder issue prior to the AGM

AP3 attended and voted at 25 AGMs in 2007 and was represented by Nordic Investor Services at five AGMs. AP3 also attended three extraordinary meetings and cast proxy votes in four companies. The fund also voted in five foreign companies regarding ethical and environmental issues.

The following brief report covers some of the proposals presented at the AGMs and how AP3 voted on the issues. For instance, we explain why AP3 voted one way or the other

concerning share-based incentive schemes.

Nordea is one of the companies that took advantage of the option to use organised voting by proxy at this year's AGM, which AP3 strongly supports. The company is also a stellar performer when it comes to informing large investors well in advance of the AGM so that shareholders have sufficient time to examine the proposals and express opinions if they wish. At one meeting, the company informed shareholders about a proposed long-term incentive scheme aimed at 400 senior executives and other key individuals. The new scheme, which is a combined matching funds and performance-based share ownership scheme, will replace the scheme Nordea has operated since 2003. The proposal included required investments by beneficiaries (and thus an element of personal risk), stringent performance conditions compared to the company's main competitors and relatively reasonable cost to shareholders. On that basis, AP3 voted in favour of the board's proposal.

The board of directors of **Ratos** presented a proposal to issue synthetic options to executives and other key individuals. AP3 and several other Swedish institutional investors were briefed on the proposal prior to the AGM. At the briefing, AP3 and others including AP6 expressed concerns about the proposed use of cash-settled synthetic options and argued that we would prefer to see development of the current call options scheme. The board defended its proposal on the grounds that the synthetic options device is common among private equity companies, since this kind of options scheme has stronger links to underlying investments than ordinary call options, which are more closely connected to the company's share price. The scheme is expected to result in higher employee commitment and motivation and strengthen their long-term ties to the company. The nature of

AP3's objections to the synthetic options scheme gave us no reason to oppose the board's proposal and the Fund accordingly cast an affirmative vote.

SCA does not have a share-based incentive scheme for employees, but the board is authorised to implement bonus schemes for senior management, as is the case with most listed companies according to adopted guidelines for remuneration to senior management personnel. In **SCA**'s case, performance-based pay is not pensionable income, which is acceptable.

The main issue going into **Investor's** AGM was the company's sale of another third of its investment in the subsidiary **EQT Partners AB** to **EQT** employees. AP3 and other institutional investors attended a pre-AGM briefing at which **Investor** explained its relationship to **EQT** and the long-term financial gain from the commitment to **EQT**. Because **Investor's** relative significance for **EQT** has declined since the company was founded in 1994, **Investor** believed it was only reasonable that **EQT** management should enjoy a larger share of the financial gain. AP3 did not object to this conclusion.

A relatively small but complex incentive scheme similar to the schemes of previous years was also presented at the AGM. The proposed scheme contained a financial downside for participants, an allotment limit and limited performance conditions. AP3 was invited to comment on the structure of the scheme before the AGM and we stated that we would like to see somewhat more stringent performance requirements in any future incentive schemes. AP3 voted in favour of the proposal at the AGM.

The underrepresentation of women on boards of directors was a recurring issue at many AGMs this year. For instance, the issue was raised at the **Skanska** AGM and justifiably

so, considering that only one of the company's nine current directors is a woman. A similar issue was raised at the **H&M** meeting, which did not seem equally justified. In response to the criticism, the chairman of the board mentioned the company's high percentage of women managers: two out of three regional managers and nine out of ten purchasing managers are women; on the board, four out of ten directors and both alternate directors are women. Similar issues were raised at the AGMs of shareholders in **Investor**, **SEB**, **Volvo**, **TeliaSonera** and **Kinnevik**. There was relatively intense media coverage of these discussions.

Prior to the **SEB** AGM, AP3 held discussions with the company and commented on the proposed incentive scheme. The structure of the scheme was essentially the same as in earlier years and the only objection from our perspective was that the scheme was open to a very large number of employees. While AP3 believes employee share ownership is generally positive, schemes that are overly broad often lead to an unacceptably high dilution impact on shareholders. Happily, the proposal included predefined performance conditions measured in terms of real increases in earnings per share and total returns compared to **SEB's** competitors. On that basis, the Fund chose to vote in favour of the proposal.

Ericsson's AGM was perhaps the most turbulent of the year, as the board of directors' proposal for a long-term incentive scheme was voted down. Because the savings and investment period in the current scheme ends in August 2007, the board proposed a new scheme involving a long-term bonus plan for 2007. **Ericsson's** incentive scheme was blocked by the Swedish majority rules (under the Swedish law on private placements to employees of limited companies), which require approval by nine-tenths of shares in attendance to approve a proposal, combined with

the dissenting votes of about 500 foreign shareholders, corresponding to about 11% of the shares present. The shareholders who voted against the proposal had consulted with Institutional Shareholder Services (ISS), a US provider of corporate governance solutions, and were all represented at the AGM by the same proxy. Like the incentive schemes of earlier years, the proposal would have allotted a varying number of bonus shares to employees who invested a percentage of their gross salary in Ericsson shares at the end of the three-year vesting period, provided that they were still employed by the company. ISS's recommendation was the same as last year. It objected to the component of the options scheme that was not performance-based and felt the threshold for allotments to top managers was too low. The difference was that a larger percentage of foreign investors trusted in ISS's recommendation this year than did in previous years.

Ericsson presented a revised proposal for a bonus scheme at an extraordinary general meeting in June 2007. The new proposal set a higher threshold for allotments to top executives and the company had divided the proposal into several separate decisions. The restructuring of the proposal as a bonus scheme, along with the board's explanation to Swedish and foreign investors of the proposal's importance to the company, persuaded shareholders to adopt it. AP3 chose to support the proposal because it meets the Fund's standards for share-based incentive schemes in all essential respects.

Media coverage leading up to the **Volvo** AGM focused mainly on the size and composition of the board. At the AGM, AMF proposed enlarging the nomination committee by one additional representative of a Swedish institutional investor. Robur Fonder and AP4 also backed the proposal, but it was voted down. AP3 did not have an explicit opinion

on the matter. The board of directors also presented a proposal for a share-based incentive scheme for senior management, which AP3 voted in favour of. While the proposal did not entail a financial downside for beneficiaries, it otherwise met AP3's standards for share-based incentive schemes: it is transparent, performance-based and sets a limit on allotments. Prior to the AGM, AP3 also conducted a dialogue with the company on pension terms for senior management. AP3 recommends defined contribution pension agreements and is accordingly pleased that the company is no longer entering into defined benefit pension agreements. We are also pleased that most existing pension agreements have been converted from defined benefit to defined contribution plans, even though in some cases the conversion led to individual adjustment premiums and high initial one-time costs for the company.

Eniro has amended the articles of association to permit proxy voting, but has so far chosen not to apply the procedure. Prior to the meeting, AP3 had queried the board of directors about its views on also using the option to collect proxy forms. At the AGM, the chairman of the board answered that the company will be investigating whether there is interest in such a reform. It should be noted in this context that more than 80% of voting rights at the AGM were controlled by foreign shareholders and that a clear majority of them were represented by the same proxy.

At the extraordinary meeting of shareholders in **Swedish Match** in December 2006, the nomination committee proposed an options scheme that would raise the remuneration limit for executives by more than 30% and as sharp increases in board fees of 70% for the chairman and 80% for other elected directors. The nomination committee also recommended that the higher remuneration levels should take effect as of the date of the ex-

traordinary meeting. AP3 had several concerns about the process, in which the nomination committee had played a key role in designing the proposal. Executive remuneration is a board matter and not part of the nomination committee's remit. AP3 voted against the proposed options scheme on the grounds that there was no reason to believe senior executives were underpaid. While the proposed scheme was performance-based, the requirements were relatively low. In addition, one of the performance conditions – earnings per share – was affected by the large-scale stock buybacks the company is expected to carry out in the next few years. AP3 also voted against the proposal to increase board fees because we think the increase was far too large to implement in one step. At the 2007 AGM, the nomination committee proposed that these fee levels should remain in effect and asked the AGM to adopt the higher fees. AP3 objected at the AGM and, consistent with that position, chose once again to vote against the proposal.

AP3 and other institutional investors voted in favour of the proposed new board of directors at the extraordinary meeting of shareholders in **Telia Sonera** in January 2007. The changes to the board were due to the activist fund Cevian Capital becoming a new principal shareholder. Telia Sonera is among the companies that have introduced the proxy voting option but have thus far elected not to implement the procedure. AP3 raised an issue at the AGM and asked whether proxy voting will be allowed in the future. The company answered that the first step was taken with the webcast of this year's AGM, although viewers could not vote. The board is going to consider implementing a proxy voting procedure for the next AGM and AP3 is looking forward to seeing the option made available to shareholders.

Sandvik's AGM is usually characterised by

clear and adequate information and this year was no exception. There were no controversial governance issues on the agenda.

Handelsbanken has no bonus schemes or share-based incentive schemes. It does have a profit sharing scheme (the Octagon Fund) that covers all employees. The system is not subject to decision by the AGM.

Under adopted guidelines for remuneration to senior management, **Swedbank** is permitted to issue short-term and long-term incentive schemes. The board of directors is authorised to decide on the short-term schemes, but long-term schemes can only be approved by the AGM. The bank has not adopted any long-term incentive schemes so far.

There were no controversial issues for AP3 to take a position on at the **SKF** AGM. Alecta and Aktiepararna objected to the share buyback proposal, but the AGM authorised the board to decide on a repurchase of the company's own shares until the next AGM.

AP3 raised an issue at the **Atlas Copco** AGM in response to the proposal to change the conditions of the performance-based employee share options scheme for 2006. The board proposed abandoning the vesting requirement of continued employment for share options for both the 2006 and 2007 schemes. The board justified the proposal on the grounds that the options are a reward for clearly defined and delivered performance. As the proposal is contrary to AP3's views on how incentive schemes should be structured, we elected to vote against the proposal to change the conditions for the 2006 performance-based employee share options scheme, but in favour of the board's proposed performance-based employee options scheme for 2007. This was because the proposed scheme has distinct performance-based ele-

ments in other dimensions. However, AP3 believes the continued employment principle is important and encouraged the board to reinstate the requirement for vesting in any future proposed incentive schemes. AP1 made a similar objection and voted in the same way as AP3, but the board's proposal garnered sufficient support to pass.

Boliden's AGM was held at the company's Aitik copper mine in Gällivare. AP3 had questions prior to the AGM regarding the board's proposed guidelines for remuneration to group management. The company answered the questions when the chairman of the board explained the proposal.

AstraZeneca is domiciled in the United Kingdom and is not governed by the same laws as other companies listed on the Stockholm Stock Exchange. The company's options scheme has been running since 2000. Allotments are decided by a remuneration committee, not the AGM. AP3 has voted in favour of the options scheme in the past and did so again this year. The company allows proxy voting and AP3 took advantage of the opportunity for this year's AGM.

Assa Abloy has a complex incentive scheme under which convertible instruments are issued to a company in which scheme participants may buy shares. The scheme is not performance-based, but the personal risk dimension is high enough in our estimation to make up for the lack of performance links. With own investments as high as 50% of fixed salary, we believe the incentives to work towards good share performance are very strong. Since a rising share price trend benefits both employees and shareholders, AP3 chose to vote for the proposal.

Kinnevik's notice to attend the AGM contained no proposals for share-based incentive schemes or other issues of material importance to corporate governance.

The AGM at **Lundin Petroleum** was presented with a proposal to implement a long-term incentive scheme consisting of an options plan and a performance-based equity plan. The idea is that employees will be allowed to choose among the options plan, the performance-based equity plan and a 50/50 split between the two. AP3 has commented on the proposed incentive scheme throughout the process and was given satisfactory answers to the supplementary questions posed to the board. Neither of the plans have a financial downside but both contain relatively stringent performance conditions. The performance-based equity plan has a three-year vesting period, which is acceptable. The proposed options plan has a somewhat brief vesting period of 18 months. AP3 would prefer a three-year vesting period, but we have accepted that the proposal is at least moving in the right direction, since the vesting period was lengthened from the one year required in earlier incentive schemes. AP3 chose to vote in favour of the proposal.

AP3 sharply criticised **Orexo's** proposed employee share options scheme before the AGM. One issue was that the options scheme would cover consultants, which we found peculiar. In addition, the performance link was vague, shares were allotted against no consideration and total dilution was relatively high at 7.4%. After AP3 and other large shareholders expressed their concerns, Orexo chose to amend the proposal, which including eliminating the element that covered consultants. AP3 subsequently chose to vote for the new proposal.

The main issue prior to the **Karo Bio's** AGM was the nomination committee's attempts to compose an effective board of directors. The nomination committee, on which AP3 was represented by Pernilla Klein, presented a strong proposal to the AGM.

The board of directors proposed the implementation of a new employee share options scheme to the **Medivir** AGM. The scheme does have a performance link, though it might seem rather vague as written in the AGM notice. After the company more clearly explained the structure, AP3 voted in favour of the proposed employee share options scheme.

Prior to the **Ray Search Labs**, 75% of the votes had expressed support for all proposals included in the notice to attend, which was highly unusual. AP3 contacted the company before the meeting to clarify how remuneration to senior management was structured and was given satisfactory answers. AP3 voted for the proposals at the AGM.

AP3 voted at several AGMs by proxy in addition to voting at the 26 AGMs already discussed. **Unibet** is domiciled in Malta, and under Maltese law at least 50% of the shares must be represented at the AGM for the meeting's decisions to be legally binding. For that reason, AP3 decided to vote by proxy. The other companies where we cast proxy votes were **Oriflame Cosmetics SA** and **Old Mutual plc**, although no controversial issues were dealt with at these AGMs. We elected to vote remotely in these two companies because both have strong ties with Sweden and the relatively simple voting procedure required only the completion of a voting card and a proxy.

Governance in the global equity portfolio

AP3 adopted a global 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 AP3 delegates its voting rights. Managers are devoting greater internal

resources to governance issues, especially active managers. Managers that provide passive management usually exercise voting rights in line with advice from corporate governance experts, such as Institutional Shareholder Services in the US or Manifest in the UK. AP3 talks regularly to managers to find out how they are dealing with governance issues.

AP3 is a member of the Institutional Corporate Governance Network (ICGN), a global network made up of 400 institutional investors from 30 countries with combined assets of USD 10 trillion. Membership enables AP3 to influence the development of international governance practices. ICGN responds to consultation papers and engages in lobbying to protect investor interests in legislation, listing requirements and corporate governance codes.

In the past, AP3 has been hesitant to join and pursue class actions against foreign companies, but via our custodian, Northern Trust, we always ensure that we claim AP3's rightful share of any damages that are awarded, usually after a settlement between the parties. The cases litigated in class actions usually concern the spreading of false information to the market that has influenced the company's market valuation. Certain Swedish institutional investors, including AP1 and AP7, have chosen to participate actively in these lawsuits. AP7 is currently the lead plaintiff in a class action suit against a US company.

Environmental and social responsibility

AP3's parliamentary mandate is to practise environmentally and socially responsible investment without detracting from the overriding goal of high investment returns. Environmental and social considerations are incorporated into the governance policy. AP3's social and ethical standards are based on in-

ternational conventions and agreements ratified by Sweden, such as the ILO's core conventions and the UN Declaration on Human Rights.

We use two methods to implement social and environmental responsibility. The first is based on an ethical screening process to determine whether any company in the equity portfolio is 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 joint ethical council of the national pension funds

AP1, AP2, AP3 and AP4 in 2006 conducted a joint procurement of consulting services related to responsible investment and ethics screening. The contract was awarded to GES Investment Services. While the procurement was underway, thoughts and ideas about cooperation surrounding foreign corporate dialogues began to emerge. With combined assets under management of approximately SEK 800 billion, the four AP Funds are better able to influence individual companies as a group than if each acted independently. We also believe that coordination benefits international investors by giving them a strong partner in Scandinavia in relation to active shareholder responsibility vis-à-vis social and environmental considerations.

On these foundations, AP1, AP2, AP3 and AP4 established a joint Ethical Council in early 2007. The purpose of the Council is to deal more effectively with ethics violations and work together to influence the companies in which the funds invest.

The funds' Swedish and global equity portfolios are screened twice a year by an external expert, GES Investment Services, to determine whether any of them violate international conventions. If the violation involves a

Swedish company, each fund conducts independent dialogues. Convention violations by foreign companies are followed up jointly within the remit of the Ethical Council. If a foreign company is accused of breaching international conventions, we investigate the facts, contact the company and try to initiate dialogue to encourage action to prevent any recurrence.

The joint Ethical Council will issue its first public report in the first quarter of 2008.

Proactive dialogue on social and environmental responsibility

AP3 has chosen to focus its proactive initiatives on social and environmental responsibility primarily on Swedish companies with substantial production or purchasing in countries that are governed by non-democratic regimes or have 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 established risk management systems.

Code of conduct

Companies should have group-wide codes of conduct covering human rights and environmental protection. The codes should be public and subject to regular compliance monitoring.

Reporting

Companies should publish external social and environmental audit reports as part of either the annual report or a special sustainability report. The guidelines of the Global Report-

ing Initiative, a UN initiative to create a global standard for corporate sustainability reporting, are an appropriate framework for such reports.

Dialogues with Swedish companies

AP3's main approach is dialogue with companies. We believe this provides the greatest opportunity to exert influence. In the last 12 months, we have held discussions with six Swedish companies and gained the impression that social and environmental responsibility issues are more often being considered at group level. Also, the risks associated with failure to practice social and environmental responsibility are increasingly being included in corporate operational and strategic risk assessments. In recent years, more companies have also implemented codes of conduct for their suppliers. In the wake of the global debate on climate change, environmental issues have once again become an area of intense focus.

The discussions AP3 has held in the last 12 months have dealt with issues including risk management systems and risk assessment; general industry and country risks; occupational health and safety; working conditions; environmental risks and their management; codes of conduct for own personnel and suppliers, including training, follow-up, audits and external reporting; and key environmental and social statistics and targets, reporting and follow-up.

International initiatives to further 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. AP3 was one of the main sponsors of ABG's annual survey, published in February 2007, which focused on risk exposure and risk management at 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 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 purpose of the project is to collect data on corporate emissions of greenhouse gases and compile the information in a common database that can be used by investors to identify the risks and opportunities associated with various companies.