



## AP3 STEWARDSHIP REPORT FOR THE AGM SEASON 2012

The Third Swedish National Pension Fund, known as AP3, is one of five buffer funds of the Swedish pension system and is mandated by Parliament to generate maximum possible benefit for the income pension system by managing its fund capital so as to deliver strong investment returns at a low level of risk. The role of the AP funds is to ensure a balance between incoming contributions to the income pension system and outgoing payments. The funds also play a part in the long-term financing of the pension system.

The stewardship of the AP funds is prescribed by legislation.<sup>1</sup> The Act requires the funds to take environmental and ethical concern in their investment activities, though not at the expense of investment returns. Likewise, the funds are not permitted to take political or macroeconomic policy considerations into account when making investment decisions. This autonomy and commitment to best practice strengthens the funds' credibility as institutional owners and helps them to advance their views on key stewardship-related issues. Investments in well-managed companies generate higher returns at a lower level of risk over time, which is why it is important to be an active investor and to consider investments from a sustainability perspective.

AP3's stewardship reflects the Fund's corporate governance policy – a policy required under our parliamentary mandate. We review the policy ahead of every AGM season and decide our focus areas based on our aim of achieving maximum investment returns. The Board of Directors approves the corporate governance policy, revising and supplementing it as and when needed. The policy is publicly available on the AP3 website.<sup>2</sup>

Transparency is important to AP3 and we aim to disclose our stewardship activities as openly as possible. However, it is not always practicable to provide detailed reports of our discussions with other investors, nomination committees and corporate managements and boards because confidential dialogue is often the most effective way to communicate and drive change. Nevertheless, transparency is important for building trust among our stakeholders, and in this report we present the issues that we have prioritised during the year, our core principles, and how we voted. Published annually, the Stewardship Report covers the 12 months ended 30 July.

AP1, AP2, AP3 and AP4 work closely via a joint Ethical Council to monitor environmental and ethical compliance at the foreign companies in which we invest. The Ethical Council publishes a separate annual report on its corporate dialogues and investor initiatives.<sup>3</sup>

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<sup>1</sup> National Pension Funds Act (192:192)

<sup>2</sup> [www.ap3.se](http://www.ap3.se)

<sup>3</sup> See [www.ethicalcouncil.com](http://www.ethicalcouncil.com)

## Stewardship at AP3

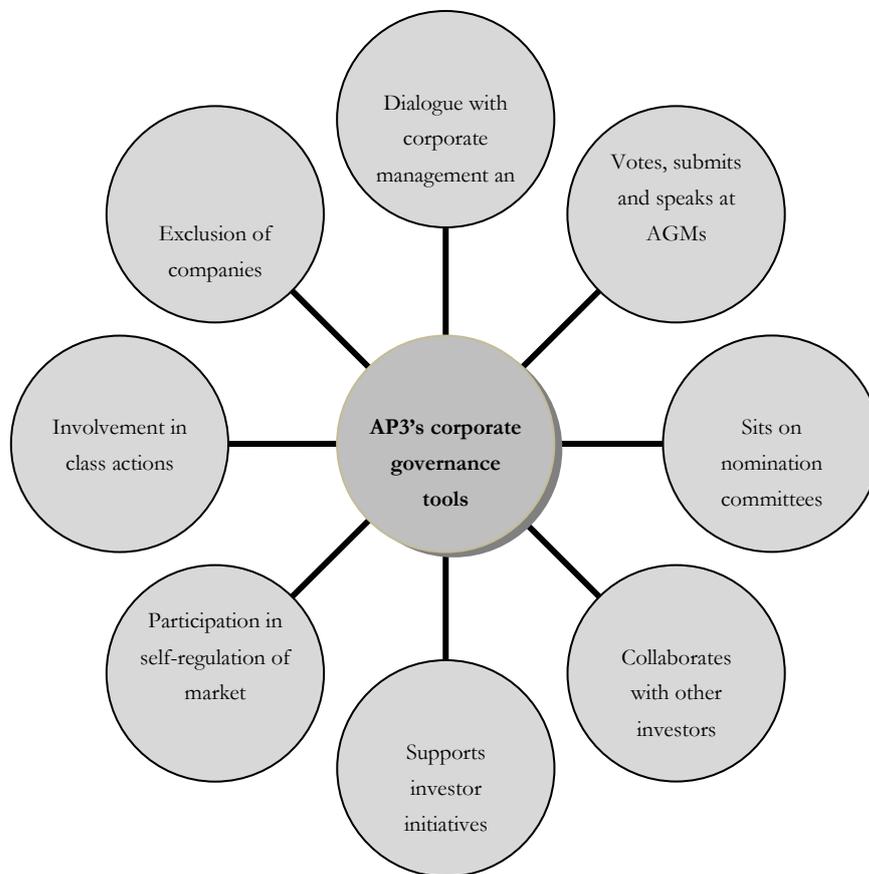
AP3 aims at all times to adapt its stewardship to the conditions dictated by our overall strategy. We hold a highly diversified portfolio invested in more than 4,000 companies worldwide and with market capitalisation of SEK 106 billion.<sup>4</sup> Our foreign listed equity holdings are small, rarely exceeding 0.05 percent of the equity and voting rights in any one entity. The Swedish equity portfolio is similarly diversified, comprising holdings in 120 of the 300 or so listed on the Stockholm stock market. In common with most institutional owners, AP3 has a home bias in its equity portfolio, meaning that the Swedish equity portfolio has a higher weight in the total portfolio than Sweden's market weight in a global share index. The upshot of this is that our Swedish equity holdings are considerably larger than our foreign equity holdings, averaging 0.7 percent of the equity and voting rights. Nevertheless, there is substantial variation and around one third of our Swedish holdings are in entities where we own equity stakes of less than 0.1 percent. Our holdings exceed 1 percent in about one in ten of portfolio companies, though in some entities this figure can be much higher and in some life science companies, for example, can amount to several percentage points. Compared to other Swedish institutions, AP3 is a medium-sized investor. The Swedish equity portfolio had a market capitalisation of SEK 24 billion at 30 June 2012.

AP3 prioritises active stewardship in entities where our equity holdings are relatively large, which for us means mainly Swedish-based companies. Our focus areas include taking active steps to influence the structure of executive remuneration packages and promoting increased diversity on corporate boards. We exert influence by engaging boards in dialogue, by participating in nomination committees and by exercising our vote at AGMs. In recent years we have also applied this blueprint to parts of our global equity portfolio, where our focus areas include executive pay and ensuring a separation of power between the positions of chief executive officer and chairman. AP3 votes independently at the AGMs of foreign entities. A new innovation in 2012 saw us contact certain companies subsequent to their AGMs to explain the reasons why we voted on specific resolutions.

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<sup>4</sup> As of June 2012

AP3's main stewardship tools are:



- **The Swedish nomination committee system**, with members elected by shareholders, is unique internationally since in most other countries the nomination committee is a sub-committee of the board. However, the Swedish model has attracted growing international interest in recent times. Nomination committees are best placed to influence governance because they nominate board members. Nomination committees in Sweden are usually composed of representatives of the three to five largest shareholders. However, the relatively small size of most of AP3's portfolio holdings means AP3 generally exercises stewardship through other channels. At the start of the 2012 AGM season AP3 held seats on six nomination committees: the medical technology firms Aerocrine, BioInvent (chair), Karolinska Development and Orexo, along with Arise Windpower and the unlisted timberland company Bergvik Skog.
- **Dialogue with boards and executive management is a key** instrument of stewardship. We aim to exert influence at an early stage in the process, usually ahead of the AGM season. Only in cases where a company board or nomination committee has failed to take account of our views do we consider raising an issue at the AGM or voting against a resolution. Swedish companies often contact institutional investors like AP3 prior to the AGM to discuss proposed resolutions, particularly when they relate to executive remuneration schemes. We also occasionally initiate dialogue when important issues arise.

- **AP3 seeks to exercise its** AGM voting rights in such a way as to optimise portfolio returns. At this year's AGMs we focused on a group of 60 Swedish companies and also voted at the AGMs of around 500 foreign entities.
- **Raising issues at AGMs** is a key stewardship mechanism. We are always prepared to speak at AGMs to explain our position on specific issues, ask questions and express criticism if warranted.
- **Contacts with foreign shareholders** are growing in importance as these investors become increasingly active voters at Swedish AGMs. Working alongside other institutional investors, AP3 pursues a proactive communications strategy to promote understanding of the Swedish corporate governance model abroad.
- **Environmental and social responsibility** is a key focus area. We engage in direct dialogue with Swedish companies in this area and work closely with the other AP funds under the aegis of the Ethical Council to engage foreign companies in similar discussions.
- **Collaboration with other investors** on issues of environmental and social responsibility has become increasingly important as a way to make our stewardship more effective and gain maximum impact. We channel much of our collaboration with other investors through the Ethical Council.
- Active participation in further developing **the Swedish model of self-regulation** is a natural focus area for AP3. We are members of the Institutional Owners Association for Regulatory Issues in the Stock Market, a forum where we discuss key stewardship and corporate governance issues with other Swedish institutional investors. We have noted a dramatic increase in the regulatory burden on boards in recent years. Even more regulation is in the offing, notably from the European Union, and AP3 wants to put a stop to unnecessary red tape being heaped on businesses. The risk is that boards will struggle to cope and be distracted from their main job of focusing on business performance. We see the Swedish Code of Corporate Governance as a strong aid to listed companies in this regard as it paves the way for voluntary adoption of rules and standards, thereby obviating the need for legislation and government regulation. AP3 also supports a range of initiatives to make it easier for investors to make their voice heard abroad. In this context, we are member of the International Corporate Governance Network.<sup>5</sup> The ICGN issues guidelines on responsible investment to protect investors' rights
- **We support investor-led initiatives**, including measures to improve corporate transparency, environmental reporting and commitment to sustainability. Here, we often work closely with the other AP funds under the umbrella of the Ethical Council.
- **Participating in and monitoring class actions** is becoming increasingly common, especially in the United States. Class actions are lawsuits in which people collectively bring a claim to court. Most class actions are settled before reaching court and settlements often involve defendant companies taking steps to improve governance. Thus, investors can use class actions

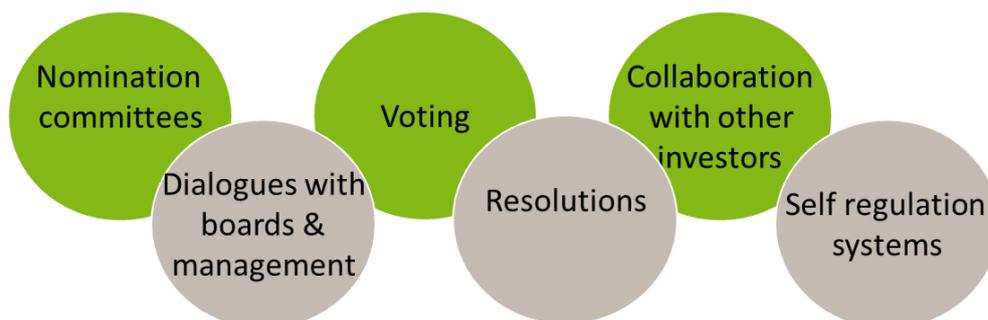
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<sup>5</sup> Also known as the ICGN.

to improve the stewardship of companies that violate rules or standards. AP3's custodian bank keeps track of settlements payable to us from class actions. In 2006-2011 the Fund received payouts of SEK 101 million from various lawsuits, with SEK 16 million paid in 2011.

### Focus areas for stewardship in 2012

AP3's corporate governance strategy prioritises initiatives most likely to contribute to our primary goal of achieving high investment returns and our secondary goal of ensuring public confidence in us as a pension fund. We prioritised five areas of stewardship in 2012:



### Executive remuneration

AP3's corporate governance policy takes a conservative line on performance-related pay to senior executives, in line with government guidelines.<sup>6</sup> The Fund has clear stipulations on how performance-related pay should be structured. Schemes should be defined in advance, contain measurable performance conditions, be finite with fixed ceilings and be subject to regular review. It is the responsibility of the board of directors to set the remuneration of senior executives. As an investor, AP3's responsibility is to ensure that boards operate remuneration structures that are commensurate with long-term shareholder value. Over the years we have communicated our views on this matter publicly and will continue to do so.

### Capital structure

Issues relating to capital structure include the parameters for distribution of profit to shareholders and the conditions for share offerings and buybacks. Buybacks are today a common and widely accepted method of returning capital to shareholders. Recent times have seen a more intensive debate about the structure and reasonableness of financial targets, and this debate may over time have an impact on the amount of profit distributed to shareholders. The focus has been on banks' yields and the extent to which the banks have adjusted to the far-reaching reforms on capital adequacy that have been or are due to be introduced.

### Board diversity

AP3 supports increased ethnic and gender diversity on corporate boards. Women currently hold 24 percent of the seats on the boards of listed Swedish companies – three times the figure eight years ago. The figures tell us that female board representation is improving. AP3 wishes to see further

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<sup>6</sup> Government guidelines for remuneration and benefits to senior executives of the AP funds.

progress in this field and believes a more equal gender balance is beneficial to companies' long-term performance. The pace of change naturally depends on how women fare in other areas. There is a pressing need, for instance, to recruit more female executives to broaden the base for board recruitment. The prime responsibility rests with companies and their shareholders. Nomination committees should be tasked with oversight of female board representation. Quotas are not the ideal solution and our view is that shareholders, who are the bearers of financial risk, should choose who should run their company. Nevertheless, the threat of quotas has increased the pressure for change, which is a good thing.

### **Stewardship in the global portfolio**

Outside Sweden, AP3's stewardship includes voting at AGMs and lending our support to investor-led initiatives. Our foreign equity portfolio is largely under external management, although we exercise our own vote at the AGMs of around 500 non-Swedish companies. Pressure is steadily growing on institutional investors to take an active role in the stewardship of companies in which they own shares. In Britain, the UK Stewardship Code has been introduced to promote the involvement of institutional investors in this field as a route to ensuring more responsible governance in listed companies. This involvement includes institutional shareholders publishing a stewardship policy, voting at AGMs and communicating their views on a range of topics to the companies concerned. Similar initiatives are being considered elsewhere in the EU.

### **Environmental and social responsibility**

AP3 sees a connection between corporate social and environmental responsibility and the capacity of enterprises to deliver long-term shareholder value. We apply high standards of environmental and socially responsible investment primarily by screening companies to ensure they are not in breach of international conventions. We also engage companies in dialogue and support joint investor initiatives. Here we operate on our own as well as through the Ethical Council.

### **Voting at Swedish AGMs in 2012**

The size of AP3's Swedish equity portfolio varies over time according to equity market trends and how we allocate our investment capital. However, the number of holdings remains relatively steady over time and this year stood at around 120. The average size of our holdings is 0.7 percent of the equity and voting rights, but in practice there is substantial variation. Around one third of our stakes are lower than 0.1 percent, while one in ten of our holdings exceed 1 percent. In some cases, particularly in the life science sector, we may own 2-3 percent of the equity. For understandable reasons, AP3's largest holdings in kronor terms are in major Stockholm-listed companies. In nominal size terms, the largest holdings are two small-cap companies: Arise Windpower and Karolinska Development, a medical technology company.

We take the view that it is not practicable to attend and vote at the AGMs of all our Swedish holdings and therefore do so on a selected basis. We used to apply a set of rules when making selections but now simply attend AGMs based on the size of our holdings. This change did not lead us to unfollow any companies in 2012 compared to the prior year, though we did extend coverage to a group of small-cap companies. We also voted at the AGMs of more companies in the life science portfolio. In total, AP3 voted at 62 AGMs (48 last year) – 49 in person and 13 by proxy. We also attended two extraordinary general meetings. EGMs are usually called to address financing and capital structure and this year's EGMs at BioInvent and Aerocrine, held to approve share offerings, were no exception.

### **Executive remuneration always in the spotlight**

This year's Swedish AGM season was relatively quiet, due largely to a drop in media coverage of performance-related pay and share-based incentive schemes. The number of proposed schemes was in line with prior years but the proposals were less controversial this time. Nowadays it is unusual for companies to make proposals that fail to meet AP3's requirements for share-based pay. A performance-based component is almost always included and the cost to shareholders is invariably known and limited. Schemes typically comprise a ceiling and an element of risk in the form of a personal investment by the beneficiary. Also, proposals are normally well-argued and include an analysis of prior schemes. That said, we have seen a few cases where companies have sought to steer programmes in what we see as the wrong direction, for instance offering free allocations of shares with no performance criterion. In such cases, criticism from AP3 and other institutional investors has persuaded the boards concerned to withdraw or amend the proposals. This shows that companies are sensitive to investors' views and that it is possible to drive change through dialogue.

### **Continued dialogue on share matching**

Share-based incentive schemes that require an element of personal risk in the form of an investment by the beneficiary often contain a form of share matching. Share matching generally works by entitling beneficiaries who purchase shares to free shares to compensate them for their investment. This can radically reduce the level of risk or even remove it entirely. In cases where the company opts to match the beneficiary's own investment in its entirety, the beneficiary would not lose any money even if the company's share price halved. Hence, the only connection that beneficiaries of such schemes have to other shareholders is if the share prices rises. AP3 therefore takes the view that boards should carefully consider how to structure share matching when structuring proposed schemes. What is an optimal level of share matching? Naturally, there is a balance between making a plan as attractive as possible to encourage participants to invest their money and ensuring maximum benefit to shareholders. One aspect that can be considered is whether participants in a highly geared performance-based programme offering generous allocations of result- and performance-based shares should have the same matching as those taking part in a pure share saving plan. Perhaps those beneficiaries who have a greater potential upside should be required to take a higher level of risk. AP3 has made this point in various contexts and discussed the matter with among others the commercial banks Nordea and SEB and manufacturers Electrolux and Ericsson prior to their AGMs. We intend to continue seeking dialogue in this area.

### **Increased focus on capital structure**

It was encouraging during the 2012 season to observe how closely focused companies and their shareholders were on the key issues confronting them: business operations, growth potential and profit opportunities. The structure and reasonableness of financial targets was a prime topic for discussion, especially in the banking sector. This was logical because the current banking and financial crisis has led to far-reaching changes in the rules governing capital adequacy requirements in the banking industry. There may be good reasons for shareholders to query the banks' relatively high financial targets because the latter do not appear to have adapted to the new rules that now apply across the sector. Certainly, there is no lack of creativity or innovative capacity in the financial services sector to tackle the challenges posed by new capital adequacy rules. Swedbank sought and obtained shareholder approval to issue contingent convertible bonds, an investment instrument that can be converted to shares if the bank's capital adequacy ratio drops below a fixed level. Contingent convertible bonds are so new that there is no proper regulatory regime in place, though the Swedish Financial Supervisory Authority intends to analyse the bonds and make comments

early next year. According to industry observers, however, it will be mandatory for banks to include contingent convertible bonds in their capital structure.

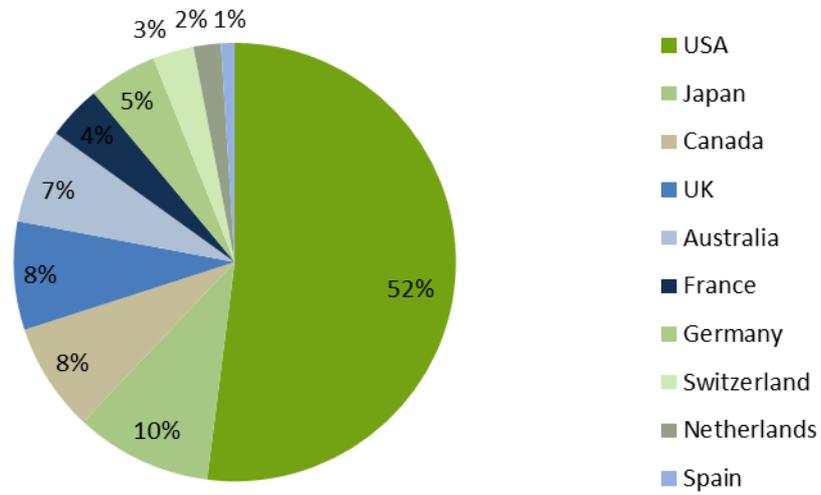
A list of AGM resolutions is published in the appendix, along with AP3's approach on the issues involved. Due to considerable public interest in matters relating to executive remuneration, we also report in the Swedish version of this report on how we voted on AGM resolutions in this area.

|                                                         | 2010/11     | 2011/12       |
|---------------------------------------------------------|-------------|---------------|
| No. of Swedish AGMs where AP3 voted                     | 52          | 64            |
| AGMs where AP3 voted as percentage of Swedish portfolio | 42%         | 50%           |
| No. of Swedish AGM agenda items on which AP3 voted      | approx. 800 | approx. 1,200 |
| No. of nomination committees in which AP3 participated  | 8           | 6             |

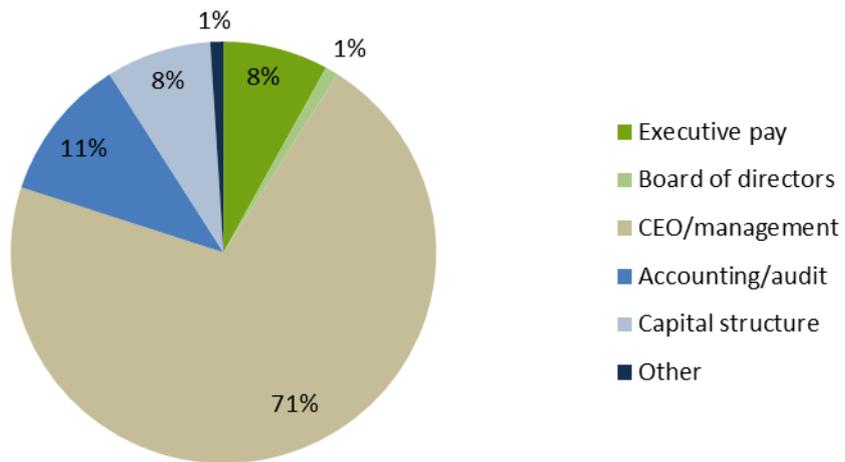
### **Stewardship in the foreign equity portfolio**

Most of AP3's foreign equity portfolio is passively managed, which means that it tracks a specific share index. In the past we delegated our voting rights to external managers. However, we have become increasingly active in our foreign equity portfolio and now vote independently at foreign AGMs. This expanded commitment builds trust in AP3's stewardship and will help us to achieve higher equity portfolio returns over time. The Fund has a diversified equity portfolio with relatively small holdings in a wide mix of companies, so the extent to which we vote actively involves striking a balance between the costs involved and the value added that our interventions can create. AP3 has investments in more than 4,000 companies at global level and currently votes at the AGMs of around 500 of these. The holdings are widely spread geographically, which means that it is not practicable or financially feasible to vote in person at all AGMs. In some cases, therefore, we vote by proxy, whereby Manifest, a UK corporate governance consultancy, provides access to an electronic voting system. Nordic Investor Services, a Swedish corporate governance consultancy, monitors the AGMs, analyses relevant paperwork and administers the voting process. At all times, however, AP3 draws its own conclusions and decides independently how to vote.

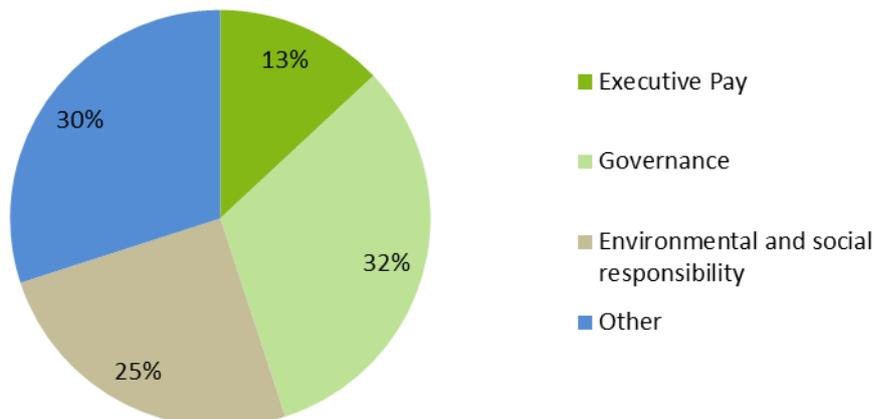
### Breakdown of AGMs 2012



### Breakdown of board resolutions 2012



### Breakdown of shareholder resolutions 2012



### Global voting policy

Alongside its global corporate governance policy, AP3 also has a global voting policy to facilitate the voting process. Both policies are based on internationally accepted standards including the OECD Principles of Corporate governance and Multinational Enterprises and the UN Global Compact. The policy content is general in nature, meaning that minor deviations may be necessary to reflect local codes, regulations, standards and market-specific conditions.

### Agenda set by share index weights

AP3 votes at the AGMs of companies located in the United States, Canada, Japan, the UK, Switzerland, France, Germany, Spain, the Netherlands and Australia, based on the company's weight in the MSCI ACWI global share index. The rule of thumb is that we vote at the largest companies in our different markets. We also vote at companies that are part of the Ethical Council's universe or with which the Council is engaged in dialogue, as well as voting in support of investor-led initiatives on specific topics and in cases where we submit an AGM resolution.

### "No" votes more common than at Swedish companies

In 2012 AP3 voted on more than 7,500 resolutions at 502 non-Swedish general meetings of 487 companies. We either voted against the board or abstained on more than one in five resolutions – a slightly lower ratio than last year but still much higher than for Swedish companies, where the pre-AGM consensus among investors tends to be higher. We voted against the board or abstained on roughly two-thirds of remuneration-related resolutions, reflecting the fact that foreign companies either have difficulty in meeting AP3's executive pay requirements or provide inadequate information. It should also be noted that we voted in favour of more than half of all resolutions submitted by other investors. Many institutions move their own resolutions to the AGMs of foreign entities and these are often of a high standard.

|                                                                                             | 2010/11 | 2011/12 |
|---------------------------------------------------------------------------------------------|---------|---------|
| No. of AGMs/EGMs of non-Swedish companies where AP3 voted in 2011/12                        | 399     | 502     |
| Ratio of companies in foreign portfolio at which AP3 voted in 2011/12, %                    | 10%     | 12%     |
| No. of agenda items at foreign companies on which AP3 voted in 2011/12                      | 7,085   | 7,528   |
| Ratio of agenda items on which AP3 voted for board's resolution                             | 72%     | 77%     |
| Ratio of agenda items on which AP3 voted against/abstained on a board resolution in 2011/12 | 28%     | 23%     |

|                                | 2011/12      |
|--------------------------------|--------------|
| No. of board resolutions       | 7,102        |
| No. of shareholder resolutions | 426          |
| <b>No. of agenda items</b>     | <b>7,528</b> |
| No. of votes for               | 5,832        |
| No. of votes against           | 1,270        |
| No. of abstentions             | 426          |
| <b>No. of agenda items</b>     | <b>7,528</b> |

|                                                   | <b>2011/12</b> |
|---------------------------------------------------|----------------|
| No. of votes in favour of board's recommendation  | 5,801          |
| No. of votes against board's recommendation       | 1,727          |
| <b>No. of agenda items</b>                        | <b>7,528</b>   |
| No. of votes in favour of shareholder resolutions | 243            |
| No. of votes against shareholder resolutions      | 146            |
| No. of abstentions on shareholder resolutions     | 37             |
| <b>No. of shareholder resolutions</b>             | <b>426</b>     |

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

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

During the 2012 AGM season AP3 voted on 71 resolutions at 48 companies. Fewer shareholder resolutions on social responsibility were recorded compared to the prior year. The same investor or group of investors often submits the same type of resolution to multiple companies. AP3 evaluates all resolutions to see if they can create positive benefits for the company concerned and its shareholders. Sometimes resolutions are not sufficiently tailored to the company in question, which in some cases may lead us to support a resolution at one company and oppose it at another. Appendix 1 shows selected examples of why AP3 voted for or against specific shareholder resolutions. It also highlights instances of where the Fund voted against a board resolution out of dissatisfaction with the way the board had handled a specific issue.

|                                                    | <b>2010/11</b> | <b>2011/12</b> |
|----------------------------------------------------|----------------|----------------|
| No. of resolutions on environmental responsibility | 44             | 44             |
| No. of resolutions on social responsibility        | 41             | 27             |
| <b>No. of shareholder resolutions</b>              | <b>85</b>      | <b>71</b>      |

### **Company feedback**

In 2012 we sent letters to companies explaining why we voted against specific resolutions. This was the first time we had offered feedback of this nature and we contacted a total of 50 companies to highlight a range of key issues. We voted against resolutions that proposed the same individual holding the positions of chairman and chief executive officer as we believe these roles should be separate. We also voted against share offerings where the issue mandate was too loose and against share-based incentive schemes that lacked clear and measurable performance criteria because these lead to unacceptable levels of dilution. Both written and verbal responses were received in a number of cases and our hope is that this dialogue will grow over time. We also intend to continue providing this type of feedback.

## **Environmental and social responsibility**

AP3's parliamentary mandate obliges us to take environmental and social concern in our investment practices without compromising our overriding goal of high investment returns.

### **Compliance with international treaties at the heart of our approach**

As part of the Swedish income pension system, AP3 bases its principles on the core values of the Swedish government when it comes to involvement, action and driving change. The Instrument of Government defines these core values as democracy, the equal worth of all individuals, the right to human freedom and dignity, and sustainable development. Sweden's core values are also reflected in the international conventions signed by Sweden (including treaties on the environment, human rights, labour protection, corruption and inhumane weapons) and through the government's support for initiatives such as the UN Global Compact,<sup>7</sup> and the OECD Guidelines for Multinational Enterprises.<sup>8</sup> International conventions and the Swedish government's core values are key instruments for AP3 in our pursuit of high standards of environmental and social responsibility. As an investor, AP3 bases its ethical and environmental standards on the assumption that all the conventions signed by Sweden are important and should be complied with. This approach is also built on decisions and statements from United Nations agencies affirming human rights as universal, indivisible, interdependent, interrelated and inalienable. By linking our standards to international conventions and by working with others who share our aims we can be part of an international coalition on the financial markets to ensure that any treaty breaches are brought to light.

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

### **Dialogues on environmental and social responsibility**

At AP3 we take a proactive approach to social and environmental responsibility, focusing primarily on Swedish companies with substantial production or purchasing in countries governed by non-democratic regimes or with weak labour and environmental laws (primarily developing countries and emerging markets). Dialogue with non-Swedish companies is through the Ethical Council. We work to ensure that the managements of companies in which we invest identify and manage social and environmental risks so as to create shareholder value. AP3 urges companies to follow the principles of the UN Global Compact and industry such as the ICMM<sup>9</sup> principles for mining companies.

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<sup>7</sup> Global Compact is a voluntary United Nations initiative to help companies operate in conformity with ten universal principles based on the UN conventions on human rights, labour standards, the environment and corruption.

<sup>8</sup> The OECD guidelines are joint recommendations to business from 40 governments, including Sweden's covering human rights, corruption, employment, competition, taxation and disclosure.

<sup>9</sup> The International Council on Metals and Mining.

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

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

- **Risk analysis and systems**

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

- **Code of conduct**

We expect companies to have group-wide codes of conduct covering human rights, working conditions and environmental protection. The UN Global Compact and the ILO's core conventions<sup>10</sup> should be the foundation for this code. They should also be publicly disclosed and subject to compliance monitoring.

- **Reporting**

Companies should disclose their social and environmental activities either in a specific section of the annual report or in a separate sustainability report and publish them on their websites. The guidelines of the Global Reporting Initiative (GRI) are an appropriate framework for such reports.<sup>11</sup>

### **Sustainability increasingly integral to corporate business models**

During the year we held discussions on social and environmental responsibility with 16 Swedish companies, alongside dialogues with non-Swedish companies under the aegis of the Ethical Council. Increasingly, environment and social responsibility is treated as a board matter and included in companies' operating and strategic risk analysis. AP3 encourages board to take command of sustainability-related issues by monitoring company guidelines, performing annual risk analyses and appointing sustainability specialists to the board or providing training to directors.

Many companies treat social and environmental responsibility as just another requirement they have to meet, though many see it as a business opportunity. As environmental stewardship has come increasingly to the fore, more and more enterprises are realising that it is a cost where there is scope to save money. On the one hand, companies are under pressure to reduce their environmental footprint; on the other, many firms have identified a strong business case for developing eco-friendly products and curbing their environmental impact.

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<sup>10</sup> The International Labour Organisation is a UN body. Its core conventions concern freedom of association, forced labour, discrimination and child labour.

<sup>11</sup> The GRI is a UN initiative to establish a global standard for corporate sustainability reporting.

### **Life cycle approach can yield competitive benefits**

More and more companies take a life cycle approach to their products, with a strong focus on environmental impact throughout the chain – from product development and choice of materials through manufacture and use to final disposal. Many firms train their customers in how to use and look after their products to minimise environmental impact. Product maintenance and use often give rise to major environmental impacts and thus offer considerable scope for cost savings. Adopting a life cycle perspective can be both a sales argument and a competitive advantage in this context.

### **Third-party supplier audits gaining ground**

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

### **Dialogue across different asset classes and areas of sustainability**

In our discussions with companies we address a wide range of issues including: working conditions and work environments; human rights; risk analysis and risk systems; sector and country risk; employee and supplier codes of conduct and training, and compliance monitoring of these codes; supplier audits; corruption risk; sustainability reporting; and third-party audits. For a number of years we have also held discussions on privacy issues with telecom and networking companies and promoted the GNI<sup>12</sup> as a preferred model. We encourage enterprises to analyse and review their environmental impact and implement targets to reduce emissions and other adverse impacts.

AP3 also holds ongoing discussions with external asset managers across different asset classes (primarily listed equities, unlisted real estate companies and private equity firms). Here we seek to monitor how they integrate social and environmentally responsible investment practices in their investing activities, how they can improve their reporting to AP3 in this area, and to encourage them to observe the United Nations' Principles of Responsible Investment (PRI).<sup>13</sup>

### **Greater focus on real estate**

AP3's real estate investments comprise shareholdings in two Swedish-based companies – Vasakronan and Hemsö – and listed international real estate funds. As of 2012 we are members of the Global Real Estate Sustainability Benchmark, (GRESB), an international initiative that gives us access to tools and benchmark data, enabling us to measure and evaluate sustainability factors in our real estate portfolio. We will use the results of GRESB's annual review of real estate companies as the basis for our discussions with international real estate fund managers.

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<sup>12</sup> GNI stands for Global Network Initiative.

<sup>13</sup> The PRI is a United Nations initiative.

### **Certified sustainable forestry**

AP3 has investments in Swedish forest holdings and international timberland funds. We aim for the timberland in which we invest to be certified by the Forest Stewardship Council (FSC) or equivalent standard. Certification involves a third party verifying that the forest owner manages the forest in compliance with sustainable forestry principles.

### **Green bonds to tackle climate change**

AP3 began investing in green bonds when the World Bank first launched them in 2008. The bonds provide finance for renewable energy and projects to tackle climate change in developing countries.

### **Engagement through the Ethical Council**

AP1, AP2, AP3 and AP4 have since 2007 coordinated their screening and dialogue processes through a joint Ethical Council. By pooling our resources and voting rights, we are better able to influence the foreign companies in which we invest and encourage them to avoid infringing international conventions ratified by Sweden.

An external expert screens the funds' equity holdings to determine whether any company in the portfolio is acting in violation of international treaties. If a company is accused of breaching a convention, the Ethical Council investigates the facts, contacts the company concerned and urges it to act to address the breach and prevent any recurrence. Infringements of international conventions often indicate a company's failure either to understand its responsibility for incidents or to focus on taking proactive action on environmental and social issues.

### **Dialogue and cooperation the prime tools**

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

In 2011 the Council ended dialogue with two companies that complied with the Council's requirements. Ten companies were on the Council's dialogue list as of 31 December 2011. The Ethical Council also engages in indirect dialogue with companies via its environmental and social responsibility consultant. In 2011 the consultant held 204 indirect discussions on behalf of AP3 and other investors. The Ethical Council also engages in dialogue with companies not associated with convention violations, working closely together with other investors. These discussions are invariably aimed at urging the company to address a specific issue or to be more transparent. The Ethical Council held dialogues with 225 companies in 2011.

### **Exclusion – a last resort when dialogue is impossible**

AP3 views disposal or exclusion as a last resort when dialogue fails to produce results.

Unfortunately, exclusion does not correct the problem, which is why we attempt where possible to drive change through dialogue. AP3 had excluded 11 holdings from its investment universe as of 30 June 2012.<sup>14</sup>

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<sup>14</sup> Alliant Techsystems, Elbit Systems, GenCorp, General Dynamics, Hanwha Corporation, L-3 Communications, Lockheed Martin, Poongsan, Raytheon, Singapore Technologies and Textron.

### **Ethical Council annual report and website**

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

### **Collaboration with other investors**

AP3 has a diversified portfolio of investments in more than 4,000 equities worldwide. Most are under passive index management, which means that instead of actively investing in a specific company we invest in exposure to a market and share index. AP3 is a relatively small investor by international standards and we rarely own more than 0.05 percent of the voting rights in foreign entities. In Swedish companies, our holdings average 0.7 percent. The diverse nature and small size of our holdings limits our ability to influence foreign companies in our portfolio and we therefore seek to work with other investors to make our voice heard. The Ethical Council is the vehicle for much of this work.

### **Joint investor-led initiatives a good way to drive change**

AP3 has joined the Ethical Council in numerous investor actions initiated either by the Council or other PRI members.

In 2010 AP3 and its fellow Ethical Council members joined the **Institutional Investors Group on Climate Change**, a European investors' forum for collaboration on climate change issues. The IIGCC aims to use investors' collective voice on climate change and engage companies, policymakers and investors to address the long-term risks and opportunities resulting from climate change. The group issued a communiqué prior to the UN climate change meeting in Durban urging policymakers to take clear, long-term decisions to curb global warming, introduce price mechanisms to facilitate climate-friendly investment and establish emissions targets.

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

AP3 has since 2006 supported the **Carbon Disclosure Project (CDP)**, which aims to encourage increased corporate awareness of climate change. The project urges companies to adopt greater transparency in reporting their climate change strategies and developing key metrics to measure improvements. The CDP aims to make the data collection process more effective by issuing a collective demand from investors for data and effective reporting of emissions. The seventh edition of the CDP questionnaire, co-authored by 655 investors with combined capital of US\$78 trillion, was sent to more than 6,000 enterprises in 2011. Responses are published on an investors' website. The response rate has been 80-90 percent in recent years. The Ethical Council hosted a seminar in late 2011 at which the CDP presented the results for 143 Nordic companies.

The Ethical Council is also supporting 44 other investors in an initiative targeting **oil sands mining** in Canada, an environmentally deleterious industry. The initiative calls for increased

transparency, encourages mining companies to conduct environmental impact assessments and recommends measures to reduce environmental effects.

After the BP oil spill in the Gulf of Mexico in 2010, the Ethical Council and a group of other investors contacted 15 oil companies to inquire about safety measures undertaken during **deep-sea drilling**. The Council analysed most of the responses during 2011.

The Ethical Council has also joined forces with several large funds in an initiative to tackle corruption. A group of 20 companies was evaluated and contacted for information on measures taken to prevent **corruption**.

AP3 is among 14 Swedish investors behind **Sustainable Value Creation**, a project that polls Sweden's 100 largest companies on the measures they are taking to promote sustainability. The aim is to encourage a structured approach in this field as part of long-term value creation. Businesses can enhance transparency by providing reliable information on how they integrate environmental and social responsibility in their operations. Launched in 2009, Sustainable Value Creation helps investors to make informed investment decisions. In 2011 the project sent out its second round of questionnaires and hosted a seminar and panel debate in January 2012 to present the results. In a number of cases, AP3 followed up the responses by meeting with company representatives.<sup>15</sup>

|                                                                                                                                    | 2010/11 | 2011/12 |
|------------------------------------------------------------------------------------------------------------------------------------|---------|---------|
| No. of corporate dialogues <sup>16</sup> via AP3 on issues of corporate governance, environmental and social responsibility (ESG). | 72      | 86      |
| No. of corporate dialogues <sup>17</sup> via the Ethical Council as at 31/12                                                       | 270     | 225     |
| No. of corporate dialogues via ethical consultant as at 31/12                                                                      | 195     | 204     |
| No. of portfolio exclusions as at 30/6                                                                                             | 11      | 11      |

### UN Principles for Responsible Investment

As of 2006 AP3 is a signatory of the Principles for Responsible Investment (PRI),<sup>18</sup> a United Nations initiative to encourage investors to integrate environmental, social and corporate governance in their financial analysis<sup>19</sup> and decision-making processes. Signing the PRI signalled our support for the initiative and our intention to comply with the principles in our business activities.

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<sup>15</sup> For further information about the project see [www.hallbartvardeskapande.se](http://www.hallbartvardeskapande.se).

<sup>16</sup> The figures do not include investor-led initiative undertaken by CDP on behalf of AP3 and other investors and which targeted 6,000 companies in 2011. The term dialogue is as defined in the PRI's annual signatory questionnaire and indicates contacts with companies at three levels: *extensive, moderate and small engagement*.

<sup>17</sup> As above.

<sup>18</sup> See [www.pri.org](http://www.pri.org)

<sup>19</sup> ESG = Environmental, social and corporate governance.

|   | <b>PRI principles</b>                                                                               | <b>Examples of actions taken by AP3</b>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                     |
|---|-----------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 1 | We will integrate ESG in our investment analysis and decision-making processes.                     | <p>We invest in a range of ESG-themed investments (e.g. cleantech, green bonds, wind power and green real estate).</p> <p>We have conducted an internal analysis to ascertain how ESG can best be integrated into the portfolio. Implementation of ESG in the portfolio is in progress.</p> <p>We participate in academic studies focusing on ESG and that have helped to develop tools to integrate and measure ESG.</p> <p>We screen the equity portfolio on ESG grounds.</p> <p>We have trained AP3 staff in ESG.</p> <p>We incorporate ESG in due diligence processes and in our procurement of external asset management mandates. We engage external managers in dialogue on ESG.</p> |
| 2 | We will be active owners and integrate ESG in our corporate governance policy and asset management. | <p>Since 2001 AP3 has integrated ESG in the corporate governance policy and in direct engagements with companies, for instance through active dialogue and by voting and submitting resolutions at AGMs.</p> <p>We have a voting policy. We support a wide range of shareholder resolutions on ESG.</p> <p>We engage companies in active dialogue on ESG-related risks and opportunities.</p> <p>We engage in dialogue with external managers to encourage them to focus on ESG-related issues.</p> <p>We take part in developing self-regulation systems and seek to influence decision-makers.</p>                                                                                        |
| 3 | We will encourage reporting and disclosure of ESG by the companies in which we invest.              | <p>We engage regularly with companies on ESG issues.</p> <p>We expect companies to report externally on ESG issues.</p> <p>We support initiatives (such as the CDP, Eiti, Global Compact, GR, IIGCC and Sustainable Value Creation) and shareholder resolutions promoting increased transparency, improved environmental reporting and corporate environmental and social responsibility.</p> <p>We engage in dialogue with external managers on ESG.</p>                                                                                                                                                                                                                                   |
| 4 | We will promote acceptance and implementation of the PRI within the investment industry.            | <p>We engage in regular dialogue with other investors and stakeholders in the investment industry on ESG.</p> <p>We attend conferences and round-table meetings to share knowledge on ESG implementation.</p> <p>We encourage external managers to sign the PRI. We include PRI-related questions in requests for proposals.</p> <p>We support academic research on ESG.</p>                                                                                                                                                                                                                                                                                                                |
| 5 | We will work together to enhance effectiveness in implementing PRI.                                 | <p>We cooperate with AP1, AP2 and AP4 via the Ethical Council.</p> <p>We participate independently and via the Ethical Council in networks and collaborative initiatives with Swedish and international investors.</p> <p>We use the PRI clearing house (extranet) as a source of best practice and to support investor-led initiatives.</p>                                                                                                                                                                                                                                                                                                                                                |

|   |                                                                             |                                                                                                                                                                                                                                                                                                          |
|---|-----------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 6 | We will report on our activities and progress towards implementing the PRI. | We disclose our ESG actions in an annual stewardship report and in the Ethical Council's annual report. The reports are available on the AP3 website. The AP3 corporate governance policy is published on our website. AP3's responses to the annual PRI questionnaire are published on the PRI website. |
|---|-----------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|

### **Stakeholder dialogue**

AP3 holds regular ESG-related dialogues with stakeholders on its own account, through the Ethical Council and in cooperation with other investors. Stakeholders include politicians, the media, NGOs, investors, companies, researchers and students. We seek to share knowledge and insights through dialogue, questions, interviews and written reports and by taking an active part in conferences.

### **Division of responsibility**

The AP3 Board of Directors reviews the corporate governance policy every year and amends it when necessary. The CEO has ultimate responsibility for implementation of the policy. The Fund has a corporate governance committee consisting of a senior asset allocation and corporate governance specialist, the Chief Legal Officer and the Head of Communication and Sustainable Investments. The latter also represents AP3 on the Ethical Council and is a member of the AP3 Executive Management Committee. AP3 has a senior fund manager who coordinates the integration of environmental and social responsibility in the investment process.

The Corporate Governance Committee reports to the CEO and Board of Directors. The corporate governance policy and a document on how AP3 implements environmental and social responsibility in its operations are available on the AP3 website.

## APPENDIX 1

### **Disclosure of AP3's voting actions on selected shareholder resolutions at foreign AGMs in 2011/12 and reasons for voting against the board**

In certain instances, AP3 may vote against the board of directors to indicate dissatisfaction with the board's handling of a specific issue or because the company has failed to respond to repeated requests to engage in dialogue. Here is how AP3 voted at several such AGMs.

AP3 joined with other investors in protesting against excessive levels of executive pay. For example, we voted against **WPP plc's** remuneration report on the grounds that executive pay at the company is excessive. WPP's CEO Martin Sorell received remuneration of GBP 30 million in 2011.

**Walmart's** Mexican subsidiary is involved in a bribery scandal that came to light in April 2012. The problems first emerged internally in 2005, at which point Walmart launched an inquiry that it later dropped. Bribes were paid to obtain planning permission during Walmart's rapid expansion in the Mexican market. Walmart's board of directors bears ultimate responsibility for ensuring that the company conducts its business in the right way and that serious accusations are properly investigated. The board failed in this responsibility and AP3 therefore voted against the board's re-election.

At **NewsCorp** AP3 voted against the board due to revelations of phone-tapping that emerged in 2011.

#### Examples of shareholder resolutions

Many of the shareholder resolutions that AP3 supported required the company to write a report or perform a review in a specific area. Resolutions of this kind are often proposed to draw attention to an issue that the company in question is perceived as having neglected or to highlight contentious business operations. A company's reporting practices are critical to whether AP3 decides that a resolution can serve as an effective tool to push the company into improving its reporting on a key issue or whether further disclosure is likely merely to replicate already-published information. Environmental resolutions are often used to drive change at companies in the extractive industries, which have a major impact on the environment and communities and thus pose a significant business risk.

#### **Enbridge Inc – Report on opposition of indigenous communities to pipeline**

*Resolution:* To request the board to provide a report describing how the board has assessed the risks associated with First Nations' and M'etis groups' opposition to the Northern Gateway Pipeline.

*Why AP3 voted in favour of the resolution:* The company has financial reports that contain information on financial and other risks, in addition to a special website ([www.northerngateway.ca](http://www.northerngateway.ca)) for the project where the risks are discussed. The website describes ongoing discussions with different groups and organisations and opponents of the project. The dialogue has been in progress since 2005 and the company has substantially revised the project's design to avert negative side-effects. At present, the company has agreements with more than 20 of the 50 or so First Nations groups that live in close to the pipeline. Substantial information is disclosed on the website and the company has invested significant effort in dialogue with First Nations and in communicating with the public. All the same, a balanced report that sets out the risks involved in an objective manner

would be a further step forward in the company's responsible approach to tackling the concerns of investors and civil society.

#### **Freeport-McMoran Copper & Gold – Appoint an environmental specialist as an independent director**

*Shareholder resolution:* To request the board that at least one candidate with environmental expertise shall be selected and recommended for election to the company's board.

The proposer of the resolution believes it is important that mining companies recognise the environmental consequences of extractive operations. Such acknowledgement is important to ensuring that companies in the future are able to obtain access to capital on the market and government permits for new projects.

*Why AP3 voted in favour of the resolution:* Via the Ethical Council, AP3 has for several years been in discussions with the company and has previously moved that the company appoints an environmental specialist to the board. This is a reasonable demand because the company's operations have major environmental impacts.

#### **Chevron Corp – Appoint an environmental specialist as an independent director**

*Shareholder resolution:* To request the board to appoint an independent director with environmental expertise as elected board directors' terms of office expires. The background was a number of past environmental accidents involving Chevron. The proposer of the resolution held the view that such incidents had the potential to impact negatively on the company and its value to shareholders and that a higher level of environmental expertise at board level would enable Chevron to manage environmental issues more effectively.

*Why AP3 voted in favour of the resolution:* Chevron has a public policy committee whose remit includes oversight of environmental issues at board level. However, the company prefers its directors to have a wide-ranging palette of skills rather than appoint a single director with specialist environmental skills. AP3 recognises the value of the board taking collective responsibility for environmental issues but believes that appointing an environmental specialist to the board would benefit Chevron's management of environmental issues considering the company's historical record in this area.

#### **Cisco Systems Inc – Establish a board committee on environmental sustainability**

*Shareholder resolution:* To establish a board committee on environmental sustainability.

*Why AP3 voted against the resolution:* The company reports its environmental performance using the GRI framework and since 2006 has an advisory panel, the Cisco EcoBoard, that reviews Cisco's actions in this field. It would have been reasonable to support the resolution if Cisco had been involved in environmental scandals or similar incidents, but the company's current processes seem to work well. More detailed regulation of the board's organisation is neither desirable nor necessary and AP3 therefore voted against the proposal.

#### **Microsoft Corporation – Approve establishment of board committee on sustainability**

*Shareholder resolution:* To approve establishment of board committee on environmental sustainability.

*Why AP3 voted against the resolution:* The governance and nomination committee is already charged with oversight of environmental policies and procedures. The company has a director of environmental strategy who reports regularly to executive management. The company is generally acknowledged as a leader in environmental protection. The proposal involved far-reaching control of the board's structure that would only be necessary if the company was clearly falling short of standards in this area. As this was not the case, AP3 voted against the resolution.

### **Valero Energy Corp – Report on steps to reduce the risk of accidents**

*Shareholder resolution:* To resolve that the board prepare a report on the steps the company has taken to reduce the risk of accidents. According to the proposer of the resolution, such steps remain widely needed in the oil industry.

*Why AP3 voted in favour of the resolution:* The company has shown that it takes the issue seriously and is working hard on the safety front. Its standards compare favourably with those of competitors. According to the company, accidents per hour worked have fallen by 46 percent since 2004. The company's disclosures are not poor but increased transparency might be beneficial for investors concerned about accident rates in the industry. AP3 therefore voted in favour of the resolution.

### **Yum Brands Inc – Adopt a sustainable palm oil policy**

*Shareholder resolution:* To request the board to adopt a sustainable palm oil policy.

*Why AP3 voted in favour of the resolution:* Unlike many of its competitors (SC Johnson, Walmart, General Mills, McDonalds, Mars, Nestle and Unilever), the company is not a member of the Roundtable of Sustainable Palm Oil. It lags behind in this area and a more proactive approach and closer focus is warranted. Thus, AP3 voted in favour of the resolution.

### **FirstEnergy Corp – Reports on plans to reduce risks of coal dependence**

*Shareholder resolution:* To request that the board reports to shareholders on plans to reduce company's exposure to coal-related costs and risks.

*Why AP3 voted in favour of the resolution:* The company reports in considerable detail on environmental issues on its website and in its report. As an energy producer, it is highly dependent on coal for power generation. It is planning to close nine coal-fired plants in Ohio, Pennsylvania, Maryland and West Virginia due to new emissions regulations, which is a sign that it needs to take these issues seriously. The company does not, however, report in compliance with the Carbon Disclosure Project guidelines, which would be appropriate. As room for improvement exists, AP3 voted in favour of the resolution.

## **Appendix 2**

**A presentation of how AP3 voted at Swedish AGMs in 2012 is available in the Swedish language version of the stewardship report.**