



AP3 STEWARDSHIP REPORT 2013

The Third Swedish National Pension Fund (AP3) is one of five buffer funds – known as the AP funds – within the Swedish pension system and is tasked by Parliament with managing its pension assets so as to generate maximum possible benefit for the income pension system by delivering 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.

AP3 is a committed and responsible investor that manages its assets based on the belief that investing in companies that are well run generates higher returns and lower risk over time. The Fund's stewardship reflects the AP3 Stewardship Policy, a statutory document approved by the Board of Directors. It is revised and updated when needed and is publicly available on the AP3 website.¹ The stewardship policy is based on the National Pensions Pension Funds Act of 2000, which requires AP3 to exercise stewardship with the aim of improving its ability to generate high investment returns for the pension system on behalf of the system's beneficiaries. Stewardship may take no heed of political or macroeconomic policy considerations, and statutory investment rules limit the Swedish equity portfolio from exceeding 2% of the capitalisation of the Swedish equity market. Moreover, the Fund may not own more than 10% of the voting equity in any one single company.

The stewardship policy incorporates the Fund's basic principles of corporate stewardship and its approach to environmental, social and corporate governance (ESG). The principles are general in character and apply to all companies in which the Fund invests, whether domiciled in Sweden or abroad. AP3 generally enjoys greater scope for influencing Swedish companies compared to foreign enterprises due to the fact that its Swedish equity holdings are considerably higher in percentage terms. Stewardship focuses on areas where the Fund believes it can achieve maximum impact and exert the greatest influence. As a result, application of the stewardship policy may vary depending on where a company is domiciled and on the size of the Fund's holding. The Board of Directors approved a revised policy in June 2013.

AP3 aims to report its stewardship engagements 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 best way to achieve results. Transparency is nevertheless critical to establishing trust and is why AP3 in this report discloses how we have exercised stewardship, including how we voted on resolutions to company meetings. The Stewardship Report is for the 12 months ended 30 June 2013. AP3 works closely with fellow AP funds AP1, AP2 and AP4 via a joint Ethical Council to monitor environmental and ethical compliance in the companies in which it holds shares. The Ethical Council publishes a separate annual report on its stewardship engagements, including corporate dialogues and investor initiatives.²

¹ The AP3 website is at www.ap3.se.

² Also see www.ethicalcouncil.com

STEWARDSHIP AT AP3

AP3 aims at all times to adapt its stewardship to the conditions dictated by our overall strategy. We manage a highly diversified listed equity portfolio worth around SEK 125 billion,³ of which around SEK 10 billion is invested in unlisted equity. The listed equity portfolio comprises around 4,000 stocks and Swedish enterprises account for around 25% of the total equity portfolio.

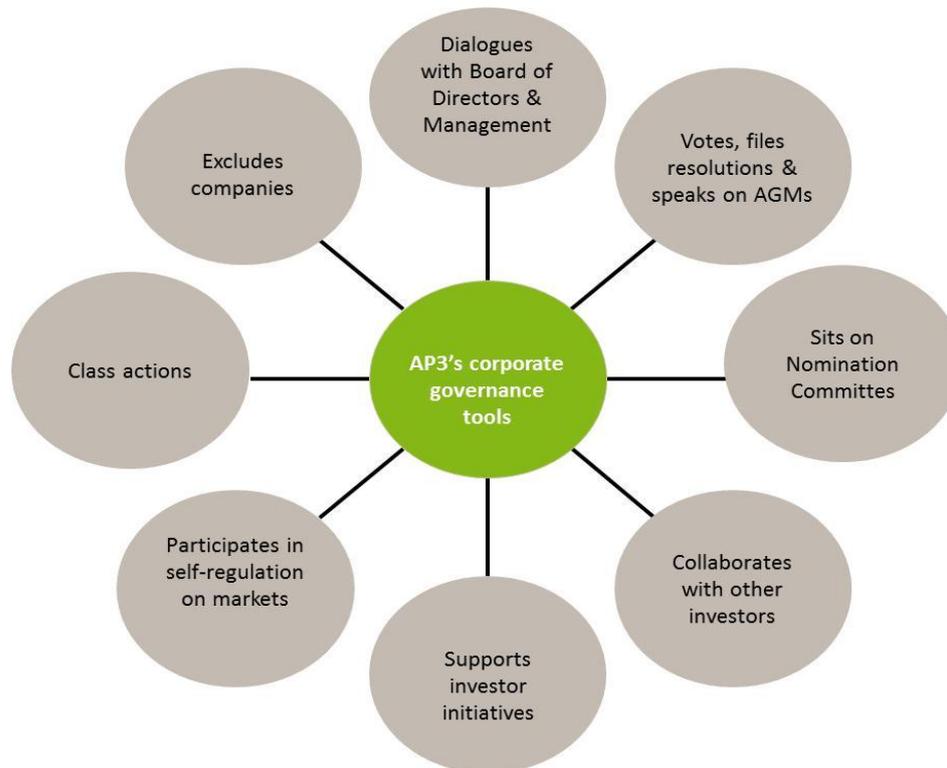
Our foreign listed equity holdings are small, rarely exceeding 0.05% of the equity and voting rights in any one entity. The Swedish equity portfolio is similarly diversified, comprising holdings in 120 of the 250 or so corporations listed on the Stockholm stock market. The Swedish equity portfolio has a home bias, which is reflected in a higher weight in the total portfolio compared to Sweden's market weight in a global equity index. As a result, our percentage holdings in Swedish corporations are considerably higher than in foreign equivalents and average around 0.7% 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%. Only in about one in ten of our portfolio companies do our holdings exceed 1%, though in some cases this figure can be much higher and in some life science companies, for example, can amount to a couple of percent. By Swedish standards, AP3 is a medium-sized institutional investor. The market value of the Swedish equity portfolio stood at SEK 29 billion on 30 June 2013.

In corporate stewardship we focus on areas where we believe we can achieve maximum impact and exert the greatest influence. AP3 generally enjoys greater scope for influencing Swedish companies compared to foreign enterprises due to the fact that our Swedish equity holdings are considerably higher in percentage terms.

Our focus areas include taking active steps to influence the structure of executive pay packages and promote increased diversity on corporate boards. We exert influence by engaging boards in dialogue, by taking seats on nomination committees and by voting at company meetings. In recent years we have also applied this blueprint to parts of our global equity portfolio, where focus areas include promoting the separation of power between the positions of chief executive officer and chairman. AP3 votes independently at the company meetings of foreign entities. We also contact selected companies to explain our reasons for how we voted on specific resolutions.

³ As at 30 June 2013.

AP3's main stewardship tools are:



Stewardship based on the six elements of the AP3 Stewardship Policy

1. Shareholder rights and responsibilities

The right to vote and submit resolutions to company meetings is an investor's primary tool for exercising governance. AP3 votes and participates actively primarily at the company meetings of entities in which it holds a substantial equity stake or in which it is committed to pursuing an issue of principle.

Dialogue with corporate boards, managements and other investors is often an effective means of exercising influence at an early stage in the stewardship process and often prior to the active phase of the company meeting season. Raising issues at company meetings is another way to exercise active stewardship and AP3 is always prepared to speak at meetings to explain our stance on a particular issue, to ask questions and, where merited, to express criticism. Contacts with foreign shareholders are growing in importance as these investors become increasingly active voters at Swedish company meetings. Working alongside other institutional investors, AP3 pursues a proactive communications strategy to promote understanding of the Swedish stewardship model abroad.

It is especially common in North America for investors to file AGM resolutions. In 2013 AP3 teamed up with AP1, AP4, UAW Retiree Medicirikal Benefits Trust, Connecticut Retirement Plans and Trust Funds, Amalgamated Bank LongView Funds, F&C Management Ltd and Illinois State Board of Investments to file a joint resolution on increased transparency and open disclosure to the AGM of Walmart. Thirty-two percent of independent investors voted in favour of the resolution, showing that Walmart shareholders believe the company should openly disclose whether it exercises its right to claw back bonuses paid out on the basis of misleading information.

Many countries operate **national codes of corporate governance** and these play a key role in maintaining confidence and trust in the equity market and in individual enterprises. They also help to facilitate the stewardship of national pension funds. AP3 plays an active role in helping to drive forward

the development of the Swedish equity market's self-regulation system. We are members of the Institutional Owners Association for Regulatory Issues in the Stock Market, a forum where we discuss key stewardship issues with other Swedish institutional investors. AP3 also supports a wide range of initiatives to make it easier for investors to make their voice heard abroad, for instance through our membership of the ICGN.⁴ We also work closely with other institutional investors.

For example, we took part in an initiative to update and strengthen the Russian Code of Corporate Governance of 2002. The OECD and the Moscow Exchange, MICEX-RTS, are revising the code in 2013, providing global investors with an opportunity to play a part in improving Russia's investment climate. AP3 was among a group of investors invited to submit input and make recommendations on how to improve the code. We also supported a similar initiative concerning the possible introduction of a stewardship code in the United States.

AP3 participates in class actions, whereby groups of plaintiffs come together to take joint legal action. 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 to improve the stewardship of companies that breach applicable rules or standards. AP3 makes sure it receives its share of settlements and awards and in 2006-2012 received a total of SEK 106 million from class actions, of which SEK 5 million was paid in 2012.

2. Capital structure

Companies should have a solid long-term capital structure that reflects their strategic and financial goals. Key issues relating to capital structure include what parameters a company has in place for distributing profit to shareholders and the conditions that apply to share offerings and buybacks.

During the period AP3 joined other institutions from the Institutional Owners Association for Regulatory Issues in the Stock Market in drafting a consultative response document on share issues. The document called for share issues to include preferential rights for existing shareholders and for private placements to be avoided and only used in exceptional circumstances. In the event that a company proposes a private placement, shareholders should impose strict demands on the process and the transparency surrounding rationale and pricing. A company's need to issue new shares promptly and without incurring major expense must be weighed against the interest of investors in ensuring that their holdings are not diluted or disadvantaged.

⁴ ICGN – International Corporate Governance Network.

3. Corporate boards

The role of the chairman of the board is to represent all shareholders in the running of a company. One of the most important tasks for a shareholder, especially an institutional investor like AP3, is to exercise a say in the election of directors. Board structure should reflect the company's needs. The expertise, experience and backgrounds of individual directors are critical to board effectiveness, and it is important that directors have sufficient time to devote to their role. Diversity is another core component of effective board operation and here AP3 works to ensure that directors are recruited from a wider base and that boards have a more even balance of male and female directors.

AP3 supports **increased ethnic and gender diversity** on corporate boards. Women currently hold 24% of the seats on the boards of listed Swedish companies – three times the ratio eight years ago. This tells us that female board representation is improving, albeit slowly. AP3 wishes to see further 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.

Calls have been growing for Sweden to implement a quota system on the lines of that introduced in Norway in 2004. Swedish government representatives have expressed frustration at the slow pace of expanding female board representation and indicated they believe there is greater cause than before to legislate in this area. The European Commission has gone further and issued a proposed directive on an improved gender balance on the boards of publicly listed companies.⁵ AP3 has commented on the proposed directive as part of the consultation process. The directive would require companies to raise the proportion of the under-represented sex to 40% by 2020. AP3 does not consider quotas to be an optimal solution and believes it should be up to shareholders, who bear the risks of the business, to choose the people to lead the company. Nevertheless, the threat of quotas has increased the pressure for change, which is a good thing. Though change has been slow, AP3 sees favourable prospects for a faster rate of progress in the future due to the age structure of existing boards.⁶ Among the eldest cohort of directors serving at companies listed on the Stockholm stock exchange (those aged over 74) just one is female and 23 are male. Among the youngest cohort, the gender balance is equal at nine women and nine men. The majority of currently serving male directors were born in the 1940s and 1950s, while the majority of female directors were born in the 1960s. In addition, a clear majority of current female directors sit on a single board. Together these factors create scope for both the ratio and number of female directors to rise over the longer term – and indeed faster than many might expect.

AP3 plays an active role in nominating directors and will typically take a seat on the nomination committee when so merited by the size of its equity holding. At the start of the 2013 AGM season AP3 held seats on six nomination committees: the medical technology companies Aerocrine, Cellavision, DiaGenic and Karolinska Development, Arise Windpower, and the unlisted timberland company Bergvik Skog.

AP3 **does not believe the chairman of the board should also hold the office of chief executive officer.** It is commonplace in many foreign companies for the same individual to hold both posts and AP3 voted against resolutions that proposed such an outcome.

⁵ European Commission's proposed directive on improved gender balance in the boards of publicly quoted companies (Ju2012/7504/L1).

⁶ SIS Ägarservice: Boards and auditors of Swedish listed companies.

4. Audit and internal control

Auditors are elected by shareholders and give investors oversight over a company's affairs. It is thus important that the audit process is considered and evaluated from an investor perspective. AP3 takes the view that the nomination committee should be responsible for evaluating and procuring audit services. Here, the independence of the auditors from the company and its management and board is critical for maintaining investors' confidence in the auditors and their oversight. To safeguard this independence, the remit given to auditors should be limited primarily to audit services. Other consulting services should be limited in scope and notified to investors at the AGM and in the annual financial statements. As a further means to ensuring independence, the company should change its audit firm and auditors at the end of a specified time frame.

The role of audit and the responsibility of auditors have been hotly debated in the wake of the global financial crises of the last decade or so and the audit issue has become a high priority for European policymakers. In 2010 the European Commission published a "green book" on audit policy in the EU that outlined various radical reforms of the regulatory framework. This was followed by a proposed directive on statutory audit that included mandatory rotation of audit firms, regulations on procurement of audit services and restrictions on additional non-audit services.

AP3 has teamed up with a large number of large European pension funds to endorse a position paper written by the UK pension fund USS that aims to reform the role of the auditor.⁷ Lack of auditor independence is a problem. In the UK, for instance, the largest 100 publicly quoted companies⁸ retain the same audit firm for 48 years on average. In some cases this rises above 100 years. The position paper attracted significant media coverage and resulted in AP3 and other investors writing an article in the Financial Times. Unlike many parts of Europe, Sweden has a satisfactory audit process. However, some Swedish companies have retained the same audit firm for a very long time. In 2013 shareholders of Investor voted in favour of the company changing its supplier of audit services to Deloitte. The chairman of the company, which had retained KPMG since 1933, acknowledged that the change was a response to the European Commission's review of the audit process and the potential introduction of automatic audit firm rotation.

5. Executive pay

AP3's Stewardship Policy takes a conservative line on performance-related pay to senior executives, in line with government guidelines.⁹ The Fund has clear stipulations on how performance-related pay should be structured: it should be defined in advance, contain measurable performance conditions, be finite with fixed ceilings and be subject to regular review. Over the years we have communicated our views on this matter publicly and will continue to do so.

Executive pay should be structured to provide cost-effective rewards for creating long-term shareholder value and to enable companies to attract and retain key personnel. AP3 believes the starting point should be the best interests of the individual enterprise. Hence, it should be the board of directors that designs, explains and defends the executive management remuneration system. The board should also ensure that executive pay packages are reviewed.

Moreover, remuneration packages for senior executives should be clearly described in the remuneration policy adopted by shareholders at the AGM. It is important that all components of the total remuneration package are presented: salary, any variable remuneration (including share-based or share-price-based

⁷ Audit – A long-term investor positive paper on proposed EU reforms.

⁸ Largest companies means those listed in the FTSE 100.

⁹ Government guidelines for remuneration and benefits to senior executives of the AP funds.

incentive programmes), pension plans and other financial benefits. AP3 looks at the entire remuneration package and works to ensure that total remuneration levels are prudent and reflect market rates.

If correctly structured, share-based or share-price-based remuneration can be an effective way to link the interests of corporate management and investors. Each company has its own particular needs and conditions. The task of drawing up value-enhancing incentive packages falls to the board of directors as the body best placed in this regard. It is also incumbent on the board to explain the relationship between how an incentive programme is structured in terms of the company's goals and how the scheme's effectiveness in driving achievement of these goals will be evaluated. AP3 has several core requirements for share-based or share-price-based remuneration:

- We favour share-based programmes rather than option schemes.
- Performance conditions should be linked to the company's financial targets and ideally benchmarked against competitors.
- We believe beneficiaries should make a personal investment in the company's shares.
- Incentive schemes should have upper limits or contain prudence clauses to protect the company against unreasonably high payouts.
- Executive pay schemes should be subject to review.

6. Environmental, social and corporate governance (ESG)

The Pension Funds Act requires the AP funds to take due account of environmental and ethical considerations without compromising the ultimate objective of achieving high returns at a low level of risk. AP3 is an integral part of the Swedish pension system and bases its principles relating to commitment, action and driving change on the values of the Swedish government. Sweden's core values are reflected in the international conventions signed by Sweden, including on the environment, human rights, labour protection, corruption and inhumane weapons, and through Sweden's support of initiatives such as the UN Global Compact and the OECD Guidelines for Multinational Enterprises, and the country's stance on issues of international law. These core values form the basis for AP3's approach and actions in ESG.

AP3 strives to ensure that investees identify and manage environmental, ethical and social risks in a way that creates value for shareholders. Enterprises should conduct risk analysis and have governance and management systems and external reporting procedures in place. They should also have codes of conduct and policies that demonstrate their approach to ESG both internally within the company and externally with regard to stakeholders, including business partners and suppliers.

VOTING AT SWEDISH COMPANY MEETINGS IN 2013

The size of AP3's Swedish equity portfolio varies over time according to equity market trends and how we allocate our investment capital. In absolute terms, however, our number of holdings has remained rather stable over time and currently comprises around 120 companies. The average size of our holdings is 0.7% of the equity and voting rights, but in practice there is substantial variation. Around one third of our stakes are lower than 0.1%, while one in 10 of our holdings exceed 1% (though in some entities this figure can be higher and in some life sciences companies, for example, can amount to a couple of percent). Since most of AP3's investments are under index management, the majority of our holdings in kronor terms are the largest companies listed on the Stockholm stock exchange, though our biggest capital holdings are in three smaller companies: Arise Windpower, in which we hold 10% of the equity and voting rights; medical technology company Karolinska Development, in which we own a 10% holding; and farm operator Agrokultura (formerly Alpcot Agro) where we have a 7% equity stake.

It is not possible for practical reasons to attend and vote at the AGM of every company in our Swedish portfolio or to prioritise heavy stewardship engagements in companies where we control only a small share of the equity. For this reason, we select a list of investees that are either large Swedish-listed corporations where we hold a large capital stake or enterprises in which we control a relatively large portion of the equity but where our capital stake is not especially large (primarily companies in the life sciences portfolio).

A number of companies are no longer on the list due to the fact that we have sold part of all of our equity holding, while a lesser number – mainly in the actively managed life sciences portfolio – have been added. In total, AP3 voted at 62 AGMs – 48 in person and 14 by proxy – and also attended three extraordinary general meetings.

Stewardship on executive pay – time-consuming and resource-intensive

Swedish corporations continue to introduce incentive schemes at an undiminished rate. A review by KPMG of AGM documentation from 232 companies revealed that just under one third of these firms held votes on incentive plans.¹⁰ Nevertheless, the typical scheme format is changing. Fifty-three percent of company meetings that passed resolutions on incentive schemes opted for share-based programmes rather than schemes based on convertible securities or options. This ratio was somewhat higher than in the prior year. There is also a trend towards schemes focusing more closely on top executives, while wider-based programmes aimed at all or large sections of staff are becoming increasingly rare. The proportion of schemes covering all employees fell from 29% to 23% in 2013 compared to the prior year. It is a good thing that employees own shares in their employer, but AP3 believes it is important that performance-based incentives are aimed at individuals who are in a real position to influence the company's development, results and share price. Many of the proposed incentive plans presented at this year's company meetings had a simpler structure than in previous years, which was a welcome development, while some companies abandoned variable remuneration for some groups of employee.

Nowadays it is unusual for Swedish companies to propose share-based incentive plans that fail to meet AP3's standards. 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. Occasionally a company will propose a new incentive programme or propose changes to existing plans that fall short of our requirements and in such cases we seek to act with other institutions to

¹⁰ Incentive schemes in Swedish listed companies, study by KPMG, 2013.

urge the board to withdraw or amend the proposal prior to the AGM. Dialogue is often an effective strategy for investors to communicate their views and companies are generally responsive.

Pay and remuneration is an important issue for companies and investors alike but tends to receive inadequate coverage, especially in the run-up to AGMs. AP3 has held discussions with other investors on how to create a better structure for handling pay and remuneration with a view to freeing up more time for topics of greater importance to companies. Among the suggestions mooted is that remuneration committees should be in charge of issuing information on share-based incentive plans rather than consultants or the executives for whom the plans are intended. Clear information should be provided on expected cost and dilution and the relationship between variable remuneration and salary. An analysis of prior programmes should also be provided. The information on the expected and maximum payouts to the chief executive officer needs to be even clearer and in this context companies should provide information that is easy to both understand and defend. AP3 will continue to promote good practice in these areas and we hope that over time a consensus will emerge between investors and companies.

Dialogue on share matching works – sometimes

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 usually 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 any share matching component when drawing up proposed schemes. What is an optimal level of share matching? Naturally, there is a balance between maximising a plan's attractiveness to encourage beneficiaries 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 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 expressed these views in various contexts and in 2013 raised them directly with a number of companies, including SEB and Electrolux, prior to their AGMs. The Electrolux board responded to the representations by scrapping allocations of matched shares to members of the company's executive management committee. The dialogue with Electrolux illustrates how AP3 as an investor can help to shape the way incentive plans are structured.

Continued focus on capital structure

One outcome from this year's Swedish AGMs is that companies and their investors are focusing more closely on what is important for the companies – namely, their operating environments, growth prospects and profit potential. The structure and reasonableness of banks' financial targets was the subject of considerable debate both in the media and at bank AGMs. This was to be expected because the financial crisis has led to far-reaching changes in the rules governing capital adequacy requirements in the banking industry. Capital adequacy regulations define how much capital banks must hold in reserve to cover their risks. New regulations due to come into force on 1 January 2013 under the Third Basel Accord (Basel III) were postponed in the EU and the US and it remains uncertain if and when they will be implemented. This hiatus is feeding uncertainty among large corporations and their shareholders. The fact that the authorities in Sweden have taken a more restrictive line than elsewhere in Europe has led to Swedish banks having to retain a larger capital buffer to meet future requirements. It should be noted, however, that Swedish banks are well equipped in capital adequacy terms not just for forthcoming regulatory changes but also to meet changing macroeconomic conditions.

The appendix to this report contains a selection of AGM resolutions and how AP3 voted on them. Due to strong public interest in executive pay, we also disclose how we voted on AGM resolutions in this area.

	2011/12	2012/13
No. of Swedish company meetings where AP3 voted	64	65
Company meetings where AP3 voted as percentage of Swedish portfolio	50%	50%
No. of Swedish company meeting agenda items on which AP3 voted	approx. 1,200	approx. 1,200
No. of nomination committees on which AP3 held a seat	6	6

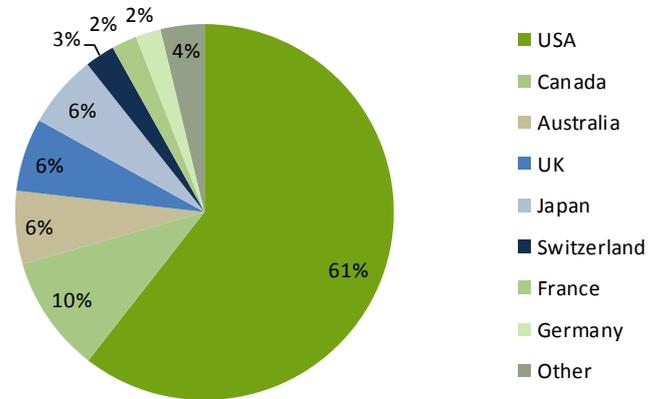
STEWARDSHIP IN THE FOREIGN EQUITY PORTFOLIO

Outside Sweden, AP3's stewardship includes voting at company meetings and lending our support to investor-led initiatives. The foreign equity portfolio is largely under external management, although we exercise our own vote at the company meetings of around 500 non-Swedish investees. Pressure is growing steadily 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 company meetings and communicating their views on a range of topics to the companies concerned. Similar initiatives are being considered elsewhere in the EU, though these are unlikely to have any major impact on AP3 as we already incorporate them in our stewardship.

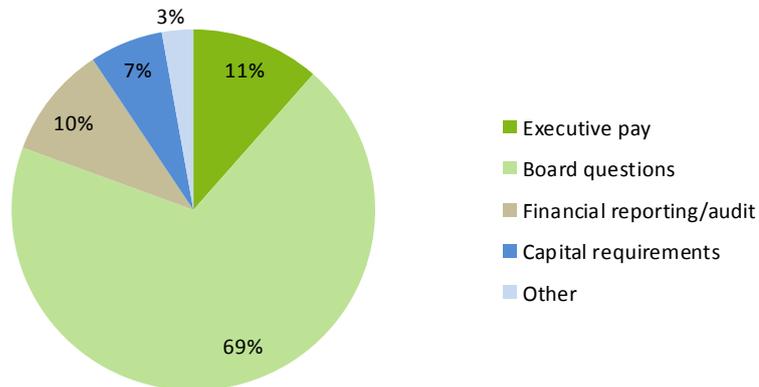
Most of the foreign equity portfolio is passively managed, which means that it tracks a specific share index. Instead of delegating our voting rights to external managers or relying on global stewardship consultants, we now vote independently at foreign company meetings as we believe that maintaining a higher profile builds confidence and trust in our stewardship. AP3 has a diversified equity portfolio with relatively small holdings in a wide range 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 around 4,000 equities with a global geographic spread and we currently vote at around 500 of these investees' company meetings. The global nature of our holdings means it is not practicable or financially feasible to vote in person at all company meetings. Therefore we vote by proxy, whereby Manifest, a UK stewardship consultancy, provides access to an electronic voting system. Nordic Investor Services, a Swedish corporate governance consultancy, monitors the company meetings, analyses relevant paperwork and administers the voting process. At all times, however, AP3 draws its own conclusions and decides independently how to vote. Prior to next year's company meeting season, AP3 will team up with AP1, AP2 and AP4 to conduct a review of our global voting procedures to see if they can be simplified and expanded.

Data on AP3's global voting 2012/2013

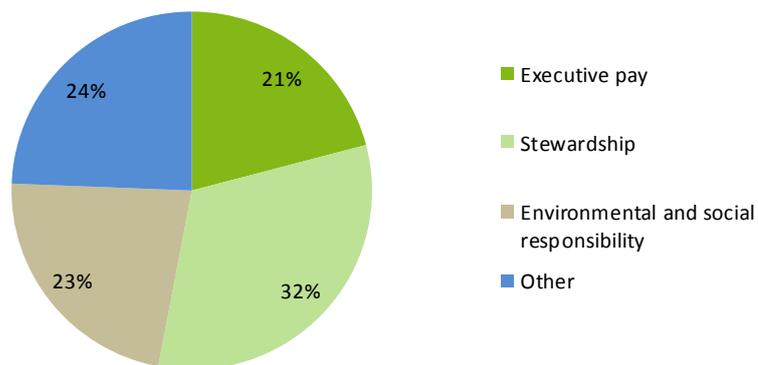
Geographic breakdown of company meetings 2012/2013



Breakdown of board resolutions 2012/2013



Breakdown of shareholder resolutions 2012/2013



Global voting policy

AP3 has a global stewardship policy and also 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 provisions are general in nature, meaning that minor deviations may be necessary to reflect local codes, regulations, standards and market-specific conditions. Henceforth, AP3 will replace the global stewardship policy with the new AP3 Stewardship Policy approved by the Board of Directors in June 2013.

Choices based on index weights

Outside Sweden, AP3 voted at investee company meetings in Australia, Canada, France, Germany, Ireland, Italy, Japan, the Netherlands, Spain, Switzerland, the UK and the United States, along with a handful of large investees domiciled in Curacao, Jersey and Panama. American corporations accounted for more than 60% of the investee company meetings at which we voted (308 companies). We based our choices on each company's weight in the MSCI ACWI global share index, with the rule of thumb being that we vote at the largest companies in our different markets. We also voted at investees that are part of the Ethical Council's universe and in support of investor-led initiatives on specific topics and at meetings where AP3 filed a resolution.

"No" votes more common outside Sweden

AP3 voted on 6,811 resolutions at 509 company meetings outside Sweden held by a total of 496 investees. The Fund abstained on or voted against around 19% of board resolutions. This is a much higher "no" ratio than for Swedish companies, where there is usually greater prior consensus between investors and investees on AGM resolutions. We abstained on or voted against the board on more than 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 six out of 10 resolutions submitted by other investors. Many institutions move their own resolutions to the company meetings of foreign entities and these are often of a high standard.

For example, AP3 voted not to approve a retention incentive to 73 key employees of **Xstrata** in conjunction with the company's merger with Glencore as we considered the plan excessively generous and lacking a clear rationale. The plan included no performance criteria for the majority of beneficiaries and offered a sizeable incentive to staff to remain with the company and implement the company's post-merger strategy while also entitling them to large payouts in the event of termination.

	2011/12	2012/13
No. of company meetings of non-Swedish companies where AP3 voted	502	509
Ratio of foreign portfolio companies at which AP3 voted, %	12%	12%
No. of agenda items at foreign companies on which AP3 voted	7,528	6,811
Ratio of agenda items on which AP3 voted in favour of board resolutions	77%	81%
Ratio of agenda items on which AP3 voted against/abstained on board resolutions	23%	19%

	2011/12	2012/13
No. of board resolutions	7,102	6,409
No. of shareholder resolutions	426	402
Total no. of agenda items	7,528	6,811
No. of votes in favour	5,832	5,514
No. of votes against	1,270	956
No. of abstentions	426	341
Total no. of agenda items	7,528	6,811
No. of votes in favour of board's recommendation	5,801	5,409
No. of votes against board's recommendation	1,727	1,402
Total no. of agenda items	7,528	6,811
No. of votes in favour of shareholder resolutions	243	239
No. of votes against shareholder resolutions	146	140
No. of abstentions on shareholder resolutions	37	23
No. of shareholder resolutions	426	402

Agenda items on environmental and social responsibility

Especially in the US and Canada, it is common for investors to file resolutions on environmental, social and corporate governance (ESG) to company meetings. AP3 has done so itself in previous years at companies such as Freeport McMoran, Goldcorp and Walmart. These resolutions often urge companies to be more transparent, appoint environmental specialists to the board of directors or address environmental impacts.

AP3 voted on 87 ESG-related resolutions filed by shareholders, a somewhat higher figure than in the previous 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 generate 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 vote in favour of a resolution at one firm and against the same resolution at another.

	2011/12	2012/13
No. of shareholder resolutions on ESG	71	87

Company feedback

AP3 contacted a group of around 50 foreign companies to provide feedback on why we voted against certain resolutions. Here we highlighted several core stewardship issues. For instance, we explained that we voted against the same individual holding the positions of chairman and chief executive officer as we believe these roles should be separate. We also voted against mandates for share offerings that were too loosely framed 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 and our hope is that this dialogue will develop over time. We also intend to continue providing this type of feedback.

ENVIRONMENTAL, SOCIAL AND CORPORATE GOVERNANCE (ESG)

Core values based on international conventions

AP3 is an integral part of the Swedish income pension system and, as such, bases its principles on the core values of the Swedish government in terms of 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 rights, corruption and inhumane weapons and through the government's support for initiatives such as the UN Global Compact¹¹ and the OECD Guidelines for Multinational Enterprises.¹² 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. At AP3 we base our ESG strategy in an investment context on the assumption that all the conventions signed by Sweden are important and should be complied with. This approach is also built on resolutions 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 companies which are well run offer a better long-term investment. We screen the companies we invest in to make sure they are not violating international conventions, we engage in active dialogue to encourage them to act responsibly, and we support investor-led initiatives aimed at specific companies or industries.

Dialogue on ESG

At AP3 we take a proactive approach to ESG, focusing primarily on Swedish companies with substantial production or purchasing in countries governed by undemocratic regimes or with weak labour and environmental laws (primarily developing countries and emerging markets). We engage with foreign investees via the Ethical Council we operate in collaboration with AP1, AP2 and AP4. We work to ensure that the managements of investee companies identify and manage social and environmental risks so as to create shareholder value. We urge investees to follow the principles of the UN Global Compact and standards applicable to specific industries, such as the ICMM¹³ principles on mining and sustainable development and the GNI¹⁴ principles for the ICT¹⁵ industry.

Our primary approach is to engage in 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 investees respond to our views and demands until we achieve our objectives in each case. Through dialogue we aim to ensure that companies have risk management systems and code of conduct in place and that they employ sustainability managers to reduce the risk of the organisation breaching international conventions. We communicate a number of core requirements during the dialogue process:

¹¹ The UN 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.

¹² The guidelines are joint recommendations to business from 40 governments, including Sweden's, and cover human rights, corruption, employment, competition, taxation and disclosure.

¹³ The International Council on Mining and Metals.

¹⁴ Global Network Initiative.

¹⁵ ICT refers to the information and communications technology sector.

- **Risk analysis and systems**

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

- **Codes of conduct**

We expect investees to have a group-wide code of conduct covering human rights, labour rights, anti-corruption and environmental protection and expect these to be based on the UN Global Compact and the ILO's core conventions,¹⁶ and publicly disclosed and subject to compliance monitoring.

- **Reporting**

Investees should disclose their social and environmental activities either in a specific section of the annual financial statements or in a separate sustainability report and publish them on their websites. The guidelines of the Global Reporting Initiative (GRI)¹⁷ can be seen as a preferred model.

Integration of sustainability in business models

During the year we held direct discussions on ESG with 16 Swedish investees and engaged in dialogue with non-Swedish investees under the aegis of the Ethical Council. Increasingly, ESG is treated as a board matter and included in companies' operating and strategic risk analyses. AP3 encourages boards 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 and some boards have instituted sustainability committees. 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 have identified a strong business case for developing eco-friendly products and curbing their environmental impact.

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 production and supply chain – from product development and choice of materials through manufacture and use to final disposal. Many enterprises train their customers in how to use and look after their products to minimise environmental impact. Product maintenance and use often gives rise to major environmental impacts and thus offers considerable scope for cost savings. In this context, adopting a life cycle perspective can be both a sales argument and a competitive advantage.

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 perform supplier compliance audits in addition to, or instead of, in-house auditors. The retail industry has taken the lead in auditing suppliers' ESG compliance, but enterprises in many other sectors have also realised the importance of supply chain control – a change that AP3 has been advocating in our engagement with investees for a number of years.

Dialogue across different asset classes and areas of sustainability

When engaging with companies we address a wide range of issues, including: labour rights; workplace

¹⁶ The International Labour Organisation is the United Nations body that monitors working conditions and labour issues. The ILO conventions concern freedom of association, forced labour, discrimination and child labour.

¹⁷ The Global Reporting Initiative (GRI) is a UN project to create a global standard for corporate sustainability reporting.

health and safety; human rights; risk analysis and risk systems; sector and country risk; employee and supplier codes of conduct (and training in and compliance monitoring of these codes); supplier audits; corruption risk; sustainability reporting; and third-party audits. For several years we have also engaged in discussions on data integrity with telecom and data networking companies, promoting the GNI¹⁴ as a preferred model. AP3 encourages enterprises to analyse and review their environmental footprint 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 equity, unlisted real estate and private equity). Here we monitor how managers integrate ESG in their investing activities and how they can improve their reporting to AP3 in this area. We encourage them to observe the United Nations' Principles for Responsible Investment (PRI).

During the year AP3 participated in the drafting of an ESG Disclosure Framework for the private equity industry,¹⁸ joining 40 investors limited partners from 11 nations, 20 private equity associations and 10 leading general partners. Launched in March 2013, the framework articulates common objectives in terms of disclosures that limited partners wish to see made when investing in private equity funds and over the term of such investments.

Increased focus on real estate

AP3's real estate investments comprise shareholdings in three Swedish-based companies – Vasakronan, Hemsö and Trophi – and unlisted international real estate funds. As of 2012 we are members of the Global Real Estate Sustainability Benchmark (GRESB), an international initiative that by providing access to tools and benchmark data enables us to measure and evaluate sustainability factors in our real estate portfolio. AP3's engagement with real estate owners and managers is based on the results of the GRESB annual survey.

Certified sustainable forestry

AP3 has investments in Swedish forest holdings and international timberland funds. Our objective is to invest in timberland 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 they were first launched by the World Bank in 2008. The bonds provide finance for renewable energy and projects to tackle climate change in developing countries. In 2013 we invested in a global credit fund focused on businesses that tackle sustainability challenges and opportunities, including the transition to a carbon-smart economy.

Stewardship via 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 foreign investees and encourage them to conduct their business activities without breaching international conventions ratified by Sweden.

The Ethical Council takes both a proactive and reactive approach. An external expert screens the funds' equity holdings to determine whether any company in the portfolio is acting in contravention of

¹⁸ The Environmental, Social and Corporate Governance (ESG) Disclosure Framework for Private Equity can be downloaded from www.unpri.org.

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. The Ethical Council takes proactive steps to urge companies in specific sectors to work preventively to reduce sustainability risks and ensure responsible stewardship.

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 Ethical Council's main objective is to drive change and it believes this is best achieved through active engagement with investees.

In 2012 the Ethical Council engaged with 220 companies (118 in direct dialogue and 102 indirectly through consultants).

Exclusion – a last resort when dialogue is impossible

AP3 views disposal or exclusion as a last resort for 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. As of 30 June 2013, AP3 had excluded 11 holdings from its investment universe.¹⁹

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 Ethical Council is available at www.ethicalcouncil.com.

Cooperation with other investors

AP3 has a diversified equity portfolio comprising investments in around 4,000 equities worldwide. The majority of our holdings 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% of the voting rights in foreign entities, compared to an average of 0.7% for Swedish companies. 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.

Driving change through collaborative investor initiatives

Via the Ethical Council AP3 has taken part in numerous collaborative investor actions initiated either by the Council or other PRI members.

In 2012 the **PRI** decided to review practices and procedures surrounding its collaborative platform, Clearinghouse, in a bid to focus on a small number of long-term priority areas and to encourage more investors to use the platform. A steering committee under the leadership of the chairman of the Ethical Council was appointed to assist the PRI in this process and it worked closely with the PRI to identify priority areas for in-depth collaboration: director nomination process; human capital management; labour conditions in the supply chain; fracking; and water risks in the food, beverages and textiles sectors.

¹⁹ As of 30 June 2013 AP3 had excluded the following companies from its portfolio: Alliant Techsystems, Elbit Systems, GenCorp, General Dynamics, Hanwha Corporation, L-3 Communications, Lockheed Martin, Poongsan, Raytheon, Singapore Technologies and Textron.

In 2010 AP3 and its fellow Ethical Council members joined the **Institutional Investors Group on Climate Change (IIGCC)**, a European investors' forum for collaboration on climate change issues. The IIGCC, which also collaborates with counterpart investor groups in Australia, New Zealand and North America, aims to give investors a collective voice on climate change and engage companies, policymakers and investors in addressing the long-term risks and opportunities resulting from climate change. Its focus areas included the EU Emissions Trading System (EU ETS). In 2012 the Ethical Council played a key role in drafting an expectation document²⁰ aimed at providing enterprises with a coherent view of what investors expect them to do to reduce climate change-related risks and capitalise on the opportunities created by climate change. The document also urges companies to improve their stewardship and disclosure practices in this regard. In 2013 the IIGCC focused its policy efforts on the revision of EU ETS that is currently in progress.

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. Clear disclosure of revenue and costs in host countries increases transparency and creates better conditions for good financial stewardship. AP3 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 seeks 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 also works to make the data collection process more effective by issuing a collective demand from investors for data and effective reporting of greenhouse gas emissions. The eighth edition of this format, from 722 institutional investors with combined assets of over US\$87 billion, was sent to more than 6,000 enterprises in 2012. Responses are published on an investors' website. The response rate has been 80-90 percent in recent years. Companies face an ever-greater burden in meeting calls for increased transparency and more extensive reporting of key parameters to give investors closer insight into the risks and opportunities affecting their businesses. As a supporter of both the CDP and the GRI,²¹ AP3 welcomes a recent collaboration between the two organisations aimed at harmonising and clarifying applicable disclosure requirements, frameworks and standards for enterprises.

Corruption undermines the legitimacy of the financial system and invariably forms part of the Ethical Council's proactive engagements with investees. The Ethical Council has also joined forces with a couple of large funds in an initiative to tackle corruption. This initiative involved analysing a group of 20 companies and contacting them for information on the measures they take to prevent

AP3 is also one of 14 Swedish institutional investors behind **Sustainable Value Creation**²², a project that polls Sweden's 100 largest companies on the measures they are taking to promote sustainability. The project launched in 2009 and aims to highlight the importance of listed Swedish companies taking a structured approach to sustainability as a means to driving long-term value creation. Businesses can enhance transparency by providing reliable information on how they integrate ESG in their operations. Sustainable Value Creation helps investors to make informed investment decisions. In 2013 it focused on corruption and in February hosted a seminar on this topic including a panel debate and round-table session.

²⁰ The Institutional Investors' Expectations of Corporate Climate Risk Management.

²¹ The Global Reporting Initiative (GRI) is a UN project to create a global standard for corporate sustainability reporting.

²² More information can be found at www.hallbartvardeskapande.se.

The Ethical Council is part of an initiative that seeks to persuade a group of 10 or so **cocoa producers** to tackle child labour in the supply chain and also is part of a similar drive to encourage **tobacco companies** to expand their disclosures of sustainability-related activities. Since 2011 the Ethical Council has been engaged in a project aimed at building understanding of what approach companies in **extractive industries** take to sustainability and what policies and practices they follow in this area. The project has benchmarked a group of around 30 companies against the 10 sustainability principles of the International Council of Metal and Mining.

AP3 supports an in international investor initiatives focusing on supply chains in **Bangladesh**. Recent accidents that have claimed many lives and caused multiple injuries at textile factories in Bangladesh prompted AP3 to join forces with international and Swedish investors in 2013 to press companies to improve safety standards in the country. The investors also want companies that have declined to sign the Accord on Fire and Building Safety in Bangladesh to endorse this document. Only a few US retailers have signed the document, whose signatures include the European fashion chains H&M and Zara.

	2011/12	2012/13
No. of corporate dialogues ²³ via AP3 on ESG	86	84
No. of corporate dialogues ²⁴ via the Ethical Council as at 31/12	126	118
No. of corporate dialogues via ethical consultant as at 31/12		102
No. of portfolio exclusions as at 30/6	11	11

UN Principles for Responsible Investment

As of 2006 AP3 is a signatory to the Principles for Responsible Investment (PRI),²⁵ a United Nations initiative to encourage investors to incorporate environmental, social and governance considerations (ESG) in financial analysis and management processes.²⁶ Signing the PRI signalled our support for the initiative and our intention to comply with its principles in our business activities.

²³ The figures do not include the investor initiative aimed at around 6,000 companies in 2012 and undertaken by CDP on behalf of AP3 and other investors. The term "dialogue" is as defined in the PRI's annual signatory questionnaire and involves active discourse at three levels: extensive, moderate and small engagement.

²⁴ As above.

²⁵ Also see www.pri.org.

²⁶ ESG = Environmental, social and corporate governance.

	PRI principles	Examples of what AP3 does
1	We will integrate ESG in our investment analysis and decision-making processes.	<p>We have one or more ESG-related investments (for example, cleantech, a credit fund focused on sustainable businesses, green bonds, windpower and green buildings).</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 that have helped to develop tools to integrate and measure ESG.</p> <p>We screen the equity portfolio using ESG parameters.</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 committed owners and integrate ESG in our stewardship policy and asset management.	<p>Since 2001 AP3 has integrated ESG in its stewardship policy and in direct engagements with investees, for instance through active dialogue, taking up positions on nomination committees and by voting and submitting resolutions at company meetings.</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. We expect companies to report externally on ESG issues.</p> <p>We support initiatives (such as the CDP, GRESB, Eiti, Global Compact, GRI, 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 the PRI.	<p>We cooperate with AP1, AP2 and AP4 via the Ethical Council.</p> <p>We participate independently and via the Ethical Council on a regular basis in networks and collaborative initiatives with Swedish and international investors.</p> <p>We use the PRI Clearinghouse global platform 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.	<p>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.</p> <p>The AP3 Stewardship Policy is published on our website.</p> <p>AP3's responses to the annual PRI questionnaire are published on the PRI website.</p>

Stakeholder dialogue

AP3 holds regular ESG-related dialogues with stakeholders privately, through the Ethical Council and collaboratively with other investors. Stakeholders include politicians, the media, NGOs, investors, companies, researchers and students. We seek to share knowledge and insights through engagement, questions, interviews and written reports and by active participation at conferences. The Ethical Council invites NGOs to take part in an annual round-table event.

Division of responsibility

The Stewardship Policy is approved by the AP3 Board of Directors and may be reviewed and updated when necessary. The latest update was in June 2013. The CEO has overall responsibility for implementing the policy but can delegate stewardship-related matters internally. Stewardship matters of key importance are discussed in consultation with the Board of Directors, while day-to-day stewardship issues are handled by an internal corporate stewardship committee consisting of a senior asset allocation strategist, the Chief Legal Officer and the Head of Communications and Sustainable Investment. 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 integration of ESG in the investment process.

The Stewardship Committee reports to the CEO and Board of Directors. The stewardship policy is available on the AP3 website.