



AP3 SUSTAINABILITY AND STEWARDSHIP REPORT 2013–2014

Sustainable business practices are fundamental to the ability of the companies in which AP3 invests being able to generate favourable and stable returns over time. Active and responsible ownership helps create well-managed companies that deliver higher returns at a lower level of risk over the long term.

The Third Swedish National Pension Fund is one of five buffer funds – known as the AP funds – within the Swedish pension system and is tasked by Parliament with managing its 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 pensions. The funds also play a part in the long-term financing of the pension system.

AP3 is a committed and responsible investor with a firm conviction that investing in well managed companies generates higher returns and lower risk over time. The AP3 stewardship policy provides the basis for our actions in this field. The policy is mandated and approved by the Board of Directors. It is updated on an ongoing basis and is publicly available on the AP3 website.¹ The stewardship policy is based on the National Pensions Act of 2000, which requires AP3 to exercise stewardship with the aim of improving its scope for generating high investment returns on behalf of the pension system and its beneficiaries. Stewardship must be independent from political or macroeconomic policy considerations. Statutory investment rules limit the Swedish equity portfolio from exceeding 2% of the capitalisation of the domestic equity market. Moreover, AP3 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 investees, whether domiciled in Sweden or abroad. 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. Stewardship focuses on areas where we believe we can exert the greatest influence. 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 disclose the details of discussions with other investors, nomination committees and corporate managements and boards because confidential dialogue is often the best way to achieve results. However, transparency is vital to public trust in AP3, which is why we document in this report how we have exercised stewardship. The report is for the 12 months ended 30 June 2014. AP3 works closely with counterparts AP1, AP2 and AP4 via a joint Ethical Council to monitor environmental and ethical compliance in the companies in which we hold shares. The Ethical

¹ The AP3 website is found at www.ap3.se.

Council reports on its work, including corporate dialogues and investor initiatives, annually in April or May in a separate report.²

ESG FULLY INTEGRATED IN ASSET MANAGEMENT

As of 2006 AP3 is a signatory of the UN Principles for Responsible Investment (PRI), which urge investors to integrate environmental and social governance (ESG) in financial analysis and decision-making processes. By endorsing the PRI we support the process and commit to apply the principles in our business activities. AP3 reports annually on ESG to the PRI.

During the period, AP3 continued to prioritise the integration of sustainability throughout the investment process as a means to enhancing control of portfolio risk and building trust and confidence in the fund as a portfolio manager. AP3 applies general principles that govern our approach to ESG risks. All internal management mandates are required to abide by these principles when making portfolio investments. External management contracts contain no specific stipulations on ESG, but managers must follow clear reporting guidelines. AP3 also monitors external mandates and evaluates how managers incorporate ESG in their investment decisions.

The Fund uses negative and positive screening and proactive engagement to encourage practical application of ESG in the investment decision-making process. An external consultant, Global Engagement Services (GES), is tasked with screening all AP3 holdings based on information obtained from a wide range of sources, including UN data, media reports and information from non-governmental organisations and stakeholder groups. GES screens AP3's equity holdings against this data. If any reported incidents occur of companies breaching international conventions and treaties, AP3 investigates the matter further. AP3's internal managers use the MSCI ESG Manager research and analytics platform provided by the Fund's index supplier, MSCI, to manage ESG risks. The platform is used primarily to screen the equity portfolio but will in future be extended to the fixed income portfolio.

AP3 has for a couple of years been a member of the Global Real Estate Sustainable Benchmark (GRESB), an international industry association for real estate investors that provides a channel to help us to monitor and analyse ESG performance and compliance in real estate investment. AP3's unlisted real estate holdings – Vasakronan, Hemsö and Trophi – all submit data to the GRESB database.

Our timberland holdings are certified by the Forest Stewardship Council (FSC), an organisation that promotes environmentally sound, socially beneficial and economically prosperous management of the world's forests.

We provide ESG training to employees to promote increased awareness and knowledge in this field, operating an ESG programme at different levels. All employees, for example, will receive basic training in ESG and responsible investment from RI Fundamentals, while some have more extensive know-how in this area. The aim of all ESG training is to raise levels of ESG expertise within our investment teams. From an organisational perspective, the Fund has a manager in charge

² Also see the Ethical Council's website at www.etikradetapfonderna.se.

of ESG integration who works alongside a dedicated ESG working group. A similar structure – responsible manager working alongside working group – also applies in corporate stewardship.

AP3 is committed to transparency in its external reporting, which takes the form of an annual report (presented according to Global Reporting Initiative standards) and an annual sustainability and stewardship report.

...AS CONFIRMED BY THE GOVERNMENT'S REVIEW

ESG actions and engagements were a key focus area of the government's most recent review of the AP funds.³ In this context, the funds' auditors and consultants McKinsey & Co performed special analyses of the funds' ESG work. The government sees the strategic importance of ESG to attaining high returns and effective risk management over time, which in turn is critical to public confidence in the AP funds and state pension system. The review showed that the funds had done well in comparison with other international pension funds in integrating sustainability into their operations and noted that the funds had well-defined guidelines for ownership and commendable stewardship reporting. However, the government said it believed the funds could be clearer in spotlighting their focus issues and their targets, results and any differences between goals and outcomes. The review also suggested there were good reasons for the funds to work together on developing stewardship practices.

REFORM OF THE AP FUND SYSTEM

The AP funds' investment rules have been unchanged since the state pension system was reformed in 2001. A few years ago the government commissioned a report to determine whether, and to what degree the system needed to change. A round of consultations that formed part of this process revealed a wide span of opinions on what actions were necessary. Most of those involved, including AP3, therefore had few expectations that the review would lead to any changes and it came as a surprise when the Pensions Group, consisting of the Moderate, Liberal, Centre, Christian Democratic and Social Democratic parties, announced in March 2014 an agreement to reform major parts of the pension system.

The Pensions Group took the view that the system was largely effective but that external changes and insights gained during close to 15 years of the system's operation warranted a wide-ranging overhaul. The proposed changes include alterations to the structure and investment rules of the buffer funds, more even performance from the income pension system, a longer working life and modifications to the premium pension system. The recommendations are general in character, with varying levels of detail in the different areas. In all areas, the recommendations require further work and refinement before the government can submit a bill to Parliament.

The main proposals that affect the AP funds directly concern the establishment of a separate supervisory body linked to the Swedish Pensions Agency to oversee the funds. Another proposal involves reducing the buffer funds from five to three independent agencies tasked with managing the funds' capital. Among the recommendations is the replacement of the current quantitative investment rules with a general prudence principle. The supervisory body would set asset

³ Disclosure of AP funds' operating activities up to and including 2013, government notice 2013/14:130.

management targets and establish a benchmark portfolio. The changes are scheduled for implementation during summer 2016.

The Pensions Group has stated that the prime reason for changing the current AP fund system is to improve cost efficiency. In its review of the AP funds, the government compared their returns after expenses with a group of international pension funds with similar mandates and concluded that the AP funds perform well by comparison.

AP3 will remain committed to its mission of managing its assets to generate maximum benefits for the pensioners of today and tomorrow until the new rules are introduced.

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 with a market value of approximately SEK 135 billion,⁴ of which around SEK 10 billion is invested in unlisted equity. The listed equity portfolio comprises around 3,800 stocks and Swedish enterprises account for some 22% of the total equity portfolio. The Swedish equity portfolio had a market capitalisation of close to SEK 30 billion at 30 June 2014.

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 260 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 0.8% of the equity and voting rights. Nevertheless, there is substantial variation and one in three of our Swedish holdings are in entities where we own equity stakes of less than 0.1%. Only in just over one in ten of investees 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.

In corporate stewardship we focus on areas where we believe we can exert the greatest influence. AP3 is generally better placed to influence Swedish companies rather than foreign enterprises due to the fact that our Swedish equity holdings are considerably higher in percentage terms. Our views also resonate more strongly with Swedish companies because the Fund represents the pension assets of the Swedish public.

Our focus areas include taking active steps to influence the structure of executive pay packages and promoting increased diversity on corporate boards. We exert influence by engaging boards in dialogue, by holding 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 we also focus on executive pay and actively promote 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.

⁴ As at 30 June 2014.

AP3's main stewardship tools are:



GOVERNANCE BASED ON THE AP3 STEWARDSHIP POLICY

1. Shareholder rights and responsibilities

The Swedish stewardship model, based on clear division of responsibilities between executive management, board and shareholders, works well in practice. The annual general meeting is a company's highest decision-making body and **the right to submit resolutions to the AGM** is an investor's prime instrument for exerting influence. AP3 votes and participates actively at the company meetings of entities primarily in which we hold a substantial equity stake or are committed to pursuing an issue of principle.

Dialogue with corporate boards, managements and other investors is often the best means of exercising influence at an early stage in the stewardship process. Such dialogue often takes place before the AGM season enters full swing. It is critical that such dialogue remains confidential between the parties, and for this reason it is not possible to publish all the details of our stewardship-related discussions. Where dialogue does not result in change, AP3 can continue to

advance its viewpoint by submitting a shareholder resolution, abstaining from voting or voting against a board proposal.

Contacts and **collaboration with foreign shareholders** are becoming more important 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.

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 facilitate AP3's stewardship. The Fund is active in helping to drive forward the development of the Swedish equity market's system of self-regulation. We belong to the Institutional Owners Association for Regulatory Issues in the Stock Market, a forum where we discuss key governance issues with other Swedish institutional investors. We also support a wide range of initiatives to make it easier for investors to vote in foreign company meetings. In this regard, we are members of the International Corporate Governance Network (ICGN) and also work closely with other institutional investors.

AP3 participates in class actions, whereby groups of plaintiffs unite 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 2006-2013 received SEK 114 million from class actions, of which SEK 8 million was paid in 2013.

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.

New share issues should include preferential rights for existing shareholders, while private placements should 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.

3. Corporate boards

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, and the board itself should represent the interests of all shareholders. 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. For this reason, directors should not have an excessive number of board memberships. **Ethnic and gender diversity** is another core component of effective board operation and here AP3 works to ensure that directors are recruited from a wider base.

Women currently hold around one in four seats on the boards of listed Swedish companies. This figure is increasing, but far too slowly: at the rate seen in the last 10 years it would take 30 years before women filled half of all board seats. Calls have been growing for Sweden to implement a quota system on the lines of that introduced in Norway in 2004. However, AP3 takes the view that the issue of female board representation should be a matter of self-regulation and that responsibility rests first and foremost with shareholders and nomination committees.

In May 2014 the Council for Swedish Corporate Governance tightened the national corporate governance code in an effort to achieve greater gender equality on the boards of listed companies. The council wants owners to accelerate progress towards a percentage of around 40% for the under-represented sex across all listed companies by 2020. By 2017 the largest listed companies are expected to have reached around 35%, with small enterprises approaching 30%. The council has adopted three strategic initiatives to achieve an acceptable gender balance across all corporate boards, though without explicitly saying that each individual company must meet the criteria. These initiatives are:

1. Clearer principles in the national corporate governance code highlighting the importance of responsible and sustainable stewardship for good governance, maintaining public confidence in the code and preserving the ability to attract investment capital. A broader recruitment base for boards is a prerequisite for optimal company development.
2. Tighter rules achieved by tasking nomination committees with scrutinising the list of candidates selected for board membership in the light of the need to achieve gender equality. Nominations should provide clear reasoning for selections in the light of the code's requirements on gender equality. Also, specific information on the nomination committee's work in this context should be presented at the AGM.
3. Supportive activities conducted in partnership with major shareholders and nomination committees and a statement of intent to ensure the rules are implemented.

AP3 welcomed the Council for Swedish Corporate Governance's initiatives. We consider it positive that the council has highlighted sustainability, equality and public trust as key factors in corporate success. In our view, the council struck a good balance between not constraining shareholder rights and requiring nomination committees to tackle the equality issue. We hope the measures will create added pressure in this field and accelerate the rate of progress.

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 our equity holding. Prior to the 2014 AGM season, AP3 held nomination committee seats at four listed companies (Aerocrine, Agrokultura, Arise and Karolinska Development) and two unlisted companies (Bergvik Skog and Vasakronan).

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 proposing that a CEO should also serve as chairman.

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.

5. Executive pay

AP3's stewardship policy takes a conservative line on performance-related pay to senior executives, in line with government guidelines.⁵ In certain circumstances, however, we accept variable remuneration awards to executive management if they are deemed commensurate with the company's long-term development and prospects. AP3 engages actively with companies to express opinions on incentive programmes. This engagement also includes active participation at shareholder meetings. We have seen favourable results from our efforts to encourage companies to adopt a more conservative line on executive remuneration. The criteria set out in the stewardship policy enjoy broad support and have gained growing acceptance in the financial markets, especially in Sweden.

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.

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

If correctly structured, share-based or share-price-based remuneration can be an effective way to marry 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

⁵ Government guidelines for remuneration and benefits to senior executives of the AP funds.

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)

As an integral part of the Swedish state pension system, AP3 bases its values on international conventions signed by the Swedish government in the field of the environment, human rights, labour protection, anti-corruption and inhumane weapons. Our values also include support provided by Sweden to initiatives such as the OECD's Principles of Corporate Governance and Guidelines for Multinational Enterprises, the UN Global Compact, and Sweden's stance on issues of international law. The Pension Funds Act requires the AP funds to take due account of environmental and social governance without compromising the ultimate objective of achieving high returns at a low level of risk.

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 and externally with regard to stakeholders, including business partners and suppliers.

VOTING AT SWEDISH COMPANY MEETINGS IN 2013–2014

The size of AP3's Swedish equity portfolio varies over time according to equity market trends and how we allocate investment capital. The portfolio consists of 120 holdings and the portfolio structure has historically been very stable. Since most investments are under index management, the majority of our holdings in kronor terms are in the largest corporations listed on the Stockholm stock exchange. However, our biggest capital holdings are in four smaller companies: wind power company Arise (approximately 10% of the equity), medical technology company Karolinska Development (10%), real estate company Sagax (8%) and agribusiness Agrokultura (7%).

For practical reasons it is not possible to physically attend and vote at the AGMs of all Swedish investees portfolio or to prioritise heavy stewardship engagements in companies where we control only a minor share of the equity. For this reason, we focus our efforts on selected investees that are either large Swedish-listed companies where we have 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). We sometimes also attend meetings at companies in which we are monitoring a specific governance-related issue.

In total, AP3 voted at 53 AGMs – 40 in person and 13 by proxy – and also attended in a number of extraordinary general meetings. The Fund voted on approximately 1,000 agenda items.

	2012/2013	2013/2014
No. of Swedish AGMs at which AP3 voted	65	53
AGMs at which AP3 voted as percentage of Swedish portfolio	54%	44%
No. of Swedish AGM agenda items on which AP3 voted	approx. 1,200	approx. 1,000
No. of nomination committees on which AP3 held a seat	6	6

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

Stewardship on remuneration consumes a great deal of resources

Executive remuneration consumes a great deal of our time and resources because Swedish corporations continue to introduce incentive schemes at an undiminished rate. 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. Meanwhile 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 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.

Continued focus on capital structure

One outcome from this Swedish AGM seasons was that companies and their investors are focusing more closely on what is important to the business, namely operating environment, growth prospects and profit potential. The structure and reasonableness of banks' financial targets has been the subject of considerable debate both in the media and at bank AGMs. This was to be expected because the banking and financial crisis prompted 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. The new Basel III capital adequacy were due to take effect on 1 January 2013 but implementation was postponed and it is now unclear if and when the regulations will be introduced. This creates uncertainty among companies and investors. 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 asset buffer to meet future requirements.

STEWARDSHIP IN THE FOREIGN EQUITY PORTFOLIO

Outside Sweden, AP3's stewardship includes voting at company meetings and lending support to investor-led initiatives. The foreign equity portfolio is managed both internally and by external managers. AP3 votes at around 500 foreign AGMs. Pressure is growing steadily on institutional investors to take an active stewardship role at the companies in which they own shares. In Britain, the recently introduced UK Stewardship Code seeks to encourage investors to be more active and involved. This involvement envisages institutional investors 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. For AP3, such codes have little direct impact as we already include these factors in our stewardship.

Independence and integrity of key importance

AP3 has a diversified equity portfolio with relatively small holdings in a wide range of companies, so the extent of our voting involves striking a balance between the costs involved and the value added that our interventions can create. AP3 has investments in around 3,800 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. In some cases, therefore, we vote by proxy, whereby Institutional Shareholder Services (ISS), a global corporate governance consultancy, provides access to an electronic voting system and 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. It should be noted that AP3 elected to vote differently from ISS's recommendations fairly frequently. In around two cases out of 10 in which ISS issued a voting recommendation based on its analysis, AP3 voted differently and in accordance with our own stewardship policy. This is important to note and is one of the main reasons why in recent years we have extended our voting responsibilities with regard to foreign investees rather than leaving this to governance consultants.

Global voting policy

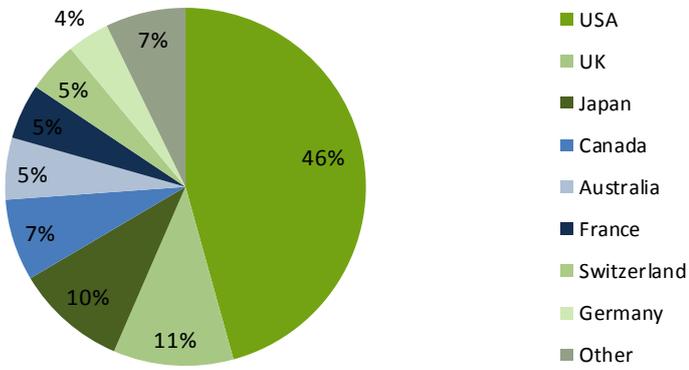
AP3 has a global voting policy to facilitate the voting process for non-Swedish investees. Both policies are based on internationally accepted standards for corporate governance, including the OECD's Principles of Corporate Governance and Guidelines for Multinational Enterprises and the UN Global Compact. The voting policy is framed in general terms, meaning that deviations may be necessary to reflect local rules, industry standards and market-specific conditions.

Selections based on index weights

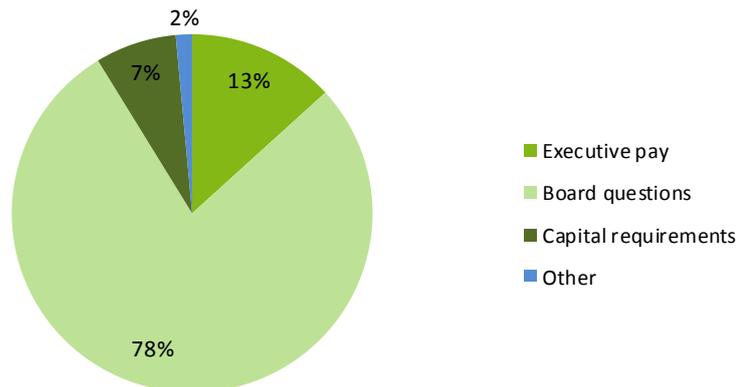
Outside Sweden, AP3 voted at investee company meetings in Australia, Belgium, Canada, France, Germany, Ireland, Italy, Japan, the Netherlands, Spain, Switzerland, the UK and the United States, and at small group handful of large investees domiciled in Bermuda, Curacao, Jersey and Panama. We based our choices primarily on each company's weight in the MSCI ACWI global share index, resulting in our voting at the largest companies in the selected markets. We also voted at investees that are part of the Ethical Council's universe, for instance those with which the council engages or where it supports international initiatives on specific topics, and at meetings where AP3 filed a resolution.

Data on AP3's global voting in 2013–2014

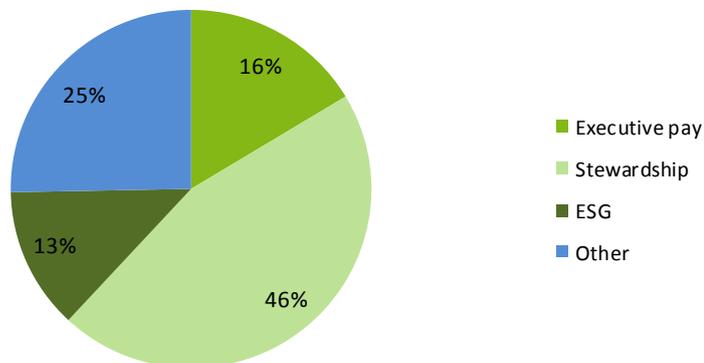
Geographic breakdown of company meetings 2013/2014



Breakdown of board resolutions 2013/2014



Breakdown of shareholder resolutions 2013/2014



“No” votes more common outside Sweden

AP3 voted on 7,238 resolutions at 501 company meetings outside Sweden. We abstained on or voted against around 18% 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. On executive pay, we voted or abstained in approximately half of all cases, reflecting the fact that foreign companies have a greater tendency than Swedish enterprises to fall short of our requirements regarding remuneration systems. It should also be noted that we voted in favour of more than half of resolutions submitted by other investors. Many institutions move their own resolutions to non-domestic AGMs and these are often of a high standard. Examples include resolutions for improved reporting of political donations and separation of the role of CEO and chairman.

A list of all the foreign AGMs at which AP3 voted and how we voted is available on the Fund's website at www.ap3.se.

	2012/2013	2013/2014
No. of AGMs of non-Swedish investees at which AP3 voted	509	501
Ratio of foreign investees at which AP3 voted, %	12%	12%
No. of agenda items at foreign investees on which AP3 voted	6,811	7,238
Ratio of agenda items on which AP3 voted in favour of board resolutions, %	81%	82%
Ratio of agenda items on which AP3 voted against/abstained on board resolutions, %	19%	18%

	2012/2013	2013/2014
No. of board resolutions	6,409	6,873
No. of shareholder resolutions	402	365
Total no. of agenda items	6,811	7,238
No. of votes in favour	5,514	5,940
No. of votes against	956	811
No. of abstentions	341	487
Total no. of agenda items	6,811	7,238
No. of votes in favour of board's recommendation	5,409	5,920
No. of votes against board's recommendation	1,402	1,318
Total no. of agenda items	6,811	7,238
No. of votes in favour of shareholder resolutions	239	196
No. of votes against shareholder resolutions	140	159
No. of abstentions on shareholder resolutions	23	10
Total no. of shareholder resolutions	402	365

Strong support for ESG-related resolutions

AP3 also supports investor resolutions on environmental and social governance. Especially in the US and Canada, it is common for investors to file resolutions on environmental, social and corporate governance (ESG) to company AGMs and AP3 has done so itself in previous years. These resolutions often urge companies to be more transparent, appoint environmental specialists to the board of directors or address environmental impacts. AP3 voted on 59 ESG-related resolutions filed by shareholders, a somewhat lower figure than in the prior year.

Company feedback

As in previous years, AP3 contacted 50 foreign investees to provide feedback on our reasons for voting against certain AGM 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 CEO 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. We received a mix of written and verbal responses from most companies and our hope is that these dialogues will intensify, leading to better understanding of our views among the companies concerned and their managements.

ENVIRONMENTAL, SOCIAL AND CORPORATE GOVERNANCE (ESG)

Core values based on international conventions

AP3's guiding principles of engagement, action and driving change reflect the core values of the Swedish government. The Instrument of Government defines these 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 Compact⁶ and the OECD's Principles of Corporate Governance and Guidelines for Multinational Enterprises.⁷ International conventions and the Swedish government's core values are key instruments for AP3 in our pursuit of high standards of environmental and social governance.

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.

⁶ 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 protection, the environment and anti-corruption.

⁷ The OECD Principles of Corporate Governance and Multinational Enterprises are recommendations to businesses from 40 governments, including Sweden's. They cover human rights, anti-corruption, employment, competition, taxation and disclosure.

AP3 sees a connection between companies' ethical conduct and their capacity to deliver long-term shareholder value and it is our firm belief that companies which are well run offer a better long-term investment. We screen investees 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 companies via the AP funds' joint Ethical Council. We also work to ensure that the managements of investee companies identify and manage social and environmental risks so as to create shareholder value. In this context, we urge investees to follow the principles of the UN Global Compact and standards applicable to specific industries, such as the ICMM principles on mining and sustainable development and the Global Network Initiative principles for the ICT industry.

Engagement is AP3's prime tool for influencing portfolio 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 engagement we aim to ensure that companies have risk management systems and codes of conduct in place and that they have personnel with a sustainability remit. This reduces 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 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 group-wide codes of conduct covering human rights, working conditions and environmental protection and expect the codes to be based on the UN Declaration on Human Rights and the ILO's core conventions, 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) are a preferred model.

Integration of sustainability in business models

During the year we held direct discussions on ESG with around 10 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 is 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 analysis and appointing sustainability specialists to the board or providing training to directors. A growing number of boards have also instituted sustainability committees.

Many companies treat social and environmental responsibility as just another requirement 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 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 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 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 ESG

In our discussions with companies we addressed 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 compliance monitoring of, and training in, such codes; supplier audits; corruption risk; sustainability reporting; and third-party audits. We have for a number of years also engaged with telecom and data networking companies on data integrity, promoting the Global Network Initiative (GNI) 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 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 PRI.

Increased focus on real estate

AP3's real estate investments comprise shareholdings in three Swedish-based companies – Vasakronan, Hemsö and Trophi – and investments in 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 analysis tools and benchmark data enables us to measure and evaluate ESG factors in our real estate portfolio. We base our engagement with real estate investees and fund managers 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 climate change abatement projects in developing countries. In 2013 we invested in a global credit fund managed by Generation Investment Management. The fund focuses on companies that confront the challenges and opportunities of sustainability, including the transition to a low-carbon economy.

STEWARDSHIP VIA THE ETHICAL COUNCIL

AP1, AP2, AP3 and AP4 have since 2007 coordinated their screening and engagement 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 consultant screens the four funds' equity holdings to determine whether any company in the portfolio is acting in contravention 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 to understand its responsibility for incidents or to focus adequately on taking proactive action in ESG. The Ethical Council works to encourage companies in specific sectors to take preventive measures to reduce ESG risks and ensure responsible stewardship.

Dialogue and cooperation the prime tools

Engagement with companies 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 sees this as best achieved through active engagement with investees.

In 2013 the Ethical Council engaged in dialogue on issues including human rights, environmental protection and anti-corruption with 234 investees in different sectors. A total of 133 of these contacts took place directly between the Ethical Council and the investee and 101 were handled by the Ethical Council's 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 from the portfolio does not solve the problem, which is why we attempt, where possible, to drive change through dialogue. Based on advice from the Ethical Council, AP3 in late 2013 divested holdings in four companies linked to breaches of international conventions. This followed several years of dialogue between the council and the four companies – Walmart, Freeport McMoRan, Incitec Pivot and Potash. These discussions, however, proved unsuccessful and the council advised AP3 to remove the companies from our portfolio. As of 30 June 2014, we have excluded a total of 15 investees from our investment universe.⁸

Ethical Council annual report and website

The Ethical Council publishes an annual report containing information on its corporate dialogues and investor initiatives. The report and further information about the Ethical Council is available at www.etikradetapfonderna.se.

COOPERATION WITH OTHER INVESTORS

AP3 has a diversified equity portfolio with relatively small holdings in foreign entities, which limits our ability to influence these companies. 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 Ethical 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 was appointed under the leadership of the Ethical Council chairman 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 and beverages and textiles sectors. Work to develop a new collaborative platform will be presented at the PRI conference in Montreal during autumn 2014.

The Ethical Council works closely with the **Institutional Investors Group on Climate Change** (IIGCC), a European investors' forum for collaboration on climate change issues. The IIGCC, which also teams up with counterpart investor groups in Australia, New Zealand and North America, aims to design clear long-term guidelines that facilitate investment in the transition to a low-carbon economy. In 2013 the IIGCC published a report on the European Union's next climate plan and in it expressed investors' desire for a pan-European carbon price signal instead of the fragmented national systems currently in place.

During autumn 2013 the Ethical Council hosted a **seminar on the financing of a low-carbon economy** at which politicians, stakeholder groups and investors listened to Michael Liebreich, a

⁸ As of 30 December 2014 AP3 had excluded the following companies from its portfolio: Alliant Techsystems, Elbit Systems, Freeport McMoRan, GenCorp, General Dynamics, Hanwha Corporation, Incitec Pivot, L-3 Communications, Lockheed Martin, Poongsan, Potash, Raytheon, Singapore Technologies, Textron and Walmart.

leading renewable energy expert at Blomberg New Energy Finance. His message was that long-term falls in production costs, combined with increased efficiency of wind power, solar power and batteries, were creating greater scope for a cost-effective transition to a low-carbon economy. The challenge, he said, was to choose the right investments, suggesting that the larger-scale opportunities for investors would be concentrated to infrastructure.

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. As a supporter of both the CDP and the GRI,⁹ AP3 welcomes collaboration between the two organisations aimed at harmonising and clarifying applicable disclosure requirements, frameworks and standards for enterprises.

Measures to tackle **corruption**, which distorts competition and can destroy company value, is a focus area for the Ethical Council. The council took part in the first phase of the PRI's anti-corruption project from 2010 to 2012. The project included third-party analysis of the work done by a group of approximately 20 companies to tackle corruption. A group of investors then contacted each company to discuss the findings and propose improvements. The project was a success and in the latter part of 2013 entered phase two. This involves a group of 20 investment institutions contacting around 30 companies, with each institution responsible for one or more of the dialogues. The Ethical Council is in charge of the dialogues along with four Asian companies.

The Ethical Council also supports the **Extractive Industries Transparency Initiative (EITI)**. Transparency and good governance are crucial in countries that are rich in natural resources but have weak governments. Clear disclosure of income and payment levels 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. A group of 30 investors, including AP3, in August 2013 wrote to the US Securities and Exchange Commission (SEC) and Natural Resources Canada urging both agencies to adopt a global standard for tax and royalty revenue from companies in extractive industries.

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

For the last couple of years, the Ethical Council has been part of an initiative aimed at encouraging a group of 10 or so **cocoa producers** to tackle child labour in the supply chain. The council is also part of a similar drive to encourage **tobacco companies** to expand their disclosures on

⁹ The Global Reporting Initiative (GRI) is a UN initiative to create a global standard for corporate sustainability reporting.

sustainability-related activities. Together with the Dutch pension fund PGGM and AP7, the Ethical Council has since 2011 been part of a project to gain insight into how **mining companies** approach ESG and to encourage mining companies to implement policies and processes in this area. The project has benchmarked a group of around 30 mining companies against the 10 sustainability principles of the International Council of Metal and Mining. In mid-2014 the Ethical Council wrote to 70 or so mining companies urging them to comply with the ICMM's sustainability principles.

Over the years AP3 has held numerous **discussions with companies that purchase goods from low-cost countries**, where working conditions for textile workers, in particular, are often sub-standard. Wages are so low that workers cannot live on them and workers' rights are often insufficient. Workplaces may be dangerous, a fact to which the serious accidents seen in Bangladesh in recent years can testify. In 2013 the Ethical Council joined a large number of international and Swedish investors in urging a group of 100 companies to shoulder greater responsibility by signing the Accord on Fire and Building Safety in Bangladesh. Swedish clothing chain H&M joined the signatories but few US companies have done likewise.

In late 2013 the Ethical Council launched a project with the Church of Sweden and the Dutch pension fund PGGM to persuade the **pharmaceutical industry** to take counter measures against emissions of active substances from drug production. Antibiotic resistance is growing worldwide due to the spread of antibiotics in the natural environment. Initially the project will focus on a small group of companies with production facilities in developing countries in order to develop an understanding of what demands can reasonably be made of suppliers when it comes to effective water treatment and how monitoring of post-production wastewater should be structured.

The Ethical Council is part of a PRI initiative to develop knowledge among investors of **palm oil** and develop a consensus-based approach to sustainable palm oil production. During 2013 the Ethical Council participated in an international investor initiative to encourage companies to produce and purchase certified palm oil and the council will continue its involvement in this field in 2014.

	2012/2013	2013/2014
No. of corporate dialogues via AP3 on ESG	84	67
No. of corporate dialogues via Ethical Council as at 31 Dec.	118	133
No. of corporate dialogues via consultants as at 31 Dec.	102	101
No. of portfolio exclusions as at 30 June	11	15