



Tredje AP-fonden

SUMMARY OF AP3'S CORPORATE GOVERNANCE ENGAGEMENT ACTIVITY DURING THE FIRST HALF OF 2005

The corporate governance policy approved by AP3's Board of Directors sets out a number of principles for how the Fund should exercise its influence as a shareholder.

- Every company is unique. Flexibility is required at all times to ensure the best interests of the company in question.
- Corporate governance is an integrated part of the Fund's active equity management and a means of achieving our goal of a maximum return on investment.

TRENDS DURING THE 2005 AGM SEASON

During this year's Swedish AGM season we noted a clear improvement in the willingness of corporate boards to discuss agenda proposals with shareholders prior to the AGM. This gave shareholders the opportunity to comment on AGM agendas at an early stage and led to fewer open conflicts between boards and shareholders. This did not mean, however, that institutions played a less active governance role. Rather, the salient point is that discussions between shareholders and boards now take place prior to the AGM rather than during the meeting itself, giving institutions a greater say in AGM proposals. This is because shareholders cannot modify AGM agenda proposals – only vote on them – once the notice to attend the AGM has been sent to shareholders.

At AP3 we see this trend towards improved consultation in a very positive light. We know from experience that we can maximise our influence as shareholders if we are able to pursue a close dialogue with a company's board. However, this approach places new demands on the way we publicly disclose our corporate governance activities. It is not always possible for us to communicate the full detail of the discussions in which we are involved. Nevertheless, we aim for a high degree of openness in our general approach to governance issues and the implementation of our corporate governance policy.

The agendas of this year's AGMs revealed a number of trends:

- Most new share-based *compensation schemes are now performance-related*. Whether such schemes are based on shares or options, they now usually contain a requirement for specific targets to be reached in order for the benefits to vest. These targets are often set in close consultation with major shareholders.
- *Higher rates of board remuneration*. Many companies have introduced special compensation for committee work in response to the increased demands that are being made of directors. These demands have arisen partly from the introduction of the Swedish Code of Corporate Governance.

- *Board assessments.* The code has helped to establish the principle of nominating committees (Swedish nomination committees consists of representatives of the major shareholders.) basing their recruitment process on an evaluation of the incumbent board's performance. Such assessments have now been adopted by most Swedish boards.

THE AP3 EQUITY PORTFOLIO

AP3's equity portfolio was worth SEK 89 billion at 31 December 2004. Approximately 30% of the capital was invested in Sweden and the remainder abroad. The Swedish equity portfolio represents some 1% of the Stockholm stock market's capitalisation. It is managed actively and during spring 2005 consisted of between 40 and 45 different stocks. AP3 is a relatively small institutional shareholder in Swedish-listed corporations and its shareholdings seldom exceed 1%. By contrast, the Fund holds much larger equity stakes (of between 3.5% and 8%) in medium-sized companies. Our shareholdings in these companies are sufficiently large to warrant a seat on the nominating committee.

The resources that we assign to active governance in a particular company depend primarily on the size of our shareholding. The most time is allocated to where AP3 is a major shareholder (usually defined as more than 2 percent of shares.) In these companies AP3 holds continuous discussions with the company's board, executive management and other shareholders. In large corporations, in which we hold a smaller proportion of the equity, we rely partly on other means to exercise governance, namely promoting the application of best practice on the Swedish stock market. We are also more inclined to use the AGM as a forum for communicating our views since our ability to engage in direct discussions with the board is limited. Dialogue with other private and institutional shareholders is, therefore, particularly important in large corporations.

The AP3 foreign equity portfolio is managed by external managers and spans a wide spectrum of approximately 5,000 different stocks. Our equity interest in these companies averages just 0.02% and is far lower than for our Swedish portfolio companies. Here, AP3 delegates its governance role to the external managers with the proviso that our voting rights be exercised to enhance portfolio returns.

PRIORITY ISSUES

During the 2005 Swedish AGM season AP3 highlighted a wide variety of governance issues relating to the various companies in its portfolio. The following areas received particular attention:

Board evaluation

Through our nominating committee memberships we promoted a structured evaluation of board performance to provide a sound basis for the nomination process. We prefer that these evaluations are performed by external parties, though internally managed questionnaires can do the job if used correctly. In a number of nominating committees we spoke to individual directors for their views on the board's operations and whether there was any need for additional expertise.

Broad-based and professional recruitment process

AP3 promoted a broad and professional recruitment processes for new directors in the

context of the specific needs identified by nominating committees. This approach has the advantage of being based on objective criteria rather than the incumbent board's contact network, thereby broadening the recruitment base and making it easier to identify potential female candidates. AP3 is positive to the hiring of recruitment consultants to compile a list of candidates and also draws up its own lists of qualified potential independent board members.

Share-based incentive schemes linked to performance

AP3 pressed for special conditions to be attached to participation in share-based incentive schemes. Such schemes should either require a personal investment by the participant (i.e. an element of risk) or include performance criteria linked to grant size and/or vesting. The performance targets should be relevant, suitably demanding and disclosed fully to shareholders. In a number of instances, AP3's engagement efforts resulted in incentive schemes being changed in a more shareholder-friendly direction.

Code flexibility required

AP3 sees the new Swedish Code of Corporate Governance as a benchmark of best practice and has urged companies to adopt its provisions. One of the code's key aims is to foster understanding of the Swedish corporate governance model among international investors, thus reducing the risk of Swedish corporations receiving lower valuations than their foreign competitors due to any concerns over governance standards.

At the same time, we aim to ensure flexibility within the parameters of the code. What governance practices that best serve shareholder's interests varies between companies. A key element of the code is the flexibility offered by its "comply or explain" principle, which enables the market to decide whether an explanation for non-compliance is acceptable or not.

AP3 urged companies to include a corporate governance report in their 2004 annual reports, in accordance with the code's guidelines. We hope to foster corporate governance reporting that is clear, concise and not overly legalistic in tone. It is important that the market is aware of cases in which a company has departed from the code and which model it has applied instead.

NOMINATING COMMITTEES

AP3's policy is always willing to take a seat on a nominating committee if invited to do so. Prior to the 2005 AGM season we were represented on the nominating committees of the following corporations:

Alfa Laval
Cardo
Castellum
Haldex
Höganäs
Nobia
SwitchCore
Telelogic

AP3'S ACTIONS AT THE 2005 ANNUAL GENERAL MEETINGS

As in previous years, AP3 met its target of exercising its voting rights in all the companies in its Swedish equity portfolio – a total of 42. Our staff participated in 33 AGMs, AP3 directors attended a further four and powers of attorney were given to another institution at four AGMs. In one case we exercised our vote by proxy-voting.

Though the primary focus was on the ten or so companies in which we have our largest shareholdings, we also played an active governance role in our other portfolio companies. In total we had some form of contact with either with the board or major shareholders of 29 companies in our Swedish equity portfolio.

Share-based incentive schemes featured on the AGM agendas of 11 companies in our Swedish portfolio:

AstraZeneca
Electrolux
Eniro
Ericsson
Investor
Kinnevik
MTG
Nobia
Ratos
SEB
Telelogic

We contacted all the above corporations to hear the board's reasoning behind the proposed long-term incentive schemes and a description of them. In eight cases we voiced concrete criticism and in four of these our opinions were taken wholly or partly on board. Our opinions related chiefly to the introduction of a link to performance and how this should be formulated. In three cases – Investor, Electrolux and MTG – AP3 publicly criticised the schemes at the AGM. However, in each instance we voted to approve these programmes, along with all other institutional shareholders.

AP3 contacted four companies to discuss their management of environmental and social issues and at one AGM (Assa Abloy) we called on the company to improve its sustainability reporting.

AP3 initiated discussions with two companies concerning their capital structure. Our criticism in one of these instances led to a change in the board mandate for issues of new shares.

SKANDIA

Skandia's AGM attracted by far the most attention of any AGM during the spring. Prior to the meeting, AP3's executive management spent much time considering the Skandia's board explanation for its proposed settlement with former chairman Lars Ramqvist. AP3 CEO Kerstin Hessius and Head of Corporate Governance Pernilla Klein attended a

number of meetings with representatives of the Skandia board (Björn Björnsson and Bernt Magnusson) and Skandia legal adviser Peter Danowski.

After a thorough analysis of the documentation submitted by Skandia prior to the AGM, we decided to vote in favour of the settlement (which was later approved by shareholders at the AGM). From a shareholder perspective, we found the settlement to be reasonable, while we considered the chances of bringing a successful civil action against Ramqvist for damages to be unduly small.

ENVIRONMENTAL AND SOCIAL RESPONSIBILITY

During spring 2005 we continued to implement the provisions of our corporate governance policy relating to environmental and social responsibility. We focused our efforts on Swedish corporations with significant production or purchasing in countries ruled by undemocratic regimes or with weak labour protection and environmental legislation. These are generally transition economies, developing countries or new industrial nations. We make the following demands on companies active in these markets:

- *Corporate code of conduct.* Companies should have a group-level code of conduct on human rights and environmental issues that is published and disclosed to stakeholders.
- *Reporting.* A company's external reporting of environmental and social issues, either in its annual report or corporate sustainability report, should comply with the guidelines of the Global Reporting Initiative.

During the last 12 months AP3 has written to three Swedish corporations in this regard. Our letters resulted in meetings with the executive managements of these companies and our overall impression was that our views were met with strong interest. In most cases, significant steps were taken to address our concerns.

We also attended follow-up meetings with two companies with which we had been in contact regarding environmental and social issues. Both companies have continued to make substantial progress. We made a presentation at the AGM of one of these companies, Assa Abloy, regarding improvements in external sustainability reporting.

AP3 has joined the Swedish Amnesty Business Group in order to promote the efforts of Swedish corporations in preventing human rights abuses.

AP3 IN THE GOVERNANCE DEBATE

Active participation in the Swedish and international corporate governance debate has been a focal point of our activities in this sphere.

The Fund is a member of the following governance-related organisations:

- Institutionella ägares förening (an association of Swedish institutional shareholders)
- Swedish Centre for Business and Policy Studies Corporate Governance Forum

- International Corporate Governance Network

AP3 CEO Kerstin Hessius and deputy chairman Lars Otterbeck are also members of the Council for Swedish Corporate Governance, which oversees the national corporate governance code.

To date in 2005, the Fund has given presentations at the following conferences:

- Swedish Centre for Business and Policy Studies congress on the under representation of women on corporate boards
- Fourth Annual European Governance and Responsible Investment Summit in Stockholm (theme: active ownership, engagement and investor activism)
- Scandinavian Institutional Investors Summit in Stockholm (theme: monitoring corporate governance and sustainability)
- International Corporate Governance Network Annual Conference in London

APPENDIX
REMARKS BY AP3 ON SHARE-BASED INCENTIVE SCHEMES AND
ENVIRONMENTAL AND SOCIAL RESPONSIBILITY MADE FROM THE FLOOR AT
SWEDISH CORPORATE AGMS IN 2005

Investor

Remarks by AP3 Head of Corporate Governance Pernilla Klein:

“Let me start by saying that AP3 is positive to Investor having a share-based incentive scheme for its employees. It is a good way to create incentives tied to the value of the share, and is good for us as shareholders. For this reason, we will be voting in favour of the proposal.

“However, we would like to use this opportunity to make a few remarks to the board on how we would like to see the Investor scheme develop. The options programme the board is proposing is of the traditional kind. It is sufficient for the Investor share to rise above a certain threshold for the scheme to pay out.

“During the stock market bubble we saw how traditional options programmes could have an adverse impact if rising equity prices are not supported by underlying values. We now see that many corporations, both in Sweden and the rest of Europe, have drawn lessons from negative experiences of these traditional options schemes.

“We see a trend of creativity when it comes to finding new models to link employees’ incentives to those of shareholders. We see a trend away from options and towards share-based systems. We also see a growing tendency to introduce different types of performance criteria, both when it comes to allocations and also to vesting.

“In Sweden, Investor’s portfolio companies SEB and Ericsson have been at the vanguard of this new approach, which makes it somewhat surprising that Investor – whose business concept is based on expertise in corporate governance – is a step behind.

“At last year’s AGM, AP3 voted against Investor’s proposed equity-based incentive scheme. What we were signalling then was that we wanted a link to performance. Now such a link is being introduced for the allocation of options and shares, and we welcome this. We also welcome the fact that part of the scheme targeted at executive management is partly share-based. We like the fact that Investor’s top management is prepared to put itself in the same boat as we shareholders when it comes to risk.

“Unfortunately, however, only 60 per cent of the total programme is in shares. I would like to ask the board why you haven’t made the full leap to a scheme based solely on shares in the same way as Ericsson has done.

“We would also like to see performance conditions attached to the vesting of the options. The only vesting criterion today is that one is a company employee. We would like to see more creativity here, and I would like to ask [Investor chairman] Claes Dahlbäck for his view on how relevant performance targets for vesting can be defined.”

Electrolux

Remarks by AP3 Head of Corporate Governance Pernilla Klein:

“Let me start by saying that we at AP3 are pleased that Electrolux has a share-based incentive scheme for top management. We are pleased that the company has shifted away from options to shares and appreciate that senior management is prepared to put itself in the same boat as we shareholders when it comes to risk.

“At the same time, share-based programmes are more expensive than those based on options, which makes it doubly important that we shareholders are able to assess the performance criteria that determine how large the future allocations of shares will be.

“We appreciate that the Electrolux share programme has clear internal performance targets in the form of targets for how the company measures value creation for shareholders. But we wonder why these targets have not been publicly disclosed. This makes it difficult for us shareholders to evaluate whether the programme is reasonable.

“We would, therefore, like to urge the board at least in retrospect to disclose the target levels that have formed the basis for share allocations. I will conclude by saying that AP3 will, nevertheless, be voting to approve the scheme but that we will closely monitor the way the results are communicated.”

MTG

Remarks by AP3 Head of Corporate Governance Pernilla Klein:

“Let me start by saying that AP3 is pleased that MTG has an options scheme for senior management, and we will be voting in favour of it later on. We also welcome the fact that participation in the scheme requires an investment by the individual concerned – an element of risk.

“We also think it is fine for employees at a later date to be compensated for some of this investment by way of a bonus. However, we question why this bonus is paid automatically, with no performance target.

“The proposed options schemes that the Invik and Kinnevik AGMs will consider tomorrow contain a requirement that the companies’ profits must reach a specific target. Otherwise no grants are made. Why is there no such requirement in the MTG scheme?”

Assa Abloy

Remarks by AP3 Communications Manager Christina Kusoffsky Hillesjöy:

“During 2005 AP3 has held discussions with Assa Abloy concerning your risk management in the areas of environmental and social responsibility. We have been pleased to note that Assa Abloy has performed a wide-ranging risk analysis of the group’s environmental and social risks, in addition to which the company has worked hard to develop guidelines and internal policies. We are also pleased to note that Assa Abloy has adopted a group-wide

code of conduct and that it is made available to all shareholders and stakeholders on the company website.

“We have noted that Assa Abloy’s external environmental reporting is insufficient, and that this area is accorded just a few lines in this year’s annual report. Many other Swedish corporations have set their sights higher in this field and Assa Abloy hasn’t quite kept up with developments. In this light, we would like to ask whether you plan to expand your environmental reporting and, if so, if you have a timetable for doing so?”

“We have also noted that only limited information is provided on your website and in your annual report on the extent of your internal controls regarding compliance with the Corporate Code of Conduct. We therefore ask whether you plan to develop your internal control procedures in this area and, if so, if you have a timetable for doing so?”

“We would also like to know if you have a compliance policy for your suppliers on sustainability issues. Do you have a code of conduct that covers suppliers and, if so, how do you monitor compliance? If not, do you have a schedule for implementing a code of conduct for suppliers?”