AP3

Commissioned by the Board of Directors 29 June 2021

AP3 STEWARDSHIP POLICY

The Third Swedish National Pension Fund (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.

Background

AP3's Stewardship Policy is based on the National Pension Insurance Funds (AP Funds) Act of 2000, which contains general investment rules determined by Parliament. The AP Funds shall manage the fund capital to generate the greatest possible benefit for the insured in the income pension system. The overall level of risk in the Funds' investments should be low. The assets should, at chosen risk level, be invested to achieve long-term high return. The asset management shall be conducted in an exemplary manner through responsible investments and responsible ownership. In the management, special emphasis must be given to how a sustainable development can be promoted without compromising on the overall return objective.

AP3 is required by statute to exercise stewardship with the aim of improving its ability to generate high investment returns on behalf of the pension system. Investment decisions may not be influenced by government policies, nor industrial or economic. The Fund's investments in the Swedish regulated markets may not exceed two per cent of the total market value. The Fund may hold no more than ten per cent of the votes in any single listed company.

Codes of corporate governance

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 companies. They also help to facilitate the stewardship of national pension funds. The Swedish Corporate Governance Code reflects the essence of Sweden's corporate governance model: the pre-eminence of the annual general meeting; the separation of executive functions from board membership (with occasional exceptions for CEOs); and nomination committees that include representatives of the largest shareholders. Although there are many advantages to governance codes that define best practices in local markets, corporate stewardship must be based on what is best for each individual company.

Organisation and lines of responsibility

The Stewardship Policy is approved by the AP3 Board of Directors and may be reviewed and revised when necessary. The CEO has overall responsibility for implementing the policy but can delegate stewardship-related matters internally. Stewardship matters of prime importance are discussed in consultation with the Board of Directors, while an internal corporate stewardship committee handles day-to-day stewardship issues.

In certain circumstances, the Fund's stewardship role may conflict with its role as an asset manager, for instance where there is a risk that AP3 may become privy to insider information. This may limit the Fund's ability to trade a specific share, and strict procedures are in place to deal with such eventualities.

Corporate stewardship principles

AP3 requires that the companies it invests in follows national legislation in the countries where it operates. It is the board of directors that are responsible for ensuring that the company have adequate processes and controls to ensure that this happens.

The Stewardship Policy incorporates the Fund's basic principles of corporate stewardship and its approach to environmental and social 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 companies 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.

AP3 is a signatory to the UN Principles for Responsible Investment (PRI), which are guidelines covering environmental, social and corporate governance.

AP3 applies seven core stewardship principles:

1. SHAREHOLDER RIGHTS AND RESPONSIBILITIES

AP3 works to ensure an effective balance of power between shareholders, board and management.

1.1. Equality of shareholders

The equality of all shareholders is a basic precept of corporate law. AP3 works to ensure that shares offering the same equity rights are always treated equally in financial terms. It is important that the interests of minority shareholders are protected and that no distinction is drawn between shareholders when a company pays a dividend or is wound up or taken over. Any departures from this principle should be sanctioned by the company's articles of association.

1.2. Entitlement to vote and submit AGM resolutions

The AGM is a company's highest decision-making body and the primary – and often only – means for investors to communicate their views to the company and make proposals. AGM voting rights are an investor's most important governance tool. AP3 works to protect voting rights and the right to submit resolutions to the AGM. The Fund votes and participates actively primarily at the AGMs of entities in which it holds a substantial equity stake or in which it is committed to pursuing an issue of principle.

1.3. Nomination committees

The nomination committee works on behalf of investors and its most important task is to nominate candidates for the board of directors, including the chairman, subject to AGM approval. Nomination committee members can be elected by the AGM or appointed subsequently by the largest shareholders. AP3 plays an active role in nominating directors and will typically take a seat on the nomination committee when warranted by the size of its equity holding.

1.4. Dialogue and practice

Confidential dialogue is often an excellent way to influence companies and other investors. AP3 often takes part in the preparatory work leading up to AGMs and both files its own resolutions and comments on resolutions filed by the company or other investors. Where warranted, the Fund will also initiate dialogue with representatives of companies or other investors.

2. CAPITAL STRUCTURE

Companies should have a solid long-term capital structure that reflects their strategic and financial goals. AP3 sees it as the role of the board to provide justification for any changes in capital structure. Decisions on dividends, share issues and buybacks should be taken by shareholders.

2.1. Dividends

Companies should routinely communicate their views on capital structure and clarify their dividend policy. AP3 believes that capital that cannot be effectively used to maintain or advance a company's operating activities should be distributed to shareholders.

2.2 Share issues

Companies that need to strengthen their capital base should be able to issue new shares promptly and without incurring high costs. At the same time, it is important that investors' interests are not overlooked in this context. AP3 takes the view that share issues should offer preferential rights to existing shareholders. Private placements may result in those invited to participate in the offer benefiting at the expense of investors not privy to the issue. If a private placement is proposed, it is essential to observe rigorous standards of procedure and transparency in terms of purpose 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. In the case of non-cash issues, a thorough and clear valuation must be published to enable investors to evaluate the terms and conditions of the issue in relation to the assets acquired.

2.3 Buybacks

The repurchase by a company of its own shares is one of several alternative methods to return capital to shareholders. AP3's view is that proposed buybacks should be fully explained and justified and that the board of directors should make clear to investors when a buyback mandate is likely to be executed. It should not be permissible to sell repurchased shares on the equity market unless such a sale is designed to guarantee the company's share-based incentive scheme. In the event that different share classes exist, only the cheapest share class should be made available for repurchase.

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. AP3 believes a systematic review of the work of the board and its directors is a prerequisite for the nomination committee to do its job effectively – as is the provision of information on directors' skills and professional backgrounds. To avoid any conflict of interest, it may be preferable on occasion for this review to be performed externally.

Board structure should reflect the company's needs. The expertise, experience and backgrounds of individual directors are critical to the board's effectiveness, and it is important that directors have sufficient time to devote to their role. Diversity is another element of effective board operation. Here, AP3 works proactively to promote a broader recruitment base for directors and a more even balance between male and female directors.

It is right and proper that the largest shareholder is represented on the board, though the ratio of directors affiliated to the shareholder should be in reasonable proportion to the size of the investor's equity holding. AP3 is not in favour of the chairman of the board also holding the office of chief executive officer.

Fees to directors should reflect market rates and the board's work and responsibilities. It is in the interests of investors that directors own shares in the company. However, when designing share-based incentive schemes for directors it should be borne in mind that the board's role is to oversee management. For this reason, AP3 favours schemes that allocate a portion of directors' remuneration to the purchase of shares.

4. AUDIT AND INTERNAL CONTROL

It is imperative for shareholders that external audit and internal control are of requisite quality. Auditors are elected by shareholders and provide investors with 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 the oversight they exercise. To safeguard this independence, the remit given to auditors should be limited primarily to audit services and any 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 supplier of audit services at the end of a specified time frame.

5. EXECUTIVE REMUNERATION

Executive remuneration should be structured to provide cost-effective rewards for creating long-term shareholder value and to enable companies to attract and retain key personnel. For AP3, it is important to base such packages on what is best for the company in question. Hence, it should be the board of directors that designs, explains and defends the executive management remuneration system. It should also be part of the board's role to review executive remuneration packages.

Moreover, remuneration of senior executives should be clearly described in the remuneration policy adopted by shareholders at the AGM. It is vital 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. The Fund looks at the entire remuneration package and works to ensure that total remuneration levels are prudent and reflect market rates.

5.1 Variable remuneration

Variable remuneration to executive management by way of cash payments over and above fixed salary should be in line with the long-term interests of shareholders, meaning that exceptional performance may be rewarded by such payments and vice versa. AP3 demands high standards in terms of the structure, transparency and evaluation of variable remuneration programmes. The following aspects are especially important:

- Variable remuneration should be tied to agreed and measurable performance criteria, including non-financial parameters, that can be influenced by the beneficiary.
- Variable remuneration should be limited and subject to a defined ceiling linked to salary. This is especially important if the variable remuneration is tied to the company's profits. The absence of a ceiling can lead to unreasonably high liabilities that may damage the company and its employees and shareholders.
- When designing variable remuneration packages, the board of directors should consider whether some of the money could be postponed for payment at a future date as a means of ensuring that the out-performance that merits the bonus is based on solid, sustainable grounds. A remuneration structure on these lines is likely to counter excessive risk-taking and also has the advantage of tying key personnel to the company.
- The remuneration policy should empower the board to restrict or withhold payment of variable remuneration where good cause exists and where such action is compatible with the company's responsibilities to investors, employees and other stakeholders. Payments of variable remuneration may be hard to justify if, for example, a company fails to record a profit. Companies should also reserve the right to reclaim any variable remuneration paid out under obviously false pretences.

5.2 Share-based remuneration

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 basic requirements for share-based or share-price-based remuneration:

- Share-based programmes are preferred to options schemes, especially if the latter are based on free allocations of shares with no performance conditions.
- Performance conditions should be linked to the company's financial targets and ideally benchmarked against competitors.

- AP3 believes 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.
- Incentive schemes should be subject to review, and here it is the board's responsibility to ensure that reviews are performed and the results communicated to investors.

Share-based incentive programmes that require the beneficiary to make a personal investment in the company's shares often contain an element of share matching. Share matching is usually structured as compensation to the beneficiary for his or her investment by way of free shares or the opportunity to purchase shares at a discounted rate. In some cases, the size of the discount can render the level of risk minimal or even non-existent. Moreover, full share matching only creates a link between the beneficiary and shareholders in a rising market. For this reason, AP3 prefers alternative solutions.

In addition to the basic requirements outlined above, the Fund also considers other aspects when evaluating an employee incentive plan resolution. The scope of the proposed scheme and its cost to shareholders is one such parameter. It is also important that the resolution is presented in good time prior to notification of the AGM so that investors can give the resolution their full attention.

When considering share-based remuneration, it is important to note that there are differences between companies. Share-based remuneration provides a way to unite the interests of shareholders and management, but above all it serves as a mechanism to recruit and retain key personnel. Especially in companies that have yet to generate positive cash flow, schemes on these lines can provide an extra incentive to staff without acting as a drain on liquid assets. In such cases, AP3 may be prepared to depart from its basic guidelines on how share-based remuneration schemes should be structured.

5.3 Pension plans for executive management

Defined benefit pension plans risk incurring high and extremely uncertain pension liabilities to the employer and should therefore have no place in a corporate context. Where such plans do exist, AP3 believes the companies concerned should actively seek to renegotiate them to defined contribution plans, though the cost of so doing should always be taken into account. Pensions should be based on salary and variable remuneration and share-based incentive schemes should form no part of pensionable income.

5.4 Severance pay

It is important to establish that severance pay agreements are there solely as a safety net in the event of contract termination. Hence, severance pay should be limited to a specific time frame or figure (generally not exceeding two years' salary). Severance money should not be payable where termination is at the employee's behest.

6. ENVIRONMENTAL AND ETHICAL CONSIDERATIONS

According to the National Pension Insurance Funds Act, the asset management operations are to be conducted in an exemplary manner by responsible investments and responsible ownership. In the management, special emphasis must be given to how a sustainable development can be promoted without compromising on the overall objective of high return. Based on this mission, the AP Funds have developed a common set of core values.

6.1 Core values for corporate governance and sustainability

AP3 is an active owner who gets involved, acts and requires positive changes in order to make a difference. The starting point is the belief that well-managed companies over time must be managed sustainably to provide high returns at a low risk. AP3 makes a positive difference by actively working with companies for a sustainable development, by getting involved in companies where serious and systemic problems are identified and by engaging in dialogues with companies where violations of international conventions are identified and assessed as significant and also well documented.

As part of the Swedish national pension system, AP3's core values mirror those of the Swedish government, democracy and a sustainable development are key components in accordance with the wording in the Instrument of Government. AP3's core values are also based on the international conventions ratified by Sweden. In cases where Sweden support a new convention or modification of the existing convention, but where the new or modified one is not yet formally ratified AP3 will act as if ratification had already occurred. AP3 will regularly monitor the progress of the ratification process of the new or modified convention. If Sweden has not ratified the convention within three years from when Sweden endorsed the same, AP3 may revise its guidelines concerning the issues affected by the new or modified convention.

AP3's view is that companies have a responsibility to ensure compliance with international conventions and that this responsibility applies regardless of whether the conventions are addressed to governments, to individuals or to companies and organizations. This responsibility applies regardless of whether the countries in which the companies operate have signed the conventions or apply laxer standards at national level.

6.2 Work on sustainability

AP3's aim is to ensure that the companies in which it invests works systematically and in a structured way with sustainability and that business is conducted responsibly. The companies should, among other things deal with relevant aspects of sustainability, have appropriate policies and procedures and ensure that these are followed and also have relevant control and monitoring systems in place.

AP3 is working together with the other AP Funds in the joint Ethical Council, with various industry and investor initiatives aimed at influencing companies to be transparent, act and work responsibly, structured and systematically with sustainability. It is a preventive work with the objective to hinder and minimize any incidents and problems in the company's operations. For the individual company it means to act in accordance with the rules, conventions and laws and in addition actively work for a healthy interaction with the rest of the society. Companies should be transparent and communicate how they relate to sustainability challenges that are relevant to their business.

AP3 continuously review the portfolio to identify companies that may be involved in serious and systematic problems and/or violations of international conventions. This is a reactive strategy. AP3's and the Ethical Council's tools include dialogues with companies and active use of the ownership right to vote at general meetings. The goal is to influence companies to address violations and problems and get them to implement preventive policies and systems to avoid future problems.

The likelihood of problems disappearing when an engaged owner finishes its ownership is low, while the ability to influence will be considerably negatively affected. The risk is high that the abuses continue. Therefore, AP3 exclude companies as a last resort and only when the opportunity to make a positive difference is deemed futile.

7. INFORMATION DISCLOSURE

Companies should aim for an open and ongoing dialogue with shareholders. Company information should be accurate, clear, objective and credible. The information from the companies should enable a qualified assessment of the company's future development and of the factors that create value for shareholders. Companies should be clear on the objectives and the financial and strategic implications of the goals.

Companies should publish a code of conduct and other relevant policies, such as an anti-corruption policy. Companies should also be transparent in matters relating to taxation, for example by publishing a tax policy. Companies should also describe how policies and guidelines are implemented, monitored and evaluated.

AP3 works to ensure that the companies have relevant environmental policies, that they report their carbon footprint and that they establish plans for how they can reduce their own climate impact and also analyze how they themselves are affected by the climate change.