



Corporate Governance Report Six months ending June 30th 2006

Skandia, Husqvarna and signature of UN Principles for Responsible Investment (PRI) most important corporate governance issues

For the second year in succession, Andra AP-fonden (hereafter referred to as “the Second AP Fund”) is publishing a separate corporate governance report. The report addresses the Second AP Fund’s role in connection with the Skandia takeover and the spinning-off of Husqvarna, and describes action taken by the Fund at a number of AGMs during the spring. The report concludes with a summary of the Second AP Fund’s efforts with respect to corporate ethics and the environment.

The Second AP Fund’s involvement in corporate governance issues is designed to enhance the value of its capital investment. Active ownership and the Fund’s commitment to governance issues are intended to improve prospects of a higher long-term return on assets under management.

Skandia

The following graph, which traces the performance of the Skandia share over the years 2003–2006, clearly illustrates the course of events. The encircled figures represent the Second AP Fund’s holdings in the company, expressed as a percentage, and key events are marked on the graph.



The Second AP Fund was represented on Skandia’s nominating committee from 2004 to 2006. The Fund’s most significant contribution was as a member of the 2004 nominating committee. At that time, the company was in deep crisis, and recruiting members for the Skandia board was a complicated business.

The Second AP Fund’s holdings in Skandia performed well. Return on investment exceeded the relevant benchmark index.

New capital market players create new game rules during a takeover

In recent years, large amounts of capital have been injected into “event-driven” hedge funds, which exploit the opportunities presented by transaction announcements (merger arbitrage) and other one-time events. In the simplest terms, event-driven hedge funds pressure bidders to raise their bid by themselves adopting the role of investors.

In the case of Skandia, these hedge funds rapidly acquired a key role once the bid had been placed by Old Mutual. Within the space of a few months, Skandia’s investor base had been replaced. Put simply, foreign institutional investors abandoned their holdings, to be replaced by event-driven hedge funds. It was calculated that about 30 percent of Skandia was held by this type of investor by December, less than three months after the bid was placed.

The hedge funds conduct an appraisal to determine the importance of the deal to the bidder, based on judging the likelihood that the bid will be raised. In this instance, the incentive for the bidder to raise the bid was considerable. By acquiring Skandia, Old Mutual, at a single stroke, would be transformed from an emerging-market company to an international insurance company.

The presence of hedge funds also dramatically increases the likelihood that the bid would go through. Their greatest risk is that the bid might be withdrawn, so that they seldom say no.

The role of hedge funds arouses keen debate among institutional investors and market regulators. Several cases have been cited where hedge funds have been accused of collaborating to “drive” markets, with a view to serving their own ends. The Swedish

Financial Supervisory Authority's fellow agencies in London and New York have both initiated programmes to monitor significant changes in the portfolio positions adopted by the largest hedge funds.

The Second AP Fund was virtually alone in increasing its stake in Skandia during the bidding period, in an attempt to promote the company's future growth and market value. There is a valuable lesson to be learned from the series of events that constituted the Skandia affair. Once the bid has been made, it is important to rapidly establish consensus among major investors who not concur about the bid and the target company, but who are also prepared to act to achieve their common goal.

Swedish nominating committees quick to let new investors into the board room

Sweden is one of the few countries where employee representatives are included on nominating committees. Normally, nominating committees are part of the board of directors (USA and England). The Swedish system offers many benefits in terms of shareholder influence, but it also means that new investors in a company can rapidly demand a place on the nominating committee.

The events surrounding Skandia raise the question as to whether nominating committees should feature a degree of inbuilt inertia when it comes to nominating new members for seats on corporate boards.

Poor protection of minority interests in insurance companies

One of the factors that contributed to the Second AP Fund's ultimate decision to sell its interest in Skandia was the special protection afforded to minority shareholders in accordance with Swedish insurance company regulations, in stark contrast to normal public companies. The institution of minority and special auditors has been replaced by the Swedish Financial Supervisory Authority (FI) that, according to its own regulatory code, is entrusted with protecting minority investors. Consequently, the FI is faced with a delicate dual role, having to protect the interests both of policyholders and minority investors.

Active ownership in Husqvarna pays dividends

The Fund's stake in Electrolux is one of its major holdings. The Electrolux board proposed that the AGM approve a plan to spin off Husqvarna, a proposal welcomed by the Fund. However, the Electrolux board also proposed that the distribution of assets would involve two classes of share – "A" (preferred stock) and "B" (non-preferred stock) shares.

The Second AP Fund tabled its own proposal concerning Electrolux' planned distribution of shares in Husqvarna. The proposal arose out of considerations concerning the economic worth of the shares distributed in a company in the light of the terms of the Swedish Companies Act, whereby all shareholders are granted an equal right to share in the individual company's economic worth. By distributing A-class and B-class shares, Electrolux abandoned the principle of equal treatment. Similar cases exist, where A-class shareholders have received considerable premiums (almost 30 percent) in connection with takeover bids. It is therefore important to pursue the issue of B-class shareholder rights.

The Second AP Fund's proposal involves a single share series, rather than two. The Electrolux board rejected the Fund's argument that all shareholders are entitled to benefit from the same economic worth in a company. Nevertheless, Investor made a voluntary counter-proposal involving a reform of the way Husqvarna's voting rights are structured. In line with this proposal, the amount of A-class shares in Husqvarna would be raised from three to 25 percent, by granting holders of B-class shares the right to convert to A-class shares.

In practice, this has enhanced the rights of those with B-class shares in the company. This reform of voting rights in Husqvarna adds considerable economic value to the holdings of B-class shareholders.

The AGM season 2006

During the first half of 2006, the Second AP Fund exercised its voting rights at the AGMs of 48 Swedish exchange-listed companies. In one case, the Fund voted against the board's proposal to the AGM. This was at Tele2's AGM, where the board requested a proxy to cover the costs of a failed options programme. The Second AP Fund felt that the information

available to the AGM was too poor to provide a satisfactory basis on which such a decision could be made.

In recent years, the Second AP Fund has voted at the AGMs of some 50 of its largest foreign holdings. This process was put on hold in 2006, to secure the quality of the decision data on which voting is based.

The Fund has also been represented on the nominating committees of 16 companies (Artimplant, Capiro, Electrolux, Haldex, Handelsbanken, Husqvarna, Karo Bio, Meda, Oriflame, Pergo, Proact, Sardus, Skandia, Volvo, Vitrolife and Wedins).

Women on boards and executives

In the past four years, the Second AP Fund has monitored the percentage of women on the boards and executive managements of publicly listed Swedish companies, to encourage and facilitate the recruitment of women to corporate boards and executive managements. The study, which has been conducted in association with Nordic Investor Services, indicates that the percentage of women on corporate boards has increased from 15.9 to 17.7 percent. The number of women in executive management positions has increased from 11.6 to 12.1 percent.

On the boards of companies in which the Second AP Fund has a representative on the nominating committee, the level of female representation has increased from 23.3 to 23.6 percent.

Capital structure

Thanks to strong balance sheets and solid cash flows, the level of dividends paid out by many companies has risen. Institutional investors seem to express a clear preference for dividends or the redemption of shares as opposed to repurchase options.

Several active stakeholders, such as the Second AP Fund, are making their voices heard with respect to the capital structure issue, and discussions with major stakeholders are increasingly common prior to finalisation of dividend proposals. Even so, when capital structure tops the agenda, many corporate boards and major institutional investors still fail to see eye to eye on the issue. Stakeholders fear the spectre of expensive acquisitions that could emerge towards the close of a business cycle, and are not interested in providing their portfolio companies with financial buffers. Listed companies must also focus on capital structure, driven by acquisition appraisals generated by venture

capital companies, where part of the appraisal involves increased leverage and payment of dividends.

The Second AP Fund is committed to achieving greater clarity on these issues, when communicating with corporate boards. If such issues are not addressed, the companies in question may become easy acquisition targets, and shareholders may fail to reap the benefit of their investments.

Swedish corporate governance-culture abroad

In many instances, the Swedish code features specifically Swedish solutions. One example is the fact that the election committee is not a part of the board but is comprised of representatives for the shareholders. In Anglo-Saxon countries, the election committee is part of the board. Cross ownership and differential voting rights are other factors that contribute to Sweden's low ranking in the international corporate governance stakes.

This low ranking is a serious matter for Sweden. This may to a large extent be attributed to an inability to clarify the benefits of our Swedish system. The Swedish Corporate Governance Board (Kollegiet för svensk bolagstyrning) has launched an initiative to address this issue.

Few initiatives for proxy voting

The new Swedish Companies Act permits voting by proxy. There is consensus among large Swedish investors, including the Second AP Fund, that Sweden should make it easier for foreign investors to vote at AGMs. At present, the Swedish system for submitting votes by proxy is extremely complex and unwieldy, compared to other countries.

At the same time, there is considerable anxiety over the fact that poorly informed foreign investors with limited knowledge of the Swedish Companies Act continue to vote against, for example, discharging boards from liability for the administration of their companies. The granting of such a discharge in this respect is a requirement for Swedish publicly listed companies, but can seem strange when viewed from, for example, a US corporate law perspective. There is an urgent need to inform foreign investors about the Swedish system and the Swedish Corporate Governance Board has seized the initiative in this matter.

This year, only a handful of companies, including

Capio, adapted their articles of association to enable voting by proxy in 2007.

New Code and new Swedish Companies Act

Although the new Corporate Governance Code formally came into effect on July 1st 2005, the practical results of its implementation could first be seen in the annual reports and corporate governance reports published in early 2006. The follow-up conducted by the Swedish Corporate Governance Board indicates that in most cases observance of the Code has been satisfactory. The numbers of complaints from companies about excessive bureaucracy have declined, and several companies have elected to explain their failure to observe the Code, in accordance with the observe-or-explain principles defined. The greatest uncertainty concerning implementation of the Code has arisen in connection with the rules and follow-up procedures applied to internal audits.

For the Second AP Fund and other large investors, the greatest benefit of the new Code has been the standardisation of routines for forming nominating committees, evaluating board performance and for establishing reporting procedures in connection with the work of nominating committees. This has simplified the whole process, reduced unnecessary discussion about procedural formalities and improved the quality of the work carried out by nominating committees.

Compared with the AGMs of previous years, verbal presentations concerning the observance of various rules and regulations have been kept to a minimum, which has improved the meetings. It has been easy for the chairman of the AGM to refer his audience to the corporate governance report.

There has been a clear improvement in the quality of the work carried out by nominating committees, especially by virtue of the fact that they now start earlier. Some form of written evaluation is now standard, often complemented by interviews or some other form of follow-up. External assessors are seldom used. On the other hand, the use of recruitment consultants in connection with the nomination of new candidates is becoming increasingly common.

The new corporate governance policy presented by the Second AP Fund during the first half of 2005 is well adapted to these new regulations. It focuses

on value-generating issues such as capital, corporate and ownership structures, the nominating process, board composition, incentive schemes, leadership issues, information, corporate culture, corporate ethics and the environment. Based on an analysis conducted in consultation with the Fund's investment managers, a number of company-specific issues are selected, which the Fund then pursues as a major investor in these same companies.

The Second AP Fund's corporate governance policy was the first to be revised after implementation of the new Code. The ten principles cited in this policy form the basis of the analysis recorded in the Fund's corporate governance "log".

The corporate governance log provides a summary of the analyses of specific corporate governance issues supplied by investment managers and analysts. The log is updated every six months and forms the basis for "cases" which the Fund pursues in its efforts to create value by means of quality corporate governance. The "cases" are selected with a view to creating the greatest possible absolute value by exerting active influence on the company in question. The process comprises an in-house analysis, collaboration with other investors, contact with the chairman of the board, the board itself, executive management, legal counsel and, in certain cases, contact with the media.

The environment and business ethics

The Second AP Fund, in association with some 30 other major fund managers, has signed the UN's Principles for Responsible Investment (PRI).

The Fund has cooperated with Sustainable Asset Management, SAM, which manages some SEK 700 million of the Fund's assets. A programme has been initiated to promote a transfer of competence, to ensure that Second AP Fund asset managers adopt a consistent approach in addressing sustainability issues when making investment decisions. The Second AP Fund applies SAM's methods for evaluating sustainability criteria in its dialogue with its largest Swedish holdings. Meetings held with companies have been prepared in detail. The Fund has gathered its data from SAM's analyses, the company's own material, material supplied by NGOs (Non Governmental Organisations) and the media, as well as information

provided by the Fund's in-house investment managers and analysts. The companies have been highly positive to these visits.

A study of the Fund's ten largest holdings has resulted in an analysis of the degree to which these companies satisfy the Fund's requirements with respect to the environment and business ethics. Generally speaking, this analysis indicates that the companies fully meet the requirements stated in the Fund's current policy.

The Second AP Fund has chosen to adopt a more "opportunity-focused" approach with regard to ethical and environmental issues. Consequently, the Fund has initiated work on the development of an in-house analytical model, based on research conducted by Hart and Milstein.

Put simply, this approach may be described as a two-dimensional analysis. One axis defines measures implemented and planned, the other internal and external measures.

This analytical model has now been integrated into the corporate governance log, which already includes almost 20 company-level analyses of Fund

holdings, in which respective points have been "colour-coded" in line with "log" principles.

The Second AP Fund has also participated in the Carbon Disclosure Project, an initiative whereby some 100 major fund managers place demands on the world's 500 largest exchange-listed companies regarding their position with respect to a number of "greenhouse" issues.

In the case of Wal-Mart, the Second AP Fund voted in 2005 for the adoption of clearer reporting procedures concerning remuneration to executive management, the company's sustainability programme and remuneration to staff, with respect to gender and ethnic origin. In 2006, the Second AP Fund was asked (and agreed) to participate in an investor group, which has since been engaged in a dialogue with the company.

In association with the First, Third and Fourth AP Funds, the Second AP Fund has initiated discussions concerning the procurement of "screening-services" to monitor issues relating to the environment and business ethics. This procurement process should be completed during the autumn.

Gothenburg, August 7th 2006

Eva Halvarsson
CEO



Andra AP-fonden
Second Swedish National Pension Fund - AP2