



*Andra AP-fonden*  
Second Swedish National Pension Fund - AP2

# Corporate Governance Report

JULY 1 2009 - JUNE 30 2010



## Contents

Chief Executive's review	3
The role of active investor	4
Corporate governance activities 2009/2010	5
Second AP Fund's nine principles of governance	5
Growing number of women on publicly quoted boards	8
Solid return on 'Green Bonds'	10
Demand for environmental expert on mine company board	10
Enhanced shareholder influence in USA	11
Climate commitment continues	11
Investments that make a difference	12
More stock-related plans, fewer options plans	14
Better incentive plans	15
Sweden's take on nomination committees	16
Conference on sustainable venture capitalism	18

The Second AP Fund is officially translated as the Second Swedish National Pension Fund/AP2. In body text, for convenience, this is shortened to the Second AP Fund and, in some cases, AP2.

## The Second AP Fund in brief

The Second AP Fund is one of five 'buffer funds' within the Swedish national pension system. This means that the Fund is engaged in the management of Sweden's national pension assets, involving a global portfolio of investments.

Just over 50 percent of Fund capital is invested in foreign equities and bonds. The Fund manages assets in excess of SEK 200 billion, featuring several asset classes. It numbers just over fifty employees: portfolio managers, analysts and other specialists in various areas.

### Long investment horizon

The Second AP Fund is tasked with maximizing the long-term return for pensioners in relation to the level of risk exposure accepted by the Fund. The long investment horizon and nature of the buffer fund mission means that the Second AP Fund can bear a greater degree of risk than, for example, a life insurance company. One benefit is the ability to invest a large part of its capital assets in equities.

### A vital mission

The Second AP Fund, together with the other buffer funds, is tasked with maintaining consistent pension levels even during periods affected by a retirement peak or economic downturn. Combined, the buffer funds account for approximately ten percent of the total national pension system.

### Ethics and the environment – how to stay one step ahead

The Second AP Fund is actively engaged in its holdings with a view to creating long-term value. By its active engagement in issues such as ethics and the environment, the Second AP Fund can help its portfolio companies identify opportunities and risks at an early stage, thereby contributing to their improved performance.

### An international player in Gothenburg

The Second AP Fund is headquartered in Gothenburg, Sweden's second largest city, which boasts a venerable trading tradition and many successful export companies. This encourages an international approach at the Second AP Fund, an independent player with innovative thinking and global reach.

# Increased demand for sustainable investment

The importance of 'sustainable capitalism' in optimizing long-term economic values in a responsible manner is attracting growing attention. In contrast to 'conventional capitalism', this sustainable version is to be attained by making ethics, the environment and corporate governance integral to corporate analyses, thereby including the cost of negative effects that are unrelated to the market price. It involves factors such as the consumption of non-renewable resources and damage to our common environment, in the form of climate change and the destruction of ecosystems. Current surveys reveal that less than 30 percent of today's markets are analysed and evaluated in terms of sustainable capitalism, although this figure is expected to double over the next ten years.

## Sustainable return

As one of the buffer funds of the Swedish national pension system, the Second AP Fund is entrusted with a vital mission – to maximize return on the pension assets under management, at a low level of risk, to ensure that pensions are written down as little as possible. This mission requires that we also take environmental and ethical considerations into account, without compromising the broad objective of achieving a high return.

To spread risk, the Second AP Fund invests in companies all over the world, managing its assets against index. Selection of specific companies depends mainly on which companies are publicly quoted on these markets. This poses a considerable challenge – to address ethical and environmental considerations when managing against index. The Joint Ethical Council of the Swedish National Pension Funds is committed to driving positive change in foreign companies associated with violations of international conventions on the environment and human rights. We are convinced that making money and addressing the demands of sustainability are entirely compatible. Take our investment in Generation, for example, a successful global investment fund where sustainability analysis is an integral feature of its fundamental share analysis – or our investment in the World Bank's 'Green Bond' (read more on page 10).

We also believe we have made some progress towards integrating sustainability issues into our portfolio management activities, although there is still more to do. We practise active governance, with a view to increasing the Fund's return on invested assets. We believe that, in time, the mutually dependent relationship between net return and sustainability will become increasingly clear.



## Growing demand for regulation

The Second AP Fund's collaboration with other investors on improving corporate governance is yet another of our long-term projects. Among other things, we participate in developing policies, regulations and standards. A number of EU-level initiatives have been launched during the spring and summer involving enhanced requirements for regulating the activities of ourselves and other institutional investors. As a member of the IÄF (Institutional Ägares Förening för regleringsfrågor på aktiemarknaden/Swedish Institutional Investors' Federation for Regulatory and Stock Market Issues), we have participated in drafting a response to the European Commission. Our views are based largely on examples of Swedish corporate governance practice, which we feels functions well. Among other aspects, we have highlighted the way we use nomination committees in Sweden (read more on page 16).

## Remuneration

Finally, we note that the public debate about incentive programmes for top executives has continued during the year. In view of the fact that company boards are responsible for the development of relevant and appropriate remuneration packages, we have intensified our dialogue with these boards regarding the issue of executive remuneration. The Second AP Fund favours long-term incentive programmes, where it is felt that these contribute to the company's future development.

## Future inspiration

To summarise, I believe that the Second AP Fund has successfully sustained its commitment as an active and forward-looking investor. This belief is also supported in the conclusions of the review of the Swedish National Pension Funds, conducted annually by the Swedish Government. It confirms that our efforts in the field of corporate governance are having an effect. This is naturally highly pleasing, but does not mean that we are going to rest on our laurels. Quite the opposite: it inspires us to strive for still greater success.

A handwritten signature in black ink, which appears to be 'Eva Halvarsson'. The signature is stylized and written in a cursive script.

Eva Halvarsson  
CEO



## **The role of active investor**

**The Second AP Fund is tasked with maximizing the long-term return on the pension assets under management. Environmental and ethical considerations must be addressed, without compromising the broad objective of a high return. The Second AP Fund is actively engaged in promoting good corporate governance and thereby adding value to its investments.**

**The Second AP Fund's commitment to corporate governance issues is founded on regulations and conventions such as the OECD's Guidelines for Multinational Enterprises and Principles of Corporate Governance, the United Nations Global Compact and Principles for Responsible Investment (PRI), the Swedish Companies Act and the Swedish Corporate Governance Code.**

**The Second AP Fund's operational activities with respect to corporate governance are based on the Fund's Corporate Governance Policy and its nine principles of governance. The complete policy and more information about these governance principles can be downloaded from the Second AP Fund website at [www.ap2.se](http://www.ap2.se)**

# Corporate governance activities 2009/2010

In exercising its corporate governance responsibilities, the Second AP Fund is an active participant at the AGMs of Swedish and foreign companies and maintains a dialogue with the boards of directors and executive managements of its portfolio companies.

## 1. Capital structure

The company shall have a well-balanced capital structure that takes into account anticipated net profit, cash flow, financial status, investment levels and capital cost, seen over an entire economic cycle.

AP2's nine principles of governance

## Voting at AGMs

During spring 2010, the Second AP Fund exercised its voting rights at the AGMs of more than 50 publicly quoted Swedish companies.

Compared to the preceding year, 2010 saw an increase in the number of foreign AGMs at which the Fund exercised its voting rights, rising from around 60 to more than 370. To improve the governance of their foreign investments, the four major buffer funds participated in a joint pilot project during 2008/2009. This project focused on formulating a joint voting platform for the management and exercise of the funds' voting rights, based on predetermined criteria. Following an evaluation of the project,

the First, Second, Third and Fourth AP Funds decided to tender for the design of a joint voting software platform. Among other things, completion of the procurement process in December 2009 contributed to a dramatic rise in the number of AGMs at which the Fund exercised its vote, compared to the preceding year.

## Remuneration issues

In April 2009, the Swedish Government published its new guidelines "Terms of employment for senior executives within the AP Funds".

The Fund's corporate governance policy was subsequently adjusted in autumn 2009. Among other things, it stresses that responsibility for formulating the individual company's system of remuneration in an appropriate manner devolves upon the company's board of directors. The form of remuneration subsequently proposed shall serve to promote the sustainable long-term development of the individual company. It is important to emphasise that each remuneration programme is judged on its individual merits.

## 2. Corporate structure

Corporate acquisitions and investments shall be conducted with a view to promoting the long-term development of the company, to increase its share value.

AP2's nine principles of governance

## 3. Shareholder structure

In companies with varied voting rights, situations can arise where minority shareholders have difficulty in asserting their rights. In such cases, the Second AP Fund is positive to the equalisation of voting rights.

AP2's nine principles of governance

During the year, the Second AP Fund has engaged in a number of dialogues with company boards concerning the formulation of incentive programmes, with a view to promoting improvements. Among others, the Second AP Fund voted against the guidelines for remuneration to senior executives and suggested incentive programmes proposed by the board of Lundin Petroleum, as these lacked any performance requirement. The Second AP Fund also voted against proposals concerning incentive programmes submitted by almost half the foreign companies in which it exercised its voting rights.

The Fund submitted two statements for deliberation during the autumn of 2009. One concerned the proposal from the Swedish Corporate Governance Code regarding the remuneration paid to senior executives. The second concerned the Swedish Financial Supervisory Authority's proposal with regard to the remuneration systems within the financial industry.





#### Participation in nomination committees

During the 2010 AGM season, the Fund has been represented on the nomination committees of seven companies: Boliden, Meda, Hexagon, Haldex, Kungsleden, Lundin Petroleum and Opus Prodox.

#### 4. Board of directors and nomination process

It is important that every exchange-listed company has an effective board, dedicated to the company's well-being. The nomination committee shall ensure that a structured assessment of the board is conducted on a regular basis. It shall also ensure that new board members are recruited from a broad base of potential candidates. Members of the board should own shares in the company on whose board they sit.

#### AP2's nine principles of governance

#### Board composition

The Second AP Fund stresses the importance of increasing the number of women on the boards of publicly quoted companies and duly observes this principle when participating in the nomination process. The Fund also feels that nomination committees should draft a concrete plan to attain the most appropriate board composition, with respect to gender, age, background, experience and competence.

During the spring, the Second AP Fund conducted its annual survey to determine the number of women on the boards and executive managements of publicly quoted companies. The survey revealed that female representation on

corporate boards has risen to 22.2 percent, the highest level since the survey was launched in 2003. However, the proportion of women on executive managements has declined to 13.8 percent.

The Fund is engaged in a dialogue with a number of companies where female representation is limited, concerning selection processes for senior management and seats on the board. Read more about this on page 8.

#### Ethics and environment

The Joint Ethical Committee of the Swedish National Pension Funds was established in 2007 and published its third annual report in the spring of 2010. The Joint Ethical Committee is engaged in monitoring and analysing the foreign portfolios of the AP Funds, to ensure that the companies in which they invest are not involved in infringements of international conventions to which Sweden is a signatory. The work of the Joint Ethical Committee is founded on the assumption that all conventions to which Sweden has subscribed are of equal importance and must therefore be strictly observed. This standpoint is also grounded in the resolutions and stated aims of the various UN agencies, which

#### 5. Executive management and executive remuneration

It is important that executive management be adequately balanced in terms of experience and competence. Remuneration to executive management shall be relevant, motivating and shall be in proportion to the company's size and net result. Stock-related remuneration plans shall be based on a long investment horizon and shall reflect a clear correlation between performance and remuneration.

#### 6. The auditors' role

The auditors' independence from the company's executive management and board of directors is decisive to investor confidence in their scrutiny of the company's administration.

#### AP2's nine principles of governance

stress that human rights are universal, indivisible, mutually dependent and interrelated, and cannot be ranked in order of preference.

The Committee has established routines for monitoring foreign holdings. Some 10-15 companies are placed on a 'dialogue list', in cases where the Funds believe they will be able to exert influence, encouraging them to institute new routines that can prevent future incidents or infringements of conventions.

Dialogues with four companies were completed during 2009, when the original objectives of these dialogues had been satisfied. The four companies are Grupo Ferrovial, PetroChina, Thales and Yahoo. These dialogues, which have been ongoing for some two years, have now led to acceptable improvements within these companies. Read more at [www.ethicalcouncil.com](http://www.ethicalcouncil.com)

#### Excluded companies

Wal-Mart and Singapore Technologies are two companies that have already been excluded from the Second AP Fund's investment universe.



In 2008, the Fund excluded a further nine companies, which market cluster bombs in contravention of a ban on cluster bombs to which Sweden is a signatory. These are Alliant Techsystems, Gencorp, General Dynamics, Hanwha, L-3 Communications, Lockheed Martin, Poongsan, Raytheon and Textron.

During 2010, the Fund decided to also exclude Elbit Systems Ltd, when the dialogue conducted by the Joint Ethical Committee failed to achieve the desired result. The company develops, supplies and maintains a customized surveillance system for parts of the West Bank separation barrier, which is associated with the infringement of fundamental conventions and norms.

#### **For a sustainable future**

During the autumn of 2009, the Second AP Fund joined fourteen other Swedish institutional investors in the Sustainable Value Creation Project, to exert joint influence on publicly quoted Swedish companies with respect to sustainable development and long-term value creation.

These institutional investors are: the Second AP Fund, DnB NOR, the Fourth AP Fund, Folksam, the First AP Fund, Handelsbanken, The Knowledge Foundation, Nordea, Meta Asset Management, SEB, Skandia Liv, SPP, Swedbank Robur, the Church of Sweden and the Third AP Fund.

#### **7. Information and its distribution**

Companies shall seek to establish an open and ongoing dialogue with their shareholders.

The main reason the Second AP Fund is participating in the Sustainable Value Creation Project is a belief in the importance of encouraging publicly quoted Swedish companies to adopt an active approach to the environmental and social impact of their business operations, with a view to reducing risks and costs as well as creating and benefiting from new business opportunities. Read more about the project at [www.hallbartvardeskapande.se](http://www.hallbartvardeskapande.se)

#### **8. Corporate culture**

Major investors, the board, company management and auditors shall work together to promote a sound corporate culture.

#### **AP2's nine principles of governance**

#### **The Göteborg Award**

The internationally recognized 'Göteborg Award for Sustainable Development', of which the Second AP Fund is a sponsor, is being presented for the eleventh year in succession in autumn 2010. This year, the Award goes to two distinguished individuals who have in different ways made major contributions to developing a sustainable relationship with the marine environment. These are Ken Sherman, an oceanographer and marine biologist from the USA, and Randall Arauz, who chairs the environmental organization PRETOMA in Costa Rica. Read more at [www.goteborgaward.com](http://www.goteborgaward.com)

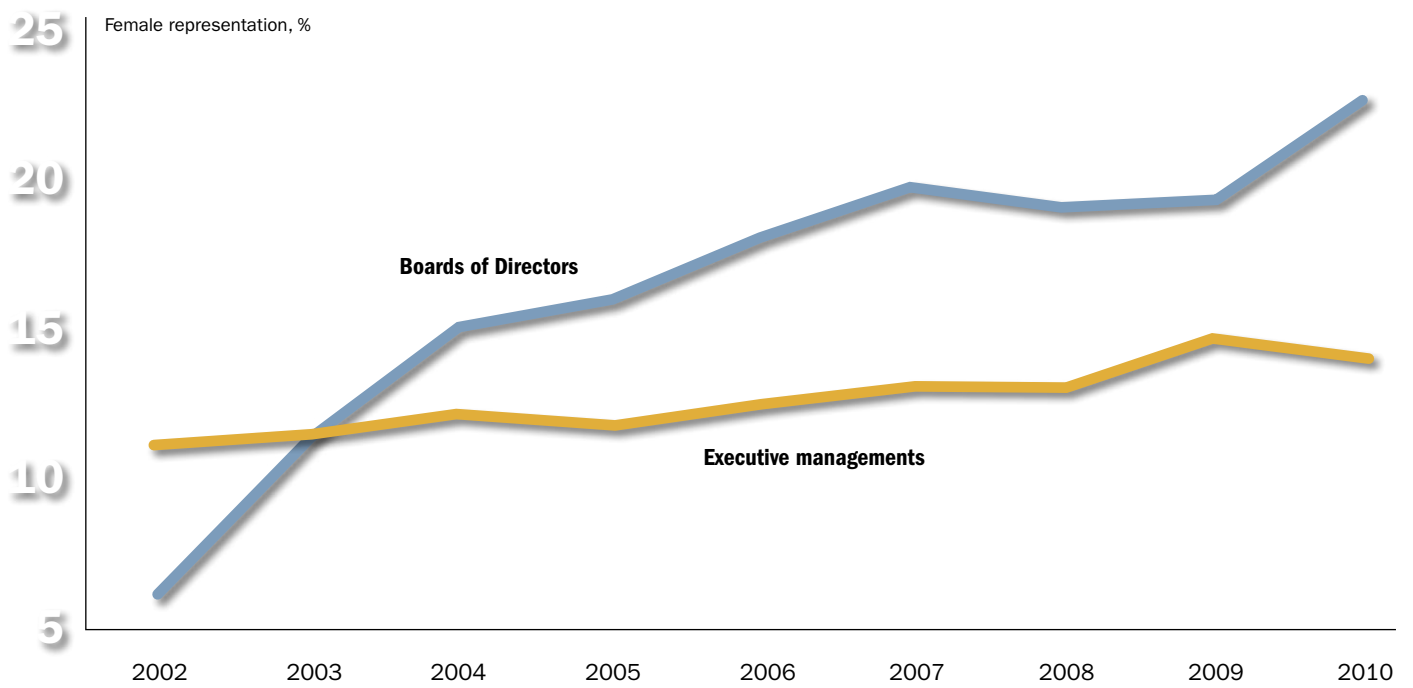
#### **Memberships and initiatives**

The Second AP Fund is both a member of and provides support to a number of Swedish and international initiatives. The Second AP Fund was one of the founding signatories of the United Nation's Principles for Responsible Investment (PRI). Within the framework of PRI, the Second AP Fund has also participated in a project with a number of private equity companies, with a view to joint development of better principles for addressing ethical and environmental issues in connection with investment in and ownership of companies. Read more on page 18 and at [www.unpri.org](http://www.unpri.org)

The Second AP Fund is a member of the Carbon Disclosure Project. This is an initiative adopted by some 100 major fund managers, who demand that the world's largest publicly quoted companies report on their greenhouse gas emission and other data pertinent to managing the climate challenge. Furthermore, this data shall be stored on a joint database. The Second AP Fund is also a member of the International Corporate Governance Network (ICGN); the European Corporate Governance Institute in Brussels, Swesif and Sweden's SNS Corporate Governance Network.

#### **9. Environment and ethics**

A farsighted and positive attitude to environmental and ethical issues enhances the value of companies. For the individual company, this involves acting in compliance with regulations, conventions and legislation, as well as acting proactively to promote a sound relationship with society as a whole.





# Growing number of women on publicly quoted boards

*The proportion of women on the boards of publicly quoted Swedish companies is increasing, now amounting to 22.2 percent, having stagnated over the past two years at just below 20 percent.*

*By far the greatest percentage of women is found in the large publicly quoted companies, while the smaller companies continue to lag behind.*

Ever since 2003, the Second AP Fund has published an annual Female Representation Index, in which it charts the percentage of women represented on the boards and executive managements of publicly quoted Swedish companies. During the first few years, there was a dramatic rise in the percentage of women represented on publicly quoted boards, followed by a period of stagnation at around 19 percent from 2007 through 2009. In conjunction with AGMs held during the spring of 2010, however, this trend was broken and the number rose to the current 22.2 percent.

“It is pleasing to note the increasing percentage of women on publicly quoted boards, a fact which also demonstrates that efforts to increase female representation have produced results. What is somewhat disturbing, however, is that we are now seeing a decline in the percentage of women in executive management, since this is an important source of recruitment for board members,” states Eva Halvarsson, CEO of the Second AP Fund.

The decline in the percentage of women represented on the executive managements of publicly quoted companies is fairly minimal. Compared with the preceding year, there was a decline from 14.3

percent till 13.8 percent. Even so, it is clear that, broadly speaking, the appointment of women to executive-management positions at publicly quoted companies is progressing much more slowly than appointment to seats on the board. Over the past eight years, the percentage of women appointed to executive positions has increased by a mere 2.7 percentage units – from 11.1 percent in 2002. During the same period, the percentage of women appointed to seats on the board rose from 6.1 to 22.2 percent.

As well as charting female representation on boards and executive managements, the Second AP Fund has also studied the percentage of women to have graduated in disciplines from which company executives and board members are traditionally recruited. Over the past 30 years, the percentage of women to have graduated in these disciplines has grown from less than 20 percent to more than 40 percent today. In spite of this, there is a consistent disparity between the percentage of female graduates and female employees (only 30 percent of those employed by publicly quoted companies are women), between employees and mid-management (only 25 percent are women) and between mid-management

and senior executives (14 percent).

“A more equitable balance in terms of the percentage of men and women represented on a board of directors is important to ensure its effective composition. As major investors, we must also promote increased diversity in terms of age, background, experience and competence as a matter of urgent priority,” concludes Eva Halvarsson.

## Female Representation Index

The Female Representation Index has been compiled jointly by the Second AP Fund and Nordic Investor Service since 2003.

The survey is conducted subsequent to the conclusion of Sweden’s April-June AGM season every year, when most Swedish publicly quoted companies hold their AGMs. The percentage of board seats held by women is based on the composition of the boards as of June 2010 and then compared with the number held in June 2009, May 2008, May 2007, May 2006, May 2005, May 2004, July 2003 and December 2002.

The Female Representation Index measures the number of places on the boards, the number of persons in executive management, and the number of employees. With respect to the boards, the number of women is given as a percentage of the total number of seats on the board approved by the respective AGMs. In the case of executive management, the number of women is divided by the total number of senior executives.

In all, the Female Representation Index comprises 251 companies quoted on the Stockholm Stock Exchange, involving as many chairpersons and 1 662 seats on boards. This adds up to a total of 1 661 senior executives, including 251 CEOs.



## Solid return on 'Green Bonds'

In 2008, the Second AP Fund invested for the first time in what is known as a Green Bond, issued by the World Bank, under the auspices of SEB. This 'Green Bond', which was the first of its kind, will finance a number of climate-approved projects.

During autumn 2009, the Fund invested SEK 250 million in a further 'Green Bond', issued by the European Investment Bank (EIB). This bond will also finance a number of environmental projects. The market for this type of bond has grown, attracting several new borrowers. These borrowers are normally supranational agencies such as the World Bank, the EIB (European Investment Bank) and the IFC (International Finance Corporation). In spring 2010, additional investments were made in Green Bonds, totalling approximately SEK 350 million.

"We are satisfied with these investments: they yield a higher return than Swedish government securities of the same maturity, the borrowers are highly creditworthy and we are at the same time supporting projects that favour the environment," notes Ole-Petter Langeland, who heads Fixed Income at the Second AP Fund.

## Demand for environmental expert on mine company board

The Freeport-McMoRan mine, on the Indonesian island of Papua, is being severely censured for releasing mine waste into a nearby river. Via the Joint Ethical Committee, the Second AP Fund has been engaged in a dialogue designed to elicit more detailed information about the environmental implications. To increase pressure on the company, the Second AP Fund agreed with the First, Third and Fourth AP Funds, with Holland's APG and with New York City Pension Funds to present a joint resolution at the Freeport-McMoRan AGM in 2009. The resolution involved a demand that an independent environmental expert be appointed to the board. No less than 32.5 percent of shareholders attending the AGM voted in favour of the proposal.

The company made a number of positive noises immediately following the

Meeting but, in the end, decided against appointing any environmental expert to the board. The Second AP Fund, in concert with the same shareholders from the previous year, consequently decided to present the resolution for a second time at the 2010 AGM. Once again, the proposal received support from about a third of the shareholders.

"We hope Freeport-McMoRan will appreciate how important it is for a mining company that has such a dramatic impact on the environment to appoint people with environmental expertise to its board," states Christina Olivecrona, environmental analyst at the Second AP Fund.

Barrick Gold, a competitor to Freeport-McMoRan, has recently let it be known that it will be appointing an environmental specialist to its board.





## Climate commitment continues

In spite of the fact that the United Nations' Climate Conference in Copenhagen in December 2009 failed to reach any clear conclusions as to what will happen when the Kyoto Protocol reaches the end of its term in 2012, the climate and the energy issue continue to be of urgent interest. Although it is likely to be some time before agreement is reached on a global carbon dioxide tax, greater efficiency in the use of energy and other resources is becoming of vital importance to companies. For many companies, energy efficiency is already a valuable sales argument. To secure more reliable analyses, greater numbers of companies must report their carbon dioxide emissions and ensure that the data is reliable.

As a result of last year's work on charting the portfolio's carbon footprint, the Second AP Fund gained several ideas as to how the emissions issue could be integrated as part of the investment process. The study has yielded insights about the climate risks associated with the portfolio. During this report period, the Fund has evaluated a number of climate-related alternative investments. In the past year, it has started to invest in agriculture and forestry, offering the dual benefit of reducing its carbon footprint while diversifying its portfolio risk.

The Second AP Fund also invested in Flexenclosure AB during the year, a company that has developed technology that enables base stations for mobile telephony to be powered by renewable energy. The technology allows mobile network operators to reduce operating costs and carbon dioxide emission from base stations by as much as 80 percent, by utilizing renewable energy sources such as solar and wind power. The technology has been developed primarily for mobile networks in developing countries in areas that often lack electrical power.

## Enhanced shareholder influence in the USA

From a Swedish standpoint, it can be difficult to understand how little influence one has as a shareholder in a company quoted on the US stock market. In the wake of the financial crisis, however, the trend initiated in recent years, although slow in gaining momentum, has seen the rights of minority shareholders enhanced.

The Dodd-Frank Wall Street Reform Act, that finally passed into the US statute books during the summer of 2010, and which primarily focused on reform of the financial markets, provided this large group of shareholders with increased powers in a number of areas. These new regulations grew out of the realization, in the USA as well as Europe, that inadequate corporate governance contributed to the enormity of the financial crisis. One important change is that an individual shareholder, or group of shareholders, controlling at least three percent of the voting rights in a company, may nominate up to 25 percent of its board members. The company is then required to include these candidates in the ballot papers distributed to all shareholders. The companies must now also justify their reasoning if they propose to combine the roles of CEO and chairman

(which has been traditional) or separate them (which is what most shareholders would prefer).

This type of change may seem marginal, but should nevertheless be interpreted as a clear signal of the desire for increased shareholder participation. Several other adjustments to the regulations point in the same direction. This applies for instance to a range of new regulations governing the manner in which companies publish the remuneration paid to senior executives and, although admittedly not binding, must offer shareholders the opportunity to approve/reject such proposals every three years. Furthermore, the remuneration committees that companies are required to appoint may only comprise independent board members.

The fact that the chairman of the SEC (the U.S. Securities and Exchange Commission) recently referred to Swedish nominating committees as an interesting model may possibly also indicate that a number of changes in US corporate governance are in the pipeline. Several major institutional investors are also promoting a number of initiatives for increased influence. The will is there already: the means may well be on the way.



# Investments that make a difference

**Where do you go for ideas, innovative concepts – and to discover which companies are destined to be tomorrow’s high-flyers? One hot tip is to check out Khosla Ventures’ portfolio of investments. Meet Vinod Khosla, one of the true stars of the venture capital firmament.**

**V**inod Khosla immigrated to the USA from India. After graduating from university, he helped found Sun Microsystems. He subsequently transferred to the firm of venture capitalists Kleiner Perkins Caufield & Byers (KPCB), where he was involved in developing companies such as Amazon.com, Cisco and Juniper Networks. Since 2004, Vinod Khosla has operated his own company Khosla Ventures, with a clear mission to support entrepreneurs with ideas and innovative concepts that might have a positive impact on societal development. In summer 2009, the Second AP Fund invested USD 35 million in the Khosla Ventures III Fund.

*“I am not a venture capitalist. I am not in the finance industry. I am in business development. I aim to be the best assistant to the individual who is striving to build a major technology-intensive company,” states Vinod Khosla.*

Talking to Vinod Khosla, it is also clear that his motivation goes beyond financially ingenious concepts and quick returns. He himself admits it was the need to operate with a greater degree of flexibility and a desire to be more experimental that led him to launch Khosla Ventures.

*“I wanted to invest in scientific experiments that might sometimes appear a bit risky, and get involved in projects of social*

*as well as economic merit. Our venture capital investments therefore focus both on traditional technology and ‘cleantech’,” notes Vinod Khosla.*

#### **More than 100-percent reduction in emissions**

To illustrate what he means, Vinod Khosla names a number of investments his company has made. They comprise everything from a smart way to make use of carbon dioxide, to ingenious ways of resolving the global energy problem.

*“Among other ventures, we have been involved in the start-up and financing of Calera, a company that utilizes carbon dioxide in the fabrication of cement, an industry that is traditionally one of the greatest sources of carbon emissions. Instead, Calera technology makes it possible to bind half a ton of carbon dioxide for every ton of cement produced. This means that we can make the city’s infrastructure as green and effective as the forest in its ability to bind carbon.”*

The technology behind Calera comes from Stanford researcher Brent Constantz who, three years ago, got in touch with Vinod Khosla to present his idea.

*“After investing in the project, it took only three years to establish a demonstration facility and initiate production. Normally, this would demand more like 13 years,” explains Vinod Khosla with justified pride.*

#### **From biomass to crude oil**

Vinod Khosla then quickly turns to a project that utilises biomass to produce crude oil, for subsequent processing in refineries.

*“The transformation of biomass into oil has considerable commercial potential, while simultaneously offering a number*

*of other advantages. It reduces dependence on fossil fuels, promotes economic development and creates new jobs in rural areas. Because it relies on waste products that derive from agriculture and forestry, an added benefit of this technology is that it has no impact on global food production either.”*

There’s no mistaking Vinod Khosla’s genuine fascination for and belief in the application of new technology and its commercial potential.



*“It seems to have become accepted wisdom that the price of energy must rise. This is simply not true. Quite the reverse, in fact. Developments in technology have the potential to reduce the cost of power generation. Take windpower, for example – we are currently investing in a project that involves a technical breakthrough that offers a commercially viable solution to the storage of wind-generated energy.”*

Khosla Venture’s fundamental business concept is to build long-term

value, as opposed to trading assets for short-term gains. With its proven track record, down-to-earth approach and close collaboration with the companies in which it invests, Khosla Ventures has established an excellent reputation among business entrepreneurs.

*“Vinod Khosla and Khosla Ventures have established a convincing track record of value creation through investment in new and exciting technology. Many people have made considerable amounts of money by investing in funds*

#### **Vinod Khosla in brief**

**Born:** 1955 in Poona, India

**Education:** IIT Delhi, India (Bachelor of Electronic Engineering); Carnegie Mellon University (M.Sc. in Biotechnology) and Stanford Graduate School of Business (MBA).

**Career:** Founder of Sun Microsystems, partner at Kleiner Perkins Caufield & Byers, and founder of Khosla Ventures.

**Other commitments:** Founder of TiE, a non-profit global network for entrepreneurs, a seat on the board of The Indian School of Business and a profound commitment to issues affecting social entrepreneurship, with a special focus on microfinancing in India and Africa.

#### **Khosla Ventures in brief**

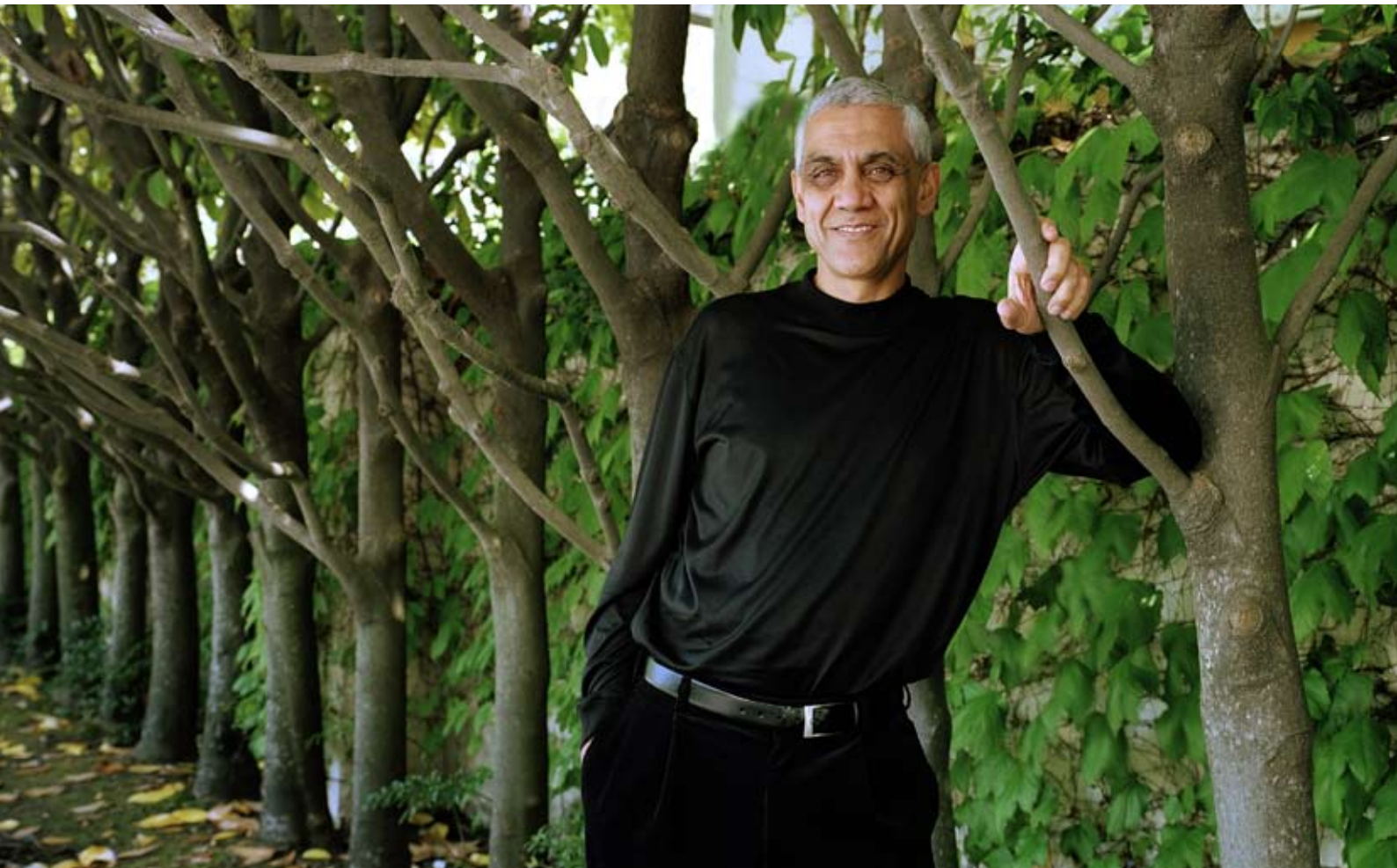
**Established:** 2004

**Head Office:** Menlo Park, California, USA

**Combined assets:** : USD 1 billion

**Website:** [www.khoslaventures.com](http://www.khoslaventures.com)

*in which Vinod Khosla has been involved. It therefore feels very satisfying to have invested a small proportion of Sweden’s pension assets in one of Khosla Ventures’ funds,” says Anders Strömblad, Head of External Management at the Second AP Fund.*







## More stock-related plans, fewer options plans

*Long-term incentive plans are regaining popularity with the major publicly quoted companies. The percentage of stock-related plans is growing at the expense of options plans. This trend is confirmed in an annual survey published by PwC (PricewaterhouseCoopers).*

“At AGMs held in the spring, almost half the major publicly quoted companies decided to implement new stock-related incentive plans,” notes Magnus Lidén, who headed the PwC survey.

During the first six months, 48 percent of the AGMs held by companies on the Swedish Large Cap list were asked to consider the implementation of new incentive plans. The corresponding figure for the preceding year was 43 percent.

“One reason for this increase is that the companies believe in this form of remuneration as part of the overall incentive package offered to their employees,” states Magnus Lidén.

When it comes to the way these plans are formulated, the big difference between 2009 and 2010 is the increase in the percentage of stock-related plans, at the expense of the options alternative.

The most common plan is the stock purchase plan (SPP) where, to participate, employees must purchase company stock with their own money, normally in the form of a deduction from salary. During the first six months of 2010, two-thirds of the proposed incentive plans were SPPs, compared with just half the year before.

After a certain time, employees who have invested in SPPs and who decide to retain rather than sell their stock, and who are also still employed by the company, normally receive ‘matching stock’. They may even be entitled to additional stock, if they have satisfied certain performance targets.

“One explanation that so many large publicly quoted companies wish to implement SPPs is that it involves employees in accepting an individual risk. These employees become shareholders as soon as the plan is implemented, clearly linking employee and shareholder interests,” states Magnus Lidén.

Another trend is the increasing demand that incentives be performance-linked. Last year, 57 percent of these plans were performance-linked. For 2010, the figure is 66 percent.

“The formulation of these incentive plans has been influenced by shareholders’ demands for measurable and predetermined performance targets. The survey reveals increased diversity in terms of performance targets,” Magnus Lidén continues.

According to Magnus Lidén, the way these plans are designed has also been

affected by new regulations governing executive remuneration, as outlined in the Swedish Corporate Governance Code. Transitional regulations require that the Code be implemented not later than July 1 2010.

“It is highly important that these incentive plans should support and be fully compatible with the individual company’s business strategy and corporate culture. Long-term incentive plans should also address the manner in which any variable short-term remuneration is paid.”

Another factor concerns the regulations and tax legislation to be applied to employees in different countries. If most of the company’s employees are domiciled in Sweden, it makes sense to formulate incentive plans that comply with Swedish tax legislation. In contrast, many large publicly quoted companies with employees in several countries must adapt their incentive plans accordingly.

“We should not forget that, in the majority of cases, the main function of these long-term incentive plans is to attract, motivate and retain employees in an increasingly competitive business climate,” concludes Magnus Lidén.



## Better incentive plans – an ongoing process

*Few topics arouse such strong feelings as bonuses and other incentive plans. Poorly formulated plans, lacking clearly defined ceilings and with only vague performance requirements – or with only a very limited connection to the development of the business – often lead to infected debate. In some cases, however, a responsibly formulated plan can prove a powerful competitive tool in attracting and retaining expertise. With this in mind, the Second AP Fund therefore continuously monitors developments in this field and evaluates the plans presented at AGMs.*

During the summer of 2010, the Second AP Fund conducted a survey of the incentive plans submitted for consideration of the Swedish AGMs that the Fund had attended during the spring.

“We evaluate each incentive plan according to the principles outlined in our corporate governance policy, and then make an overall assessment. Although the boards of the individual companies are responsible for drafting remuneration principles and putting together relevant and reasonable incentive packages, we still feel it important to maintain a dialogue with them concerning remuneration,” states Ulrika Danielson, head of Communications and HR at the Second AP Fund.

Where the Fund feels that changes must be made, pressure is placed on the boards of directors. One dialogue that will intensify in the near future, for example, concerns ‘matching shares’.

“It is extremely important that companies operating incentive plans that feature matching shares explain their inclusion. We consider it to be a free share, given to employees without any counter-performance requirement, beyond the fact of being an employee,” says Ulrika Danielson.

### Mixed result

The Second AP Fund survey reveals that a large proportion of the companies surveyed satisfy the principles of adopting a holistic and long-term approach. The principles regarding relevance, reasonableness, follow-up and transparency are implemented fairly well.

However, AP2’s principles in terms of stability and predictability are not adequately fulfilled. This is partly because a fairly large portion of the total salaries paid by several of the companies are variable, and partly because of uncertainties concerning the final outcome of a specific remuneration plan. Generally, it may be said that companies are better at communicating details of their long-term rather than their short-term remuneration plans.

### Common to demand reciprocal performance

One clear conclusion to be drawn from this survey is that many of the companies demand some form of reciprocal performance. Some 93 percent of the companies make such demands, although in 37 percent of these, the demand for reciprocity is related only to a system of matching shares.

“Broadly speaking, the survey indicates that the portfolio companies have already

come quite a long way, although it is also clear that there is still some way to go before all of them are able to live up to our demands. This is an ongoing process and we must always be prepared to adapt to the way things develop,” concludes Ulrika Danielson.

### Broad remuneration principles

One of the bases for the survey was the Second AP Fund’s stance on incentive plans, which can be summarized under the following headings:

**Holistic approach** – The remuneration principles shall embrace all forms of remuneration to senior executives and other key personnel. The entire remuneration package must be considered in determining whether the remuneration is relevant and reasonable.

**Stability/predictability** – The percentages of fixed/variable payments made in relation to total remuneration shall be justified. If an incentive plan features matching shares, these shall also be justified. Pensions paid shall be based on the fixed salary paid.

**Long-term approach** – Remuneration derived from long-term incentive plans shall constitute the major part of variable remuneration. Variable remuneration based on a shorter payment horizon shall not undermine long-term development. Long-term incentive plans shall derive from entitlements earned over several years.

**Relevance** – Variable remuneration plans shall only fall due for payment once the designated performance requirements are fulfilled, where such requirements are relevant to the company’s strategic development.

**Reasonableness** – Remuneration shall be reasonable in terms of the company’s benchmark group and in relation to its long-term earnings potential.

**Follow-up/transparency** – To enable decisions taken regarding the incentive plan to be followed up, the company shall monitor progress and report on its success to its shareholders, providing an analysis to determine the success of these decisions.



## Sweden's take on nomination committees

*The Swedish Corporate Governance Code ('The Code') celebrated its fifth anniversary on January 1 2010. When the Code first came into force, one of the novelties it introduced was the formalization of the nomination committee process, which had developed towards the end of the 1990s. Nowadays, virtually all publicly quoted companies operate some form of nomination committee, a system that has proved to function well.*

Despite positive experience of the system, Sweden remains fairly alone in its approach to nomination committees. Norway is really the only country to have followed suit. However, there are now signs of increasing international interest, such as in Finland. In the UK, the Tomorrow's Company think tank has started to look more closely at the Swedish model.

"Resistance to the Swedish nomination committee model derives mainly from anxiety about letting shareholders with short-term investment objectives, such as hedge and private equity funds, and who have their own agenda, gain influence in the respective company," notes Carl Rosén, CEO of the International Corporate Governance Network, based in London.

### Move towards greater transparency

In spite of this resistance, the trend in many countries is towards greater shareholder influence with respect to nomination processes. In Germany, for example, where boards of directors are divided into management and supervisory boards, the minority shareholders in Infineon tried to introduce

an alternative candidate to the post of chairman, in opposition to the majority shareholders. They managed to solicit the support of almost 40 percent of shareholders at the AGM, yet still failed to achieve their objective.

"Even in the USA, minority shareholders now have the potential to influence the nomination process, although it is an expensive and complex legal process. As of next year, it will become easier to present alternative candidates. This will also signal the removal of the 'broker-vote' system, which until now has in principle meant that shares registered in the name of an authorized agent have been treated as 'Yes' votes in support of the executive's proposals," Carl Rosén explains.

In England, the nomination process has up till now been managed in a highly informal manner. Carl Rosén explains the reason this system has remained unchanged appears to be because it has, in spite of everything, worked quite well in practice. However, with the increase in the numbers of major institutional investors, such as pension funds, that seek to geographically diversify their investment portfolios, the power of the small group that has previously constituted the control network for individual markets is on the wane.

"This increases the need to introduce a more structured and transparent nomination process. I am therefore convinced that we shall witness a continued move in this direction, with minority shareholders gaining increasing influence over the nomination process. This will not necessarily involve adopting the Swedish model, of course, but must be based on what is appropriate to the specific conditions that apply to each market," states Carl Rosén.

### International Corporate Governance Network (ICGN)

The ICGN is a global membership organization dedicated to raising standards of corporate governance worldwide. ICGN members are largely institutional investors who collectively represent funds under management of around USD 9.5 trillion. The ICGN currently numbers 450 members in 45 countries.



## Nomination committee selection process prior to 2006-2010 AGMs, %

	2010	2009	2008	2007	2006
<b>AGM elected</b>	<b>23</b>	<b>28</b>	<b>17</b>	<b>17</b>	<b>19</b>
<b>Procedure</b>	<b>76</b>	<b>70</b>	<b>78</b>	<b>78</b>	<b>77</b>
<b>Other</b>	<b>1</b>	<b>2</b>	<b>5</b>	<b>6</b>	<b>4</b>
<b>Total companies</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>

Source: Swedish Corporate Governance Board Annual Report 2010.

The controversy surrounding the issue of nominating candidates for seats on the boards of publicly quoted companies is not new. In Europe, the public debate really took off in connection with the publication of the Cadbury Report in the UK, following a series of scandals that affected the British business community in the early 1990s. This development coincided with the collapse of the planned Volvo-Renault merger in 1992, as a result of which a number of institutions suddenly found themselves sharing joint responsibility for the company's future.

Towards the end of the 1990s, several countries started to draw up national corporate governance codes. In the USA, they instead chose to opt for the legislative approach, by adopting parts of the Sarbanes-Oxley Act (SOX), introduced in 2002 after the Enron scandal.

### **Nomination committees for greater transparency**

The Swedish nomination committees were conceived as a means of promoting greater transparency. There was also a wish to broaden the recruiting base for seats on the board. Five years on, most commentators concur that this is what has happened.

Previously, the nomination process was conducted without benefit of any common guidelines. Normally, the chairman came up with a list of names and then sought the support of the major shareholders. Some companies had a nomination committee that functioned as a working party for the board. In such cases, a selected number of board mem-

bers were responsible for the nomination process.

The introduction of the Code now means that board members may still participate in the nomination committee, but they may not constitute a majority. In most cases, this has meant that the chairman participates in the work of the nomination committee, while the rest of its members are recruited externally.

### **Two principal methods**

Nowadays, two principal methods are adopted when determining the composition of nomination committees. Where the first (AGM) method is adopted, the question of who is to serve on the committee is determined by the AGM. If the second (procedural) method is adopted, the AGM determines a selection procedure to be implemented when making subsequent appointments to the nomination committee. This may require that the nomination committee comprise the company's chairman and representatives for the three largest shareholders on a given date.

The procedural method is by far the most common and is preferred by about 75 percent of the companies, the AGM method being applied by the remaining 25 percent. The procedural method is deemed preferable because it pre-empts the effects of changes in the company's shareholder structure following the AGM, while reducing the risk of insider problems.

On the other hand, the AGM method is considered to assign the nomination committee greater legitimacy and clar-

ity. Looking ahead, there is a growing tendency for companies to progress to the AGM method.

### **A successful approach...**

Most would now agree that nomination committees have made the nomination process more structured, professional and transparent. Shareholders now know which individuals are on nomination committees, when they start their work and how they can be reached.

The fact that nomination committees are now required to report their deliberations increases pressure on them to do a thorough job. Issues such as the company's real needs and the effectiveness of the board have been opened up to greater scrutiny.

### **...that has outlived its critics**

The new nomination committees led to a number of objections. Possibly the main objection was concern about the competence of committee members and their limited insights into the companies, which some thought might be less effective compared to the previous system. A further criticism was the fear that nomination committee members might become insiders.

In retrospect, the insider issue has become less of a problem than anticipated. As for the worries raised concerning competence and a possible lack of insight into the companies, these issues appear to have been resolved in various ways and outweighed by the advantages.

## Conference on sustainable venture capitalism

*In June, almost 300 people representing the private equity sector and its investors gathered to attend a major conference held in London. Among others, the conference was arranged under the auspices of the United Nations PRI (Principles for Responsible Investment) initiative. Its objective was to discuss how the private equity sector could embrace and develop the concept of long-term sustainability.*

PRI is a United Nations initiative that aims to engage the financial sector in sustainability issues. The organization initially focused exclusively on investments in publicly quoted companies, but in recent years has also drafted principles governing investment in private equity funds. The London conference was the first addressed exclusively to this sector.

The conference was arranged primarily to provide a forum for the exchange of mutual insights and expertise. This was also reflected in the conference agenda, which consisted mainly of panel debates on specific subjects, featuring representatives of diverse interest groups.

“It was a fairly mixed group of market players. Some have already come a really long way and have adopted a structured and integrated approach to sustainability issues, while others adopt a more sceptical attitude,” notes Martin Jonasson, General Counsel for the Second AP Fund and a conference participant.

### Potential pioneer

“The private equity sector may not have been the first to adopt a structured approach to sustainability issues, but is progressing all the time. It is also a sector with a capacity for achieving speedy results, since private equity funds can exert direct influence on the companies in their portfolios. They are ideally suited

to pioneer change in this respect,” says Martin Jonasson.

The fact that several leading international players attended the conference, including CalPers, PGGM and Carlyle, clearly demonstrated the keen level of interest in these issues. As well as private equity funds and institutional investors, the conference attracted representatives from trade union organizations, the academic world and the media. A number of other Swedish players were also represented.

### One size does not fit all

One difficulty is to develop a working approach that is structured, while at the same time being appropriate to the varying conditions encountered in different industries and on different markets.

“The Second AP Fund’s main motive in raising these issues is to learn how companies address the sustainability challenge, to the best of their own abilities. It is not about trying to implement a universal policy, but about discovering whether the companies in question have developed a strategic approach and work in a structured manner,” states Martin Jonasson.

Work with sustainability issues has made great strides forward in the past decade. Efforts in this field are gaining increasing strategic importance and are acquiring a more global perspective.

“Investors like ourselves must ensure that we contribute to this development. It is not enough merely to invest in funds that specialize in ‘cleantech’. The real challenge lies in integrating sustainability concerns in a relevant manner – to embed them as an integral part of the day-to-day operations of private equity funds. Only then can sustainability become commercially viable. If these funds fail to do this, their operations will never be that sustainable,” explains Martin Jonasson.

### More than just the environment

Sometimes we allow ourselves to be blinded by the environmental aspects of the sustainability mission. These environmental concerns can often be measured and evaluated and, in many cases, can be resolved by applying more advanced technology. In many countries, however, other aspects of sustainability – such as the work environment, workers’ rights and similar issues are at least as important. These issues tend to be more local in nature, making it more difficult to come up with universally applicable solutions.

“A key challenge is to learn how to apply arguments derived from universal principles to conditions that vary from one country to another. This is precisely why it is so important to get together and engage in cross-border discussions as was the case in London,” concludes Martin Jonasson.



## **Sources of further information**

- Second AP Fund: Corporate Governance Policy and Annual Report 2009, [www.ap2.se](http://www.ap2.se)
- Second AP Fund: Report on the Female Representation Index 2010, [www.ap2.se](http://www.ap2.se)
- Joint Ethical Committee, [www.ethicalcouncil.com](http://www.ethicalcouncil.com)
- Sustainable Value Creation, [www.hallbartvardeskapande.se](http://www.hallbartvardeskapande.se)
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