



Tredje AP-fonden

29 September 2004

COMMENTS ON GOVERNMENT PROPOSAL SOU 2004:46 SWEDISH CODE OF CORPORATE GOVERNANCE

The views expressed in these comments are based on the Third Swedish National Pension Fund's (AP3's) role as a large institutional investor on the Stockholm stock exchange and its core goal of achieving a maximum return on pension capital. From this asset management perspective, we consider the impact of the code on small companies as the most important issue for the code group to consider in its continued handling of the proposed code (see comments below). If the code's introduction were to lead to small companies withdrawing from the stock market it would result in the Swedish National Pension Funds no longer being able to maintain direct holdings of equities in these companies (under current investment rules).

Advantages of a code based on self-regulation

AP3 welcomes the proposed Swedish Code of Corporate Governance, which it considers to be overall well-balanced and skillfully drafted. As one of the largest institutional shareholders on the Stockholm stock exchange, we see many advantages in having a Swedish corporate governance code.

- The code may help to expand understanding of the Swedish corporate governance model among institutional investors and thereby reduce the risk of Swedish companies being assigned lower valuations than foreign competitors due to any lack of confidence in Swedish corporate governance.
- Codification increases the opportunities to preserve and nurture the many advantages of Sweden's corporate governance model: the high status attached to the annual general meeting; boards that contain no representatives of executive management other than the CEO; clear rules relating to controlling shareholders; and nominating committees that include representatives of institutional shareholders.

We seek to safeguard the tradition of self-regulation on the Swedish equity market. Self-regulation and public regulation are in essence founded on different principles. Public regulation involves the state passing legislation that all parties must follow and that imposes penalties for contravention of the rules. Self-regulation allows greater flexibility but requires broad acceptance among relevant parties in order to guarantee adherence to such regulations. This is the only way for self-regulation to obtain credibility and legitimacy.

We seek to preserve the diversity of Swedish corporate governance. Though there are many advantages in having a code that sets out a benchmark for what constitutes good practice, it is

essential to realize that every company is unique. What is best for shareholders in one company may not necessarily be best for shareholders in another. The principle of "comply or explain" in respect of deviations are (whereby the market – shareholders – decides whether an explanation is acceptable) creates important flexibility.

Applicability of the code to small companies

There is no doubt that the code is designed with large companies in mind. The majority of small companies will probably need to explain why they have deviated from many of the code's requirements. There is a risk that these companies will be forced to enlist expensive legal assistance in governance issues. At worst, companies may feel tempted to delist in order to avoid having to comply with the code. This would reduce AP3's ability to invest in these companies.

One way of making things easier for small companies would be to set up a model for simplified exemption for these companies, for example by simply allowing "small company" as a valid justification for exemption. Requirements that are not applicable to small companies include the setting up of a nominating committee and audit committee and the stipulation that a company must have a special unit for internal control.

An important task for the Council for Swedish Corporate Governance will be to review experiences of the way the code applies to different categories of company, especially small companies. The council should also consider whether small companies should be entitled to straightforward exemptions in specific areas. One way of achieving this might be to commission the council to evaluate the code's introduction from this standpoint.

Shareholders have an important role to play in determining the extent to which a company's justification for any deviations from the code, published in its annual governance report, are acceptable. Institutional shareholders have a key role to play in developing standards of best practice in this area. AP3 aims to promote clear and straightforward governance reports in which any explanations of deviations are not overly detailed or legally complex. The important thing is that the market is informed about the extent to which a company has chosen not to observe the code and which model it has chosen instead.

The Swedish code is considerably more detailed than equivalent international codes. This high level of detail risks further increasing companies' costs. It is therefore desirable that consideration is paid to reducing the scope of the code and scaling back the regulations. This is especially so in the case of sections 3.2 (Size and composition of the board) and 3.5 (Work of the board of directors).

Consequences for Nordic companies

Companies are increasingly becoming pan-Nordic, i.e. listed on two or more Nordic stock exchanges and with controlling shareholders domiciled in different Nordic countries. Yet separate corporate governance codes are currently being introduced in the different Nordic countries, and in some respects these differ substantially. This makes it very difficult for companies to meet the standards of best practice in the various countries. The council should, therefore, also be mandated to review prospects for harmonising corporate governance codes within the Nordic region.

Consequences for board responsibilities and remuneration

There is an obvious risk that the code will lead to boards having to devote more time to formalities. It is AP3's view that the board's most important function is to set out company goals and strategy and thus establish the framework for how to create value for shareholders. The council should monitor whether the introduction of the code reduces the amount of time that boards spend on strategic issues.

Introduction of the code will place greater demands on the time of directors. This will be particularly so for directors who are members of nominating and remuneration committees. As a result, we as owners must be prepared to accept an increase in directors' remuneration levels as well as the payment of special fees to committee members.

COMMENTS ON SPECIFIC ASPECTS OF THE PROPOSALS

2.1. Nominating committee

The code introduces the nominating committee as a new corporate body whose role (according to the Government Commission on Business Confidence) should be enshrined in legislation. Compared to today's nominating committees, the committees proposed in the code would have wider responsibilities and powers. It is AP3's view that the legal and practical implications of this change have not been sufficiently highlighted.

Will the nominating committee's insight into company operations be such that its members (and the institutions they represent) become privy to insider information? Should this be the case it will make it difficult for AP3 and other institutions with similar asset management mandates to take up seats on nominating committees. AP3's mission to achieve a maximum return on investment means that we must at all times be freely able to buy or sell individual equities.

Can a committee member be regarded as having a conflict of interest if he or she sits on the nominating committees of competitor companies? Since governance issues today are typically handled by one or two people within a financial institution this may create problems for such institutions in taking up their positions on nominating committees.

What legal responsibility flows from membership of a nominating committee? The committee's responsibility should be limited so that individual members are not subject to personal liability.

A section should be added to the legislation sanctioning the payment of remuneration to nominating committee members. Existing legislation leaves no room for such remuneration, and this issue must be resolved.

The code should include a description of the boundaries of the nominating committee's responsibility. It should be stated clearly that the nominating committee as a corporate body does not rank higher than the board of directors but works solely on the basis on mandates approved by the annual general meeting.

2.2 Election and remuneration of directors

Section 2.5.1 states that the nominating committee is to "evaluate the audit work" prior to selection of auditors. It seems scarcely reasonable to expect the nominating committee to be able to invest the time required to conduct such an evaluation. Evaluating an audit and preparing the election of auditors is the task of the board. The role of the nominating committee should be limited to ensuring that the board has performed this task satisfactorily. This requirement may reasonably be met by the audit committee providing an account of its work to the nominating committee.

2.3 Evaluating the board

This section requires the nominating committee to perform its own evaluation of the board's work and states that the board's own evaluation of its performance should form part of the nominating committee's documentation for arriving at its conclusions. It is not realistic to expect that a nominating committee will have the resources to conduct its own independent evaluation of the board's work. Its role should be to examine the board's own assessment and to ensure it is complete and relevant.

3.2 Size and composition of the board

We reject the proposals relating to a maximum number of directors (3.2.4) and the requirement that an explanation be provided if a director retains a seat on the board for more than eight years and is aged over 70 (3.2.7). The continuity and experience that accrues from long-term board involvement and the presence of senior directors is important for board expertise and independence.

3.4 Chairman of the board

The code states that it should be determined on a case-by-case basis whether it is appropriate for an outgoing CEO to be elected as chairman of the board. We recommend that the code should be amended so that it clearly states that an outgoing CEO should not be elected to chair the board.

3.8 Board-auditor relationship

Sections 3.8.1 and 3.8.4 are formulated to state that the board must ensure the quality of the company's financial reporting, including its internal control. This can be interpreted as if the board should conduct a separate external audit of its internal control, which cannot reasonably be the intention. The board's responsibility is to ensure effective internal control, not to evaluate the effectiveness of such control. The task of ensuring the existence of internal control should be included as part of usual audit procedure. The formulation of these sections should be clarified in this respect.

Appendix. Summary of the code's information requirements

It is unclear who should disclose deviations from the code in respect of board composition. In reality, such decisions should be taken by the nominating committee and, ultimately, by the annual general meeting. Thus, responsibility for disclosure rests with them. A possible solution would be to mandate the nominating committee to produce a disclosure text explaining the deviation. This could then be adopted by the annual meeting.

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On behalf of the Third Swedish National Pension Fund

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