

Responsible Investment Instructions for ethical and sustainable Asset Management for the National Level of the Church of Sweden

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1 Ethical and sustainable investment instructions - background

In the Financial Policy for the National Level of the Church of Sweden, adopted by the Central Board of the Church of Sweden 22 April 2010, it is stipulated that the Asset Management Council shall draw-up investment instructions for asset management. This document covers the ethical and sustainable aspects of such management. Other governing documents drawn-up by the Asset Management Council are, Financial Investment Instructions for Asset Management for the National Level of the Church of Sweden and, Forms of Working and Reporting for Asset Management for the National Level of the Church of Sweden.

The Asset Management Council regularly examines, normally on an annual basis, whether changes need to be made in these investment instructions.

The Financial policy does not go into detail, for example in regard to how controversial businesses shall be interpreted (see section 6.3 in the Financial policy) or what restrictions based upon climate change considerations mean or imply (Section 6.3.1). Neither has what the Church of Sweden considers to be responsible investment been described in detail. To address this issue, these investment instructions have been developed to clarify our view of responsible companies and particular sectors. **These instructions are an elucidation of the Finance Policy and provide necessary guidance for asset managers.** The asset managers who have questions about the policy and the investment instructions are welcome to get in touch with the Financial unit of the Church of Sweden's national level at 018-169500.

2 Responsible companies – overall purpose of the investments

In the Financial policy, Section 6.2.2, it states that, “ The Church of Sweden wants to contribute to the solutions for a sustainable development of our world. Therefore, asset managers of the Church of Sweden are expected to choose companies based upon their benefits to society in which the global Sustainable Development Goals provide direction. What is meant here is companies whose goods and services contribute to sustainable development or companies who work systematically and consciously with issues that regard the environment, working conditions, human rights and the fight against poverty, where it is relevant for the business.

It also concerns issues that deal with corporate governance, e.g. corruption, remuneration systems and transparency.

The asset managers that we engage must be able to justify holdings based upon the wording in the Financial policy mentioned above. Special requirements have been established for companies that are active in regions or sectors where the risk of corruption or lack of respect for human rights and the environment are high.

2.1 Screening and corporate engagement

The policy states (Section 6.2.2) that companies chosen shall adhere to international regulations whose purpose it is to protect people and the environment. For this reason, the list of holdings undergoes a norm-based screening. The companies that are not approved are looked into more closely since there is a significant risk that they are in breach of the policy. A decision is made regarding whether the shares in the company shall be retained or sold-off based upon what measures the company takes, how serious the infringements are and how well sustainability work in its entirety is integrated.

The asset managers shall also be knowledgeable regarding the strengths and weaknesses in a company's sustainability work. In the examples below, we illustrate how the Church of Sweden at the national level views some of the issues concerned with whether or not to invest.

Example 1. Shortcomings in a company with well-developed sustainability work

Even companies that have done much can exhibit serious shortcomings in parts of its operations and

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consequently risks being in breach of the policy. The asset manager shall engage the company in question (or several companies in the same sector) in a dialogue for the purpose of improving the company's working methods. Again, the company's response, action plan and how serious the shortcomings are all determine whether or not it is possible to invest in the company.

Example 2. Companies that have begun late

Certain companies and sectors have achieved more in their sustainability work than others. Those companies who began late or for other reasons have not integrated sustainability issues in their businesses have to at least have reached an acceptable level, or be able to display clear and ambitious change work for investment to be compatible with the Church of Sweden's investment policy.

Example 3. Small and medium sized companies

Large companies often have staff who are responsible for environmental issues or a sustainability department that communicates with investors. Smaller companies seldom have such resources.

Regardless, their impact on the environment and the surrounding local community can in any case be significant. Our demands for risk analysis, a well-thought out strategy for sustainability as well as the implementation and follow-up of activities are equally high regardless of the size of the company. However, we do think that the demands for how comprehensive this work should be, ought to be in relation to a company's size and the actual impact its operations have.

2.2 Exclusion of particular sectors

Accordingly, asset managers shall focus on finding responsible companies. Then, there are other aspects of responsibility regarding particular controversial products and sectors that the Church of Sweden will not invest in (see Section 6.3 in the Financial policy). In line with this, the Church of Sweden has formulated specific demands on sectors associated with fossil energy, weapons, pornography, tobacco, alcohol and gambling for money. In particular instances, a qualitative analysis must be carried out to determine whether or not it is possible to invest in a company. How these determinations are made is described in the following section.

3 Climate adjustment - a guide for interpretation based upon sectors

The Church of Sweden had implemented a climate adjustment in its portfolio on the national level which is stated in Section 6.3.1 of the Financial policy as seen below:

The Church of Sweden perceives climate change as a serious threat to Creation as well as basic living conditions on our planet and therefore has a restrictive view as regards investments in companies that are active in the extraction of fossil energy sources. We also do not invest in businesses that are involved in, e.g. oil-sand and shale-gas operations. Managers of the Church of Sweden's assets are expected to instead invest in companies that contribute to resolving the climate issue in a constructive manner.

Increased focus on individual equities

The climate adjustment has two aspects. First, the Church of Sweden actively looks for companies that offer sustainable "climate smart" goods and services, sustainable energy sources and have energy efficient processes. Second, the Church does not invest in companies that extract fossil energy sources. The focus of all investments is to select equities that the asset manager determines to be economically, socially and environmentally sustainable in the long term while as the same time yielding good financial returns.

Less focus on benchmarking

Succeeding in the first case mentioned above requires that the asset manager find companies that have processes and products that contribute to the conversion to a low-carbon economy. It is difficult,

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while actively managing funds, to achieve a low *Tracking Error* (the standard deviation between the yield of the fund and the yield of the benchmark) in indices such as MSCI World or DJSI. This is due to the fact that the large oil companies and other fossil-fuel extraction companies make up a significant portion of these indices.

We permit (and expect) Tracking Errors that are higher in relation to more conventional asset management that is based upon a close adherence to indices regarding exposure to different industrial sectors.

The asset manager should be able to show in an analysis how deviations from the benchmark have affected yield. The fact that the Tracking Error can clearly differ between different active asset management methods with the same benchmark is not in itself unusual.

3.1 Sectors that require special screening

The other aspect of the Church's climate adjustment regards particular sectors and equities that do not match the Church of Sweden's overall climate goals or intentions stated in the Financial policy, and for this reason are excluded for investment purposes. Today, the world is dependent upon fossil energy, but at the same time needs to convert to a more sustainable energy supply. We believe that it is easier for an energy supply company to use more renewable energy sources to produce heat, cooling and electricity than it is for oil, coal and gas companies to shift to the deployment of renewable energy sources. To date, we are not aware of any oil, coal or gas companies that pursue development towards the production of sustainable energy sources and display sufficiently high standards in regard to the environment and human rights. However, there are a number of such energy companies. For this reason, we make a distinction between extraction companies and energy companies in the climate adjustment.

The results of this approach are seen below. The guidelines shall be applied by all asset managers who state that they adhere to the Financial policy.

3.1.1 Sector by sector interpretation (based upon Global Industry Classification Standard - GICS Codes)

Certain companies in the sectors are excluded. Other companies are in different types of sectors and are therefore subject to other types of limitations. Companies with considerable fossil reserves (according to the list from Carbon Tracker Initiative¹) are not investable.

A. Oil and Gas

- Excludes the following sectors: Exploration & Production, Integrated Oil & Gas, Oil Equipment & Services, Pipelines.
- Excludes GICS Codes 10102030, 10102040, 10102050.
- Excludes prospecting and extraction of oil-sand and shale-gas regardless of sector/industry and extent.

B. Coal

1. Excludes the following sectors: Coal
2. Other sectors: Excludes companies with revenues > 5% of turnover from prospecting and extraction of coal, e.g. certain mining companies.

C. Service companies, other sectors and majority owners

Excludes: a) service companies (including oil and gas distribution) with revenues >50% from

¹ Click at "rankings": <http://fossilfreeindexes.com/the-carbon-underground-2014/>

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operations within A and B above; b) companies with revenues >50% from operations as in A and B but that are part of another sector; c) majority owners of companies under a) and b) above.

D. Energy production companies

1. Nuclear power

Energy production companies employing significant amount of nuclear power are chosen based upon the "best in class" principle with a focus on health, safety and environmental issues and if they are at the forefront in their sector regarding sustainability issues.

2. Coal intensive electrical production companies

Energy companies are investable if less than half (<50%) of installed generation capacity is designed for fossil energy sources.

E. Energy intense companies

Companies within certain energy intense sectors such as cement, steel and paper are chosen based upon the "best in class" principle with a focus on environmental score (i.e. the E-factor in the ESG rating) and if they are at the forefront on their sector regarding sustainability issues.

4 Alcohol, tobacco and gambling for money

The Church of Sweden has established limitations for how great a proportion of sales, i.e. turnover that a company can have from a particular product that they manufacture. We have determined that sales volumes be highest 5% for alcohol, 0% for tobacco and and 5% for gambling for money. (See section 6.3.3 in the policy.) Companies whose products are necessary for the design or development of software or platforms specifically for the gambling for money industry are also not investable.

We have not set absolute limitations in regard to the distribution of these products since gathering this type of data and ensuring that it is correct and then setting appropriate limitations that lead to a fair and meaningful evaluation is problematic. This does not imply "carte blanche" for companies that distribute alcohol, tobacco and gambling for money. If such a company is chosen, then the asset manager shall be able to justify the choice of this company based upon the requirements for responsibility investment in Section 6.2.2 of the Financial Policy.

The investments made by the Church of Sweden shall focus on responsible companies that have sustainable processes and products that make a positive contribution to society (see Section 6.2.2 in the Financial policy). Investments in companies whose turnover are based upon tobacco, alcohol and gambling are problematic in regard to the investments made by the Church of Sweden. If such companies are selected by an asset manager, the asset manager must be able to justify the selection based upon the requirements for responsibility in Section 6.2.2 of the Financial policy.

5 The Church of Sweden's Weapons Criteria - a guide to interpretation

Section 6.4.4 in the Financial policy describes the weapons criteria.

The Church of Sweden shall abstain from investing in companies and enterprises whose business operations include, to an appreciable extent, the manufacture and/or sales of weapons or materials used for the purposes of waging war.

The Church of Sweden excludes investments in companies or enterprises actively involved in the development and production of especially inhumane weapons of war and the vital

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components associated with them. Active involvement is defined as the supply of products and services that are specifically adapted to a particular weapon or weapons.

Definition of weapons and weapon related war materials

Weapons are defined as products whose purpose is to kill, maim or destroy and are sold for military purposes. War materials are considered to be products or sub-components that have been specifically developed to be a part of a weapon or a weapon system. Products and services covered by the Church of Sweden's policy are listed in Annex. 1 of the Military Equipment Ordinance (1992:1303) which can be accessed from the website of Swedish Agency for Non-Proliferation and Export Controls (ISP). Products covered are all war materials for combat and the products and services under Miscellaneous War Material which are significantly modified for use in war materials for combat. Other products in the Annex are not covered as they are considered to have dual areas of use (military/civil) and/or lack clear connection to combat functions.

5.1 Assessment based upon relevance

5.1.1 One percent - a signal for further analysis

For companies whose turnover from weapons or war materials is central to combat there is a zero limit (0%). Companies whose turnover from other military products (e.g. test instruments) exceeding one (1%) percent are in principle not acceptable for investment, however if their turnover is under one (1%) percent they are approved for investment. However the one (1%) percent limit is a marker. Companies whose turnover lies close to this limit are not automatically included or excluded - they are assessed individually.

Also, it is important to take into consideration if the company's link to weapons involves large amounts of money. If the company is on the list of the 100 largest contracts for leading military customers but in any case under the one percent limit, this shall be considered in the analysis.

5.1.2 See the company in its entirety

If the company has products with a link to weapons of about one (1%) percent, but the products are not central to a combat function, the asset manager should also carry out an overall assessment of how responsible the company is. The less transparent a company is, the more careful an asset manager should be when assessing ties to weapons. A somewhat larger percent of turnover than 1% may be acceptable if the company is transparent and shows good sustainability work. Asset managers are required to justify such holdings. This degree of flexibility is only applicable if the company's products with a link to weapons are not central to combat functions.

5.1.3 Exert influence on a company to sell its operations

If a company has weapons' related production that is under one (1%) percent of its turnover, but this production is central to a combat function it is not permissible to invest in this company. In this case, holdings in this company shall be divested immediately. In some cases, it may be possible to influence the company in question to sell its weapons' related operations. This applies especially if the operations are very marginal and have a negative effect on the company's sustainability profile. There are a number of examples of companies that are excluded from different sustainability profiles due to a marginal link to weapons in spite of the fact that they have a high sustainability rating. There are also examples of companies with a sustainability rating that have sold their military related operations. The asset manager and the Church of Sweden should therefore investigate the possibility of encouraging the company in question to sell its operations that have ties to weapons. If the company is open to such a discussion, the Church of Sweden and the asset manager, as well as other investors and asset managers engage the company in a dialogue. In cases when the engagement does not yield results within a reasonable time, the holding are sold in line with the discretionary mandate. In open-ended funds, the asset manager makes the decision on selling off the holding. If the asset manager does not take our viewpoint into consideration we are forced to consider divesting our holdings in the fund. In this manner, we are acting responsibly as investors to influence the company

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to adopt a more sustainable and responsible orientation. Each such case must be examined individually by the Church of Sweden (who has the final responsibility for how the weapons criteria are interpreted) based upon how we see the company, the weapon related product and the possibilities of reaching the desired result through engagement.

5.1.4 List of weapons and war materials

The Military Equipment Act (1992:1300) is regulated in Swedish legislation while products that are used for both military and civilian purposes are embraced by EU legislation. During 2012, the list for weapons and war materials was updated and is now aligned with the Common Military List of the European Union (ML). It is divided into 22 different areas. In regard to companies that deliver services to military customers; the asset managers should determine whether these services are a part of core activities and if they are intended for the waging of offensive war.

Read the complete list [here](#). Currently, there is no list in English.

http://www.isp.se/documents/Regelverk/FM/ISP_forklaring_forteckning_kmtb.pdf

5.2 How should the criteria be interpreted?

5.2.1 Examples of company types in which investment is permissible

Company A

The company owns 20% of another company that falls under "Other war materials" in accordance with ISP's categorisation. The turnover from this production that can be linked to weapons is only 0.3% and is not central to a combat function.

Company B

The turnover from this part of operations and that can be tied to weapons is only 0.3% and thus marginal. The content is not central to a combat function.

Company C

Company C owns twenty (20%) percent of company E - see below. Otherwise, there are no ties to weapons.

Company D

This company manufactures test instruments which are important (but not central) to a combat function. Approximately one (1%) percent of turnover is weapons related. They are a leader in sustainability issues. Our overall assessment is that this company is suitable for investment.

Companies that manufacture semi-conductors - which can be compared to manufacturing nuts and bolts in another context - are not in themselves vital to combat functions. It is permissible to invest in the company as long as the products are also sold to non-military customers.

It is permissible to invest in companies that manufacture certain other war materials.

Examples are protective equipment and ammunition for hunting or sport shooting.

5.2.2 Examples of companies in which investment is not permissible

Company E

Approximately three (3%) percent of turnover is weapons related. They own 49% of a company that manufactures combat vehicles which are categorized as being central to combat. They are excluded based upon both turnover and type of products.

Company F

Despite their turnover being under one (1%) percent, they are excluded due to the content of their products. They have an advanced pilot training programme for strike aircraft that is used on a large scale.

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Company G

Through their wholly owned subsidiary they manufacture advanced combat vehicles which are central to a combat function. Therefore, they are excluded from investments. Turnover from these operations is however under one (1%) percent.

6 The Church of Sweden's pornography criteria

The criteria can be found in Section 6.4.5 and reads as follows:

“The Church of Sweden does not invest in companies that provide pornography that in a blatant and provocative manner reproduce sexual situations or events that violate human value and dignity.

Provision encompasses production and intermediary activities that are a result of the company's own activities.”

6.1 Guide for interpreting active distribution

The production of pornography only occurs in a very few cases among the world's listed companies. These companies are immediately excluded from investments in line with the criteria. The distribution of pornography concerns the following sectors:

- Trade
- Telecom suppliers
- Media
- Hotel

Different sectors are involved to different degrees and have various reasons for being involved. There is a clear boundary in the degree of activity among different companies that receive a considerable portion of their income from pornography and companies that only earn a small amount on the distribution of pornographic materials. The companies that actively market pornographic materials are also those who earn the most money on these activities. These companies are found in the media sector.

On the other hand, income from the distribution of pornographic materials in the hotel, trade and telecom sectors is marginal. Companies in these sectors are also passive in their distribution.

Pornographic materials can be available for those who are interested, but the customer must actively look for them and make an active and conscious choice in securing such materials. This can be compared to a library that has pornographic materials.

The hub in distribution is however the media companies. They own and manage the channels for cable and satellite TV. They also sell videos and films via the Internet. It is the activities of these companies in the media sector that are found in the other three sectors that primarily function as distribution channels for these media companies. In the future, it is possible that the telecom companies will become more active at which point we will need to conduct a new assessment.

Screening of pornographic materials is therefore only necessary in regard to the media sector. It is not permissible to invest in media companies that have a clear link to pornography. In regard to the other branches (trade, telecom and hotels) it can be said that the distribution of pornography that does occur is passive. Moreover, the extent of such activities is very limited.

For this reason only screening of media industry companies (cable and satellite) with the code the GICS code 25401025 should be done.
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