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2014 China Proxy Voting Summary Guidelines

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Institutional Shareholder Services Inc.

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ISS' 2014 China Proxy Voting Summary Guidelines

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Overview

Companies must hold their annual general meetings (AGMs) within six months of the close of each fiscal year. The following resolutions are commonly seen at a shareholder meeting:

- Approval of financial statements and statutory reports;
- Dividend distribution;
- Election of directors;
- Election of supervisors;
- Auditor appointment;
- Capital raising requests;
- Debt issuance requests;
- Amendments to articles of associations;
- Provision of guarantees;
- Related-party transactions.

Other items that may be submitted for shareholder approval include:

- Remuneration;
- Mergers and acquisition;
- Investments in financial products using idle funds.

Policies in this document are presented in the order that generally appears on the ballot.

Approval of Financial Statements and Statutory Reports

Pursuant to Article 6.2 of Shenzhen Stock Exchange (SZSE) Listing Rules and Article 6.1 of Shanghai Stock Exchange (SSE) Listing Rules, listed companies are required to prepare and release annual reports within four months of the end of each financial year; interim reports within two months of the end of the first half of each financial year; and quarterly reports within one month of the end of the first three months and the end of the first nine months of each financial year, respectively.

In addition to financial statements, Chinese companies often submit the reports of the board of directors, supervisors, and independent directors (collectively referred to as statutory reports) to shareholders for approval.

- The directors' report typically discuss the company's operations for the previous year, including a review of the company's performance, justification of dividend levels and profits or losses, special events such as acquisitions or disposals, and future plans for the company.
- The supervisors' report contains statements as to the company's performance, finances, related-party transactions, and other operating matters during the year. Supervisors review the company's various documents, management work reports, special reports, and major policy decision matters as presented in the company's shareholder meetings and board of directors meetings, and determine whether these are in accordance with prevailing laws and regulations.

These reports are usually included in the company's annual report and are ordinarily non-contentious in nature. ISS generally recommends voting for such requests unless:

- There are concerns about the accounts presented or audit procedures used; or
- The company is not responsive to shareholder questions about specific items that should be publicly disclosed.

Voting requirement: this is an ordinary resolution.

Ordinary resolutions can be adopted by a majority of all attending shareholders.

Dividend Distribution

In the guideline (Several Decisions over the Regulations on Cash Dividend Distribution of Listed Companies) issued by CSRC in 2008, it is required that, in order for a listed company to be eligible for a securities issuance (including stocks, convertible bonds, and other securities authorized by CSRC), the cumulative dividend distribution in the most recent three years shall not be less than 30 percent of the average annual distributable profit over the same period.

ISS generally recommends voting for approval of the allocation of income, unless:

- The dividend payout ratio has been consistently below 30 percent without adequate explanation; or
- The payout is excessive given the company's financial position.

Voting requirement: this is an ordinary resolution.

Ordinary resolutions can be adopted by a majority of all attending shareholders.

Board of Directors

The Company Law of PRC (article 109) requires a company to have five to 19 directors on the board, whilst a 2001 CSRC guidance document requires that independent directors should represent at least one-third of the board, of which at least one independent director must be an accounting professional. Independent directors are subject to a maximum term of six years.

Meeting attendance of independent directors is required to be disclosed by the Code of Corporate Governance 2002. Independent directors who do not join in a board of directors meeting in person three consecutive times are required to step down and be replaced.

Election of Directors

Where independent directors represent at least one-third of the board, ISS will recommend supporting election of a board-nominated candidate unless:

- He or she is classified by the company as independent, but fails to meet the ISS criteria for independence;
- He or she has been a partner of the company's auditor within the last three years, and is on the audit committee of the company; or
- He or she has attended less than 75 percent of board meetings over the most recent two years, without a satisfactory explanation.

Where independent directors represent less than one-third of the board, ISS will generally NOT support the election of a candidate if:

- He or she is classified by the company as independent, but fails to meet the ISS criteria for independence;
- He or she is an executive director. If more than one executive director is up for election, ISS will recommend against only one (typically, the director with the worst attendance record). Executives do not need to sit on the board for directors to access their expertise. Executives can be invited to board meetings to make presentations and answer questions.
- He or she is a representative of a substantial shareholder on a board where the reason independent directors constitute less than one-third of the board is because of a preponderance of executive directors and representatives of one substantial shareholder. In these cases, ISS will recommend against only one representative of the substantial shareholder (typically, the director with the worst attendance record);
- He or she has been a partner of the company's auditor within the last three years, and is on the audit committee of the company; or
- He or she has attended less than 75 percent of board meetings over the most recent two years, without a satisfactory explanation.

In making these recommendations, ISS generally will not recommend against the election of the CEO or a company founder who is integral to the company.

Under extraordinary circumstances, ISS will recommend against individual directors, members of a committee, or the entire board, due to:

- Material failures of governance, stewardship, risk oversight, or fiduciary responsibilities at the company;
- Failure to replace management as appropriate; or
- Egregious actions related to a director's service on other boards that raise substantial doubt about his or her ability to effectively oversee management and serve the best interests of shareholders at any company.

Voting requirement: this is an ordinary resolution.

Ordinary resolutions can be adopted by a majority of all attending shareholders.

Voting for Director Nominees in Contested Elections

Vote case-by-case on the election of directors in contested elections, including election of shareholder nominees or the dismissal of incumbent directors. For shareholder nominees, ISS places the persuasive burden on the nominee or the proposing shareholder to prove that they are better suited to serve on the board than management's nominees. Serious consideration of shareholder nominees will be given only if there are clear and compelling reasons for the nominee to join the board. These nominees must also demonstrate a clear ability to contribute positively to board deliberations; some nominees may have hidden or narrow agendas and may unnecessarily contribute to divisiveness among directors.

The major decision factors are:

- Company performance relative to its peers;
- Strategy of the incumbents versus the dissidents;
- Independence of directors/nominees;
- Experience and skills of board candidates;
- Governance profile of the company;
- Evidence of management entrenchment;
- Responsiveness to shareholders;
- Whether a takeover offer has been rebuffed.

When analyzing proxy contests/ shareholder nominees, ISS focuses on two central questions: (1) Have the dissidents proved that board change is warranted? and (2) if so, are the dissident board nominees likely to effect positive change (i.e., maximize long-term shareholder value)?

It is not, however, uncommon in China for a major shareholder to propose shareholder nominees. While these candidates are technically shareholder nominees, they are usually presented with consent of and often at the request of management. ISS treats the election of these shareholder nominees as uncontested director election unless there is an indication of director contest.

Board of Supervisors

Company Law of PRC requires that companies establish a supervisory board, and that this board consists of at least three members, with no less than one-third representing mass employees. These employee representatives are elected by employees and are not subject to shareholder approval in general meetings. Directors and senior executives are prohibited from serving as supervisors.

These supervisory boards are charged with overseeing company finances and supervising the conduct of directors and senior executives, with supervisors typically nominated by major shareholders of the company.

Election of Supervisors

ISS generally recommends voting for such candidates unless:

- He or she is a senior executive or director of the company;
- He or she has been a partner of the company's auditor within the last three years; or
- There are concerns about the performance or conduct of an individual candidate.

Voting requirement: this is an ordinary resolution.

Ordinary resolutions can be adopted by a majority of all attending shareholders.

Remuneration

Director Remuneration

According to Article 38 of Company Act, director and supervisor remuneration requires shareholder approval. In most cases, however, it is disclosed as an aggregate amount. One exception is the finance industry, where state-owned entities are subject to higher disclosure requirements.

ISS generally supports resolutions regarding directors' and supervisors' fees unless they are excessive relative to fees paid by other companies of similar size.

Voting requirement: this is an ordinary resolution.

Ordinary resolutions can be adopted by a majority of all attending shareholders.

Equity-based Compensation

Stock option plans and restricted stock schemes have become increasingly popular in China in recent years, with companies employing increasingly sophisticated schemes.

ISS will recommend voting against a stock option scheme if:

- The plan permits options to be issued with an exercise price at a discount to the current market price; and/or
- The maximum dilution level for the scheme exceeds ISS guidelines of 5 percent of issued capital for a mature company and 10 percent for a growth company. However, ISS will support plans at mature companies with dilution levels up to 10 percent if the plan includes other positive features such as challenging performance criteria and meaningful vesting periods, as these features partially offset dilution concerns by reducing the likelihood that options will become exercisable unless there is a clear improvement in shareholder value; and/or
- Directors eligible to receive options under the scheme are involved in the administration of the scheme; or
- The company fails to set challenging performance hurdles for exercising the stock options compared with its historical financial performance or the industry benchmarks.

Generally vote against a stock option scheme if:

- The scheme is proposed in the second half of the year and the measurement of the company's financial performance starts from the same year. The rationale is that the company's financial performance has been largely determined for that particular year and thus by linking the vesting conditions of part of the options to that year's financial performance, the company is providing incentives for the period of the second half only, which can either be too aggressive (if the target is far out of reach) or too insufficient (i.e., the target has already been reached).

ISS will recommend voting against a restricted stock scheme if:

- The grant price of the restricted shares is less than 50 percent of the average price of the company's shares during the 20 trading days prior to the pricing reference date;
- The maximum dilution level for the scheme exceeds ISS guidelines of 5 percent of issued capital for a mature company and 10 percent for a growth company. However, ISS will support plans at mature companies with dilution levels up to 10 percent if the plan includes other positive features such as challenging performance criteria and meaningful vesting periods, as these features partially offset dilution concerns by reducing the likelihood that restricted shares will be unlocked unless there is a clear improvement in shareholder value;
- Directors eligible to receive restricted shares under the scheme are involved in the administration of the scheme; or
- The company fails to set challenging performance hurdles for unlocking the restricted shares compared with its historical financial performance or the industry benchmarks.

Generally vote against a restricted stock scheme if:

- The scheme is proposed in the second half of the year and the measurement of the company's financial performance starts from the same year. The rationale is that the company's financial performance has been largely determined for that particular year and thus by linking the vesting conditions of part of the restricted stocks to that year's financial performance, the company is providing incentives for the period of the second half only, which can either be too aggressive (if the target is far out of reach) or too insufficient (i.e., the target has already been reached).

Voting requirement: This is a special resolution.

Special resolutions can be adopted by a super majority vote (2/3 or more) of all attending shareholders.

Auditor (re)Appointment

The practice of auditors providing non-audit services to companies is problematic. While large auditors may have effective internal barriers to ensure that there are no conflicts of interest, an auditor's ability to remain objective becomes questionable when fees paid to the auditor for non-audit services such as management consulting, general bookkeeping, and special situation audits exceed the standard annual audit fees. While some compensation for non-audit services is customary, the importance of maintaining the independence of the auditor is paramount. If fees from non-audit services become significant without any clear safeguards against conflicts of interest, ISS recommends opposing the auditor's reappointment.

In China, the CSRC requires listed companies to disclose the aggregate amount of fees paid to the auditor, as opposed to component breakdowns.

With regard to the proposals to (re)appoint auditors, ISS will recommend supporting the appointment of auditors and authorizing the board to fix their remuneration, unless:

- There are serious concerns about the accounts presented or the audit procedures used;
- The auditor is being changed without explanation.; or
- Non-audit related fees are substantial or are routinely in excess of standard annual audit fees.

Whilst ISS will consider the nature and scope of non-audit fees when assessing their magnitude, where non-audit fees have constituted more than 50 percent of total auditor compensation during three out of the five most recent financial years, ISS will ordinarily not recommend support for the reelection of the audit firm.

Voting requirement: this is an ordinary resolution.

Ordinary resolutions can be adopted by a majority of all attending shareholders.

Capital Raising

Share issuance requests allow companies to issue shares to raise funds for general financing purposes. The CSRC stipulates in a document entitled "Measures for the Administration of the Issuance of Securities by Listed Companies 2006" (referred to as Measures 2006 hereafter) that:

- The number of new shares issued via a public rights offering shall not exceed 30 percent of the number of shares already issued, and a successful rights offering shall have subscription rate no less than 70 percent;
- Share issuances via a private placement shall be issued to not more than 10 specific parties;
- The share issue price for a private placement shall not be lower than 90 percent of the average trading price of the company's A shares 20 trading days from the benchmark date;
- The share lock-up period shall be 12 months for minority investors and 36 months for the controlling shareholder and actual controlling person of the company.

Chinese companies do not ask for general mandates to issue shares to third parties, rather they seek shareholder approval for a specific issuance. In analyzing such request, ISS will examine such requests on a case-by-case basis, with reference to the identity of the place, the use of proceeds, and a company's past share issuance requests.

Voting requirement: This is a special resolution.

Special resolutions can be adopted by a super majority vote (2/3 or more) of all attending shareholders.

Debt Issuance Requests

The issuance of debt instruments is a commonly seen financing channel used by companies to finance projects and fund operations in China. In evaluating such proposals, the following factors will be considered:

- Rationale/use of proceeds: Why does the company need additional capital? How will that capital be used?
- Terms of the debts: Are the debt instruments convertible into equity? What are the interest rate and maturity? Any call or put options? Often these terms will not be determined until the time of issuance of debt instruments (or when the actual loan agreement is signed). The terms of the debts would generally be determined by the market conditions, and lack of disclosure concerning these terms should not be a cause for significant concern so long as the debt is not convertible into equity.
- Size: At a minimum, the size of the debt issuance/potential borrowing should be disclosed.
- The company's financial position: What is the company's current leverage and how does that compare to its peers? The risk of non-approval: What might happen if the proposal is not approved? Any alternative source of funding? Could the company continue to fund its operations? Would it hinder the company's ability to realize opportunities?

ISS will evaluate non-convertible debt issuance requests on a case-by-case basis, with or without preemptive right. ISS generally recommends voting for these proposals if:

- The size of the debt being requested is disclosed;
- A credible reason for the need for additional funding is provided;
- Details regarding the assets to be pledged are disclosed (for specific asset pledge proposal); and
- There are no significant causes for shareholder concern regarding the terms and conditions of the debt.

A vote against will be warranted only in extremely egregious cases or where the company fails to provide sufficient information to enable a meaningful shareholder review.

For the issuance of convertible debt instruments, as long as the maximum number of common shares that could be issued upon conversion meets ISS' guidelines on equity issuance requests, a vote for will be warranted. ISS will also recommend voting for proposals to restructure existing debt arrangements unless the terms of the restructuring would adversely affect the rights of shareholders.

Moreover, where a general authority to issue debt or pledge assets is requested, in addition to the above criteria, ISS will oppose such a proposal if it could result in a potentially excessive increase in debt. A potential increase in debt may be considered excessive when:

- The proposed maximum amount is more than twice the company's total debt;
- It could result in the company's debt-to-equity ratio exceeding 300 percent (for non-financial companies); and
- The maximum hypothetical debt-to-equity ratio is more than three times the industry and/or market norm.

If ISS does not have data regarding the normal level of debt in that particular industry or market, only the company-specific information will be considered.

Voting requirement: this is an ordinary resolution.

Ordinary resolutions can be adopted by a majority of all attending shareholders.

Amendments to Company Bylaws

Proposals to amend company bylaws are commonly seen at shareholder meetings. Companies usually disclose the details of the proposed amendments in their meeting circulars. Amendments are nearly always bundled together as a single voting resolution, and ISS' general approach is to oppose article amendments as a whole when they include changes ISS opposes. In general, ISS reviews amendments to company bylaws on a case-by-case basis.

Articles of Association

The following are some of the most common or significant types of changes.

- Change of registered capital to reflect the implementation of share issuance or stock dividend distribution;
- Change of the company's business scope and/or its address;
- Change of board size.

ISS generally recommends a vote for these amendments unless the details of the amendments are not disclosed, or the increase in the decision authority is considered excessive in the absence of a compelling justification from the company.

Voting requirement: This is a special resolution.

Special resolutions can be adopted by a super majority vote (2/3 or more) of all attending shareholders.

Other Company Bylaws

Other company bylaws include but are not limited to:

- Management System of Raised Funds
- Rules and Procedures Regarding Shareholder's Meeting;
- Rules and Procedures Regarding Supervisors' Meeting;
- Rules and Procedures for Election of Directors and Supervisors;
- Rules and Procedures Regarding Board of Directors' Meeting;
- Procedures for Endorsement and Guarantees.

Regarding these bylaw proposals, ISS generally recommends voting on a case-by-case basis.

Voting requirement: this is an ordinary resolution.

Ordinary resolutions can be adopted by a majority of all attending shareholders.

Provision of Guarantees

Chinese companies often provide loan guarantees for subsidiaries, affiliates, and sometimes unrelated parties.

According to Article 9.11 in both Shanghai and Shenzhen stock exchange Listing Rules, shareholder approval shall be sought in the following situations:

- The amount of the guarantee is more than 10 percent of the last audited net asset value;
- The cumulative amount of the guarantee provision over the most recent 12-month period has already exceeded or will exceed 50 percent of the last audited net asset value with the addition of the new guarantee being proposed
- The guarantee-receiving party has a debt-to-asset ratio over 70 percent;
- The cumulative amount of the guarantee provision over the most recent 12-month period has already exceeded or will exceed 30 percent of the company's last audited total asset value with the addition of the new guarantee being proposed; or
- The cumulative amount of the guarantee provision over the most recent 12-month period has already exceeded or will exceed 50 percent of the last audited net asset value with the addition of the new guarantee being proposed and the absolute amount of the proposed guarantee exceeds CNY 50.00 million.

Such requests will be evaluated on a case-by-case basis. Generally vote against the provision of a guarantee where:

- The identity of the entity receiving the guarantee is not disclosed;
- The guarantee is being provided to a director, executive, parent company or affiliated entities where the company has no direct or indirect equity ownership; or
- The guarantee is provided to an entity in which the company's ownership stake is less than 75 percent; and such guarantee is not proportionate to the company's equity stake or other parties have not provided a counter guarantee.

When the proposed guarantee does not fall into the above criteria, ISS recommends a vote for such request provided that there are no significant concerns regarding the entity receiving the guarantee, the relationship between the listed company and the entity receiving the guarantee, the purpose of the guarantee, or the terms of the guarantee agreement. Examples of such concerns include a previous default by the entity receiving the guarantee or a sub-investment grade credit rating.

Voting requirement: this is an ordinary resolution unless the cumulative amount of the guarantee provision has already exceeded or will exceed 30 percent of the company's last audited total asset value with the addition of the new guarantee being proposed.

Ordinary resolutions can be adopted by a majority of all attending shareholders.

Special resolutions can be adopted by a super majority vote (2/3 or more) of all attending shareholders.

Related-Party Transactions

ISS assesses related-party transactions on a case-by-case basis. However, all analyses are conducted from the point of view of long-term shareholder value for the company's existing shareholders.

As with many Asian markets, two types of related-party transactions are commonly seen in China – the non-recurring transaction and the recurring service provision agreement. Commonly seen related-party transactions include (but are not limited to):

- Transactions involving the sale or purchase of goods;
- Transactions involving the sale or purchase of property and/or assets;
- Transactions involving the lease of property and/or assets;
- Transactions involving the provision or receipt of services or leases;
- Transactions involving the transfer of intangible items (e.g., research and development, trademarks, license agreements);
- Transactions involving the provision, receipt, or guarantee of financial services (including loans and deposit services);
- Transactions involving the assumption of financial/operating obligations;
- Transactions that include the subscription for debt/equity issuances; and
- Transactions that involve the establishment of joint-venture entities.

According to article 5.1 of Guidelines for Introducing Independent Directors to the Board of Listed Companies by CSRC, 2001 (referred to as Guidelines 2001 hereafter), independent directors must ratify any related-party transaction amounting to more than 5 percent of net assets or RMB 3 million, whilst at board meetings held to discuss such transactions interested directors must abstain from voting (PRC Company Law (article 125)).

Related-party transactions are regulated by Chapter 9 and 10 in the Listing Rules of Shanghai and Shenzhen Stock Exchange, with definitions of related parties and associated transactions given in articles 10.1.1, 10.1.3, and 10.1.5. These rules require that related parties abstain from voting on defined related-party transactions at shareholder meetings.

Articles 12 to 14 of the Code of Corporate Governance also include principles regarding the disclosure, pricing, and other issues involved in a typical related-party transaction.

ISS assesses related-party transactions on a case-by-case basis. However, all analyses are conducted from the point of view of long-term shareholder value for the company's existing shareholders.

Loan Financing Requests

Chinese companies often seek loan financing from banks, financial institutions, or controlling shareholders. Occasionally, companies also undertake to provide funding for subsidiaries, affiliates, or related parties. Generally, the funds obtained from the loan application are used by companies, subsidiaries, affiliates, and/or related parties to supplement working capital, fund ongoing projects, and take advantage of investment plans.

Article 10.2.3 of the Shanghai and Shenzhen Listing Rules documents prohibit the making of loans to directors, supervisors, or senior management either directly or through subsidiaries.

ISS analyzes loans and financing proposals on a case-by-case basis.

In assessing requests for loan financing provided by a related party:

- ISS will examine the stated uses of proceeds, the size or specific amount of the loan requested, along with interest rates to be charged. ISS also gives importance to, and seeks disclosure on, the specific relation of the party to be granted the loan to the company.

In assessing requests to provide loan financing to a related party:

- ISS will examine the stated uses of proceeds, the size or specific amount of the loan requested, along with interest rates to be charged. ISS also gives importance to, and seeks disclosure on, the specific relation of the party to be granted the loan to the company.
- ISS will generally recommend shareholders vote against the provision of loans to clients, controlling shareholder, and actual controlling persons of the company.

Group Finance Companies

It is not uncommon for large companies in China to establish group finance companies (GFC) as an internal agent to accept deposits from, and make loans to, group companies. Shareholder approval is typically required when the company makes deposits to, obtains loans from, and/or receives other forms of financial services from a GFC.

Given that these GFCs may engage in intragroup lending, and that any default in the payment of loans awarded by finance companies to other members of the group may expose the company's deposited funds to further risks, ISS will recommend that shareholders vote against requests to deposit monies with a GFC.

Voting requirement: this is an ordinary resolution.

Ordinary resolutions can be adopted by a majority of all attending shareholders.

Mergers & Acquisitions

ISS recommends a vote on any merger or acquisition on a case-by-case basis, taking into consideration of following factors:

- Valuation - Is the value to be received by the target shareholders (or paid by the acquirer) reasonable? If a fairness opinion has been prepared, it provides an initial starting point for assessing valuation reasonableness, but ISS also places emphasis on the offer premium, market reaction, and strategic rationale.
- Market reaction - How has the market responded to the proposed deal? A negative market reaction will cause ISS to scrutinize a deal more closely.
- Strategic rationale - Does the deal make sense strategically? From where is the value derived? Cost and revenue synergies should not be overly aggressive or optimistic, but reasonably achievable. Management should also have a favorable track record of successful integration of historical acquisitions.
- Negotiations and process - Were the terms of the transaction negotiated at arms-length? Was the process fair and equitable? A fair process helps to ensure the best price for shareholders.
- Conflicts of interest - Are insiders benefiting from the transaction disproportionately and inappropriately as compared to non-insider shareholders? As the result of potential conflicts, the directors and officers of the company may be more likely to vote to approve a merger than if they did not hold these interests. ISS will consider whether these interests may have influenced these directors and officers to support or recommend the merger.
- Governance - Will the combined company have a better or worse governance profile than the respective current governance profiles of the respective parties to the transaction? If the governance profile is to change for the worse, the burden is on the company to prove that other issues (such as valuation) outweigh any deterioration in governance.

Voting requirement: This is a special resolution.

Special resolutions can be adopted by a super majority vote (2/3 or more) of all attending shareholders.

Proposals to Invest in Financial Products Using Idle Funds

Recently, there has been an increasing number of proposals to invest in financial products using idle funds by Chinese listed companies.

According to Article 9.3.2 of the listing rules, the company's external investments, including investment in financial products, with a cumulative amount more than 50 percent of its last audited net asset value and exceeding CNY 50 million in the previous 12 months, requires shareholder approval. In addition, China Securities Regulatory Commission (CSRC) issued a new regulation in late 2012 to allow listed companies to invest part of their idle raised funds in financial products with approval of shareholders.

ISS recommends a vote on these proposals on a case-by-case basis. Key factors for evaluating such requests include:

- Any known concerns with previous investments;
- The amount of the proposed investment relative to the company's assets;
- Disclosure of the nature of the products in which the company proposes to invest; and
- Disclosure of associated risks of the proposed investments and related risk management efforts by the company.

Voting requirement: this is an ordinary resolution.

Ordinary resolutions can be adopted by a majority of all attending shareholders.

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