



# Hong Kong

## Proxy Voting Guidelines

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Benchmark Policy Recommendations

**Effective for Meetings on or after February 1, 2019**

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## 1. OVERVIEW

Hong Kong companies are required to present the summary of its financial report within four months after the end of the financial year. Public companies must hold their AGM within a period of 15 months from the last convened AGM. The following resolutions are commonly seen at a shareholder meeting:

- › Approval of financial statements and statutory reports;
- › Dividend distribution;
- › Election of directors;
- › Approval of remuneration of directors;
- › Election of supervisors;
- › Auditor appointment and approval of auditor remuneration;
- › Capital raising requests;
- › Compensation proposals.


Other items that may be submitted for shareholder approval include:

- › Related-party transactions;
- › Amendments to articles of associations;
- › Debt issuance requests;
- › Provision of guarantees;
- › Mergers and acquisitions.

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


## 2. OPERATIONAL ITEMS

### Approval of Financial Statements and Statutory Reports

 **General Recommendation:** Vote for approval of financial statements and director and auditor reports, 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.

### Dividend Distribution


 **General Recommendation:** Generally vote 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.

### 3. BOARD OF DIRECTORS

The SEHK listing rules require that at least three independent non-executive directors be appointed to boards of listed companies or at least one-third of the board be independent, whichever is higher. Companies are likewise required to form audit committees composed entirely of non-executive directors, a majority of whom including the chairman must be independent. The committee must have at least one independent director with appropriate professional qualifications or accounting or related financial management expertise. The establishment of a remuneration committee is also required in Hong Kong, and the committee must be majority independent, including the chairman. Insiders are allowed to serve on the remuneration committee so long as the committee is majority independent. Companies listed in Hong Kong must also establish a nomination committee, or explain the reasons of noncompliance. The nomination committee must comprise of a majority of independent directors, and must be chaired by either an independent director or the chairman of the board.

#### Voting for Director Nominees in Uncontested Elections

 **General Recommendation:** Generally vote for the re/election of directors, unless:

##### **Independence:**

- › The nominee has been a partner of the company's auditor within the last three years, and serves on the audit committee;
- › Any non-independent director nominees where the board is less than one-third independent under ISS' classification of directors.
- › The nominee is an executive director serving on the audit committee;
- › The nominee is an executive director serving on the remuneration committee or nomination committee, and the committee is not majority independent;
- › The nominee is a non-independent director serving as the chairman of the audit committee, remuneration committee, and/or nomination committee (except for a non-independent director serving as chairman of the nomination committee who also serves as the chairman of the board).

When the board does not have a formal audit committee, remuneration committee, and/or nomination committee, vote against if:

- › The nominee is an executive director and the board is not majority independent;
- › The nominee is a non-independent chairman of the board.

Under the [ISS Classification of Directors](#), an independent non-executive director shall be considered non-independent if such director serves as a director for more than nine years, if the company fails to disclose the reasons why such director should still be considered independent, or where such reasons raise concerns regarding the director's true level of independence.

##### **Composition:**

- › The nominee has attended less than 75 percent of board and key committee meetings over the most recent fiscal year, without a satisfactory explanation. The calculation of director attendance will not include meetings attended by alternate directors. Acceptable reasons for director absences are generally limited to the following:
  - › Medical issues/illness;
  - › Family emergencies;
  - › The director has served on the board for less than a year; and
  - › Missing only one meeting (when the total of all meetings is three or fewer).

- › The nominee sits on more than six<sup>1</sup> public company boards.

In making any of the above recommendations on the election of directors, ISS generally will not recommend against the election of a CEO, managing director, executive chairman, or founder whose removal from the board would be expected to have a material negative impact on shareholder value.

**Accountability:**

***Problematic Audit-Related Practices***

Generally vote against all members of the audit committee<sup>2</sup> up for reelection if:

- › The non-audit fees paid to the auditor are excessive; or
- › The company did not disclose the audit fees and/or non-audit fees in the latest fiscal year.

***Governance Failures***

Under extraordinary circumstances, vote against or withhold from 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.

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<sup>1</sup> A commitment to reduce the number of boards to six or fewer by the next annual meeting will be considered. The commitment would need to be disclosed prior to the AGM in the relevant meeting materials, such as the meeting notice, circular, or annual report.

<sup>2</sup> Except for directors newly-appointed to the committee or who served on the committee for a partial year, who are considered on a case-by-case basis.

## Classification of Directors

### Executive Director

- › Employee or executive of the company or a wholly-owned subsidiary of the company;
- › Any director who is classified as a non-executive, but receives salary, fees, bonus, and/or other benefits that are in line with the highest-paid executives of the company.

### Non-Independent Non-Executive Director (NED)

- › Any director who is attested by the board to be a non-independent NED;
- › Any director specifically designated as a representative of a shareholder of the company;
- › Any director who is also an employee or executive of a significant<sup>[1]</sup> shareholder of the company;
- › Any director who is also an employee or executive of a subsidiary, associate, joint venture, or company that is affiliated with a significant<sup>[1]</sup> shareholder of the company;
- › Any director who is nominated by a dissenting significant shareholder, unless there is a clear lack of material<sup>[2]</sup> connection with the dissident, either currently or historically;
- › Beneficial owner (direct or indirect) of at least 10 percent of the company's stock, either in economic terms or in voting rights (this may be aggregated if voting power is distributed among more than one member of a defined group, e.g., family members who beneficially own less than 10 percent individually, but collectively own more than 10 percent), unless market best practice dictates a lower ownership and/or disclosure threshold (and in other special market-specific circumstances);
- › Government representative;
- › Currently provides or has provided (or a relative<sup>[3]</sup> provides) professional services<sup>[4]</sup> to the company, to an affiliate of the company, or to an individual officer of the company or of one of its affiliates in the latest fiscal year in excess of USD 10,000 per year;
- › Represents customer, supplier, creditor, banker, or other entity with which the company maintains transactional/commercial relationship (unless company discloses information to apply a materiality test<sup>[5]</sup>);
- › Any director who has a conflicting relationship with the company, including but not limited to cross-directorships with executive directors or the chairman of the company;
- › Relative<sup>[3]</sup> of a current employee or executive of the company or its affiliates;
- › Relative<sup>[3]</sup> of a former employee or executive of the company or its affiliates;
- › A new appointee elected other than by a formal process through the General Meeting (such as a contractual appointment by a substantial shareholder);
- › Founder/co-founder/member of founding family but not currently an employee or executive;
- › Former employee or executive (five-year cooling off period);
- › Directors with a tenure exceeding nine years will be considered non-independent, unless the company provides sufficient and clear justification that the director is independent despite his long tenure.
- › Any additional relationship or principle considered to compromise independence under local corporate governance best practice guidance.

### Independent NED

- › No material<sup>[2]</sup> connection, either directly or indirectly, to the company (other than a board seat) or the dissenting significant shareholder.

### Employee Representative

- › Represents employees or employee shareholders of the company (classified as “employee representative” but considered a non-independent NED).

### Footnotes:

[1] At least 10 percent of the company's stock, unless market best practice dictates a lower ownership and/or disclosure threshold.

[2] For purposes of ISS' director independence classification, “material” will be defined as a standard of relationship financial, personal, or otherwise that a reasonable person might conclude could potentially influence one's objectivity in the boardroom in a manner that would have a meaningful impact on an individual's ability to satisfy requisite fiduciary standards on behalf of shareholders.


[3] “Relative” follows the definition of “immediate family members” which covers spouses, parents, children, stepparents, step-

children, siblings, in-laws, and any person (other than a tenant or employee) sharing the household of any director, nominee for director, executive officer, or significant shareholder of the company.

[4] Professional services can be characterized as advisory in nature and generally include the following: investment banking/financial advisory services; commercial banking (beyond deposit services); investment services; insurance services; accounting/audit services; consulting services; marketing services; and legal services. The case of participation in a banking syndicate by a non-lead bank should be considered a transaction (and hence subject to the associated materiality test) rather than a professional relationship.

[5] A business relationship may be material if the transaction value (of all outstanding transactions) entered into between the company and the company or organization with which the director is associated is equivalent to either 1 percent of the company's turnover or 1 percent of the turnover of the company or organization with which the director is associated. OR, A business relationship may be material if the transaction value (of all outstanding financing operations) entered into between the company and the company or organization with which the director is associated is more than 10 percent of the company's shareholder equity or the transaction value, (of all outstanding financing operations), compared to the company's total assets, is more than 5 percent.

## Voting for Director Nominees in Contested Elections

 **General Recommendation:** 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 and Hong Kong 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.

## 4. BOARD OF SUPERVISORS

Company Law of China requires companies incorporated in the country to establish a supervisory board, and this board should consist 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

▶ **General Recommendation:** Generally vote 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.

## 5. REMUNERATION

### Director Fees

▶ **General Recommendation:** Generally vote for resolutions regarding directors' fees unless they are excessive relative to fees paid by other companies of similar size.

### Equity Compensation Plans

▶ **General Recommendation:** Generally vote for an equity-based compensation plan unless:

- › The maximum dilution level for the scheme, together with all outstanding schemes, exceeds 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 for all outstanding schemes of up to 10 percent if each individual 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. In addition, ISS will support a plan's dilution limit that exceeds these thresholds if the annual grant limit under all plans is 0.5 percent or less for a mature company (1 percent or less for a mature company with clearly disclosed performance criteria) and 1 percent or less for a growth company.
- › The plan permits options to be issued with an exercise price at a discount to the current market price; or
- › Directors eligible to receive options or awards under the scheme are involved in the administration of the scheme and the administrator has the discretion over their awards.



## A-share Stock Option Schemes and Performance Share Schemes

▶ **General Recommendation:** Vote against a stock option and/or performance share scheme if:

- › Pricing basis - The plan permits the exercise price of the stock options and/or grant price of the performance shares<sup>3</sup> to be set at an unreasonable price<sup>4</sup> compared to the market price without sufficient justification;
- › Dilution - The maximum dilution level for the scheme exceeds 10 percent of issued capital; or 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 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;
- › Performance benchmark - 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 and/or performance shares 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); or
- › Incentive plan administration - Directors eligible to receive options and/or performance shares under the scheme are involved in the administration of the scheme.

## Employee Stock Purchase Plans

▶ **General Recommendation:** Generally vote for employee stock purchase plans (ESPPs) unless any of the following applies:

- › The total stock allocated to the ESPP exceeds 10 percent of the company's total shares outstanding at any given time;
- › The share purchase price is less than 90 percent of the market price<sup>5</sup> when the share purchase is conducted solely through private placement;
- › The company's significant shareholders (i.e. individuals with 5 percent or more of beneficial ownership of the company) are involved as plan participants;
- › The ESPP is proposed in connection with an equity financing scheme which does not warrant shareholder support; or
- › The ESPP contains any other terms that are deemed disadvantageous to shareholders.

<sup>3</sup> Performance share, termed as "restricted stock" literally in Chinese by companies incorporated in China, is a type of stock award that is commonly granted as a performance-based incentive in the market. The shares issued under such performance share plans are immediately locked after issuance, and will only be vested upon completion of certain performance conditions.

<sup>4</sup> The Administrative Measures on the Equity-based Incentive Schemes of Listed Companies recommends the following pricing basis:

- › Performance share grant price - the higher of the two: 1) the average trading price one day before the announcement day; 2) the average trading price 20, 60, or 120 days before the announcement day.
- › Stock option exercise price - the higher of the two: 1) the average trading price one day before the announcement day; 2) the average trading price 20, 60, or 120 days before the announcement day.

<sup>5</sup> Calculated as the average trading price 20 trading days prior to the announcement, pursuant to the CSRC's guidelines on private placements.

## 6. AUDIT

▶ **General Recommendation:** Vote for 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
- › The non-audit fees exceed half the total fees paid to the external auditor in the latest fiscal year without satisfactory explanation.

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 the most recent fiscal year, ISS will ordinarily not recommend support for the reappointment of the audit firm. In circumstances where non-audit fees include fees related to significant one-time transactional fees that were accrued due to special projects or capital structure events (such as initial public offerings, bankruptcy emergence, and spin-offs) and the company makes public disclosure of the amount and nature of those fees that are an exception to the standard "non-audit fee" category, then such fees may be excluded from the non-audit fees considered in determining the ratio of non-audit to audit/audit-related fees for purposes of determining whether non-audit fees are excessive.

## 7. SHARE ISSUANCE REQUESTS

### General Issuance Mandate

▶ **General Recommendation:** Generally vote for the general share issuance mandate for companies that:

- › Limit the issuance request to 10 percent or less of the relevant class of issued share capital;
- › Limit the discount to 10 percent of the market price of shares (rather than the maximum 20 percent permitted by the Listing Rules); and
- › Have no history of renewing the general issuance mandate several times within a period of one year which may result in the share issuance limit exceeding 10 percent of the relevant class of issued share capital within the 12 month period.

### Discussion

Hong Kong companies routinely seek shareholder approval to authorize their boards to:

- › Issue shares up to 20 percent of existing capital without preemptive rights (General Issuance Mandate);
- › Repurchase shares of up to 10 percent of issued capital (Repurchase Mandate); and
- › Reissue repurchased shares by extending the General Issuance Mandate to include the number of shares repurchased (Share Reissuance Mandate).

This section deals with the General Issuance Mandate, while the other two mandates are discussed below. The interrelationship between the three items is, however, extremely important because the Share Reissuance Mandate

extends the board's authority to issue shares without preemptive rights from 20 percent to 30 percent, assuming a 20 percent request has been made under the General Issuance Mandate.

Hong Kong companies routinely ask shareholders to grant the board of directors a "general mandate to issue shares" without preemptive rights, at least once every year. This mandate, pursuant to the Listing Rules, allows companies to issue shares of up to 20 percent of issued capital without preemptive rights at a discount to market prices of up to 20 percent (or more under special circumstances). This is a routine item on AGM agendas, but companies can also seek to renew (or "refresh") the share issuance amount at an EGM later in the year. The authority is limited to one year or the next general meeting, as revoked or renewed by shareholders.

## Share Repurchase Plans (Repurchase Mandate)

► **General Recommendation:** Generally vote for resolutions seeking for share repurchase mandate.

### Discussion

The Hong Kong Code on Share Repurchases, enacted in 1991, made stock repurchases legal under specific guidelines. Companies usually request the authority under the title "General Mandate to Repurchase Shares," and the authority lasts for one year or until the next shareholder meeting. Repurchase programs are limited to 10 percent of the company's outstanding capital on the date the authority is granted. In addition, the funds to make the repurchases should be obtained from reserves established or authorized for this purpose. Companies are allowed to purchase ordinary shares or warrants on the open market through brokers, but purchases cannot knowingly be made from specific individuals or shareholders. Repurchased shares must be destroyed and removed from the company's issued capital. In some cases, however, the company seeks separate authority to reissue the shares repurchased over and above the General Issuance Mandate (see "Share Reissuance Mandate," below).

## Reissuance of Shares Repurchased (Share Reissuance Mandate)

► **General Recommendation:** Generally vote for the share reissuance mandate for companies that:

- › Limit the aggregate issuance request - that is, for the general issuance mandate and the share reissuance mandate combined - to 10 percent or less of the relevant class of issued share capital;
- › Limit the discount to 10 percent of the market price of shares (rather than the maximum 20 percent permitted by the Listing Rules); and
- › Have no history of renewing the general issuance mandate several times within a period of one year.

### Discussion

Companies may request board authorization to reissue any shares repurchased during the year under the Repurchase Mandate without limiting the General Issuance Mandate. This is known as the Share Reissuance Mandate. This authority is limited to shares repurchased in a given year and is thus limited to the maximum 10 percent allowed under the Repurchase Mandate. It is valid for one year. The Share Reissuance Mandate extends the board's authority to issue shares without preemptive rights from 20 percent to 30 percent, assuming that a 20 percent request has been made under the General Issuance Mandate.

The Share Reissuance Mandate gives the board power to issue shares on the same terms and conditions (for example, in relation to discount to market price) as exist under the General Issuance Mandate.

## A-share Private Placement Issuance Requests

- ▶ **General Recommendation:** Vote case-by-case on share issuance requests, with reference to the identity of the placees, the use of proceeds, and the company's past share issuance requests.

### Discussion

Share issuance requests allow companies to issue shares to raise funds for general financing purposes. In the Measures for the Administration of the Issuance of Securities by Listed Companies 2006 and the Detailed Rules for Private Placement by Listed Companies, the China Securities Regulatory Commission (CSRC) stipulates the following regarding public rights offerings:

- › 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 a subscription rate of no less than 70 percent. The controlling shareholder is required to make a public commitment to indicate the number of rights to which it will subscribe.

In the Chinese market, the rights issued are non-renounceable rights, which are not transferable and cannot be traded in the open market. The trading of rights issued in the A-share market was terminated by the CSRC in June 1996. Investors therefore could not sell their entitlements for a cash value to, in turn, compensate for the losses in their percentage of ownership should they decide not to exercise the rights entitlements.

Further, given the high level of retail investors' participation in the market, a portion of the rights issued are often left unexercised due to the lack of awareness of these investors, resulting in increased control by the controlling shareholder at a steep discount via the public rights offering.

The Detailed Rules for Private Placement by Listed Companies stipulates the following regarding share private placements:

- › 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 prior to the first day of the issuance period;
- › The lock-up period of the shares shall be 12 months for unaffiliated investors and 36 months for the controlling shareholder and actual controlling person of the company;
- › A cooling-off period of at least 18 months from the last share issuance should be in place;
- › The resulting dilution from a private share placement should be capped at 20 percent of the company's total shares outstanding prior to the share issuance.

Chinese companies do not ask for general mandates to issue shares to third parties, rather they seek shareholder approval for a specific issuance.

## 8. 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 Hong Kong - 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.

### Group Finance Companies

▶ **General Recommendation:** Vote against requests to deposit monies with a group finance company.

#### Discussion

It is not uncommon for large Chinese companies listed in Hong Kong 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.

## 9. AMENDMENTS TO ARTICLES OF ASSOCIATION/COMPANY BYLAWS

### Articles and Bye-law Amendments

▶ **General Recommendation:** Vote case-by-case on proposed amendments to the Articles and Bye-Laws based on the details of the proposed amendments provided by the company.

In the absence of adequate information that would specify the details of proposed amendments, generally vote against:

- › The proposed amendments;
- › The adoption of new Articles of Association; or
- › The replacement of the current constitutional document.

Vote case-by-case on the adoption of new constitutional document with no previous reference.

## Communist Party Committee

- ▶ **General Recommendation:** Generally vote against proposals for article and/or bylaw amendments regarding Party Committees where the proposed amendments lack transparency or are not considered to adequately provide for accountability and transparency to shareholders.

### Discussion

Driven by the corporate reforms initiated by the China Communist Party, the regulatory enforcements to legitimize the existence of a Communist Party Committee or to establish one in state-owned enterprises (SOEs) have prompted listed SOEs to amend their articles, while non-SOEs have begun to follow suit. Such committees' members are not necessarily directors elected by shareholders, nor are they carrying out their duties as transparently as any board members or held accountable to shareholders. However, whilst no regulations explicitly grant the Party Committee the authority to override a company's board of directors, many proposals have included provisions that will modify the board representation and allow the Party Committee to assert disproportionate influence over the board. These issues raise governance concerns. Given that most companies neither delineate the responsibilities of the Party Committee from those of the board of directors or its key committees, nor specify clearly the actual interaction between the two when making material decisions, a more stringent approach is requested by institutional investors and market participants, including issuers, in general.

## 10. CAPITAL

### Debt Issuance Requests

- ▶ **General Recommendation:** Vote case-by-case on non-convertible debt issuance requests, with or without preemptive rights.

Vote for the creation/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.

Vote for proposals to restructure existing debt arrangements unless the terms of the restructuring would adversely affect the rights of shareholders.

In evaluating debt-related 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 dates? 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? Are there any alternative sources of funding? Could the company continue to fund its operations? Would it hinder the company's ability to realize opportunities?

A distinction will be made between a specific debt issuance or pledging of assets, and authority to issue or increase debt; as in the case of specific equity issuances and requests for authority to issue equity. For specific debt issuances or pledging of assets, while the above factors will be examined, in general a vote for these proposals will be warranted 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 proposals); and
- › There are no significant causes for shareholder concern regarding the terms and conditions of the debt.

So long as the proposal meets the above conditions, a vote for will be warranted even if the company has a high level of debt or the proposed issuance could result in a large increase in debt. An against vote will be warranted only in extremely egregious cases or where the company fails to provide sufficient information to enable a meaningful shareholder review.

Where a general authority to issue debt or pledge assets is requested, in addition to the above criteria, we will oppose such 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.

When the above conditions are met, the proposed increase in debt may be considered excessive, and thus, the proposal may warrant an against vote. If we do not have data regarding the normal level of debt in that particular industry or market, only the company-specific information will be considered.

### Adjustments of Conversion Price of Outstanding A-share Convertible Bonds

- ▶ **General Recommendation:** Generally vote against the downward adjustment of the conversion price of A-share convertible bonds unless the proposed adjusted conversion price is deemed reasonable given the company's justification; and the company is under extraordinary circumstances, such as liquidation or debt restructuring process due to financial distress.

### Pledging of Assets for Debt

- ▶ **General Recommendation:** Vote for proposals to approve the specific pledging of assets for debt 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; and
- › There are no significant causes for shareholder concern regarding the terms and conditions of the debt.

For proposals seeking a general authority to pledge assets for debt, the specific assets to be pledged need not be disclosed. However, in such cases, the authority should be limited such that it would not result in an excessive increase in debt. If the proposal grants excessive authority to the board or management, a vote against will be recommended.

In certain countries, shareholder approval is required when a company needs to secure a debt issuance with its assets. In many cases, this is a routine request and is a formality under the relevant law. When reviewing such proposals, ISS takes into account the terms of the proposed debt issuance, the company's overall debt level, and the company's justification for the pledging of assets.

ISS will issue vote recommendations against specific requests to pledge an asset in cases where no information regarding the size of the debt to be raised is disclosed, no credible explanation for the need of funding is provided, no

details regarding the assets to be pledged are disclosed, or in extreme cases where shareholders' rights and economic interests could be negatively affected.

### Increase in Borrowing Powers

- ▶ **General Recommendation:** Vote for proposals to approve increases in a company's borrowing powers if:
- › The size of the debt being requested is disclosed;
  - › A credible reason for the need for additional funding is provided;
  - › The potential increase in debt is not excessive; and
  - › There are no significant causes for shareholder concerns regarding the terms and conditions of the debt.

In some countries, companies are required to seek shareholder approval for increases in their aggregate borrowing power authorities. The aggregate limit on the board's ability to borrow money is often fixed in a company's articles, and shareholder approval to change this limit is therefore legally required. ISS' analysis of borrowing power increase requests takes into account management's stated need for the increase, the size of the increase, and the company's current gearing level. Large increases in borrowing powers can sometimes result in dangerously high debt-to-equity ratios that could harm shareholder value. If no information regarding the limit on the borrowing power is disclosed, no credible explanation for the need of funding is provided, or an increase is excessive considering the company's debt level as well as normal levels of debt in its industry or market, ISS recommends opposing the request.

### Loan Guarantee Requests

Chinese companies listed in Hong Kong often provide loan guarantees for subsidiaries, affiliates, and related parties.

- ▶ **General Recommendation:** Loan guarantee 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, 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.

## 11. MERGERS & ACQUISITIONS

- ▶ **General Recommendation:** Vote case-by-case on mergers and acquisitions, 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.

## 12. SOCIAL AND ENVIRONMENTAL ISSUES

Issues covered under the policy involve a wide range of topics, including consumer and product safety, environment and energy, labour covered standards and human rights, workplace and board diversity, and corporate political issues. While a variety of factors goes into each analysis, the overall principle guiding all vote recommendations focuses on how the proposal may enhance or protect shareholder value in either the short term or long term.



**General Recommendation:** Generally vote case-by-case, examining primarily whether implementation of the proposal is likely to enhance or protect shareholder value. The following factors will be considered:

- › If the issues presented in the proposal are more appropriately or effectively dealt with through legislation or government regulation;
- › If the company has already responded in an appropriate and sufficient manner to the issue(s) raised in the proposal;
- › Whether the proposal's request is unduly burdensome (scope or timeframe) or overly prescriptive;
- › The company's approach compared with any industry standard practices for addressing the issue(s) raised by the proposal;
- › Whether there are significant controversies, fines, penalties, or litigation associated with the company's environmental or social practices;
- › If the proposal requests increased disclosure or greater transparency, whether reasonable and sufficient information is currently available to shareholders from the company or from other publicly available sources; and
- › If the proposal requests increased disclosure or greater transparency, whether implementation would reveal proprietary or confidential information that could place the company at a competitive disadvantage.

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