GLASS LEWIS

2020

PROXY PAPER™

# GUIDELINES

AN OVERVIEW OF THE GLASS LEWIS APPROACH TO PROXY ADVICE

# CHINA

# Table of Contents

# Guidelines Introduction

## GOVERNANCE CODE AND REGULATIONS

Chinese corporate governance is centered primarily around (i) the Company Law of 1993 (as amended, "Company Law"); (ii) the Securities Law of 1998 (as amended); (iii) the Code of Corporate Governance for Listed Companies in China (the "Code"); and (iv) the Listing Rules of the Shanghai and Shenzhen stock exchanges ("Listing Rules"). The principal regulatory agency for public companies in China is the China Securities Regulatory Commission, which continuously works to enhance regulations pertaining to a wide range of related matters such as corporate governance and the exchange of securities.

# A Governance Structure that Serves the Interests of Shareholders

## STRUCTURE OF BOARDS OF DIRECTORS AND SUPERVISORS

In accordance with the Company Law, Chinese companies may elect to be governed by a two-tier board structure consisting of the board of directors and board of supervisors. The board of directors typically comprises executive, non-executive and independent directors. The board of supervisors typically comprises shareholder and employee representatives with limited independent representation. Employee representatives are elected by a company's employees and shareholder representatives are elected by a company's shareholders. The board of supervisors provides oversight of the financial affairs of a company and supervises members of the board of directors and management, while the board of directors makes decisions related to a company's business and investment strategies.

## ELECTION OF BOARD OF DIRECTORS

The purpose of Glass Lewis' proxy research and advice is to facilitate shareholder voting in favor of governance structures that will drive performance, create shareholder value and maintain a proper tone at the top. Glass Lewis looks for talented boards with a record of protecting shareholders and delivering value over the medium- and long-term. We believe that boards working to protect and enhance the best interests of shareholders are sufficiently independent, have a record of positive performance, and have members with a breadth and depth of experience.

### INDEPENDENCE OF DIRECTORS

The independence of directors, or lack thereof, is ultimately demonstrated through the decisions they make. In assessing the independence of directors, we will take into consideration, when appropriate, whether a director has a track record indicative of making objective decisions. Ultimately, whether a director is independent or not must take into consideration both compliance with applicable independence listing requirements, historical conduct and whether the director has a track record that indicates a lack of objective decision making.

We look at each director nominee to examine the director's relationships with the company, the company's executives, and other directors to determine if personal, familial, or financial relationships (not including director compensation) may impact the director's decisions. We believe that such relationships make it difficult for a director to put shareholders' interests above the director's or the related party's interests.

Thus, we put directors into three categories based on an examination of the type of relationship they have with the company:

> **Independent Director** — An independent director has no material[1] financial, familial[2] or other current relationships with the company[3], its executives, or other board members, except for board service and standard fees paid for that service. An individual who has been employed by the company

1 A material relationship is one in which the dollar value exceeds 1% of either company's consolidated gross revenue for other business relationships (e.g., where the director is an executive officer of a company that provides services or products to or receives services or products from the company).
2 Familial relationships include a person's spouse, parents, children, siblings, grandparents, uncles, aunts, cousins, nieces, nephews, in-laws, and anyone (other than domestic employees) who shares such person's home. A director is an affiliate if the director has a family member who is employed by the company.
3 A company includes any parent or subsidiary in a group with the company or any entity that merged with, was acquired by, or acquired the company.

within the past five years[4] is not considered to be independent. We use a three-year look-back for all relationships[5] other than employment.

**Affiliated Director** — An affiliated director has a material financial, familial or other relationship with the company or its executives, but is not an employee of the company.[6] This includes a director who owns or controls 1% or more of the company's voting stock or is a spouse, father, mother or child of a shareholder who owns or controls 1% or more of the company's voting stock[7]. Also, directors who hold a position in a unit which holds more than 5% of the company's voting stock or a director who is such employee's spouse, father, mother or child is considered affiliated. In addition, where we find independent non-executive directors receiving additional compensation in the form of salaries, allowances and/or emoluments that exceed 50% of a director's normal fee-based compensation, we will consider such independent directors as being affiliated.

**Inside Director** — An inside director simultaneously serves as a director and as an employee of the company. This category may include a board chair who acts as an employee of the company or is paid as an employee of the company.

### Voting Recommendations on the Basis of Board Independence

Glass Lewis believes that a board of directors will most effectively perform the oversight necessary to protect the interests of shareholders if it is independent. As recommended in the Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies (the "Guidelines")[8], we believe that at least one-third of the board should be independent. In the event that less than one-third of the directors are independent, we typically[9] recommend voting against some of the inside and/or affiliated directors in order to satisfy the independence threshold we believe is appropriate.

In determining our recommendation as to who we may recommend shareholders vote against for board independence, we will reserve discretion to not recommend against a company's CEO or managing director. In particular, given the importance of the executive's role, if the executive has no other issues that would warrant a negative recommendation, we will exempt such directors from receiving an against recommendation. However, should the executive have additional issues that would warrant an against recommendation, we will generally oppose the reelection of such executives on the basis of the board being insufficiently independent.

Pursuant to the Guidelines, independent directors' terms shall be three years and they shall not be elected to more than two consecutive terms. In addition, we scrutinize avowedly "independent" chairs. We believe that they should be unquestionably independent or the company should not tout them as such.

## PERFORMANCE OF DIRECTORS

The most crucial test of a board's commitment to the company and its shareholders lies in the actions of the board and its members. We look at the performance of these individuals as directors and executives of the company and of other companies where they have served. We also look at how directors voted while on the board.

4 In our view, a five-year standard is appropriate because we believe that the unwinding of conflicting relationships between former management and board members is more likely to be complete and final after five years. However, Glass Lewis does not apply the five-year look-back period to directors who have previously served as executives of the company on an interim basis for less than one year.

5 The Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies (the "Guidelines") uses a one-year look-back period for most relationships.

6 If a company classifies a director as non-independent, Glass Lewis will classify that director as an affiliate, unless there is a more suitable classification (i.e., shareholder representative or employee representative). Moreover, in cases where there is a conflict between Glass Lewis' classification method and the classification used by the company, the latter will prevail.

7 We view 1% shareholders as affiliates because they typically have access to and involvement with the management of a company that is fundamentally different from that of ordinary shareholders. More importantly, 1% holders may have interests that diverge from those of ordinary holders, for reasons such as the liquidity (or lack thereof) of their holdings, personal tax issues, etc.

8 A comply-or-explain code issued by the China Securities Regulatory Commission (CSRC) on August 16, 2001. The guideline, which covers all companies listed on the Chinese stock exchange but not Chinese companies listed outside China, includes specific rules on the definition of independence as well as gives independent directors more power with regard to board functions.

9 With a staggered board, if the affiliates or insiders that we believe should not be on the board are not up for election, we will express our concern regarding those directors.

### Voting Recommendations on the Basis of Performance:

We disfavor directors who have a record of not fulfilling their responsibilities to shareholders at any company where they have held a board or executive position. We typically recommend voting against:

1. **Poor Attendance** — A director who fails to attend a minimum of 75% of the board meetings or 75% of the total of applicable committee meetings and board meetings.[10] Attendance via proxy will not be counted toward fulfilling this standard.

2. **Serious and Material Restatement** — A director who is also the CEO of a company where a serious and material restatement has occurred after the CEO had previously certified the pre-restatement financial statements.

3. **Company Performance** — In the event a company's performance has been consistently lower than its peers and the board has not taken reasonable steps to address the poor performance, we will consider voting against all members of the board.

## EXPERIENCE OF DIRECTORS

We find that a director's past conduct is often indicative of future conduct and performance. We often find directors with a history of overpaying executives or of serving on boards where avoidable disasters have occurred appearing at companies that follow these same patterns. Glass Lewis has a proprietary database that tracks the performance of directors across companies worldwide.

We typically recommend that shareholders vote against directors who have served on boards or as executives of companies with records of poor performance, overcompensation, audit- or accounting-related issues, and/or other indicators of mismanagement or actions against the interests of shareholders.[11]

Additionally, we recommend the board include at least one non-executive director with core industry experience. Likewise, we examine the backgrounds of those who serve on key board committees to ensure that they have the required skills and diverse backgrounds to make informed judgments about the subject matter for which the committee is responsible.

## DIRECTOR COMMITMENTS[12]

We believe that directors should have the necessary time to fulfill their duties to shareholders. In our view, an overcommitted director can pose a material risk to a company's shareholders, particularly during periods of crisis. In addition, recent research indicates that the time commitment associated with being a director has been on a significant upward trend in the past decade.[13] As a result, we generally recommend that shareholders vote against a director who serves as an executive officer of any public company while serving on more than two public company boards and any other director who serves on more than five public company boards. We will count directors who serve as board chairs in select other non-Asian markets, per our global policies, as two board seats given the time commitment of directorship in those markets. Academic literature suggests that one board takes up approximately 248 hours[14] per year of each member's time.

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10 However, where a director has served for less than one full year, we will typically not recommend voting against the director for failure to attend 75% of meetings. Rather, we will note the failure with a recommendation to track this issue going forward. We will also refrain from recommending voting against directors when the proxy discloses that the director missed meetings due to serious illness or other extenuating circumstances. However, in practice, many Chinese companies only disclose attendance rates for independent directors. Pursuant to the Guidelines, independent directors who are absent from the board meeting in person three consecutive times should be replaced.

11 We typically apply a three-year look-back to such issues and also examine whether the responsible directors have been up for election since the time of the failure.

12 Directorship and supervisorship in public companies are considered.

13 NACD Public Company Governance Survey 2015-2016. p. 22.

14 *Ibid.*

Because we believe that executives will primarily devote their attention to executive duties, we generally will not recommend that shareholders vote against overcommitted directors at the companies where they serve as an executive.

When determining whether a director's service on an excessive number of boards may limit the ability of the director to devote sufficient time to board duties, we may consider relevant factors such as the size and location of the other companies where the director serves on the board, the director's board roles at the companies in question, whether the director serves on the board of any large privately-held companies, the director's tenure on the boards in question, and the director's attendance record at all companies.

We may also refrain from recommending against certain directors if the company provides sufficient rationale for their continued board service. The rationale should allow shareholders to evaluate the scope of the directors' other commitments as well as their contributions to the board, including specialized knowledge of the company's industry, strategy or key markets, the diversity of skills, perspective and background they provide, and other relevant factors. We will also generally refrain from recommending to vote against a director who serves on an excessive number of boards within a consolidated group of companies or a director that represents a firm whose sole purpose is to manage a portfolio of investments which include the company.

## CONFLICT OF INTEREST

- **Professional Services and Business Transactions** — We do not believe that a director who has provided material professional services, or a director who is an immediate family member of whom has provided such services, during the last fiscal year or on an ongoing basis, should serve on the board. Material professional services may include legal, consulting or financial services to the company. Also a director who engages – or has a family member of whom engages – in business contracts with the company such as purchase or sales agreement will have to make unnecessarily complicated decisions that may pit their interests against those of the shareholders they serve. With a limited exception, we will recommend voting against a director if his/her direct/indirect related party transactions exceed any of the following thresholds: (i) US$50,000 or no disclosure for personal direct transactions; (ii) US$100,000 for indirect transactions with an entity in which a director holds more than 50% interest; (iii) US$100,000 for indirect professional services transactions with a professional services firm in which a director works for; or (iv) 1% of a company's consolidated gross revenue for indirect transactions with an entity in which a director serves as an executive. In light of the nature of intra group transactions of a controlled entity, in which the parent entity controls more than 50% of the shares, we will refrain from recommending shareholders vote against such transactions.

- **Interlocking Directorships** — CEOs or other top executives who serve on each other's boards create an interlock that poses conflicts that should be avoided to ensure the promotion of shareholder interests above all else[15].

## SIZE OF THE BOARD OF DIRECTORS

While we do not believe there is a universally applicable optimum board size, we do believe boards should have at least five directors to ensure sufficient diversity in decision-making and to enable the formation of key board committees with independent directors. Conversely, we believe that boards with more than twenty members will typically suffer under the weight of "too many cooks in the kitchen" and have difficulty reaching consensus and making timely decisions. Sometimes the presence of too many voices can make it difficult to draw on the wisdom and experience in the room by virtue of the need to limit the discussion so that each voice may be heard.

To that end, we typically recommend voting against the board chair[16] if a board has: (i) fewer than five directors or (ii) more than twenty directors.

15 There is no look-back period for this situation. This only applies to public companies and we only footnote it for the non-insider.

16 In the event that a committee system has been adopted, we will recommend voting against the nominating committee chair.

## SEPARATION OF THE ROLES OF BOARD CHAIR AND CEO

Glass Lewis believes that separating the roles of corporate officer and chair creates a better governance structure than a combined executive/chair position. An executive manages the business according to a course the board charts. Executives should report to the board regarding their performance in achieving goals the

board sets. This is needlessly complicated when a CEO sits on or chairs the board, since a CEO presumably will have a significant influence over the board.

It can become difficult for a board to fulfill its role of overseer and policy setter when a CEO/chair controls the agenda and the boardroom discussion. Such control can allow a CEO to have an entrenched position, leading to longer-than-optimal terms, fewer checks on management, less scrutiny of the business operation, and limitations on independent, shareholder-focused goal-setting by the board.

A CEO should set the strategic course for the company, with the board's approval, and the board should enable the CEO to carry out the CEO's vision for accomplishing the board's objectives. Failure to achieve the board's objectives should lead the board to replace that CEO with someone in whom the board has confidence.

Likewise, an independent chair can better oversee executives and set a pro-shareholder agenda without the management conflicts that a CEO or other executive insiders often face. Such oversight and concern for shareholders allows for a more proactive and effective board of directors that is better able to look out for the interests of shareholders.

We do not recommend that shareholders vote against CEOs who serve on or chair the board. However, we typically encourage our clients to support separating the roles of chair and CEO whenever that question is posed in a proxy (typically in the form of a shareholder proposal), as we believe that it is in the long-term best interests of the company and its shareholders.

## BOARD EVALUATION AND REFRESHMENT

Glass Lewis strongly supports routine director evaluation, including independent external reviews, and periodic board refreshment to foster the sharing of diverse perspectives in the boardroom and the generation of new ideas and business strategies. Further, we believe the board should evaluate the need for changes to board composition based on an analysis of skills and experience necessary for the company, as well as the results of the director evaluations, as opposed to relying solely on age or tenure limits. When necessary, shareholders can address concerns regarding proper board composition through director elections.

In our view, a director's experience can be a valuable asset to shareholders because of the complex, critical issues that boards face. This said, we recognize that in rare circumstances, a lack of refreshment can contribute to a lack of board responsiveness to poor company performance.

On occasion, age or term limits can be used as a means to remove a director for boards that are unwilling to police their membership and enforce turnover. Some shareholders support term limits as a way to force change in such circumstances.

While we understand that age limits can aid board succession planning, the long-term impact of age limits restricts experienced and potentially valuable board members from service through an arbitrary means. We believe that shareholders are better off monitoring the board's overall composition, including its diversity of skill sets, the alignment of the board's areas of expertise with a company's strategy, the board's approach to corporate governance, and its stewardship of company performance, rather than imposing inflexible rules that don't necessarily correlate with returns or benefits for shareholders.

However, if a board adopts term/age limits, it should follow through and not waive such limits. If the board waives its term/age limits, Glass Lewis will consider recommending shareholders vote against the nominating and/or governance committees, unless the rule was waived with sufficient explanation, such as consummation of a corporate transaction like a merger.

### GENDER DIVERSITY ON BOARDS

Glass Lewis recognizes the importance of ensuring that the board is comprised of directors who have a diversity of skills, thought and experience, as such diversity benefits companies by providing a broad range of perspectives and insights. As with previous years, Glass Lewis will continue to closely review the composition of the board and may note as a concern instances where we believe the board lacks representation of diverse director candidates, including those boards which have no female directors.

Glass Lewis will carefully review a company's disclosure of its diversity considerations and may refrain from recommending shareholders vote against directors when boards have provided a sufficient rationale for not having any female board members or where boards have disclosed a plan to address the lack of diversity on the board.

## BOARD COMMITTEES

Pursuant to the Code of Corporate Governance for Listed Companies in China (the "Code"),[17] listed companies may establish an audit committee, a remuneration committee and a nominating committee in addition to other committees, in accordance with a shareholder resolution. According to the Code, a company's audit, remuneration and nominating committees should consist of a majority of independent directors.[18] In addition, in accordance with the Code, the audit committee chair must be an independent director with appropriate professional accounting or financial management expertise. The audit, remuneration and nominating committees must be chaired by an independent director.[19] While we accept the standards provided by the Code for a nomination committee, our standards for membership in the audit and remuneration committees part ways with the Code, as set forth in greater detail in the following sections.

We typically recommend that shareholders vote against any affiliated or inside director seeking appointment to an audit, remuneration or nominating committee when the committee does not comprise a majority of independent directors.

### AUDIT COMMITTEE PERFORMANCE

An audit committee is required to consist of a majority of independent directors in accordance with the Code. Glass Lewis, however, believes that an audit committee should consist solely of independent non-executive directors given its integral role in monitoring the work that management and the auditors perform in the accounting and financial reporting process.

When assessing an audit committee's performance, we are aware that an audit committee performs a critical role by ensuring the provision of adequate information and explanation to the auditor, which is essential for it to be able to conduct a proper audit of the Company's accounts. The quality and integrity of the financial statements and earnings reports, the completeness of disclosures necessary for investors to make informed decisions, and the effectiveness of the internal controls should provide reasonable assurance that the financial statements are materially free from errors. The independence of the external auditors and the results of their work also provide useful information by which to assess the audit committee.

For an audit committee to function effectively, it must include members with sufficient knowledge and financial expertise to diligently carry out their responsibilities. We are skeptical of audit committees with members that lack expertise as a Certified Public Accountant (CPA), Chief Financial Officer (CFO), corporate controller or other similar experience.

17 A comply-or-explain code issued by the China Securities Regulatory Commission.
18 The Code, Article 38.
19 *Ibid.*

Thus, we would recommend voting against the following members under the following circumstances[20]:

1. Any audit committee member who is not considered independent based on our research.

2. The audit committee chair, if the audit committee does not have a financial expert or the committee's financial expert does not have a demonstrable financial background sufficient to understand the financial issues unique to public companies.

3. The audit committee chair if the committee has less than three members.

4. The audit committee chair if the audit committee met less than four times during the previous fiscal year.

5. The audit committee chair if the company has failed to disclose the auditor fees or a breakdown thereof.

6. All members of an audit committee in office when the company paid excessive fees[21] to its independent auditor for non-audit services[22].

7. All members of an audit committee in office when material accounting fraud occurred at the company or financial statements had to be restated due to serious material fraud.

8. All members of an audit committee in office when the company repeatedly fails to file its financial reports in a timely fashion two or more years in a row.[23]

9. All members of an audit committee in office when the company and the board failed to provide adequate financial information to the independent auditor.

## REMUNERATION COMMITTEE PERFORMANCE

A remuneration committee is required to consist of a majority of independent directors in accordance with the Code. However, we believe it is crucial for the remuneration committee to be in the position of reviewing and evaluating executives' performance and pay and providing fair and appropriate remuneration to reward their efforts. This oversight is likely to be more complicated and less rigorous when an executive serves on the committee that determines his/her compensation. Therefore, we believe that a remuneration committee should be comprised of only non-executive directors, a majority of whom are independent.

Remuneration committees have the final say in determining the compensation of executives. This includes deciding the bases on which compensation is determined, as well as the amounts and types of compensation to be paid. This process begins with the hiring and initial establishment of employment agreements, including the terms for items such as pay, pensions and severance arrangements. In establishing remuneration arrangements, pay levels should be consistent with – and based on – the performance of the company's long-term shareholders' returns.

The remuneration committee is also responsible for overseeing the transparency of compensation structures. This oversight includes the disclosure of compensation arrangements, the matrix used in assessing pay for

20 Where the recommendation is to vote against the committee chair and the chair is not up for election, we do not recommend voting against any members of the committee who are up for election; rather, we will simply express our concern with regard to the committee chair. In the absence of an audit committee, we will recommend voting against the board chair.

21 Where audit and audit-related fees total less than 50% of the total fees billed by the auditor.

22 In China, companies are not required to disclose auditor compensation. Under the Company Law, appointment or removal of independent auditors should be approved by shareholders or the board of directors.

23 The Company Law requires listed companies to prepare and publish their financial and accounting reports at the end of each fiscal year. These reports should include the company's balance sheet, income statement, cash flow statement, and profit and loss statement. The accounting reports of listed companies should be available for shareholder inspection at the company's premise.

performance and the use of remuneration consultants. It is important for investors to have a clear and complete disclosure of all the significant terms of compensation arrangements in order for them to judge the decisions of the remuneration committee.

Finally, remuneration committees are responsible for the oversight of internal controls in the executive compensation process. This includes controls over gathering information used to determine compensation, the establishment of equity award plans and the granting of equity awards. Lax controls can contribute to conflicting information being obtained, possibly through the use of nonobjective consultants, for example. Lax controls can also contribute to improper awards, such as backdated or spring-loaded options, or bonuses for years when the payment triggers were not met.

We evaluate remuneration committee members on the basis of their performance while serving on the remuneration committee in question, not for actions taken solely by prior committee members who are not currently serving on the committee.

Thus, we would recommend voting against remuneration committee members under the following circumstances:

1. Any remuneration committee member who serves as an executive at the company.

2. All members of the remuneration committee (during the relevant time period) if: (i) the company entered into excessive employment agreements and/or severance agreements; (ii) performance goals were lowered when employees failed or were unlikely to meet original goals, or performance-based compensation was paid despite goals not being attained; or (iii) excessive employee perquisites and benefits were allowed.

3. All remuneration committee members who are up for election and served at the time when the company entered into excessive employment agreements and/or the non-executive directors of the company received compensation other than base fees and equity-based compensation.

4. The remuneration committee chair, if non-executive directors of the company received compensation other than base fees and equity-based compensation.

5. The remuneration committee chair if the committee has less than three members.

6. The remuneration committee chair if the remuneration committee did not meet during the year, but should have (e.g., because executive compensation was restructured or a new executive was hired).

## NOMINATING COMMITTEE PERFORMANCE

The nominating committee, as an agency for shareholders, is responsible and accountable for the selection of objective and competent board members.

Regarding the nominating committee, we will recommend voting against the following:[24]

1. The nominating committee chair (i) if the chair is not independent; (ii) if the nominating committee did not meet during the previous fiscal year; (iii) when the board is less than one-third independent; (iv) when a director who did not attend any meetings in the previous fiscal year is renominated without sufficient explanation; (v) when there are more than twenty members on the board; and/or (vi) when there are less than five members on the board.[25]

24 Where the recommendation would be to vote against the committee chair and the chair is not up for election, we do not recommend voting against any members of the committee who are up for election; rather, we will express our concern with regard to the committee chair. In the absence of a nominating committee, we will recommend voting against the board chair.

25 We believe that voting against the chair of the nominating committee would make the board even smaller. Therefore, we will signal our concern to investors and monitor the issue going forward.

2. All members of the nominating committee, when the committee nominated or renominated an individual who had a significant conflict of interest or whose past actions demonstrated a lack of integrity or inability to represent shareholder interests.

3. Any nominating committee member who is not considered independent, if the committee is not majority independent.

### ENVIRONMENTAL AND SOCIAL RISK OVERSIGHT

Glass Lewis understands the importance of ensuring the sustainability of companies' operations and believes that an inattention to material environmental and social issues can present direct legal, financial, regulatory and reputational risks for companies that could serve to harm shareholder interests. Therefore, we believe that these issues should be carefully monitored and managed by companies and that companies should have an appropriate oversight structure in place to ensure that they are mitigating attendant risks and capitalizing on related opportunities to the best extent possible.

Where it is clear that companies have not properly managed or mitigated environmental or social risks to the detriment of shareholder value, or when such mismanagement has threatened shareholder value, Glass Lewis may consider recommending that shareholders vote against members of the board who are responsible with oversight of environmental and social risks. In the absence of explicit board oversight of environmental and social issues, Glass Lewis may recommend that shareholders vote against members of the relevant committee. In making these determinations, Glass Lewis will carefully review the situation at hand, its effect on shareholder value, as well as any corrective action or other response made by the company.

## INDEPENDENCE OF BOARD OF SUPERVISORS

The board of supervisors is responsible for overseeing the operations and management of a listed company. At their discretion, supervisors may exercise the following powers to this end: (i) examine the financial statements; (ii) supervise the execution of duties of directors and senior management, and recommend the recall of any such officers in the event of violation of applicable laws, regulations, the articles of association or resolutions of shareholder meetings; (iii) call upon directors or senior management to rectify matters that harm the interests of a company; (iv) call a special meeting of shareholders; (v) submit items for consideration on the agenda of a shareholder meeting; (vi) initiate lawsuits on behalf of a company against its directors or senior management; and (vii) other powers as designated by a company's articles of association.

In accordance with the Company Law of the People's Republic of China (the "Company Law"), listed companies should have a board of supervisors composed of not fewer than three members, consisting of shareholder and employee representatives. Shareholder representatives are nominated and elected by shareholders through a shareholder meeting, while employee representatives are elected by a company's employee association. At least one-third of the board should be employee representatives, though the precise ratio may vary from company to company in accordance with their articles.[26] A director or executive may not serve concurrently as a supervisor.[27]

The current laws and regulations neither provide any basis for evaluating supervisors' independence nor do they require them to be independent. However, Glass Lewis believes that the existence of personal, familial or financial relationships makes it difficult for a board member to put the interests of the shareholders whom she is elected to serve above her own interests or those of the related party. Therefore, we examine the relationships of the members of the board of supervisors with the company, the company's directors and executives, along with other board members, to determine whether pre-existing personal, familial or financial relationships (apart from compensation as a supervisor) are likely to impact the supervisor's decisions.

26 The Company Law, Article 118.
27 *Ibid.*

To that end, we also classify supervisors acting as shareholder representatives in three categories: (i) independent; (ii) affiliated; and (iii) insider, based on the type of relationships they have with the company, using the same criteria to evaluate their independence as we do with directors.

Glass Lewis believes that a board of supervisors will most effectively perform the oversight necessary to protect the interests of shareholders if it is independent. Therefore, we believe that there should be at least one shareholder representative on the board and we are firmly committed to the belief that at least one-third of the supervisors should be independent. In the event that less than one-third of the supervisors are independent, we typically recommend voting against some of the inside and/or affiliated supervisors nominated as shareholder representatives.

Furthermore, we typically recommend voting against a supervisor who has an immediate family member providing independent auditing services to the company at any time during the past three years.

# Transparency and Integrity in Financial Reporting

## ACCOUNTS AND REPORTS

As a routine matter, the Company Law requires that shareholders approve a company's financial resolution, financial budget, directors' report and supervisors' report for them to be valid.[28] The financial resolution typically contains important financial indicators drawn from the audited consolidated financial statements, which combine the results of the activities of the company and its subsidiaries. In addition, Chinese companies often ask shareholders to approve reports such as the independent directors' report or independent auditor's report.

Approval of such proposals does not discharge the board from liability. Unless there are concerns about the integrity of the statements/reports (e.g., the independent auditor has issued no opinion or qualified opinion on the financial statements), we will recommend voting for these proposals.

In the event that all the necessary documents (i.e., annual financial statements, director reports and auditor reports) have not been made available, we do not believe shareholders have sufficient information to make an informed judgment regarding this matter. As such, we will recommend that shareholders abstain from voting on this agenda item.

## ALLOCATION OF PROFITS/DIVIDENDS

Glass Lewis generally supports a company's policy when it comes to the payment of dividends including decisions not to pay them. In most cases, we believe the board is in the best position to determine whether a company has sufficient resources to distribute a dividend or if shareholders would be better served by forgoing a dividend to conserve resources for future opportunities or needs. As such, we will only recommend that shareholders refrain from supporting dividend proposals in exceptional cases.

In accordance with Chinese company law, prior to the distribution of dividends, companies are required to allocate at least 10% of their after-tax profits to a legal reserve. Additional allocations for legal reserves are no longer required when the legal reserve reaches 50% of the company's share capital (i.e., the nominal value of all company issued shares) as of the last day of the year. After the statutory requirement for allocation to the legal reserve has been met, the board may decide to declare a dividend payable to shareholders (in cash or shares), to allocate a portion to a specific reserve and/or to carry the profits forward in retained earnings.

In 2012, the China Securities Regulatory Commission (CSRC) issued the "Notice on Issues Concerning Further Implementing Cash Dividends Distribution of Listed Companies", which requires listed companies to amend their articles of association to reflect certain provisions regarding profit distribution policy, specifically clearing the decision-making procedures and mechanisms on profit distribution.[29] According to the notice, among others, the accumulated profit to be distributed in cash for any three consecutive years shall not be less than 30% of the average annual distributable profit realized in the most recent three years. We believe that most provisions under the notice will further improve the transparency and operability of decision-making on dividend distribution and strengthen the protection of legitimate rights and interests of shareholders.

28 Company Law, Article 38. In addition, all publicly listed companies have to file and disclose financial results on a quarterly basis. Although continuous disclosure is not required, any significant event that may impact stock prices has to be publicly announced immediately. Because Chinese regulations are generally principles based, no specific definition of what constitutes a significant event exists. In addition, pursuant to the Listing Rules, Chinese public companies shall prepare and release annual reports within four months of the end of each financial year.

29 The notice and the Code, Article 10.

## APPOINTMENT/RATIFICATION OF AUDITOR

The auditor's role as gatekeeper is crucial in ensuring the integrity and transparency of the financial information necessary for protecting shareholder value. Shareholders rely on the auditor to ask tough questions and to do a thorough analysis of a company's books to ensure that the information provided to shareholders is complete, accurate, fair, and that it is a reasonable representation of a company's financial position. The only way shareholders can make rational investment decisions is if the market is equipped with accurate information about a company's fiscal health.

Shareholders should demand an objective, competent and diligent auditor who performs at or above professional standards at every company in which the investors hold an interest. Like directors, auditors should be free from conflicts of interest and should avoid situations requiring a choice between the auditor's interests and the public's interests. Almost without exception, shareholders should be able to annually review an auditor's performance and to annually ratify a board's auditor selection.

In China, under the Company Law, appointment or removal of independent auditors should be approved by shareholders or the board of directors. Though companies are not technically required to disclose the breakdown of audit versus non-audit fees, they are required to disclose the remuneration of both the financial auditors and internal control auditors (these are usually the same firm). In such cases, we designate the financial audit fees as "audit fees" and the internal control audit fees as "non-audit fees."

### VOTING RECOMMENDATIONS ON AUDITOR RATIFICATION

We generally support management's choice of auditor except when we believe the auditor's independence or audit integrity has been compromised. When there have been material restatements of annual financial statements or material weakness in internal controls, we usually recommend voting against the auditor. In the event that the audited financial statements have not yet been disclosed, we base our voting recommendations on the company's financial statements for the previous years. We do not hold a company's auditor responsible for the company's failure to comply with reporting obligations or a lack thereof, depending on the jurisdiction.

Reasons why we may not recommend in favor of ratification of an auditor include:

1. When audit fees are less than the non-audit fees.

2. Recent material restatements of annual financial statements, including those resulting in the reporting of material weaknesses in internal controls and including late filings by the company where the auditor bears some responsibility for the restatement or late filing.[30]

3. When the company has aggressive accounting policies evidenced by restatements or other financial reporting problems.

4. When the company has poor disclosure or lack of transparency in its financial statements.

5. Where the auditor limited its liability through its contract with the company.

6. Other relationships or concerns with the auditor that might suggest a conflict between the auditor's interests and shareholder interests.

7. In cases where a company has failed to disclose the auditor fees or a breakdown thereof, we will recommend to vote against the auditor's appointment and authority to set auditor's fees proposal or auditor fees proposal. We will additionally recommend to vote against the audit committee chair.

30 Given that the auditor is generally not required to audit interim financial statements, we typically do not believe that an auditor should be opposed due to a restatement of interim financial statements unless the nature of the misstatement is clear from a reading of the incorrect financial statements.

## RELATED PARTY TRANSACTIONS

In China, shareholders are generally requested to approve any agreement to be entered into, directly or indirectly, between the company and its directors, board chair, CEO, a shareholder owning at least 5% of the voting rights[31], or if such shareholder is a company, the company controlling such a shareholder. These agreements generally pertain to transactions between the company and third parties in which one of the persons listed above (i.e., director, CEO, 5% shareholder, controlling shareholder representative, or affiliated entity) has an interest.

All such transactions must be authorized by the board of directors[32] and included in the company's report on the transactions.[33] Subsequently, the report must be presented to shareholders at a general meeting for ratification of each transaction. In the event that the company does not disclose the opinion of the independent financial advisor for major transactions, such as for smaller transactions, we will rely on the published opinion of the independent directors. In the event that their opinion is not provided, we do not believe shareholders have sufficient information to make an informed judgment regarding this matter. As such, we will recommend that shareholders abstain from voting on this agenda item.

We will evaluate related party transactions on a case-by-case basis. We generally do not oppose a transaction which falls within the company's regular course of business, so long as the independent financial advisor's opinion or independent directors' opinion confirms that these transactions were regular commercial transactions and the terms of the transaction are fair and reasonable.

However, with a limited exception, we will recommend voting against a director if his/her direct/indirect related party transactions exceed any of the following thresholds: (i) US$50,000 or no disclosure for personal direct transactions; (ii) US$100,000 for indirect transactions with an entity in which a director holds more than 50% interest; (iii) US$100,000 for indirect professional services transactions with a professional services firm in which a director works for; or (iv) 1% of a company's consolidated gross revenue for indirect transactions with an entity in which a director serves as an executive.

In addition, we generally recommend shareholders vote against any deposit transaction of the Company and a financial arm of their non-controlling parent company (or within their groups). We believe such pooling of the group's cash through an unlisted financial vehicle may give the parent company control over the listed company's finances. In addition, such practices may lead to lax lending practices within the parent group, potentially exposing the shareholders of a listed company to undisclosed risks. Accordingly, we generally do not support such financial services transactions absent compelling economic rationale.

We note that in light of the nature of intra group transactions of a controlled entity, in which the parent entity controls more than 50% of the shares, we will refrain from recommending shareholders vote against such transactions.

## PROVISION OF GUARANTEES

It is a common practice for Chinese companies to provide bank loan guarantees for its subsidiaries or other affiliated entities. We generally believe that the ability to offer loan guarantees will provide the company and its subsidiaries with the flexibility to access finance capital at a lower interest rate. Therefore, unless the total amount of guarantees is extremely high compared with the company's net assets and the company does not provide sufficient justification for the transactions, we usually support the provision of loan guarantees.

31 Listing Rules, Articles 10.1.3.4, 10.1.5.1.

32 The CSRC "Guidelines on Establishment of Independent Director Systems by Listed Companies" accords a special role to independent directors to oversee related-party transactions in a proper manner. Specifically, related-party transactions whose total value exceeds RMB 3 million or 5% of the company's net assets should be approved by the boards' independent directors before being submitted for board discussion.

33 Pursuant to the Rules Governing the Listing of Stock on the Shanghai Stock Exchange ("Shanghai Listing Rules"), the company shall employ an independent financial advisor to present an evaluation of transactions exceeding RMB 30 million and 5% of a company's most recently audited net assets in value.

## DIRECTOR INSURANCE AND INDEMNIFICATION

Under the Code, a listed company may purchase director liability insurance for directors if approved by shareholders at the general meeting. However, director liability insurance shall not cover liabilities arising in connection with directors' violations of laws, regulations or the company's articles of association.

Chinese law is silent on the indemnification of directors. In practice, indemnification of directors, if approved or stipulated in the articles of association, is possible and additional indemnities may also be agreed upon in the engagement agreements between the company and the relevant members of the board.

# The Link Between Pay and Performance

## FEES OF DIRECTORS AND SUPERVISORS

Glass Lewis believes that non-employee directors or supervisors should receive compensation for the time and effort they spend serving on the board and its committees. In particular, we support compensation plans that include equity-based awards that help to align the interests of outside directors with those of shareholders. Director fees and supervisor fees should be competitive in order to retain and attract qualified individuals. But excessive fees represent a financial cost to the company and threaten to compromise the objectivity and independence of non-employee directors or supervisors. Therefore, a balance is required.

Although state-owned entities may be subject to stricter disclosure requirements, many Chinese companies submit proposals to fix directors' or supervisors' fees for the next fiscal year without disclosing the amount of the fees to be paid to each individual. In such cases, we will look at a company's recent compensation practices in order to determine whether to grant the board the authority to fix directors' or supervisors' fees for the following year. If we find the company's recent compensation practices to be reasonable and in line with the company's peers, we will recommend voting for the proposal.

In particular, we support compensation plans that include option grants or other equity-based awards, which help to align the interests of outside directors with those of shareholders. Glass Lewis compares the costs of these plans to the plans of peer companies with similar market capitalizations in the same country to help inform its judgments on this issue.

## EXECUTIVE COMPENSATION

As a general rule, Glass Lewis believes that shareholders should not be involved in setting executive compensation. Such matters should be left to the board's compensation committee. We view the election of directors, and specifically those who sit on the compensation committee, as the appropriate mechanism for shareholders to express their disapproval or support of board policy on this issue. Further, we believe that companies whose pay-for-performance is in line with their peers should be granted the flexibility to compensate their executives in a manner that drives growth and profit.

Glass Lewis favors performance-based compensation as an effective means of motivating executives to act in the best interests of shareholders. Performance-based compensation may be limited if a chief executive's pay is capped at a low level rather than flexibly tied to the performance of the company.

## EQUITY-BASED COMPENSATION PLANS

Glass Lewis believes that equity-based compensation awards are a useful tool, when not abused, for retaining and incentivizing employees to engage in conduct that will improve the performance of the company. We generally evaluate option plans taking into account the overall cost of the plan, potential dilution to current shareholders, the size of the company, as well as its performance.

Additionally, we will evaluate the following aspects of the plan in determining our recommendation: (i) When the discounted exercise price of equity-based compensation plan is determined at the discretion of the plan administrator, we will in general recommend voting against the plan. (ii) When the number of options or

shares to be granted to a person or persons under the equity compensation plan is not disclosed, we will in general recommend voting against the proposal. (iii) Furthermore, when the vesting period under the equity compensation plan is less than two years, we will in general recommend voting against the proposal.

Shareholders commonly ask boards to adopt policies requiring that a significant portion of future stock option grants to senior executives be based on performance. Performance-based options are options where the exercise price is linked to an industry peer group's stock-performance index.

Glass Lewis believes in performance-based equity compensation plans for senior executives. We feel that executives should be compensated with equity when their performance and the company's performance warrant such rewards. While we do not believe that equity-based pay plans for all employees should be based on overall company performance, we do support such limitations for equity grants to senior executives (although some equity-based compensation of senior executives without performance criteria is acceptable, such as in the case of moderate incentive grants made in an initial offer of employment or in emerging industries).

Boards often argue that basing option grants on performance would hinder them in attracting talent. We believe that boards can develop a consistent, reliable approach to attract executives with the ability to guide the company toward its targets. If the board believes in performance-based pay for executives, then proposals requiring the same should not hamper the board's ability to create equity-based compensation plans.

We generally recommend that shareholders vote in favor of performance-based option requirements.

# Governance and Financial Structure and the Shareholder Franchise

## AMENDMENTS TO THE ARTICLES OF ASSOCIATION

We evaluate proposed amendments to a company's articles of association on a case-by-case basis. We are opposed to the practice of bundling several amendments under a single proposal because it prevents shareholders from judging each amendment on its own merits and is a practice which we believe negatively limits shareholder rights. In such cases, we will analyze each proposed change individually. We will recommend voting for the proposal only when, on balance, we believe that all of the amendments are either in the best interests of shareholders or are inconsequential.

### COMMUNIST PARTY COMMITTEE

While we consider proposals on a case-by-case basis, we generally believe that companies should disclose as much relevant information relating to the interaction between the company and the Communist Party Committee as possible to help shareholders understand the company's decision making process.

We may consider recommending a vote against the article and/or bylaw amendments in cases where there is clear evidence of the board letting the Party Committee make material decisions, as the party committee's members are not elected by shareholders and thus are not accountable to shareholders.

Overall, decisions regarding management and policy (including those related to governmental interactions), are best left to management and the board as they, in almost all cases, have more information regarding the company's strategy and the associated risks.

## AMENDMENTS TO PROCEDURAL RULES/MANAGEMENT SYSTEMS

Chinese companies commonly request shareholder approval to amend their procedural rules or management systems which are governance documents that set forth rules and procedures regarding a particular area of business or corporate governance. Companies often adjust the procedural rules and management systems to accord with amendments to the articles of association. We typically apply the same standards to these rules as we do to amendments to the articles and will approve the amendments to them provided that a company has fully disclosed the proposed changes to each of the documents in question.

## ISSUANCE OF SHARES AND/OR CONVERTIBLE SECURITIES

In general, issuing an excessive amount of additional shares and/or convertible securities can dilute existing holders. Further, the availability of additional shares, where the board has discretion to implement a poison pill, can often serve as a deterrent to interested suitors. Accordingly, where we find that the company has not detailed a plan for use of the proposed shares, or where the number of shares far exceeds those needed to accomplish a detailed plan, we typically recommend against the authorization of additional shares.

While we think that having adequate shares to allow management to make quick decisions and effectively operate the business is critical, we prefer that, for significant transactions, management come to shareholders to justify their use of additional shares rather than providing a blank check in the form of a large pool of unallocated shares available for any purpose.

### WITHOUT PREEMPTIVE RIGHTS

In our view, any authorization to issue shares and/or convertible securities without preemptive rights should not exceed 20% of the company's total share capital. Likewise, we believe the discount rate for the new issue should not exceed 15% of the average market price.

## ISSUANCE OF DEBT INSTRUMENTS

In China, it is a routine matter for shareholders to grant the board authorization to issue and/or trade in non-convertible, convertible and/or exchangeable debt obligations, at any time, in accordance to the country's legal standards.

Generally, the board is granted the authority to establish a fixed or variable interest rate, and more globally, to establish all other aspects of the debt instruments.

We believe it is customary for a company to increase its leverage by using debt to finance its expansion plans. A majority of companies issue debt to avoid short-term equity dilution and to signal the firm's future growth opportunities. If the requested authority to issue debt is reasonable, we see no reason to recommend voting against such a proposal.

## AUTHORITY TO TRADE IN COMPANY STOCK

A company may want to repurchase or trade in its own shares for a variety of reasons.[34] A repurchase plan is often used to increase the company's stock price, to distribute excess cash to shareholders or to provide shares for equity-based compensation plans for employees. In addition, a company might repurchase shares in order to offset dilution of earnings caused by the exercise of stock options.

We will recommend voting in favor of a proposal to repurchase and trade in company stock when the following conditions are met: (i) a maximum number of shares that can be purchased is set; (ii) a maximum price to be paid for each share (as a percentage of the market price) is set; and (iii) an expiration date of eighteen months is established. Furthermore, the Company Law limits the number of shares that can be repurchased to no more than 5% of the company's capital in the event that they will be used as employee compensation.

## AUTHORITY TO CANCEL SHARES AND REDUCE CAPITAL

In conjunction with a share repurchase program, companies often proceed to subsequently cancel the repurchased shares. In the event that the repurchased shares are used as consideration for a merger, the shares should be cancelled within 6 months. If the repurchased shares are used as employee awards, the shares purchased by the company shall be transferred to the employees within one year.

34 Under Article 143 of the Company Law, a company shall not purchase its own shares, except for in any of the following circumstances: (i) to decrease the registered capital of the company; (ii) to merge with another company holding shares of this company; (iii) to award the employees of this company with shares; or (iv) it is requested by any shareholder to purchase his shares because the shareholder raises objections to the company's resolution regarding a merger or split-up made at a session of the meeting of shareholders. Where a company needs to purchase its own shares for any of the reasons as mentioned in items (i) through (iv) of the preceding paragraph, it shall be subject to a resolution of the shareholders' meeting. After the company purchases its own shares according to the provisions of the preceding paragraph, it shall, under the circumstance mentioned in item (i), write them off within 10 days after the purchase; while under the circumstance mentioned in either item (ii) or (iv), shall transfer them or write them off within 6 months.

## ANTI-TAKEOVER DEVICES

Glass Lewis believes that authorities that are intended to prevent or thwart a potential takeover of a company are not conducive to good corporate governance and can reduce management accountability by substantially limiting opportunities for shareholders.

Chinese law is silent as to whether anti-takeover measures are permitted. However, under the Takeover Management Measures for Listed Companies ("Takeover Management Measures"), the board of a listed company receiving a takeover bid is prohibited from proposing the following matters except as already approved by a meeting of shareholders: (i) disposition of assets; (ii) external investments; (iii) modifications to a company's principal area of business, guarantees, or loans; (iv) or other matters that may have a significant impact on a company's assets, debts, equity interest or business performance.[35] Furthermore, directors must fairly consider the offers of potential acquirers and may not use their powers to pose undue obstruction to an acquisition, misuse the resources of a company to provide financial aid to a potential suitor, nor take actions that would harm the interests of a company or its shareholders[36].

## SUPERMAJORITY VOTE REQUIREMENTS

Glass Lewis believes that supermajority vote requirements act as impediments to shareholder action on ballot items that are critical to shareholder interests. One key example is in the takeover context where supermajority vote requirements can strongly limit the voice of shareholders in making decisions on such crucial matters as selling the business.

## SHARE TRADING SUSPENSION

Glass Lewis believes that prolonged trading suspensions may have a material adverse effect on the liquidity and marketability of a company's stock. While most temporary trading halts may be the result of complexity in structuring acquisitions of assets, we are mindful that, as recommended by the local guidelines,[37] issuers and financial advisors may be motivated to structure acquisition-related trading halts to last three months or less. As such, we generally recommend that shareholders vote against trading suspension proposals whose proposed suspension cap exceeds three consecutive months for asset restructuring-related transactions, or a month for shares placement-related transactions.

We may however refrain from recommending against certain suspensions if the company provides sufficient rationale for their continued structuring process and meets necessary information disclosure requirements. In general, the rationale should allow shareholders to evaluate the scope of the transaction and the related due diligence process, the engagement of accountants, auditors and appraisers, the financial advisory services they rendered, and other relevant factors within the context of each specific transaction.

35 Takeover Management Measures, Article 33.
36 Takeover Management Measures, Article 8.
37 The Guidelines for Trading Suspension and Resumption for Listed Companies Planning for Material Events issued by the Shanghai Stock Exchange in 2016.

# Routine Items

## TRANSACTION OF OTHER BUSINESS

We typically recommend that shareholders not give their proxy to management to vote on any other business items that may properly come before the annual meeting. In our opinion, granting unfettered discretion is unwise.

## AUTHORITY TO CARRY OUT FORMALITIES

In China, as a routine matter, shareholders are usually asked to grant management the authority to complete any and all formalities, such as required filings and registrations, needed to carry out decisions made at the meeting. Shareholders are generally also asked to approve the minutes. In general, we recommend voting for these proposals in order to help management complete the formalities necessary to validate the decisions made at the annual meeting.

# Shareholder Initiatives

Pursuant to the Company Law[38], shareholders separately or aggregately representing at least 10% of the company's shares may call for an extraordinary meeting and shareholders separately or aggregately holding 3% or more ownership may put forward a written proposal to the board of directors 10 days before a shareholders' meeting is held.

Although uncommon in China, should a shareholder proposal arise, we will evaluate it on a case-by-case basis. We generally favor proposals that are likely to increase shareholder value and/or promote and protect shareholder rights. We typically prefer to leave decisions regarding day-to-day management of the business and policy decisions related to political, social or environmental issues to management and the board except when we see a clear and direct link between the proposal and some economic or financial issue for the company. We feel strongly that shareholders should not attempt to micromanage the business or its executives through the initiative process. Rather, shareholders should use their influence to push for governance structures that protect shareholders, including actual director elections and then put in place a board they can trust to make informed and careful decisions that are in the best interests of the business and its owners. We believe that shareholders should hold directors accountable for management and policy decisions through the election of directors.

## ENVIRONMENTAL, SOCIAL & GOVERNANCE INITIATIVES

For a detailed review of our policies concerning compensation, environmental, social and governance shareholder initiatives, please refer to our comprehensive *Proxy Paper Guidelines for Shareholder Initiatives*, available at www.glasslewis.com.

38 Company Law, Article 103.

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