

ISS Releases 2013-2014 Policy Survey Results and Policy Updates

December 2, 2013

Institutional Shareholder Services Inc. (“ISS”) recently released the results of its 2013-2014 Policy Survey (the “Survey”). The stated goal of its annual Survey is to gather feedback from its institutional investor clients regarding (a) the importance to them of various corporate governance issues and (b) ISS’s manner of analyzing company data in making its proxy voting recommendations.

Further, on November 21, 2013, ISS released its annual policy update (the “Update”), which will inform ISS’s proxy voting recommendations for annual meetings held on or after February 1, 2014. The Update reflects, to some degree, the results of the Survey. As always, we urge each company to identify the extent to which each of its major shareholders relies on ISS as this will provide valuable information to the company on the significance of ISS’s recommendations and on any company outreach to shareholders.

Some of the results of the Survey and the Update are particularly important to Maryland public companies as they involve matters of Maryland statutory or case law.

1. **Response to Shareholder-Approved Proposals.** In a very welcome development, institutional investors overwhelmingly declared that a board of directors need not always implement a shareholder-approved precatory proposal. Fully 40% of investor respondents to the Survey indicated that a company’s “board should be free to exercise its discretion to respond” to majority-supported shareholder proposals “in a manner that the board believes is in the best interest of the company” and to disclose the rationale for any actions it takes. An additional 24% of investor respondents replied that “it depends on the circumstances,” thus wisely recognizing that shareholder views may be considered by, but are not binding on, the board. For many years, courts applying Maryland law have been clear that directors of Maryland corporations are not obligated to implement a shareholder-approved precatory proposal. *See Martin Marietta Corp. v. Bendix Corp.*, 549 F. Supp. 623, 633 n.5 (D. Md. 1982), *quoted in Mountain Manor Realty, Inc. v. Buccheri*, 55 Md. App. 185, 197-98, 461 A.2d 45, 52-53 (1983); *Warren v. Fitzgerald*, 189 Md. 476, 489, 56 A.2d 827, 833 (1948) (*quoting People ex rel. Manice v. Powell*, 201 N.Y. 194, 201, 94 N.E. 634, 637 (1911)); *Mutual Fire Ins. Co. v. Farquhar*, 86 Md. 668, 674-75, 39 A. 527, 529 (1898).

In response, ISS has made a significant change, perhaps indicating that it was surprised by this board-deferential response from its investor clients. Previously, ISS recommended against incumbent directors if the board failed to implement a proposal that received majority shareholder support the previous year. Now, ISS will consider, on a case-by-case basis, the company’s disclosed response as to why the board did not implement the proposal. While this is a welcome change, as it at least opens up the possibility that ISS will not automatically recommend against directors for not implementing a shareholder-approved proposal, we are withholding final judgment until we see how ISS applies this approach in the

2014 proxy season. In any event, in order to minimize the likelihood of an ISS withhold recommendation on directors, companies should ensure that (a) the reasoning behind a board decision not to implement a shareholder-supported proposal is fully articulated and disclosed in its proxy statement and (b) appropriate shareholder outreach is conducted and disclosed.

2. Director Tenure. Approximately half of the institutional respondents to the Survey stated that long director tenures, beginning at ten years, may diminish both the independence of a board member and the ability of the board to refresh its membership. A similar percentage stated that long tenure at key board positions (chairman, lead director or committee chair) may also be problematic. More than half of the institutional respondents recommended that ISS adopt a policy that considers director rotation with regard to these key board positions. We were glad to see ISS recognize that: “Academic studies on the topic offer conflicting conclusions.” Given the challenge public companies face in finding experienced, high-quality, independent men and women who are willing to serve as directors, we hope that ISS does not further complicate the process by concluding that directors are no longer independent based on some arbitrary period of service. While the Update did not include any policy changes in this regard, ISS is continuing to solicit comments from investors until some as yet unspecified date in February, 2014 on whether it should (a) start recommending against directors on nominating committees if average board tenure or the specific tenure of one or more directors is too long or (b) cease considering board members independent after a certain tenure. (ISS is also soliciting comments on director independence and independent chair shareholder proposals.)

3. Company Performance. The Survey asked whether, and in what circumstances, ISS should consider company performance when making voting recommendations for director elections. Fully 90% of institutional respondents replied that ISS should consider company performance, either all of the time or at least when “a company has exhibited problematic governance practices that the board does not appear to be addressing.” We are wary of the possibility that ISS will include company performance in its voting recommendations because ISS currently looks *only* at *relative* performance – *i.e.*, a company’s performance compared to a group selected by ISS based on the Global Industry Classification Standard. Of course, when considering only relative performance compared to some group, half of all companies will always be “underperforming.” This could set the stage for increased director withhold recommendations, which in turn could result in more “failed elections” at companies with majority voting, requiring incumbent directors (possibly all directors at companies with annually elected boards) who do not receive the support of a majority of votes cast to offer their resignations. The default voting standard for director elections in Maryland is plurality and, in light of the potentially increasing influence of ISS in director elections, we continue to recommend that Maryland corporations not depart from this standard. We are glad that ISS did not implement any changes in this area in the Update.

4. Equity Compensation Plans. ISS currently evaluates equity compensation plans through a highly formulaic method. If a plan has any one of several “problematic features,” ISS will automatically recommend against its approval, regardless of any other positive characteristics or the overall quality of the plan. The Survey asked which characteristics

institutional investors would consider most important if ISS were to move to a more “holistic” review of these plans. Respondents most frequently cited performance conditions on equity awards and share dilution. We believe a more holistic review of equity compensation plans is preferable, as it permits an evaluation of the overall quality of the plan. Just as determining executive compensation in its entirety often requires a multifaceted evaluation and holistic review, so does a review of the quality of equity compensation plans. While the Update did not include any policy changes in this regard, ISS is continuing to solicit comments from investors until some as yet unspecified date in February, 2014 on a possible switch to a broader review of equity compensation plans.

5. Proposals Related to Increasing Authorized Shares. The Survey asked several questions about the factors considered by institutional investors in evaluating proposals to increase a company’s number of authorized shares. The most common responses were “the size of the requested increase” and the “ratio of current shares outstanding compared to the new authorization.” For many years, Maryland law has permitted a Maryland corporation or real estate investment trust to include a provision in its charter or declaration authorizing the board, *without shareholder approval*, to amend the charter or declaration to increase or decrease the aggregate number of shares of the company or the number of shares of any class or series that the company has authority to issue. We always recommend inclusion of this provision in the charters or declarations of our Maryland-organized clients and we are not aware of any abuse of this power.

6. Say-on-Pay Proposals. In a positive development, the Update revised how ISS evaluates say-on-pay proposals. As one of several analyses, ISS determines the relative degree of alignment (“RDA”) between CEO compensation and total shareholder return at (a) the company and (b) an ISS-determined peer group. In the past, ISS determined RDA based on a 40%/60% weighted average of one- and three-year timeframes. Starting in 2014, ISS will only use the three-year timeframe. We applaud this change, as it represents a shift away from ISS’s focus on short-term performance, for which it had been rightly criticized in the past.

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As always, our colleagues and we are available at any time to discuss these or other matters of Maryland law.

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