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ISS Releases 2018 Policy Changes:
Focus on Bylaws under Maryland Law

Institutional Shareholder Services Inc. ("ISS") recently released its annual update to its Proxy Voting Guidelines (the "Update") outlining its voting recommendations for annual meetings occurring on or after February 1, 2018. Although we disagree with some of ISS's proxy voting policies, we continue to commend ISS for soliciting the views of market participants each year. As always, in guiding the company's engagement with its shareholders and in determining the potential impact of ISS's recommendations, we urge each company to review (a) the voting policies of each of its major shareholders and (b) the extent to which each of these holders relies on ISS. Here is a summary of the Update's most significant changes that may affect Maryland public companies.

Bylaws. ISS has not announced any substantive change to its policy, adopted in November 2016, that it will recommend withholds on members of nominating/corporate governance committees of boards of companies that do not permit their shareholders to amend their bylaws directly. Nevertheless, we continue to believe that (a) reasonable minimum share ownership requirements (more than the barely nominal Rule 14a-8 requirement approved by ISS), (b) supermajority vote requirements and (c) limited ring-fencing (*e.g.*, board power to amend the bylaws, D&O indemnification) are appropriate. See two recent bylaw amendments by AvalonBay Communities, Inc. and Equity Residential, each of which requires the proponent (which may be a group of up to five shareholders) to own at least one percent of the company's common shares for one year prior to the proposal, which in our view is a very reasonable position.

Indeed, we believe that the board of a company, especially one with a smaller market cap, would be fully justified in deciding that an ownership requirement of more than one percent/one year is reasonable as we do not see a meaningful substantive difference between a shareholder proposal of a nominee for director through proxy access (where the market standard is now three percent/three years) and a shareholder proposal to amend the bylaws, especially where the vote requirement is only a bare majority of the votes entitled to be cast. We also believe that a supermajority vote (as is required by hundreds of Delaware corporations) would be appropriate for amending a basic governing document such as bylaws, especially where the ownership requirements for the proposal are less than for proxy access.

We recognize that many institutional holders have general voting policies against supermajority voting. There is, however, a contextual difference – and an important substantive distinction – between (a) a supermajority shareholder vote to approve a charter amendment or a merger that has already been approved by the board and (b) a supermajority vote to approve an amendment to the bylaws that has not first been approved by the board. We, therefore, suggest for consideration a two-tiered, or "bifurcated," approach by which bylaw amendment proposals by shareholders with higher ownership levels, such as three percent for three years, could be

passed by a majority of votes outstanding and bylaw amendment proposals of shareholders with lower ownership levels, such as one percent for one year, would require a supermajority vote.

ISS has told us that if a company wishes to pursue limitations beyond those authorized by ISS, the company should disclose, in its proxy statement, the percentage of shares with whose holders they discussed such provisions and the percentage of shares supporting them. Thus, we think approaching shareholders with a well-developed and well-supported proposal is essential (and not just because of ISS), especially with respect to potential incursions into the board's oversight and decision-making roles by direct shareholder bylaw amendments.

Subtitle 8 ("MUTA"[*]). The Update includes a new policy of recommending votes against or withholds for the entire board if "[t]he company has opted into, or failed to opt out of, state laws *requiring* a classified board structure." (Italics added.) Subtitle 8 *permits* a board of a company with a class of equity securities registered under the Securities Exchange Act of 1934 and with at least three independent directors to elect to classify itself without a shareholder vote and notwithstanding any contrary provision in its charter or bylaws. We have confirmed with ISS that this new policy does not implicate Subtitle 8 and that ISS will not recommend against nominees to the board of a Maryland corporation or a Title 8 REIT solely because the company has not opted out of Subtitle 8. In any event, whatever ISS's position on Subtitle 8, we continue to strongly recommend that Maryland companies do not opt out of Subtitle 8 as it represents a company's last opportunity to use its leverage to gain additional time to negotiate with a bidder for control of the company in an unsolicited proxy contest. For more on the disadvantages of opting out of Subtitle 8, please see our client memo, "Opting Out of MUTA is Still a Bad Idea."

Shareholder Rights Plan: ISS will start recommending against all directors every year whenever a company adopts a shareholder rights plan longer than twelve months without shareholder approval. Plans of twelve months or less will be evaluated case-by-case, with ISS evaluating the company's disclosed rationale and other relevant factors, *e.g.*, a commitment to put any renewal to a shareholder vote. Companies wanting to have the benefits of a rights plan but avoid negative ISS vote recommendations should keep a rights plan "on the shelf," after a fully informed presentation to the board of directors but without adopting the plan until it is needed.

Independent Director Compensation: ISS will start recommending against the relevant directors (likely to be compensation committee members) when "there is a pattern (*i.e.*, two or more consecutive years) of excessive non-executive director compensation without disclosing a compelling rationale or other mitigating factors." The Update does not say what ISS thinks is "excessive," what rationales ISS would find "compelling" or what factors might be "mitigating." As usual for ISS's compensation policies, this new one will need to be "field tested" before we can fully understand the practices that ISS will penalize. Fortunately, ISS has stated that this new policy will not affect any nominations in 2018.

[*] Subtitle 8 is sometimes mistakenly referred to as "MUTA" for "Maryland Unsolicited Takeovers Act." In fact, there is no act by that name. Subtitle 8 was enacted as only one part of S.B. 169, now chapter 300 of the 1999 Laws of Maryland. S.B. 169 was titled "Unsolicited Takeovers" and included many provisions other than Subtitle 8.

Say-on-Pay: ISS currently may recommend against directors whenever the previous Say-on-Pay vote received the support of less than 70% of the votes cast. The Update indicates that, in making this determination, ISS will look for disclosure by the company of (a) the timing and frequency of shareholder outreach, (b) the participation of independent directors in this outreach, (c) the issues with the compensation program raised by the shareholders during the outreach and (d) whether the company made meaningful changes to its compensation program in response to the outreach.

Other Changes: According to the Update, ISS will consider recommending against directors if directors and/or officers engage in excessive pledging of the company's shares. However, ISS does not provide any clarity on how much pledging is excessive. ISS has also added a policy that it will consider a board's overall diversity when evaluating that board's "composition" but it does not specifically state how a board's diversity may affect ISS's voting recommendations as to individual directors. The Update indicates that ISS will begin calling out companies for lacking gender diversity on their boards but that a lack of diversity will not affect voting recommendations. Finally, ISS adopted a policy regarding proposals on gender pay equality, stating that it will consider such proposals case by case and it will examine a company's disclosed compensation policies, any recent controversies and a company's gender pay equality relative to its peers.

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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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