VENABLE® LLP
750 E. PRATT STREET SUITE 900 BALTIMORE, MD 21202
T 410.244.7400 F 410.244.7742 www.Venable.com

November 21, 2016

ISS Releases 2017 Policy Changes: Focus on Bylaws Under Maryland Law

Institutional Shareholder Services Inc. ("ISS") today released updates to its Proxy Voting Guidelines (the "Update") for its voting recommendations for annual meetings occurring on or after February 1, 2017. Of particular significance to Maryland corporations and Title 8 real estate investment trusts, ISS, according to its new policy, will generally recommend that shareholders "vote against or withhold from members of the governance committee [on an ongoing basis] if [t]he company's charter imposes undue restrictions on shareholders' ability to amend the bylaws. Such restrictions include, but are not limited to: outright prohibition on the submission of binding shareholder proposals, or share ownership requirements or time holding requirements in excess of SEC Rule 14a-8."

Under Maryland law, a Maryland corporation (or Title 8 REIT) may provide in its charter or bylaws that the board of directors (or board of trustees) has the sole power to amend, alter or repeal the bylaws (the "Amendment Provision"). In our experience, a substantial majority of publicly traded Maryland companies have the Amendment Provision. Most Maryland companies have the Amendment Provision in their bylaws, though several have it in their charters.

The Update, by its own terms, only covers Amendment Provisions contained in the charter. Thus, companies with the Amendment Provision in their bylaws would not be implicated. We suspect, however, that this may be imprecise drafting on ISS's part, and that ISS will begin penalizing companies whether the Amendment Provision is contained in the charter or bylaws. While we await ISS's clarification on this point, we are advising Maryland companies that ISS will likely recommend against members of a board's governance committee, on an ongoing basis, regardless of whether the Amendment Provision is contained in the charter or bylaws.

We are concerned about this change for several reasons:

First, the Amendment Provision has been a common corporate governance feature for Maryland companies for over 20 years. Many Maryland companies have had the Amendment Provision since their IPOs without its ever creating an issue with stockholders.

Second, most of the provisions of a company's bylaws deal with internal administrative matters, such as quorums for board, committee and shareholders meetings; stock certificates; inspectors of election; corporate seals; checks, drafts and deposits; consents of directors and committees; and the like. While other matters, such as shareholder-requested meeting procedures and advance notice provisions, might be regarded as having more impact on shareholder rights, the board seems ideally suited to establish all of these rules because *each director* has (i) enforceable legal duties to the corporation under Section 2-405.1 of the Maryland General Corporation Law (the "MGCL"), (ii) access to more information than any single

shareholder or group of shareholders and (iii) the legitimacy of having been elected by the shareholders. In contrast, shareholders have no legal duty to the company or to any other shareholder to act in the best interests of the company.

Third, much of the interest in the Amendment Provision has been generated by a labor union with members in the hospitality and gaming industries. This union has submitted several Rule 14a-8 proposals regarding the Amendment Provisions; however, it typically owns only a nominal number of shares, often not many more than the minimum required to file a Rule 14a-8 proposal. The union clearly has different economic interests from the interests of shareholders generally. At least until now, shareholders with typical economic interests simply have not been registering discontent with the Amendment Provision.

Fourth, SEC Rule 14a-8 provides a well established process, in place for decades, for shareholders to seek concurrent power to amend the bylaws, to seek to remove perceived impediments to the amendment of the bylaws by shareholders or simply to implement the substantive changes that would otherwise be implemented by bylaw amendment. If the shareholders approve these proposals and the board does not implement them, ISS already has policies that result in negative voting recommendations for directors. Furthermore, as noted above, most of the Rule 14a-8 proposals of which we are aware have generally come from the same labor union.

Fifth, Section 2-401 of the MGCL requires that the corporation's business and affairs be managed under the direction of the board. This is the historic role of the board – to act as the elected representatives of the shareholders and to oversee the management of the business on their behalf, subject to enforceable legal duties and the possibility of replacement or removal by the shareholders. Giving the shareholders the concurrent power to amend the bylaws will enable mischievous or harmful binding proposals, such as, to name just a few examples, dictating business strategy or decisions or limiting the board's power with respect to budgets, borrowings and major supplier or customer contracts. Permitting the shareholders to use the bylaws to make binding such business decisions would, at best, create cumbersome delays and, at worst, confer these decisions on the shareholders, a constantly changing group with no duty to act in the company's best interests.

Sixth, the shareholders have the ultimate power to elect directors. Especially with the widespread adoption of annually elected boards, we think that the shareholders' power to elect directors, for any reason or no reason (including failure to implement a proposal seeking shareholder power to amend the bylaws), is the ultimate check on directors' actions, including amendments to the bylaws.

It should be noted, however, that Delaware law has long required that shareholders have the power to amend the bylaws and this power has generally not been abusively exercised, although we would not be surprised to see activists begin to focus on this route more often in the future.

Giving up the exclusive power to amend the bylaws is a serious matter for directors that should be weighed carefully with full information and not just in reaction to a threat of a negative vote recommendation from a single governance scorekeeper with no skin in the game. In this regard, boards may want to solicit and consider the views of the company's shareholders rather than just ISS's recommendations.

For boards that may want to consider giving up exclusive control of the bylaws:

1. While not specifically addressed in the Update for existing companies, we think, based on our prior experience with ISS governance policies, that ISS may be willing to accept, as the requisite shareholder vote to approve an amendment to the bylaws, some reasonable percentage of either the votes cast or the votes entitled to be cast that is greater than a simple majority of the votes cast. We understand that this has been the practice with Delaware corporations, which we believe is appropriate in view of the significance of bylaws as an organizational document and also in recognition that the shareholders are a constantly changing group.

2. We also suspect ISS will penalize companies unless shareholders are given the power to amend the *entire* bylaws. In other words, no provisions of the bylaws may be ring-fenced from shareholder amendment or subjected to a vote requirement or other restrictions on shareholder approval determined to be unreasonable by ISS.

3. Finally, ISS states that limiting the shareholders' power to amend the bylaws to shareholders meeting the ownership limits of Rule 14a-8 would be acceptable.

The Update also contains other topics applicable to U.S. companies generally, including the existence of a dual-class capital structure upon the closing of an IPO and overboarding.

If you would like to discuss the Update as it relates to your company's bylaws and, in particular, reviewing and considering this matter with the board, please do not hesitate to contact us.

* * *

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

Jim Hanks
Mike Sheehan