November 20, 2013

ISS Addresses Dissident Director Compensation Bylaw

ISS Proxy Advisory Services recently recommended that shareholders of a small cap bank holding company, Provident Financial Holdings, Inc., withhold their votes from the three director candidates standing for reelection to the company's staggered board (all of whom serve on its nominating and governance committee) because the board adopted a bylaw designed to discourage special dissident compensation schemes. These special compensation arrangements featured prominently in a number of recent high profile proxy contests and have been roundly criticized by leading commentators. Columbia Law Professor John C. Coffee, Jr. succinctly noted "third-party bonuses create the wrong incentives, fragment the board and imply a shift toward both the short-term and higher risk." In <u>our memorandum</u> on the topic, we catalogued the dangers posed by such schemes to the integrity of the boardroom and board decision-making processes. We also noted that companies could proactively address these risks by adopting a bylaw that would disqualify director candidates who are party to any such extraordinary arrangements.

We hope ISS's position that Provident's adoption of such a bylaw was a "material governance failure" was a reaction to the "extraordinary circumstances" they found in this case (including some governance features that ISS disfavors such as the staggered board and plurality voting and the fact that the bylaw was adopted after an investor group had disclosed a large 13D ownership position). To the extent this ISS recommendation is a harbinger of a new, and previously unannounced, one-size-fits-all policy, however, it may discourage companies from protecting themselves against inappropriate director conflict and enrichment schemes, and encourage activists to offer them. In our view this would be a most unfortunate development, because ISS would be unwittingly promoting fragmented and dysfunctional boards, conflicted and selfinterested directors and short-termist behavior.

ISS clearly recognizes the risk of director conflicts arising from differential compensation (which has also been heavily criticized by the Council of Institutional Investors) but its recommendation draws a distinction between compensation paid for board service and for *candidacy*. ISS suggests that it may in some cases be appropriate for a dissident to pay candidates "a reasonable fee for agreeing to stand for election, in order to compensate them for the considerable time commitments incurred in proxy contests." But this should not lead to a more general opposition to bylaws designed to prevent special compensation arrangements that create conflicts for dissident nominees. Our strong objection to these special arrangements does not extend to a reasonable candidacy fee that would be paid if the nominee is not elected (even though proxy contests have been waged for decades without having to offer any special incentives). Indeed, many of the bylaws that companies have recently adopted would not preclude arrangements to compensate candidates who are defeated, in light of the effort they will have spent in the election contest. Candidates who are elected would be compensated in the same manner as company nominees, thereby avoiding any financial incentive conflict between the loyalties of dissident directors to their patrons and to the company.

If your address changes or if you do not wish to continue receiving these memos, please send an e-mail to <u>Publications@wlrk.com</u> or call 212-403-1443.

ISS faulted the Provident board for adopting this director qualification bylaw unilaterally, suggesting that "[i]f investors are concerned with a candidate's compensation arrangements, they are free to express their concerns at the ballot box." We believe it is perfectly appropriate for a board to adopt a default rule that discourages board conflicts and perverse economic incentives, and if shareholders wish to change the rule due to the particular circumstances of any specific company or election contest, the bylaw can be amended by shareholders in a straightforward manner, at the same meeting at which the election contest is held. What the bylaw approach does is require that a dissident wishing to offer special consideration to candidates "unbundle" the nomination and the special arrangement so that investors are indeed "free to express their concerns at the ballot box."

We believe that ISS should favor that transparency, and support a general principle that discourages special compensation arrangements that lead to board conflicts and divergent incentives (which the Council of Institutional Investors has noted "blatantly contradicts" its policies on director compensation) even as it retains the flexibility to support exceptions where circumstances warrant.

Martin Lipton Andrew R. Brownstein Steven A. Rosenblum Trevor S. Norwitz Sabastian V. Niles