EY Center for Board Matters

IPO corporate governance then and now

The evolution of board and governance practices three years after the IPO

A company that leaps from an initial public offering to a place on an index enters a dynamic new landscape. Active — not just activist — institutional investors are increasingly outspoken on governance expectations and challenging boards on fundamental issues. They view corporate governance not as a compliance exercise but as an ownership responsibility tied to investment value and risk mitigation. For newly-public companies, understanding, and being responsive to, investor expectations is critical for securing support and for attracting the kind of investors the company seeks.

Are yesterday's IPO companies prepared for today's governance challenges? That is the question guiding this report, which reviews how the board composition and corporate governance practices of companies that went public in 2013 have developed. It focuses on 114 companies that went public in the US, were included in the Russell 3000 in 2013 and remain in that index today ("the 2013 IPO companies").

The 2013 IPO companies have made governance and board changes, but many still fall short of investor expectations around key governance practices.

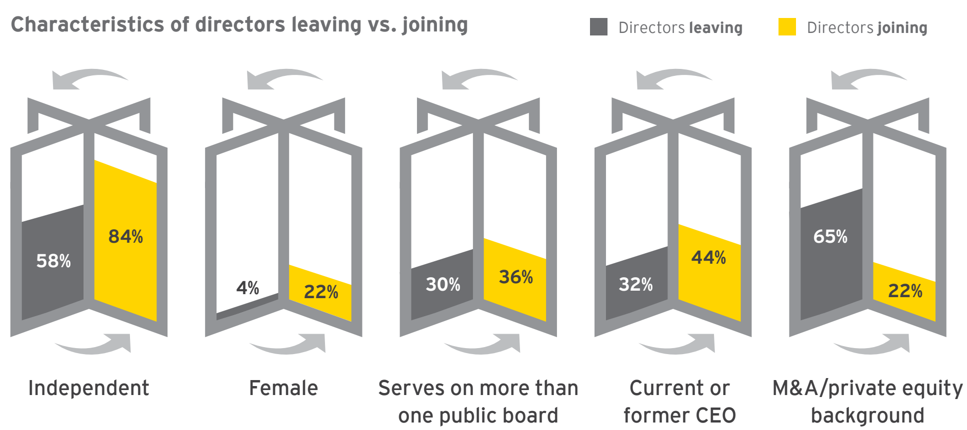
Growing independence, experience and diversity

Since going public, the 2013 IPO companies have actively refreshed their boards, ushering in slightly older, more independent directors with more CEO and public company board experience. They have also brought more women into the boardroom and bid good-bye to some of the directors representing early-stage investors that helped take the companies public. On average, companies saw 1.4 directors leave the board and welcomed 1.9 new directors, which is in line with board turnover for S&P SmallCap 600 boards over the same period.

This dynamic board refreshment is critical to recruiting new skills and expertise aligned with the company's evolving strategy, oversight needs and growth trajectory. Among the qualifications boards appear to be prioritizing as they evolve are executive leadership and expertise related to business development and technology. It also creates opportunities to enhance board diversity, which is important to many public investors. While the 2013 IPO companies have increased their gender diversity, they still lag behind more seasoned companies. The average S&P SmallCap 600 board was 14% female in 2016, compared with 12% for the 2013 IPO companies. Meanwhile, S&P 500 boards are 21% female.

The 2013 IPO board: then and now	Then	Now
Number of directors	7.8	8.2
Female	9%	12%
Independent	68%	74%
Current or former CEOs	44%	46%
Average age	56	58

Characteristics of directors leaving vs. joining



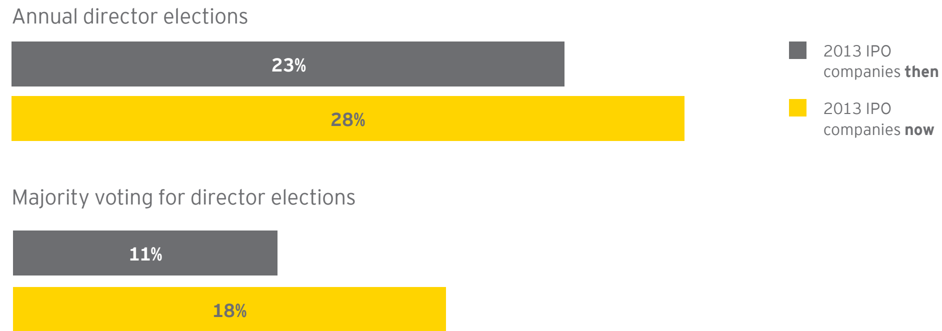
Slow adoption of annual director elections by majority vote

Electing directors on an annual basis and by a majority of votes cast (versus plurality voting) is generally viewed by investors as providing the highest level of director accountability and has become standard practice among larger companies. Indeed, 91% of S&P 500 companies elect directors annually and 88% use a majority voting standard in director elections. In comparison, 55% of S&P SmallCap 600 companies have annual director elections and 38% have majority voting.

Since most large companies have moved away from staggered elections and plurality voting, smaller companies are increasingly the targets of shareholder engagements on these topics. Notably, one of the 2013 IPO companies this year faced a shareholder proposal to adopt majority voting in director elections. The proposal received the support of 79% of the votes cast — and not acting in response to such a high vote could result in votes against directors the following year.

Investors generally expect IPO companies to adopt annual director elections and majority voting over a limited time frame, if not upon going public. They may want to see IPO companies with classified boards have sunset provisions to provide for annual director elections over time; only two of the 2013 IPO companies disclosed such a sunset provision. IPO boards that have yet to embrace these trends should anticipate pressure from shareholders to do so.

Director elections
(% of companies)



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Rising independent board leadership structures and key committees

Independent board leadership has become standard practice among companies large and small. Today, almost 95% of S&P 500 companies and 90% of S&P SmallCap 600 companies have some kind of independent board leader, whether an independent chair, lead or presiding director.

There is no consensus view on best practice. Directors have different thoughts on which leadership structure is most effective — and thoughts on what works best may change based on company-specific circumstances. Views among investors differ, too. For some investors, there is no substitute for an independent board chair, while others find lead or presiding directors to be sufficient, provided the leader has well-defined responsibilities and relevant personal strengths and qualifications.

While the 2013 IPO boards have made strides in establishing independent board leadership structures, all boards should understand that this is an area of increased investor scrutiny. Even boards with independent leadership in place should consider whether communications make clear that those independent leaders are empowered and effective.

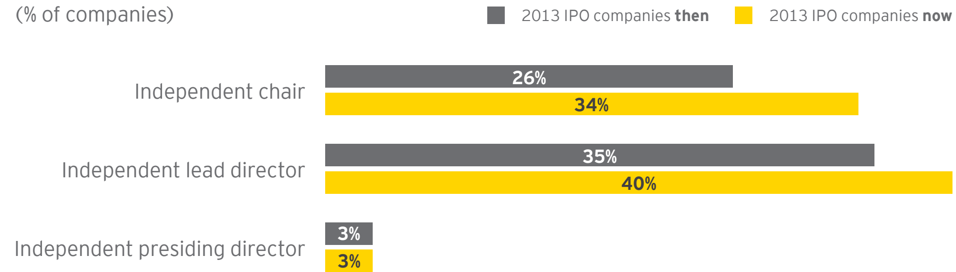
New York Stock Exchange and Nasdaq listing standards require companies to have fully independent audit, compensation and nominating committees (the so-called "key committees"), with certain exceptions. IPO companies generally have a year to phase in compliance with these requirements, and "controlled companies" (i.e., companies at which more than 50% of the voting power for the election of directors is held by an individual, a group or another company) are not required to have independent compensation or nominating committees.

As a result, as the 2013 IPO companies move further away from their listing dates, and as the percentage of controlled companies among that group declines (falling from 32% to 14%), more of these companies now have fully independent key committees. However, it appears that many of the remaining controlled companies continue to make use of their exemptions, with the average independence of compensation committees among those companies rising to just 66% from 57%, and the average independence of controlled-company nominating committees rising to just 58% from 56%.

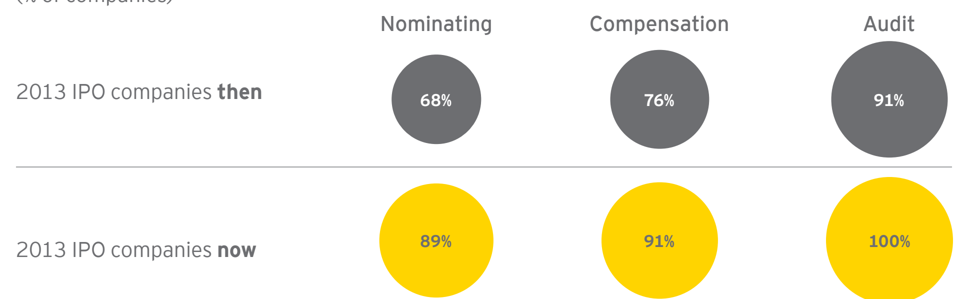
In addition, the 2013 IPO companies' committee structures are also evolving:

- More are adding committees beyond the key committees. In their first year as public companies, 18% of the 2013 IPO boards had other committees beyond the key committees. By 2016, that percentage had risen to 23%.
- The three most common other committees are compliance, executive and finance. For each of these committee types, 4% of the 2013 IPO companies had such committees in 2016.

Independent board leadership structures
(% of companies)



Fully independent key committees
(% of companies)



Minimal use of multi-class stock structures

One share, one vote — that is the mantra of most investors. Experience has taught them that concentrated voting power in the hands of company insiders can lower board accountability and increase governance-related risks. Aside from insulating company insiders, multi-class structures can be exceedingly difficult to dismantle, with the thorny issues of voting control and potential dilution of public shares.

In general, investors expect companies to enter the public market with a "one share, one vote" structure — or with sunset mechanisms in place to dismantle differential voting rights over a limited period. Among the 2013 IPO companies, 13% had multi-class common stock with differential voting rights at the time of their first annual meetings as public companies. So far, that percentage remains unchanged — and around half of these companies have disclosed related sunset provisions in their proxy statements. These companies should anticipate engagement on this issue — and should understand that investors' expectations may translate into votes against directors.

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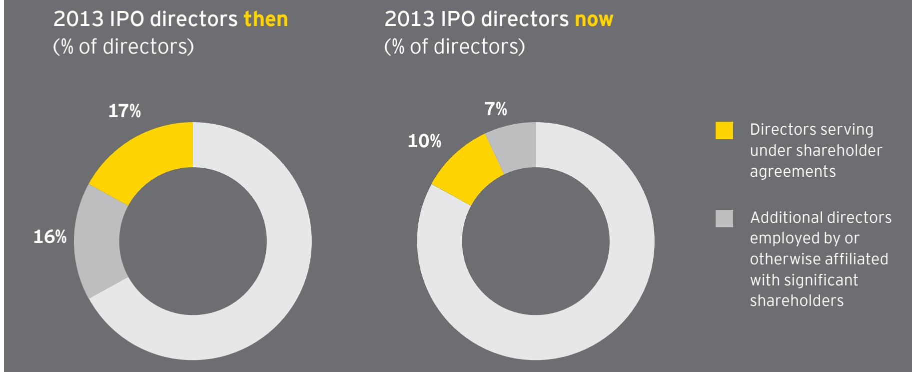
Decline in directors affiliated with significant shareholders

In the pre-IPO stage, significant venture capital and private equity investors typically take seats on the board as part of the financing arrangement. This often occurs under a shareholder agreement that grants the investor director designation rights. While in many cases these rights terminate in connection with the IPO, some agreements provide investors the right to designate or nominate directors post-IPO in connection with maintaining a certain level of equity ownership.

Our data shows that over the past three years the percentage of 2013 IPO company directors serving under such shareholder agreements has fallen seven percentage points. In addition, some directors were not appointed under shareholder agreements but are nonetheless affiliated with significant shareholders, generally as employees or directors of those firms. The percentage of these directors has declined by more than half.

A small percentage of directors continue to serve on the board despite the fact that the shareholder agreements under which they were appointed have terminated (2%), and/or the firms with which they are affiliated are no longer significant holders (4%). Having such directors remain on the board may raise questions about board composition and succession planning, and boards should be prepared to make the case for those directors' continued service.



Do investors scale their governance expectations for IPO companies?

During our investor outreach heading into the 2016 proxy season, we asked more than 50 institutional investors whether they take a scaled approach to governance that includes different expectations depending on the company's size and/or length of time in the public market. The results were mixed, and many respondents on both sides indicated that they sometimes make exceptions to their general approach. Insights shared include:

Yes 55%

- Generally give IPO companies leeway for a few years and then expect certain provisions to be phased out over time
- Initially more tolerant of staggered director elections but may draw the line at multi-class stock structures with differential voting rights
- Sensitive to the challenges of director recruitment and limited governance resources at IPO and micro-cap companies
- Have higher expectations for companies that are growing fast or were already mature at the time of IPO
- Often view themselves as having a role to play in educating IPO companies on market practice

No 45%

- Contend that publicly traded companies must meet certain standards and honor fundamental investor rights regardless of company circumstances or context
- Express concerns that certain provisions (particularly multi-class stock structures with differential voting rights) are tailored to short-term needs but have long-term consequences
- More tolerant of how company size and resources may impact governance choices and less so regarding length of time in the public market
- In some cases, seeking opportunities to influence companies before they go public

Key takeaway: Investors want companies to communicate a clearly articulated reason for maintaining governance practices that deviate from investor expectations. They also want to see companies come in line with leading practices over a limited period — and to see sunset mechanisms for more onerous provisions.

Questions for IPO boards to consider

- Does the board have proactive and ongoing director succession planning to ensure that board composition evolves in line with the company's growth and strategic plan? And is the board clearly communicating to investors its approach to board refreshment — as well as how current directors align with the company's strategy and risk profile?
- Does the board have a rigorous board and director assessment process to maximize board effectiveness, provide for continual improvement and identify skills gaps moving forward?
- Has the board identified gaps between company governance practices and investor expectations? And has the board developed a plan to close those gaps over time and communicated that plan to key investors?
- Has the board considered sunset mechanisms for certain provisions considered by investors to be particularly onerous, such as multi-class stock structures with different voting rights?
- Has the board explained — both in proxy disclosures and direct engagement conversations with investors — why they consider specific practices to be prudent in the short term? And how have they considered related investor feedback?

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