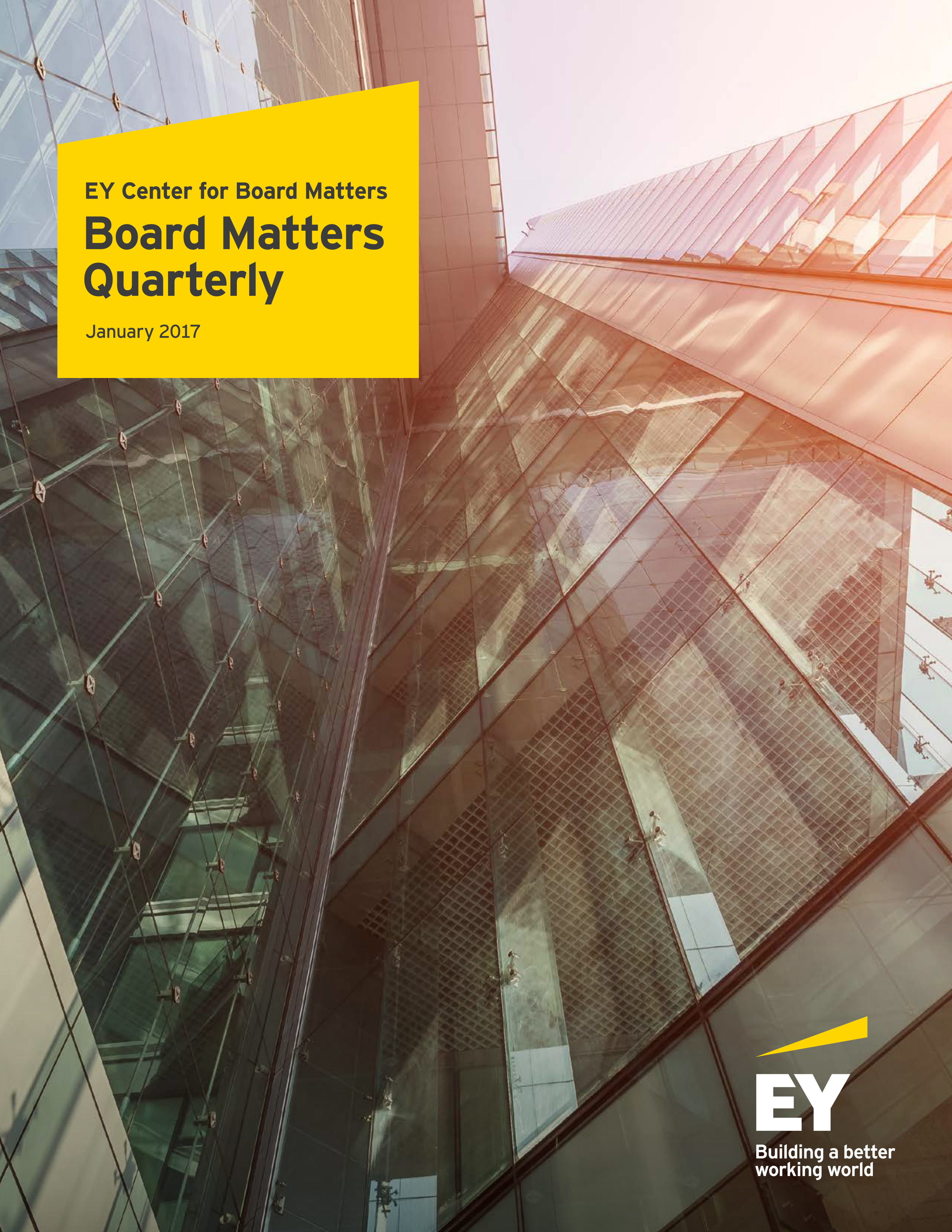
EY Center for Board Matters

Board Matters Quarterly

January 2017



Building a better working world

January 2017

Board Matters Quarterly

In this issue

Governance trends at Russell 2000 companies

Corporate governance is a topic of increasing interest to policymakers, investors and other stakeholders seeking greater transparency of board practices and oversight functions, enhanced director accountability and improved board effectiveness. However, governance practices vary widely. And while the governance practices of companies with the highest market capitalization — such as those in the S&P 500 — can serve as important indicators of emerging practices, less is known about governance trends at Russell 2000 companies.

To share insights about an area of limited study, the EY Center for Board Matters analyzed the corporate governance practices at Russell 2000 firms during the four-year period from 2012 to 2015. To add perspective and context, corresponding data from the S&P 500 was included in the analysis.

The study found continued differences between Russell 2000 and S&P 500 governance practices. For example, Russell 2000 boards tend to have more independent board chairs, are smaller and have fewer women directors.

These and other insights about the governance practices of Russell 2000 and S&P 500 companies can help directors and management of entities of all sizes benchmark their governance practices, identify areas for potential review and spotlight opportunities to enhance boardroom effectiveness.

Key findings

Boards smaller, younger and less diverse: Board size has remained steady, with Russell 2000 boards averaging 8 directors, compared with 11 for S&P 500 boards. The average age and tenure of directors remained similar for the S&P 500, but Russell 2000 figures showed a slight decline, suggesting perhaps more refreshment. Although gender diversity grew slightly in Russell 2000 boards, 36% of these boards continue to be all male, compared with 3% of S&P 500 boards.

Boards reshaping their independent board leadership structures: Boards increasingly appointed independent board chairs or lead directors, and diminished use of presiding directors. Currently, 82% of Russell 2000 firms have some form of independent board leadership, compared with 95% of the S&P 500 firms. Russell 2000 companies are more likely to have an independent board chair, while S&P 500 boards likely have an independent lead director.

Board elections continuing to gradually transform: Companies have continued to move from staggered to annual elections and replaced plurality voting with majority voting requirements for director elections (vs. plurality voting). A narrow majority of Russell 2000 companies (55%) hold annual elections, up from 51% in 2012. In comparison, 91% of S&P 500 companies have moved to this standard. Majority voting requirements are currently required for 26% of director elections at Russell 2000 companies, up from 19% in 2012. In comparison, 88% of S&P 500 boards have majority voting.

Russell 2000 boards tend to have more independent board chairs, are smaller and have fewer women directors.

Board and executive compensation generally has increased: Total compensation for Russell 2000 CEOs increased more rapidly than at the S&P 500 companies. The average CEO-to-named-executive-officer (NEO) pay ratio is now similar across Russell 2000 and S&P 500 companies at around 2.6 times.

Investor support of Russell 2000 boards grows, but when there is opposition, it may be higher: Support levels for director nominees has grown, but investor opposition votes continue to be higher for Russell 2000 nominees, at 4.6%, compared with 2.7% for the S&P 500. Average support for say-on-pay (SOP) proposals has remained high at 91% for Russell 2000 companies — about the same as the 92% average support for the S&P 500. Average support for shareholder proposals has declined but shareholder proposals submitted to Russell 2000 companies continue to average higher levels of voting support at 42%, compared with 31% for S&P 500 companies.

Questions for the board to consider

- Is the frequency of key committee meetings sufficient for addressing both immediate company needs and broader, long-term strategic interests?
- How does the age, tenure, diversity and skill sets of board members compare with peers and the changing governance expectations of investors? Are any of these characteristics likely to generate closer investor scrutiny?
- How does the company's board pay level and the internal pay ratio between the CEO and other named executive officers compare with peers?
- How do the company's governance practices align with evolving investor expectations about annual elections, majority voting requirements and proxy access?
- Is the board familiar with — and does the board have a view about — the top shareholder proposal topics of interest to the broad base of investors?

Comparison of Russell 2000 and S&P 500 boards

Key differences in governance	Russell 2000	S&P 500
Board composition		
Age	60.9	62.5
Women directors (% of board)	12%	20%
Independent directors (% of board)	78%	85%
Board tenure years	8.4	8.8
Director board service (number of public boards served)	1.6	2.1
Board and key committee meetings and size		
Frequency of board meetings (average meetings per year)	8.4	8.2
Board size	8.2	10.8
Frequency of key committee meetings (average meetings per year)	Audit: 6.9 Compensation: 5.3 Nominating: 3.3	Audit: 8.8 Compensation: 6.2 Nominating: 4.6
Committee size	Audit: 3.5 Compensation: 3.5 Nominating: 3.5	Audit: 4.2 Compensation: 4.1 Nominating: 4.2
Independent board leadership (% of companies)		
Percent of companies with independent leadership	82%	95%
Most prevalent independent leadership structure	Board chair	Lead director
Director elections (% of companies)		
Annual elections for all directors	55%	91%
Majority voting requirements in director elections	26%	88%
Proxy access bylaws	0.6%	20.0%
Investor views		
Average opposition votes against director nominees	4.6%	2.7%
Percent of all director nominees receiving >20% opposition	5.0%	1.9%
Proportion of companies with shareholder proposals voted on	3%	47%
Proportion of total number of shareholder proposals voted on	10%	76%
Average voting support for all shareholder proposals	42%	31%

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.

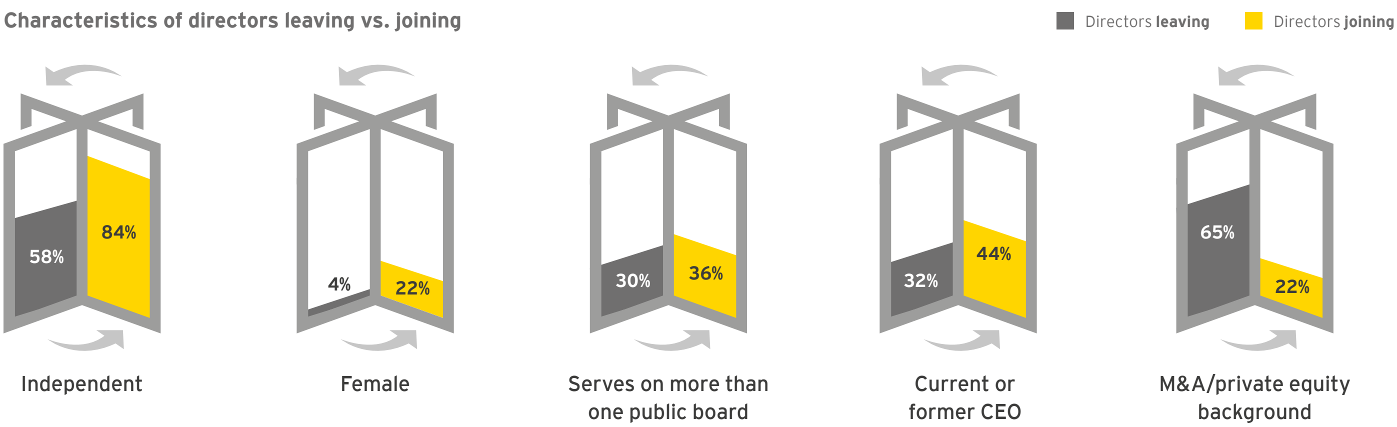
This dynamic board refreshment is critical to recruiting new skills and expertise aligned with the company's evolving strategy, oversight needs and growth trajectory. Among the qualifications boards appear to be prioritizing as they evolve are executive leadership and expertise related to business development 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

> **Board refreshment is critical to recruiting new skills and expertise aligned with the company's evolving strategy, oversight needs and growth trajectory.**

14% female in 2016, compared with 12% for the 2013 IPO companies. Meanwhile, S&P 500 boards are 21% female. A narrow majority of Russell 2000 companies (55%) hold annual elections, up from 51% in 2012. In comparison, 91% of S&P 500 companies have moved to this standard. Majority voting requirements are currently required for 26% of director elections at Russell 2000 companies, up from 19% in 2012. In comparison, 88% of S&P 500 boards have majority voting.

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

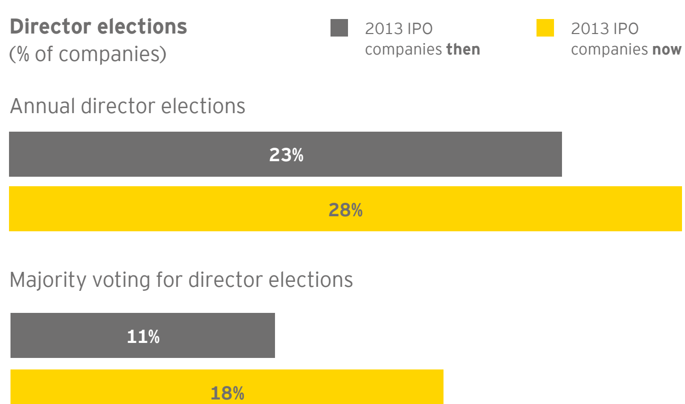


Slow adoption of annual director elections by majority vote

Electing directors on an annual basis and by a majority of votes cast (vs. 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

Director elections
(% of companies)



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.

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.

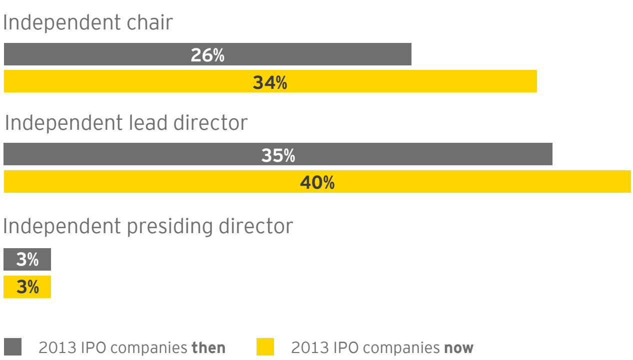
New York Stock Exchange and Nasdaq listing standards require companies to have fully independent audit, compensation and nominating committees (the so-called "key committees"), with certain exceptions. IPO companies generally have a year to phase in compliance with these requirements, and "controlled 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%.

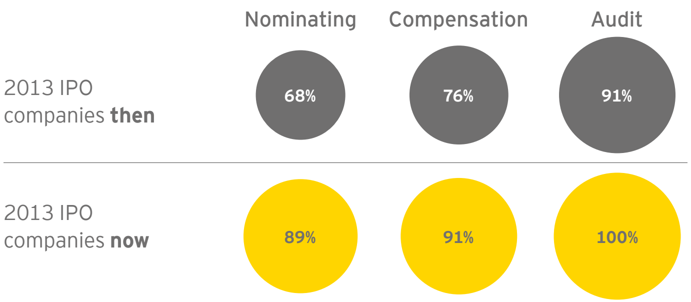
In addition, the 2013 IPO companies' committee structures are also evolving:

- 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)



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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.

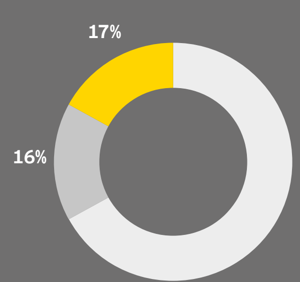
In general, investors expect companies to enter the public market with a "one share, one vote" structure — or with sunset mechanisms in place to dismantle differential voting rights over a limited period. Among the 2013 IPO companies, 13% had multi-class common stock with differential voting rights at 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.

Decline in directors affiliated with significant shareholders

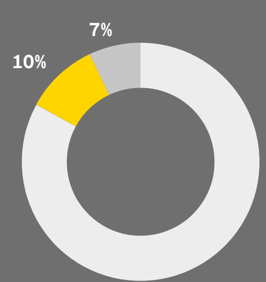
In the pre-IPO stage, significant venture capital and private equity investors typically take seats on the board as part of the financing arrangement. This often occurs under a shareholder agreement that grants the investor director designation rights. While in many cases these rights terminate in connection 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.



2013 IPO directors **then**
(% of directors)



2013 IPO directors **now**
(% of directors)

Directors serving under shareholder agreements

Additional directors employed by or otherwise affiliated with significant shareholders

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 inline 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 inline 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?

Board committees evolve to address new challenges

Oversight responsibilities shouldered by boards are increasing in scope and complexity. Much of the pressure is a result of heightened regulatory requirements, shifting investor expectations and transformative global changes.

To better address evolving responsibilities, boards are increasingly creating additional committees — beyond the three key committees that oversee the critical board responsibilities of audit and financial reporting, executive compensation, and director nominations and board succession planning. The need for additional committees reflects changing board priorities and pressures, boardroom needs and company circumstances. For example, responsibilities such as strategy or risk may shift from one committee to another, be distributed among multiple committees or addressed by the full board.

The EY Center for Board Matters reviewed board structure at S&P 500 companies between 2013 and 2016 through the lens of the committee's primary function and uncovered five observations about how S&P 500 boards are structuring committees to address oversight challenges:

1. More boards are adding additional committees

More than 75% of S&P 500 companies have at least one additional board committee, up from 61% in 2013.

Growth in use of additional committees, 2013-16		
Number of additional board committees	2013	2016
None	**39%**	**24%**
One	**28%**	**34%**
Two	**20%**	**25%**
Three or more	**12%**	**16%**
Average number of additional committees	**1.1**	**1.4**

To better address evolving responsibilities, boards are increasingly creating additional committees — beyond the three key committees.

2. Executive committees are the most common type of additional committee

Executive committees tend to handle certain board-level responsibilities when the board is not in session. Finance, compliance and risk committees are also growing more common, reflecting the benefits to some boards of having specialist committees on these oversight areas.

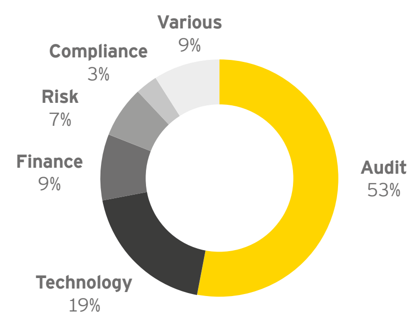
Most common functions of additional committees

Committee	Percentage of companies
Executive	37%
Finance	31%
Compliance	12%
Risk	11%
Corporate social responsibility	7%
Technology	6%
Public policy and regulatory affairs	5%
Strategy and planning	5%
Research and development	3%
Mergers and acquisitions	2%

3. Cyber, digital transformation and information technology are not only for the audit committee

Of the 15% of companies that disclosed a committee focus on these topics, over half assigned this responsibility to the audit committee — and a growing number to an additional committee. In the past year alone, the number of such committees grew by one-third.

Committees addressing cyber, digital transformation and information technology



What about smaller company board structure?

A review of S&P SmallCap 600 board committee structure reveals the following:

- Today, 46% of smaller companies have at least one additional board committee.
- Top five additional committees at smaller companies are executive (18%), risk (7%), finance (7%), strategy (6%) and compliance (5%).
- Technology-focused committees are relatively uncommon (2%).
- Risk committees saw the most year-on-year growth (three percentage points); other committees held steady.
- On a sector basis, utilities companies are the highest user of additional committees (82%), followed by financial services at a distant second (68%).

The need for additional committees reflects changing board priorities and pressures, boardroom needs and company circumstances.

4. Compliance, risk and technology committees saw the most growth

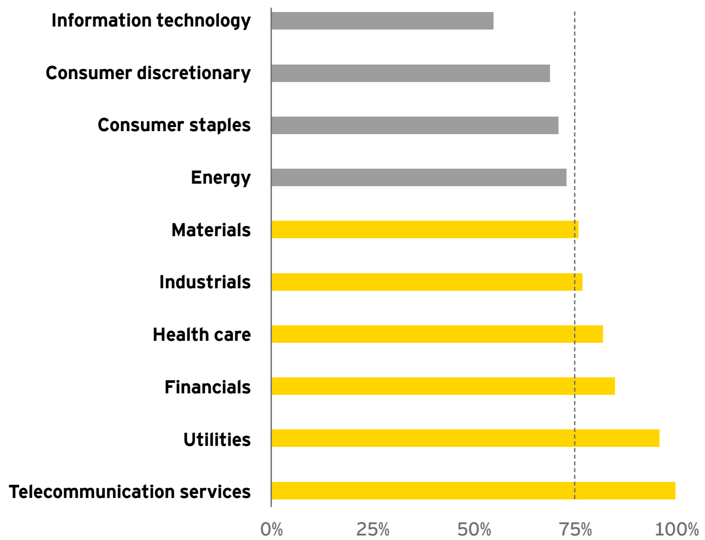
While executive committees still are the most common additional committee (see finding No. 2), several others have seen growth in the last three years. This trend suggests that some boards may be using additional committees to achieve a greater breadth and depth of focus on these complex business areas.

2013 to 2016: net growth in additional committees	
Committees	Percentage point change
Compliance	+3
Risk	+2
Technology	+2
Mergers and acquisitions	+1
Corporate social responsibility	0
Research and development	0
Strategy and planning	0
Executive	-1
Finance	-1
Public policy and regulatory affairs	-1

5. Sector matters when it comes to additional committees

In 6 of 10 industry sectors, over 75% of the companies have at least one additional committee, likely due in part to the unique compliance, risk and operational challenges of these sectors.

Percentage of companies by sector with one or more additional committees



Questions for the board to consider

- Is the board's committee structure appropriate to current board priorities and company-specific needs?
- Is the board familiar with how peer companies are addressing board oversight responsibilities?
- Do assessments of board effectiveness reveal possible pressure points that might be resolved with changes in committee structure?

Additional board committees at S&P 500 companies

Companies with this committee	Committees: function and common responsibilities	Top sectors with this committee
37%	**Executive** ‣ Exercises authority of the board when the board is not in session, except in cases where action of the entire board is required by charter, bylaws or applicable law	‣ Financial (26%) ‣ Industrials (16%) ‣ Consumer discretionary (15%)
31%	**Finance** ‣ Oversees financial policies, strategies, capital structure, and annual operating and capital budget ‣ May also oversee investments, dividend policy, credit and other market risks, share repurchases, and mergers and acquisitions ‣ Functions may overlap with risk, strategy, mergers and acquisitions, and other committees that focus on specific finance-related elements	‣ Consumer discretionary (22%) ‣ Industrials (16%) ‣ Utilities (14%)
12%	**Compliance** ‣ Oversees programs and performance related to legal and regulatory risks, as well as implementation and maintenance of the company's code of conduct and related matters ‣ May focus specifically on compliance in a variety of areas, including environmental, health, safety and technology ‣ Functions may overlap with risk, public policy and sustainability committees	‣ Health care (25%) ‣ Energy (23%) ‣ Financial (13%)
11%	**Risk** ‣ Recommends the articulation and establishment of the company's overall risk tolerance and risk appetite ‣ Oversees enterprise-wide risk management to identify, assess and address major risks facing the company, which may include credit, operational, compliance/regulatory, interest, liquidity, investment, funding, market, strategic, reputational, emerging and other risks ‣ Reviews and discusses management's assessment of the company's enterprise-wide risk profile ‣ Functions may overlap with finance and compliance committees	‣ Financial (73%) ‣ Industrials (6%) ‣ Utilities (4%) ‣ Consumer discretionary (4%) ‣ IT (4%) ‣ Consumer staples (4%)
7%	**Corporate social responsibility** ‣ Reviews policies and practices related to specific public issues of concern to shareholders, the company, employees, communities served and the general public, with oversight of corporate responsibility, environmental sustainability, diversity and inclusiveness, and/or brand management efforts ‣ Functions may overlap with public policy and compliance committees	‣ Financial (26%) ‣ Consumer discretionary (26%) ‣ Materials (19%)
6%	**Technology** ‣ Oversees and assesses the company's technology-related development and innovation strategies; makes recommendations regarding the scope, direction, quality and investment levels; and oversees the execution of technology strategies formulated by management ‣ Reviews and discusses management's assessment of the company's technology profile ‣ Addresses related risks and opportunities ‣ Functions may overlap with risk and research and development	‣ Financial (25%) ‣ Industrials (25%) ‣ Materials (14%)

More insights

Access additional information, including the following, at **ey.com/boardmatters**:

Top priorities for US boards in 2017

The EY Center for Board Matters identifies six priorities for boards in 2017, including a heightened focus on strategy, risk oversight, long-term capital allocation and human capital.

Capital allocation strategy and dialogue with the FASB

Members of the Audit Committee Leadership Network discuss how their boards consider capital allocation decisions, as well as the FASB's operations and agenda.

Election 2016 insights and questions for the board

We discuss the potential economic, social, political and tax implications of the US election and provide insights and questions for boards of directors to consider.

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