Director Notes

Corporate Governance Practices for Initial Public Offerings in the United States

by Richard Sandler and Elizabeth Weinstein

This report examines the corporate governance practices of 50 U.S. companies at the time of their initial public offerings (IPOs) and finds that pressure to update governance practices at larger companies has had only a limited effect on companies at the IPO stage.

To glean the governance practices of newly public companies, we analyze the prospectuses filed with the U.S. Securities and Exchange Commission by the 50 domestic companies with the largest IPOs (in terms of deal size) from January 1, 2009 through August 31, 2011.* The deal size of the IPOs examined ranged from $132.0 million to $18.14 billion.[1]

Despite the growing pressure for seasoned issuers to use certain corporate governance provisions, corporate governance practices at the top 50 IPO companies examined remain in many ways unchanged from those of previous years (as shown by a nearly identical review of the top IPOs in the United States from 2007 to 2008).[2] The IPOs from both time frames show similar percentages for the use of classified boards, plurality voting in uncontested board elections, and fully independent audit committees. Far fewer recent IPO companies separated the role of CEO and chairman of the board—34 percent, compared with 52 percent from the previous sample.

* Portions of this *Director Notes* are adapted from "Corporate Governance Practices of U.S. Initial Public Offerings (Excluding Controlled Companies)," published by Davis Polk & Wardwell LLP in October 2011.

1 The companies examined in this report exclude controlled companies, limited partnerships, real estate investment trusts (REITS), trusts, and blank check companies.

2 Davis, Polk & Wardwell LLP, "Corporate Governance Practices of U.S. Initial Public Offerings (Excluding Controlled Companies)," October 2009 (www.davispolk.com/files/uploads/Documents/CorpGovPractices_Web__Controlled_Excluded.pdf).

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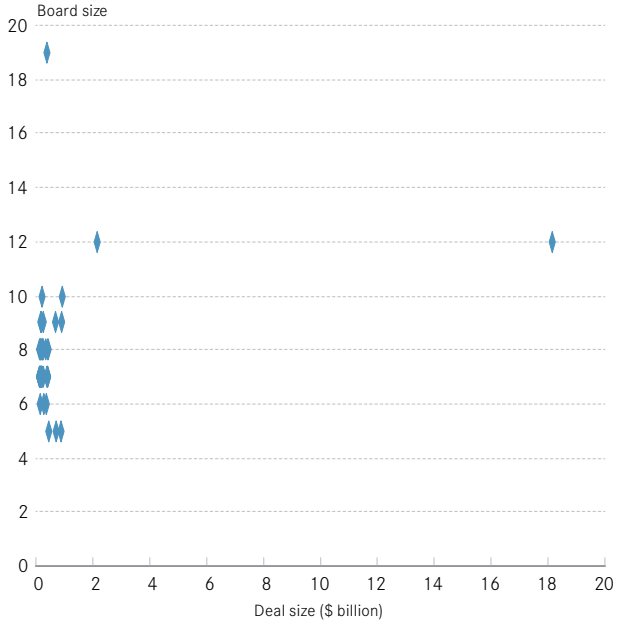
Table 1: **Comparison of Corporate Governance Provisions in IPO Companies**

	2007–2008	2009–2011
Classified Boards	74%	78%
Plurality Voting in Uncontested Board Elections	96	94
Separate Chairman	52	34
Separate Chairman who is independent	19	65
Board Independence	66	74
Have a Lead Director	20	26
Fully Independent Audit Committee	78	78
Disclosure of Compensation Consultants	66	62
Poison Pill	6	0

Source: Davis Polk & Wardwell LLP

Chart 1
Board size at IPO



The review of 2009–2011 IPOs showed an average of 74 percent for board independence versus 66 percent found in the previous review (2007–2008). Also, of the companies that separate the role of CEO and chairman, 65 percent of those in the 2009-2011 group had an independent chairman, versus 19 percent in previous years. In addition, the number of companies that had more than one financial expert on their audit committee increased to 32 percent, compared to 14 percent. Finally, in the 2009–2011 group, no companies reported using a poison pill, while 6 percent of companies in the earlier sample had done so.

Trends

A review of the 50 biggest IPOs (from 2009–2011) reveals some interesting trends. IPOs are moving toward adopting some practices more commonly found at seasoned issuers. In the following results of the review, the composition of boards and audit committees, separation of chairman and CEO, voting, and other characteristics are examined.

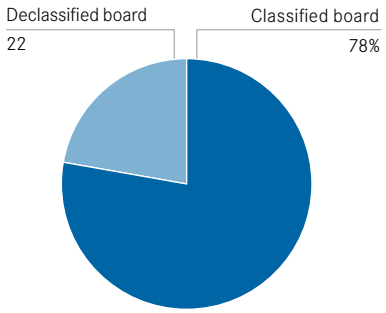
Board Composition

Board Size at Time of IPO Our review of the 50 largest IPOs of 2009–2011 shows that average board size at the IPO companies was eight, with a median board size of seven. Board size ranged from five to 19 members. There was no distinct correlation between deal size and board size.

Level of Board Independence at the Time of IPO The average level of director independence among the IPO companies in the sample was 74 percent of the board, and the median level of director independence was 75 percent. The level of director independence ranged from a low of 29 percent to a high of 90 percent. Subject to an exception for "controlled companies," NYSE and NASDAQ listing standards require that the board of directors of an IPO company consist of a majority of independent directors within one year of the date of listing.

Classified Board at IPO As shown in Chart 2 below, the majority of companies in the sample had classified boards at the time of their IPO.

Chart 2
Classified Board at IPO



The Top 50 IPOs in the United States from 2009–2011

The findings in this report are based on the analysis of prospectuses filed with the U.S. Securities and Exchange Commission by the following 50 companies:

A123 Systems, Inc.

Accretive Health, Inc.

Air Lease Corp.

Artio Global Investors Inc.

BankUnited, Inc.

Bravo Brio Restaurant Group, Inc.

C&J Energy Services, Inc.

CBOE Holdings, Inc.

Cloud Peak Energy Inc.

Cornerstone OnDemand, Inc.

Demand Media, Inc.

DigitalGlobe, Inc.

ExamWorks Group, Inc.

Financial Engines, Inc.

First Connecticut Bancorp, Inc.

FleetCor Technologies, Inc.

Fortinet Inc.

Fusion-io, Inc.

General Motors Co.

Green Dot Corp.

HomeAway, Inc.

Imperial Holdings, Inc.

IntraLinks Holdings, Inc.

Ironwood Pharmaceuticals, Inc.

LinkedIn Corp.

Molycorp, Inc.

NetSpend Holdings Inc.

Northwest Bancshares, Inc.

Pacific Biosciences of CA, Inc.

Pandora Media, Inc.

Primerica, Inc.

QuinStreet, Inc.

RealD Inc.

RealPage, Inc.

RPX Corp.

ServiceSource International

Skullcandy, Inc.

SolarWinds, Inc.

Solazyme, Inc.

STR Holdings, Inc.

Swift Transportation Co.

Symetra Financial Corp.

Targa Resources Corp.

Tesla Motors, Inc.

The Chefs' Warehouse, Inc.

The Active Network, Inc.

Vera Bradley Designs, Inc.

Verisk Analytics, Inc.

Vitacost.com, Inc.

Zipcar, Inc.

Breakdown of Industries

The 50 companies review included twenty-two industries

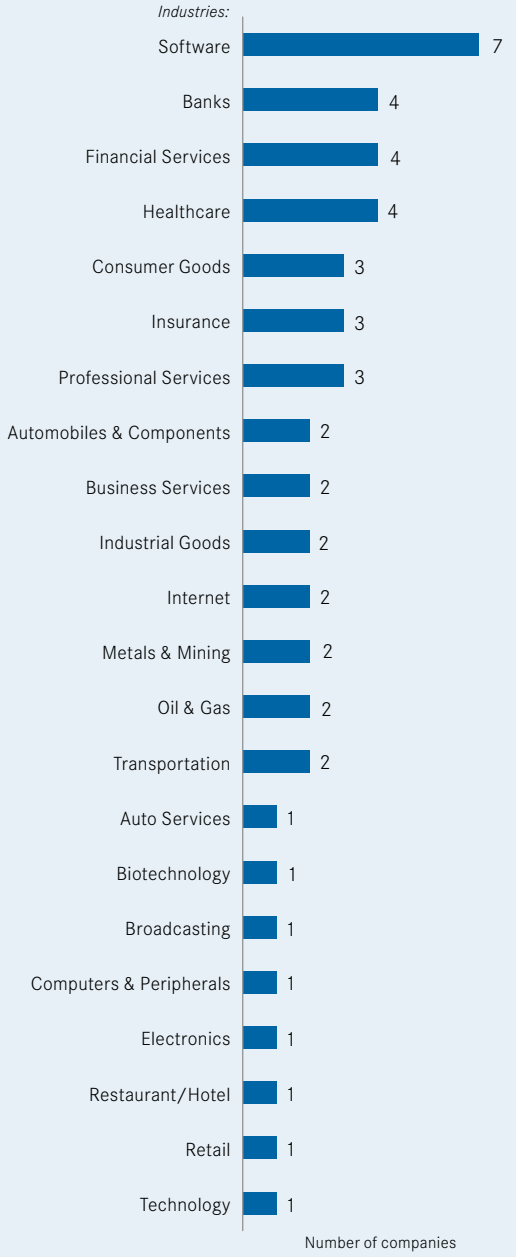
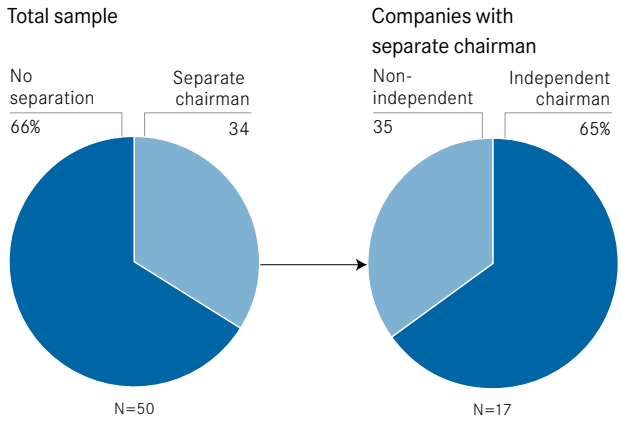


Chart 3
Separation of Chairman & CEO



Separation of Chairman and CEO

Roughly one third of the companies had a separate chairman and CEO. Of the 17 companies with a separate chairman, nearly two-thirds had an independent chairman (see Chart 3).

Lead Director

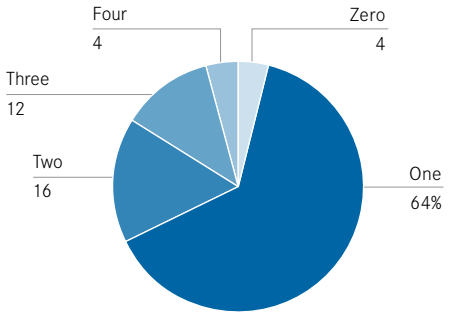
Slightly more than a quarter (26 percent) of the IPO companies had a lead director (see Chart 4).

Audit Committees

Number of Financial Experts at IPO Chart 5 shows the number of financial experts on the audit committees of the 50 IPO companies. While the number of experts ranged from zero to four, the majority of the companies in the sample had one financial expert on their audit committee.

The U.S. Securities and Exchange Commission requires a listed company to disclose in its annual report whether the board of directors has determined that the company

Chart 5
Number of Audit Committee Financial Experts at IPO



has at least one audit committee financial expert serving on its audit committee, or explain why it does not have one. Under the SEC rules, an audit committee financial expert is a person who has the following attributes: (1) an understanding of generally accepted accounting principles and financial statements, (2) the ability to assess the general application of such principles in connection with the accounting for estimates, accruals, and reserves, (3) experience preparing, auditing, analyzing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the company's financial statements, or experience actively supervising one or more persons engaged in such activities, (4) an understanding of internal control over financial reporting, and (5) an understanding of audit committee functions.

Audit Committee Independence The vast majority (78 percent) of the companies surveyed had a fully independent audit committee at the time of their IPO (see Chart 6). Under NYSE and NASDAQ rules, an IPO company must have at least one independent member of the audit committee at the time of listing, a majority of independent members within

Chart 4
Lead Director

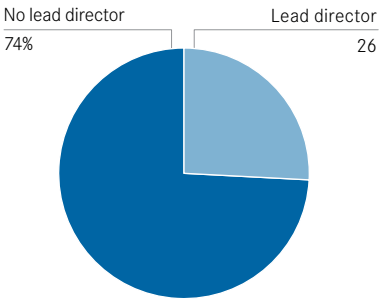
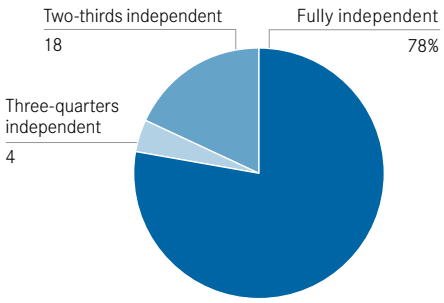


Chart 6
Audit Committee Independence at IPO



90 days of its registration statement being declared effective, and a fully independent audit committee within one year of its registration statement being declared effective.

In addition to the NYSE/NASDAQ independence standards applicable to all independent directors, audit committee members are required to meet additional specific independence requirements set forth by the SEC. These requirements provide that a director who serves on the listed company's audit committee may not (other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee) (1) accept any consulting, advisory, or other compensatory fee from the listed company (excluding fixed, noncontingent payments under a retirement plan for prior service with the listed company) or (2) be an "affiliated person" of the listed company or any subsidiary thereof.

Voting

Voting Standards in Uncontested Board Elections Ninety-four percent of the IPO companies examined required a plurality standard for board elections (see Chart 7). Under Delaware Law, in the absence of a different specification in the certificate of incorporation or bylaws of the company, directors are elected by a plurality voting system. Under the plurality voting system, the nominees for directorships are elected based on who receives the highest number of affirmative votes cast. Under a majority voting system, a nominee for directorship is elected if he or she receives the affirmative vote of a majority of the total votes cast for and against such nominee.

Supermajority Vote for Amending the Charter and Bylaws Thirty-seven of the IPO companies required a supermajority shareholder vote for amending the Charter and/or bylaws. Of those 37, 12 companies required a vote of 75 percent or more (see Chart 8).

Chart 7
Voting Standard in Uncontested Board Elections

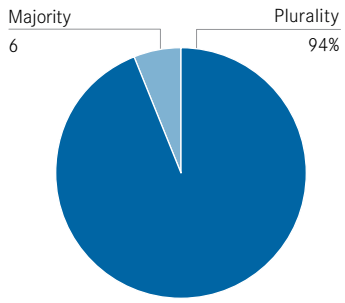
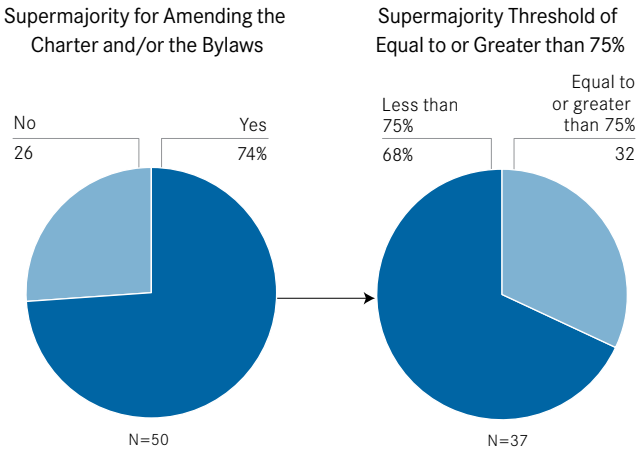


Chart 8
Supermajority Vote for Amending the Charter & Bylaws



A Comparison of IPO Companies and the S&P 500

A review of S&P 500 companies as of June 30, 2010[3] with the top 50 IPOs of 2009–2011 reveals some interesting contrasts. Many of the governance practices in place in companies at the time of their IPO differed greatly from those found among larger issuers in the S&P 500 Index. Few of the IPO companies in the sample had a majority voting standard in place for director elections (6 percent of IPO companies versus 70 percent of the S&P 500) (Table 2).

Table 2: **Corporate Governance Provisions in IPO Companies vs. S&P 500 Companies**

	IPO companies	S&P 500 companies*
Majority Voting for Directors	6%	70%
Classified Boards	78	39
Lead Director	26	65
Board Independence	74	82
Fully Independent Audit Committee	78	97
Separate Chairman & CEO	34	38

* Information for S&P 500 companies is as of June 30, 2010 and is from Institutional Shareholder Services, Board Practices, 2011 Edition

3 Information for S&P 500 Companies is as of June 30, 2010 and is from Institutional Shareholder Services, *Board Practices*, 2011 Edition.

Far more IPOs had classified boards (78 percent versus 39 percent for the S&P 500). In addition, the proportion of IPO companies with a lead director was much lower for IPO companies than for the S&P 500.

Controlled Companies vs. Noncontrolled Companies

The 50 IPO companies in the 2009–2011 sample do not include "controlled companies" as defined under the NYSE and NASDAQ listing standards. Controlled companies are subject to an exemption from certain of the board and committee independence requirements of the NYSE and NASDAQ listing standards, including the requirement that the board of directors of an IPO company consist of a majority of independent directors within one year of the date of listing. As a result, the governance practices at controlled companies often differ substantially from those found at noncontrolled companies. Table 3 provides a comparison of certain key corporate governance provisions found at the non-controlled companies in this survey versus those at controlled companies.

Table 3: **Corporate Governance Provisions in Controlled vs. Non-controlled Companies**

	Non-controlled companies	Controlled companies only*
Average level of director independence	74%	39%
Classified Board	78	64
Separate Chairman	34	54
Independent Chairman	65	20
Lead Director	26	4
Fully Independent Audit Committee	78	50
Majority Voting	6	11
Exclusive Forum	14	26
Shareholder Action by Written Consent	10	54

* The data on controlled companies is based on a review of the top 50 IPOs by deal size from January 1, 2009 through August 31, 2011. Of these 50 IPOs, 28 were "controlled companies" whose data is included herein.

Common and Preferred Stock Provisions

Primary Listing Exchange As shown in Chart 9, the companies surveyed were closely split between listing on the NYSE and the NASDAQ.

Classes of Outstanding Common Stock at IPO Survey findings show that 82 percent of the companies had only one class of common stock (see Chart 10).

Chart 9
Primary Listing Exchange

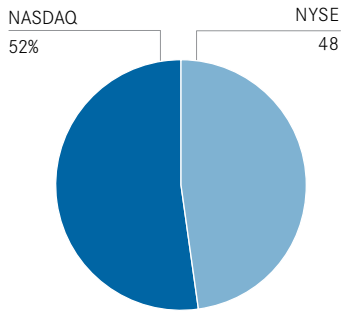
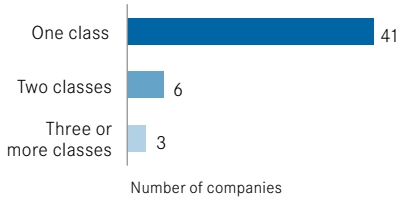


Chart 10
Classes of Outstanding Common Stock at IPO



Poison Pills and Blank Check Preferred Stock

Poison Pills None of the companies surveyed had a shareholders' rights plan.

"Blank Check" preferred stock All but one company of the top 50 were authorized to issue "blank check" preferred stock. A company may include in its authorized and unissued stock a certain amount of undesignated preferred shares. The board of the company is authorized to issue preferred shares in one or more series and to determine and fix the designation, voting power, preference, and rights of the shares of each such series and any of its qualifications, limitations, or restrictions. The existence of "blank check" preferred stock allows the board to issue preferred stock with super voting, special approval, dividend or other rights or preferences on a discriminatory basis without a shareholder vote (see Chart 11).

Chart 11
Poison Pills and Blank Check Preferred Stock

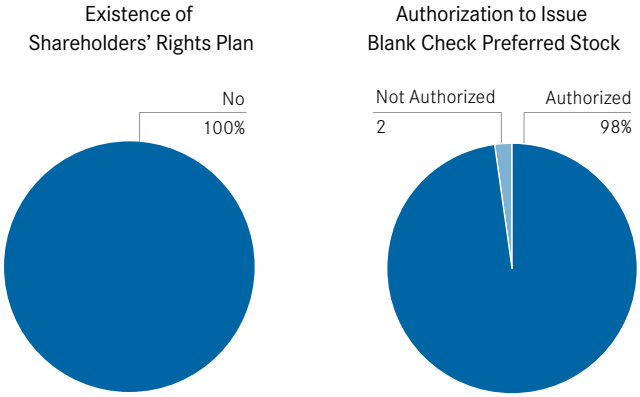
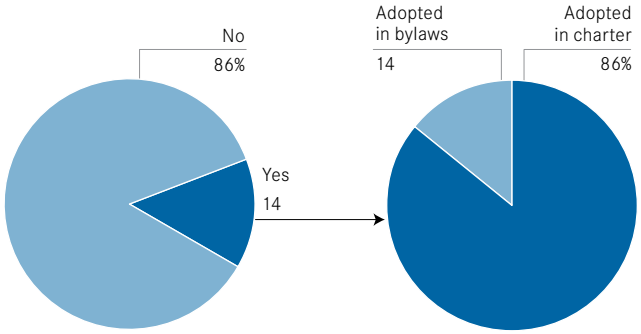


Chart 12
Adoption of Exclusive Forum Provisions



Exclusive Forum Provisions

Seven companies had exclusive forum provisions, all of which specified Delaware as the exclusive forum. Of those seven companies, six adopted the exclusive forum provision in the company's charter and one adopted it in the company's bylaws. All companies with exclusive forum provisions were from 2010 or 2011 IPOs.

Delaware forum selection provisions in a company's charter or bylaws require that the Court of Chancery of the State of Delaware is the sole and exclusive forum for certain specified classes of litigation against the company, including shareholder derivative claims. Delaware companies often choose to adopt these provisions because of the Court of Chancery's expertise, both in substantive corporate law and in the procedural aspects of shareholder litigation, combined with its relatively expeditious procedures. Delaware's well-developed body of case law also gives companies more certainty in the outcome of their litigation. Finally, exclusive forum provisions avoid expensive and duplicative litigation faced by companies when they are facing similar litigation in both Delaware and another state or federal court.

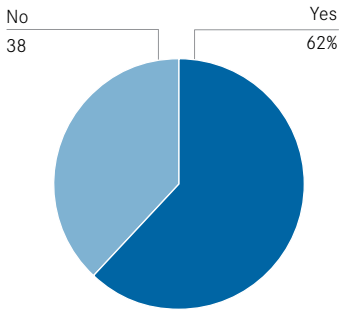
The notion of exclusive Delaware forum provisions gained traction in 2010 after the Delaware Court of Chancery in *In re. Revlon, Inc. Shareholders Litig.*[4] suggested that companies might select an exclusive forum for intra-entity disputes in their charter. Since then, a number of number of companies have adopted exclusive forum provisions in either their charter or their bylaws. Of the IPO companies that include exclusive forum provisions in their governing documents at the time of the IPO, many choose to include these in their charter. Exclusive forum provisions in charters are arguably more enforceable than those in bylaws.

Compensation Consultant Disclosure

Of the 50 companies examined, 31 (62 percent) disclosed the use of compensation consultants. Of the companies that disclosed using consultants, 29 (94 percent) cited the name of the consultancy.

The SEC requires a listed company to disclose any role of compensation consultants in determining or recommending the amount or form of executive and director compensation in its Form S-1 and its proxy statement. The company must identify such consultants, stating whether they are engaged directly by the compensation

Chart 13
Compensation Consultant Disclosure



4 990 A.2d 940 (Del. Ch. Mar. 16, 2010).

The specified consultants reported by IPO companies from 2009–2011 included:

- Amalfi Consulting
- Compensia, Inc.
- Dolmat Connell & Partners, Inc.
- Exequity
- Frederic W. Cook & Co.
- Hewitt Associates
- IPAS
- McLagan, Inc.
- Pearl Meyer & Partners
- Mercer, LLC
- Radford Surveys & Consulting
- Syzygy Consulting Group
- Towers Perrin*
- Towers Watson*
- Watson Wyatt*

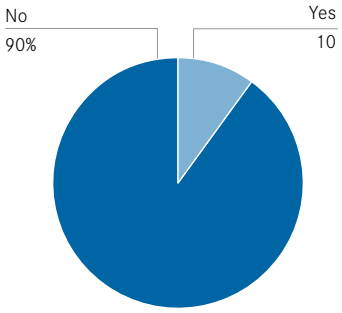
* Towers Perrin and Watson Wyatt merged to form Towers Watson on January 1, 2010.

committee (or persons performing the equivalent functions) or any other person, and describe the nature and scope of their assignment and the material elements of the instructions or directions given to the consultants with respect to the performance of their duties under the engagement.[5]

Shareholder Action by Written Consent

Of the 50 companies examined, five companies (10 percent) permit shareholder action by written consent.

Chart 14
Shareholder Action by Written Consent



5 In March 2011, the SEC proposed rules, which have not been finalized, regarding disclosure of the use of compensation consultants and conflicts of interest.

Conclusion

The analysis shows that many of the current governance practices adopted by larger, more seasoned public companies, such as majority voting and classified boards, have yet to trickle down to companies at the IPO stage. Some of that may be due to differences in their shareholder bases and the fact that investors and proxy advisory firms tend to give IPO companies time to adjust to life as public companies before focusing heavily on their governance practices. Overall, the findings suggest that newly public companies have a great deal of latitude when designing their governance structure, enabling them to tailor those structures to their specific needs.

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Richard Sandler is co-head of Davis Polk's global corporate governance group and a leader of the firm's global capital markets practice. He has extensive experience advising on all aspects of corporate governance and serves on the New York Stock Exchange Commission on Corporate Governance. He regularly advises on public and private securities offerings, including initial public offerings, high-yield debt securities, derivatives, venture capital and leveraged investments, spinoffs, restructurings, exchange offers and new financial products. Sandler also serves on the Legal Advisory Committee to the Committee on Capital Markets Regulation.

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