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Institutional Shareholder Services
policy@issgovernance.com

Re: Comment on "Unilateral Board Actions (U.S.)" Memo of October 26, 2015

Dear Institutional Shareholder Services:

Thank you for the opportunity to comment on your "Unilateral Board Actions (U.S.)" Memo of October 26, 2015, specifically the "pre-IPO" portion of your recent proposal:

> *ISS is also considering implementing a policy providing that, when a board amends the bylaws or charter prior to or in connection with the company's initial public offering to classify the board and establish supermajority vote requirements to amend the bylaws or charter, ISS will generally issue adverse vote recommendations for director nominees at subsequent annual meetings following completion of the initial public offering.*
> . . .
> *When, prior to or in connection with an initial public offering (IPO), the board classifies and implements supermajority vote requirements to amend the bylaws or charter, do you consider it appropriate to hold the directors accountable through continuing adverse vote recommendations at annual meetings following the initial public offering?"*

I urge you to reconsider this proposal, as it would represent a radical departure from the dominant practice today, in which classified boards and supermajority vote requirements are found in *nine out of every ten companies at the time of their IPO*.[1] In other words, and to response directly to your request for comment, I would *not* "consider it appropriate" for ISS to issue adverse voting recommendations—year in, year out, potentially forever—against every director of every company that follows this now-common practice. My concern is that such a policy would harm public investors and the nation as a whole by discouraging our most promising firms from ever going public in the first place.[2]

[1] Andrew A. Schwartz, *Corporate Legacy*, 5 HARV. BUS. L. REV. 237, 244, 248 tbl.1 (2015) (reporting that 89% of contemporary IPO companies go public with a classified board); *WilmerHale 2015 M&A Update* 4, https://www.wilmerhale.com/uploadedFiles/Shared_Content/Editorial/Publications/Documents/2015-WilmerHale-MA-Report.pdf (reporting that 91% of contemporary IPO companies go public with supermajority vote requirements).

[2] *See generally* DARON ACEMOGLU AND JAMES A. ROBINSON, WHY NATIONS FAIL 75 (2012) (arguing that the existence of "inclusive economic institutions," like a public stock market, is the key component of national success).

Thoughtful commentators are already troubled about the dwindling number of IPOs and public companies in today's market,[3] and Congress has taken direct action to reverse the trend and encourage private companies to launch an IPO.[4] As mentioned above, those relatively few private companies that have gone public in recent years have shown a very strong preference for classified boards and supermajority vote requirements.[5] Moreover, these structures are especially common in the sort of VC-backed high-technology firms whose absence from the IPO market has been particularly missed in recent years.[6]

Given this state of affairs, if classified boards and supermajority vote requirements were taken away from the pre-IPO palette, as your proposal aims to do, there is a very real risk that many private companies will react by declining to launch an IPO at all. In this way, your pre-IPO proposal could compound the problem of the "vanishing IPO"[7] by making private companies even less likely to launch an IPO than they already are.[8]

Alternatively, pre-IPO firms could presumably avoid application of the proposed policy by obtaining assent to the structures from the pre-IPO shareholders; in such a case their adoption would not be a "unilateral" act of the board and thus not covered by the present policy, were it in place. This will be quite easy to achieve in many, if not most, companies, for the pre-IPO shareholders commonly exert effective control over the pre-IPO board.[9]

Given that final point, one might reasonably question why the overwhelming majority of pre-IPO shareholders allow their company to go public with a classified board in place.[10]

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[3] *E.g.*, *Report of the House Financial Services Committee*, Mar. 1, 2012, H.R. REP. 112-406, at 7 ("Over the last decade, the number of companies entering the U.S. capital markets through IPOs has sharply declined, irrespective of economic conditions during the same period. . . . The falling number of IPOs has contributed to the decline of the U.S. as a global financial market."); Elizabeth Pollman, *Information Issues on Wall Street 2.0*, 161 U. PA. L. REV. 179, 184-85 (2012) (reporting that the major U.S. stock exchanges listed over 7,000 public companies in 1997 but only about 4,000 today); Darian M. Ibrahim, *The New Exit in Venture Capital*, 65 VAND. L. REV. 1, 11-12 (2012) (observing that "IPOs have fallen off dramatically" with "significant negative repercussions on venture capital"); Graham Bowley, *Wall Street, the Home of the Vanishing I.P.O.*, N.Y. TIMES, Nov. 17, 2010, at B1 (reporting that "the number of companies listed on the nation's major exchanges has plummeted" and that some "economists warn the economy will suffer if innovative private companies cannot or will not turn to the public markets").

[4] Jumpstart our Business Startups (JOBS) Act of 2012, Pub. L. No. 112-106 §§ 101-108 (relaxing the regulatory environment for smaller issuers before and after an IPO). The legislative history makes plain that a driving purpose of the JOBS Act was "[t]o encourage small companies to go public." *Report of the House Financial Services Committee*, *supra* note 3, at 9; *id.* at 6 (explaining that the JOBS Act "provides temporary regulatory relief to small companies, which encourages them to go public" in an IPO).

[5] *Supra* note 1.

[6] *WilmerHale 2015 M&A Update*, *supra* note 1, at 6.

[7] Bowley, *supra* note 3.

[8] *See* Schwartz, *supra* note 1, at 272 (predicting that a prohibition on the use of a classified board at the IPO stage "would make pre-IPO shareholders . . . less likely to bring the company public in the first place"); *id.* at 272-73 ("The expected effect would be to reduce the number of IPOs even further than the already-depressed levels that have caused concern. This unintended potential consequence provides a good reason to be cautious before following the trend in the market for mature public companies and banning, or requiring sunsets for, strong takeover defenses at the IPO stage.").

[9] *E.g.*, Michael Klausner, *Institutional Shareholders, Private Equity, and Antitakeover Protection at the IPO Stage*, 152 U. PA. L. REV. 755, 769, 771, 771 n.55 (2003) ("Prior to an IPO, venture capitalists on average own 54% of the share of firms in which they invest. Leveraged buyout funds on average own 74.8% of firms in which they invest.").

[10] Steven M. Davidoff, *The Case Against Staggered Boards*, N.Y. TIMES, Mar. 20, 2012, http://dealbook.nytimes.com/2012/03/20/the-case-against-staggered-boards ("If the staggered board is really so bad . . . then why are all of these companies going public with one?").

Indeed, this is a well-known mystery among the corporate law academy,[11] and one to which leading scholars have offered their ideas.[12] Some have suggested that this phenomenon is a function of legal advice;[13] others raised the possibility of private rent-seeking by founders.[14] I myself have argued that one reason pre-IPO shareholders endorse classified boards is that they allow the company to remain independent indefinitely and thus create a corporate legacy.[15]

In any event, regardless of the reason, it is quite clear that pre-IPO shareholders have a strong revealed preference for installing a classified board in advance of the IPO. It therefore follows that if pre-IPO firms are denied the option of going public with a classified board, fewer private firms will go public, especially in the current moment where there is so much private money available.[16] This is not a desirable outcome and one that should be avoided if at all possible. As such, I recommend that you decline to implement the tentative pre-IPO proposal quoted above.

Sincerely,

Andrew A. Schwartz

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[11] *See, e.g.*, Schwartz, *supra* note 1; Michael Klausner, *Fact and Fiction in Corporate Law and Governance*, 65 STAN. L. REV. 1325, 1370 (2013); Lynn A. Stout, *The Shareholder as Ulysses: Some Empirical Evidence on Why Investors in Public Corporations Tolerate Board Governance*, 152 U. PA. L. REV. 667, 699-701 (2003); Robert Daines & Michael Klausner, *Do IPO Charters Maximize Firm Value? Antitakeover Protection in IPOs*, 17 J.L. ECON. & ORG. 83, 111 (2001); John C. Coates IV, *Explaining Variation in Takeover Defenses: Blame the Lawyers*, 89 CAL. L. REV. 1301 (2001).

[12] Schwartz, *supra* note 1, at 249-54 (surveying the academic literature).

[13] Coates, *supra* note 11.

[14] *See* Lucian A. Bebchuk, *Why Firms Adopt Antitakeover Arrangements*, 152 U. PA. L. REV. 713, 733-34 (2003). Empirical research has cast doubt on this explanation, however. *See* Klausner, *supra* note 9, at 779 ("We analyzed whether firms in which founders were still CEOs at the time of the IPO were more likely to have takeover defenses than were firms whose founders had been replaced as CEO. Our assumption was that founder-CEOs would derive relatively high psychic benefits from retaining control of the firm and would, therefore, derive greater private benefits overall than would other managers. We found, however, that there was no statistically significant difference in takeover defenses between firms with and without founder-CEOs.").

[15] Schwartz, *supra* note 1, at 268-70 ("To summarize this Article's novel explanation for the mystery of takeover defenses at IPO firms: the age-old quest for immortality through an enduring legacy can be realized through affiliation with a perpetual corporation, especially a public one. Because public companies are vulnerable to hostile acquisition, which can put an end to corporations' independent existences, the pre-IPO shareholders favor armoring the company with powerful takeover defenses. They also know that takeover defenses must be adopted at the IPO stage, because shareholder rights advocates have made it practically impossible to add the most potent defenses to an already-public company."); Andrew A. Schwartz, *The Iliad and the IPO*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION, Aug. 12, 2015, http://corpgov.law.harvard.edu/2015/08/12/the-iliad-and-the-ipo (summarizing the argument); *see also* Schwartz, *supra* note 1, at 269 n.186 ("There may be multiple mechanisms, including those suggested in prior literature, behind the mystery of takeover defenses at IPO firms.").

[16] *See, e.g.*, Drew Fitzgerald, *In 'Another Life,' Jack Ma Says He'd Forgo Alibaba's IPO*, WALL ST. J., Jun. 9, 2015, http://blogs.wsj.com/moneybeat/2015/06/09/in-another-life-jack-ma-says-hed-forgo-alibabas-ipo ("If I had another life, I would keep my company private. . . . Life is tough when you IPO." (quoting Jack Ma, founder of Alibaba, the largest IPO of 2014)).