Key Takeaways

› **A Tale of Two Governance Regimes:** Governance practices between S&P 500 and the rest of the members of the S&P 1500 continue to differ significantly. More importantly, the rate of governance change between the two groups varies in many areas, as large-caps tend to adopt shareholder-friendly board accountability practices more quickly compared to smaller firms.

› **Classified Boards:** Annual elections are now the standard among large-cap firms, and are becoming more common among mid-caps. However, progress at small-cap firms has stalled, while there appears to be a resurgence of classified boards at micro-cap companies.

› **Majority Vote Standard:** A growing number of companies in all segments of the market are adopting the majority vote standard for uncontested director elections.

› **Proxy Access:** Almost two-thirds the S&P 500 have adopted a form of proxy access in the past three years, and the practice is beginning to emerge among mid- and small-capitalization firms. However, shareholder proposal activity is down sharply from its 2016 peak.

› **Board Leadership:** The slow and steady increase of companies establishing an independent chair continues, with 35% of S&P 1500 firms having an independent chair in 2017. Coupled with the establishment of independent lead directors, 89% of S&P 1500 firms now have some form of independent board leadership.

› **Poison Pills:** The steady decline of poison pills as a takeover defense continued in 2017, with only 4% of S&P 1500 having an active poison pill, a significant drop compared to 2005 levels, when 54% of the index had poison pills in place.

› **Supermajority Vote Requirements:** The practice is slowly diminishing among S&P 500 firms reaching an all-time low of 46% of non-controlled firms having supermajority vote requirements for a change the bylaws or charter in 2017. S&P 400 and S&P 600 constituents maintain supermajority vote requirements at approximately 62% of firms, roughly the same rate as in 2008.

› **Right to Call a Special Meeting and Right to Act by Written Consent:** Large-caps adopt the right to call a special meeting in great numbers, with two-thirds of firms having adopted the practice by 2017. No significant change has taken place at smaller firms in the past ten years. Written consent practices have also not changed considerably for both large and small firms since 2008.

› **Blank Check Preferred Stock:** More than 93 percent of S&P 1500 companies have blank check preferred stock authorizations. While most investors state opposition to the blank check authority, as it gives boards the discretion to issue shares with unspecified voting rights, management proposals related with such issuances receive average support levels of close to 90% of votes cast.

› **Future Developments:** In light of a surge in restrictive governance structures at younger firms, such as dual-class shares and classified boards, investors realize that the path to better board accountability is not a fixed trajectory towards progress. Moreover, the persistent difference in practices between large-caps and the rest of the investee universe raises the question of whether companies outside the S&P 500 are held to high enough governance standards. As such, engagements to improve board accountability will likely continue with the same intensity as in prior years.
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Methodology

ISS annually undertakes a review and analysis of the structure and composition of boards and individual director attributes among Standard & Poor Composite 1500 companies, (i.e. companies in the S&P 500, MidCap 400, and SmallCap 600 indices), in order to identify the latest practices and emerging trends.

This report focuses on board accountability structures, including the director election method (annual elections and vote standard requirements), shareholders’ ability to directly nominate directors, board leadership, board independence, the right to call a special meeting or act by written consent, and antitakeover mechanisms.

The report covers data reported in public filings (primarily company proxy statements) related to shareholder meetings occurring from Jan. 1, 2017 to Dec. 31, 2017. The companies and directors in the study are classified into the following S&P indices:

<table>
<thead>
<tr>
<th>INDEX</th>
<th>NUMBER OF BOARDS</th>
<th>NUMBER OF DIRECTORSHIPS</th>
</tr>
</thead>
<tbody>
<tr>
<td>S&amp;P 500</td>
<td>497</td>
<td>5,348</td>
</tr>
<tr>
<td>S&amp;P 400</td>
<td>395</td>
<td>3,681</td>
</tr>
<tr>
<td>S&amp;P 600</td>
<td>597</td>
<td>4,969</td>
</tr>
<tr>
<td>S&amp;P 1500</td>
<td>1489</td>
<td>13,996</td>
</tr>
</tbody>
</table>

A Tale of Two Governance Regimes

Board accountability practices involve a wide range of governance structures, such as how directors are elected to the board, and mechanisms that may make it easier or more difficult for shareholders to influence participate in key company decisions. During the past decade, S&P 500 companies have continued to improve their board accountability practices at a faster rate than smaller size firms. This trend is not surprising, as large-cap firms receive a greater level of scrutiny by shareholders on governance topics, as they often become the targets of shareholder proposal campaigns.

![Graph showing the percentage of companies with at least one voted shareholder proposal by index from 2010 to 2017.](source: ISS Voting Analytics)
However, this trend of a widening governance gap questions the theory of a potential "trickle-down" effect in corporate governance, whereby the expectation is that, once large-caps adopt best practices, the rest of the market will follow their example. Instead, we begin to observe a greater disparity in governance practices between large firms and small firms. This development becomes more concerning, as a growing number of small firms and recent IPOs tend to adopt practices that run counter to greater board accountability, such as dual-class share structures, classified boards, and supermajority vote requirements. With this broader context in mind, we now turn to specific governance practices related to board accountability.

**Annual Director Elections**

In the past ten years, an increasing number of companies have adopted annual director elections in each constituent index of the S&P 1500. Advocates of classified boards, where directors serve staggered multi-year terms, contend that they provide boardroom continuity and smooth board transitions. Proponents of annual director elections, including many institutional investors, believe that a staggered board diminishes director accountability and promotes entrenchment of poorly performing managers and unresponsive directors. Some shareholders view a classified board as a takeover defense mechanism, particularly in combination with other defenses such as poison pills, which can present a formidable hurdle to an unsolicited takeover bid.

A majority of companies in each of the S&P 500, S&P 400, and S&P 600 now hold annual director elections. The growth trend of annually elected boards, however, has slowed. From 2012 to 2014, the Shareholder Rights Project at Harvard Law School contributed to the adoption of annual board elections at over 100 S&P 500 and Fortune 500 companies through shareholder proposal filings and engagements. For several companies, the adoption of annual elections was phased in over a three-year period. By now, the phasing in of board declassification at companies that were subject to the campaign has largely been completed.

Among midcap S&P 400 constituents, the percentage of companies with annual director elections increased to 62 percent of companies in 2017, an increase of more than 50 percent since 2009 when only 40 percent of S&P 400 firms held annual elections. The rate of progress among small firms has been much slower, as approximately 53 percent of S&P 600 constituents held annual elections in the past three years, compared to 45 percent in 2009.

![Annual elections become the standard at large-cap companies, but smaller companies are slower to adopt](image-url)
The relatively slow rate of change among smaller companies may raise concerns for investors, who overwhelmingly oppose the classification of the board. The data suggests a developing new trend, whereby annual director elections becomes the standard for larger companies, while an increasing number of small firms retain a classified board structure. In the past four years, we see a reemergence of classified boards outside the S&P 1500, as the percentage of non-S&P 1500 companies in the Russell 3000 with classified boards increased from 51% of firms in 2014 to 60% of companies in 2017, according to ISS QualityScore data. This trend becomes more apparent when also reviewing the governance practices of companies that went public in recent years, as approximately 80 percent of companies with IPOs from 2014 onwards have classified boards.

### Majority Vote Standard in Director Elections

Under a majority vote standard, a director must receive support from the holders of a majority of shares voted to be deemed “elected.” However, under the laws of most states, a director continues to serve until a successor is elected and qualified, even if they fail to receive majority support. Majority voting alone does not address such “holdover” situations. Consequently, most companies with a majority vote standard for uncontested elections have also adopted a post-election director resignation policy that provides guidelines so that the company can properly address the holdover problem. While the board is not required to accept a director’s resignation in all states, a director is not legally considered "elected," as a result of a failure to gain the majority votes required for election.

A majority vote standard in uncontested elections coupled with a post-election “director resignation policy” has emerged as best practice. Many shareholders believe that this combination provides them with a clear, legally significant vote, while allowing the board to address holdover directors in a manner that accommodates both shareholder concerns and the need for board stability and continuity.

The proportion of S&P 1500 companies utilizing a majority vote standard has increased every year since 2009. Just over two-thirds of member companies have adopted a majority vote standard. In the S&P 500, only 42 companies maintain a plurality vote standard, down from 51 companies in the prior year. With the utilization of a majority vote standard edging just over 92 percent in the S&P 500, the growth rates among S&P 400 and S&P 600 companies are more pronounced. Year-over-year...
year, the number of companies with a majority vote standard increased by four percentage points to 67 percent at S&P 400 companies and by eight percentage points to 46 percent at S&P 600 companies. The growing trend of majority vote standard adoptions is also true for non-S&P 1500 companies.

Contributing to the stark increase within the S&P 600 may have been recent efforts led by the Council of Institutional Investors ("CII"). In August 2016, CII launched a campaign targeting companies in the Russell 3000 that continued to utilize a plurality vote standard to encourage them to adopt a majority vote standard.

**Proxy Access**

Proxy access is the process for a long-term shareholder, or group of long-term shareholders, to place a limited number of their own board candidates directly on the company’s ballot. Although proxy access can trace its roots to decades prior, the concept as we know it today got its start from a provision in the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act which gave the Securities and Exchange Commission the authority to craft a proxy access rule. A 2011 lawsuit challenging the SEC’s proposed proxy access guidance ultimately caused the SEC to vacate its proxy access rule. However, shareholders began filing proposals requesting companies implement proxy access, culminating in the launch of the Boardroom Accountability Project in the fall of 2014.

After significant gains in each of the past two years, the proxy access adoption rate slowed in 2017 for S&P 500 companies. Shareholder proposals asking for the right built to a peak in 2016, and have fallen since.
The number of S&P 500 companies with proxy access provisions increased by 27 percent in 2017 to reach 315 companies. However, this rate compares to triple digit growth in each of the prior two years. Just over 63 percent of S&P 500 companies had adopted proxy access as of the end of 2017. As proxy access has become widely adopted at large-cap firms, we are beginning to see the first signs of the practice spreading to smaller firms. At the end of 2017, 64 S&P 400 companies had proxy access provisions in place, a 41 percent increase from 2016, while 34 S&P 600 companies had proxy access, a 62 percent increase compared to the previous year. In 2017, the year-over-year adoption rate increase was higher among S&P 400 and S&P 600 companies, compared to the S&P 500. On an absolute basis, however, adoption rates outside the S&P 500 remain relatively low.

A majority of companies in each sector has adopted proxy access within the S&P 500. Adoption rates are highest in the energy and utilities sectors, where the Boardroom Accountability Project first
targeted most of their shareholder proposal filings. On a broader S&P 1500 basis, however, utilities is the only sector where a majority of companies provide shareholders with proxy access, with an adoption rate of 54 percent. Financial companies have the lowest rate of adoption in the S&P 1500, at just 22 percent of firms.

A growing number of companies that have adopted proxy access use provisions which allow a shareholder, or a group of up to 20 shareholders, owning at least three percent of outstanding shares for at least three years with the right to nominate up to 20 percent of the board (commonly referred to as 3/3/20/20 standard). Of the 415 companies with proxy access in the S&P 1500, 84 percent of firms utilize proxy access with these provisions. By comparison, at the end of 2016, these same provisions were used by 81 percent of companies with proxy access. The following table shows the proxy access provisions implemented by companies in each index:

<table>
<thead>
<tr>
<th>Proxy Access Provisions</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>3% of Shares Held for 3 Years</strong></td>
</tr>
<tr>
<td><strong>S&amp;P 500</strong></td>
</tr>
<tr>
<td>20%*</td>
</tr>
<tr>
<td>10 Shareholders</td>
</tr>
<tr>
<td>15 Shareholders</td>
</tr>
<tr>
<td>20 Shareholders</td>
</tr>
<tr>
<td>25 Shareholders</td>
</tr>
<tr>
<td>30 Shareholders</td>
</tr>
<tr>
<td>35 Shareholders</td>
</tr>
<tr>
<td>50 Shareholders</td>
</tr>
<tr>
<td>No Cap</td>
</tr>
<tr>
<td>25%*</td>
</tr>
<tr>
<td>5 Shareholders</td>
</tr>
<tr>
<td>10 Shareholders</td>
</tr>
<tr>
<td>20 Shareholders</td>
</tr>
<tr>
<td>25 Shareholders</td>
</tr>
<tr>
<td>50 Shareholders</td>
</tr>
</tbody>
</table>
Some companies with more restrictive provisions than the 3/3/20/20 standard in 2016 amended their proxy access to more closely follow the growing market standard. After their 2016 annual meetings, Cabot Oil & Gas Inc., Kilroy Realty Corporation, New York Community Bancorp, and Flowserve Corporation each amended their bylaws to lower the ownership threshold for existing proxy access rights from 5 percent to 3 percent. Among S&P 1500 companies, only LSB Industries Inc. and VCA Inc. continue to require a 5 percent ownership threshold. No company that adopted proxy access in 2017 included more restrictive provisions than the 3/3/20/20 standard, but eight companies included a higher nomination cap of 25 percent of the board. To date, however, no shareholder or group of shareholders have successfully utilized their proxy access rights.

**Board Leadership**

Institutional investors have long encouraged boards to appoint independent board leaders who can serve as liaisons between directors and management teams, ensuring that shareholders' interests are represented. For several years, independent board leadership structures have been gaining traction at U.S. corporations, through either an independent board chairman or an independent lead director. In 2017, just under 90 percent of S&P 1500 companies utilized either an independent lead director or an independent chair. Of the two board leadership positions, however, an independent lead director is more prevalent. Just over 54 percent of S&P 1500 companies have an independent lead director, while just over 35 percent have an independent chair. The adoption rate of an independent chair remains higher at S&P 600 companies (42 percent) and lower among S&P 500 companies (27 percent).
Since 2013, a majority of S&P 1500 companies have had separate individuals serving in the roles of the Chair and the CEO. Small and mid-cap companies are most likely to separate the roles, with over two-thirds of S&P 600 companies having separate individuals for the two roles in 2017. While S&P 500 companies have lagged, a majority of large-cap companies had separate individuals for the roles of chairman and CEO for the first time in 2017.

**Board Independence and Committee Independence**

The average board independence level at S&P 1500 companies has remained relatively steady at just above 80 percent, growing by less than half a percentage point in each of the last five years. Independence levels have remained stable for many years, as boards generally have few or no non-independent directors serving other than their CEOs. In 2017, only 80 companies in the S&P 1500 had three or more insiders on the board, down from 98 companies in 2016. At companies with four or more insiders, the number falls dramatically to just 26, but this is slightly higher than 24 companies recorded in 2016.

Governance experts have long advocated the efficacy of boards having fully independent standalone...
committees to address specific responsibilities – oversight of company audits, executive compensation, and director nomination duties. While overall board independence levels continue to rise and the vast preponderance of S&P 1500 companies maintain fully independent director representation within these three key committees, the number of committees not completely independent (as defined by ISS) has risen over the past four years.

In 2014, 28 S&P 1500 companies had a less than fully independent audit committee, increasing to 40 companies in 2017. Non-fully independent compensation committees increased from 40 to 47, and non-fully independent nominating committees increased from 70 to 74 over the same time period. These increases may be related, in part, to the concurrent increase in controlled companies within the S&P 1500 from 52 to 57 companies over the same time period.

Poison Pills

Shareholder rights plans, commonly referred to as "poison pills", were first introduced in the early 1980s, and were widely used by U.S. firms by the mid-2000s. A shareholder rights plan gives the company the ability to dilute the ownership of a hostile acquirer once they reach an ownership level above a specified threshold (typically 10 or 15 percent of shares outstanding), by issuing shares to all other shareholders at a steep discount. In this manner, poison pills prevent hostile takeovers and increase the board’s influence in takeover negotiations.

Many shareholders oppose the practice, as they express concerns that poison pills can entrench management and may deprive shareholders of opportunities to review and vote on potentially beneficial offers. As opposition to poison pills grew, several shareholders launched shareholder proposal campaigns requesting the removal of poison pills or the requirement that they at least be subject to shareholder approval. These shareholder proposals received high levels of support, sending a strong signal to boards and management teams. Furthermore, many investors adopted policies to vote against board members if they adopted shareholder rights plans without shareholder approval.

As a result, the practice has diminished significantly during the past decade. While a majority of S&P
1500 companies had active poison pills in 2005, only 65 S&P 1500 firms – approximately 4 percent of member companies – maintained poison pills in 2017. This trend is true for smaller companies also, as only 5 percent of non-S&P 1500 Russell 3000 companies had a poison pill in place in 2017, compared to 22% of companies in the same group in 2008.

Supermajority Vote Requirement

Supermajority vote requirements set high voting thresholds to approve a merger or acquisition, or to change the company’s bylaws or charter. These vote requirements make it more difficult to effect governance change in the company, thus potentially serving as anti-takeover mechanisms or entrenchment devices. For many years, shareholder advocates have made efforts to remove supermajority vote requirements from companies’ bylaws through shareholder proposal filings, and investors have overwhelmingly supported these requests.

Since 2008, ISS has tracked 164 shareholder proposals requesting the elimination of supermajority vote requirements, and 130 (or 79%) of these proposals received more than a majority of votes cast, with an average support rate of approximately 67% of votes cast.
However, despite the clear message from shareholders, supermajority vote requirements are notoriously difficult to remove. Even when management submits requests to remove supermajority vote requirements, the proposals may not necessarily reach the required threshold. The case of Eli Lilly and Company is an extreme example of how difficult it is to remove these provisions. Following engagement with shareholders, management submitted proposals to remove the supermajority vote requirement for three consecutive years (from 2010 to 2012). The proposals received support of more than 80 percent of votes cast in each year, but failed to reach the necessary threshold of 80 percent of shares outstanding. The company’s founding family’s Lilly Endowment, which controls approximately 11 percent of the company’s shares opposed the resolution.

Companies that have adopted a supermajority vote requirement have selected two-thirds of the vote as the most common threshold for changes in bylaws or charter. A significant portion of firms use the 80- and 75-percent thresholds also, as shown in the graph below.

Despite the challenge to remove supermajority vote requirements, we see a slowly decreasing rate of large firms with such provisions, as the percentage of S&P 500 companies with supermajority vote requirements has dropped from 61% in 2008 to 46% in 2017. However, the percentage of S&P 400 and S&P 600 firms maintaining the practice has remained relatively steady, and currently stands at 62% of firms for both indices.
The percentage of firms with supermajority vote requirements to approve a merger is also lower for large-cap companies, but we do not observe a pattern of significant change in the past four years. Overall, approximately 19% of S&P 1500 companies maintain such provisions.

**Right to Call a Special Meeting and Right to Act by Written Consent**

The rights to call a special meeting and act by written consent serve as an accountability measure that allows shareholders to take action in a timely manner without having to wait for the next general meeting. Such actions include the ability to remove directors or file a shareholder resolution or to respond to an offer by a bidder, who may call a special meeting to submit such an offer. Both issues have been the subject of shareholder proposal campaigns for many years with relative success.

Since 2010, shareholders have voted on 183 proposals to adopt the right to call a special meeting, and 48 of these proposals received the support of majority of votes cast, with an average support rate of 43% of votes cast. In recent years, many companies respond to shareholder resolutions with counter-proposals by management, typically requesting a higher ownership threshold. In a few instances, companies also include stricter requirements, such as procedural hurdles, board discretion to the board to reject the proposal, and advance notice restrictions.

The adoption trends vary by size. In the S&P 500, a steadily increasing number of companies adopt the right to call a special meeting, potentially as a result of shareholder engagement and shareholder resolution filings. Since 2008, the percentage of S&P 500 firms giving shareholders the right to call a special meeting has increased from 41% to 67%. Most new adopters tend to adopt an ownership threshold of either 20% or 25% of shares outstanding.
Practices among smaller firms in the S&P 400 and S&P 600 indices have remained relatively steady, with the percentage of firms allowing the right to call a special meeting increasing from 48% in 2008 to 53% in 2017. Thus, as in several other governance practices related to board accountability observed in this study, one sees a gap between large and small firms not only in the form of differences in practices but also in the rate of change.

Similar to the right to call a special meeting, consent solicitations allow for a way of taking timely action on an issue at the company. However, the right to act by written consent does not require an actual meeting to take place. Instead, shareholders can respond to a proposal via solicitation by
mail. Unlike most other practices examined in this study, the right to act by written consent has seen relatively little change in all segments of the market for the past seven years. Shareholder proposals seeking to introduce the right to act by written consent seem to have lost traction in recent years. After a successful campaign in 2010, when 13 of 18 voted proposals received majority support, support rates fell in recent years. From 2012 to 2017, only 10 of 145 proposals requesting the right to act by written consent received majority support.

Blank Check Preferred Stock

Blank check preferred stock authorizations allows companies' boards to issue preferred stock with discretion over voting rights, conversion, dividend rights, the rights of redemption, as well as liquidation preferences. Many large institutional investors oppose blank check preferred authorizations in their voting policies and guidelines, as they view them as potential takeover defenses that may also introduce unequal voting rights in the company’s share capital structure. In response, some companies have made commitments not to use these authorizations as an anti-takeover device. However, even companies that adopt so-called “declawed” authorizations, maintain discretion over voting rights and conversion rates. Despite stated opposition by investors, the vast majority of S&P 1500 companies have blank check preferred stock authorizations in place.
Companies often have legitimate reasons for issuing preferred stock, and, in most cases, such authorities are used responsibly. Typically, companies use preferred stock as a relatively lower-cost source of capital, especially if a company is experiencing a cash shortage. Management proposals to introduce or increase preferred stock authorizations generally receive high support rates, and have increased in volume in recent years.

The Future of Board Accountability

During the past decade, shareholders have increased their focus on board accountability from a voting and engagement standpoint. In particular, many investors have enhanced their voting policies to go beyond questions of board composition, placing emphasis on board behavior. In recent years, several new topics of board accountability have emerged, such as risk oversight failures, unilateral amendments to company bylaws, and material weaknesses in financial reporting. In addition, investors pay closer attention to boards' responsiveness to shareholders' votes on past management and shareholder proposals.
Board accountability structures have improved considerably during the past decade, especially among large-cap firms. However, there remains a significant governance gap between larger and smaller firms. More importantly, for many investors, there is a growing concern that a new generation of firms are shielding themselves from shareholders through restrictive measures such as classified boards and dual-class share structures, as evidenced by governance practices at recent IPOs.

Rather than waiting to see how events will unfold, many investors are taking action to address their concerns through engagement, voting, and advocacy on several fronts, including discussions with regulators and index providers. It becomes clear that the future of U.S. corporate governance and board accountability will depend on these efforts and engagements.
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& Responsible Investment

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