How Powerful is ISS? Less—and in Different Ways—than Most People Think

By Stephen Choi, Jill Fisch and Marcel Kahan

Institutional Shareholder Services (ISS) is commonly regarded as the most powerful of all proxy advisors. Virtually every major institutional investor subscribes to its proxy research services. Its voting recommendations, according to some estimates, swing 20 percent to 30 percent of the shareholder votes. Delaware's Chancellor Leo Strine colorfully explains that "[P]owerful CEOs come on bended knee to Rockville, Maryland, where ISS resides … because the CEOs recognize that some institutional investors will simply follow ISS's advice rather than do any thinking of their own."[1]

ISS might be expected to exert its greatest influence in director elections. Director elections present a potential problem for institutional investors. They are very common; apart from the (very rare) case of a contested election, they are hardly ever significant enough to merit substantial resources to figure out how to vote; and because each director election is different, they do not easily lend themselves to simple "rules of thumb" policies that institutions use for shareholder proposals (such as "always vote for proposals to dismantle a staggered board"). What could be simpler, therefore, than subscribe to ISS and head its advice?

A straightforward comparison of the votes in favor of directors who received a "for" recommendation by ISS to the votes received by directors who received a "withhold" recommendations seems to make the case that ISS is very powerful. This difference amounts to 20 percent of the votes cast. These rudimentary statistics suggest that ISS determines the voting by shareholders holding 20 percent of the shares.

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If correct, this conclusion would be troubling. ISS, which owns no shares on its own, would control the voting of by far the largest block of shares. It would be an extraordinarily powerful institution, with unclear incentives and few if any checks on how it exercises its power.

In a series of empirical studies, we have investigated the influence of ISS. Our conclusion is that the power of ISS has been greatly overstated. We estimate that an ISS recommendation shifts six percent to 10 percent of the shareholder vote. Our research further suggests that even this influence is to a large extent due to the substantive information provided by ISS and to the fact that ISS recommendations reflect the pre-existing voting preferences of its subscriber base, rather than to investors blindly following ISS.

Let us start with the statistics cited above. In our study, directors who received a "for" vote recommendation from ISS did receive about 20 percent more "for" votes than directors who received an ISS "withhold" vote recommendation. The respective percentages were 96.4 percent and 76.1 percent. But that does not mean that ISS controls 20.3 percent of the votes. In fact, much of the difference is likely explained by other factors.

First, ISS voting recommendations are not random. ISS bases its "withhold" recommendations on certain factors, many of which are consistent with widely held views about corporate governance. Thus, for example, we found that the likelihood of receiving a "withhold" recommendation increased by 39.4 percent for directors who failed to attend at least 75 percent of the board and committee meetings; by 42.2 percent for directors who failed to implement a shareholder proposal that received majority support at the preceding annual meeting; and by 16.7 percent for outside directors who had certain business relationships with the company.

These factors not only affected the ISS recommendation. They also reduced the overall shareholder vote *whether or not ISS issued a "withhold" recommendation for the director.* Thus, one reason for the 20 percent difference in votes is that shareholders and ISS may have independently, but based on the same reasons, arrived at the same conclusion as to how to vote. In fact, shareholders can and do vote in a manner consistent with ISS recommendations without even being aware of the recommendations, as long as the shareholders have access to the information that forms the basis of the recommendations and hold similar views about its significance.

In our studies, we use regression estimates to differentiate between the effects of an ISS recommendation itself and the effects of the factors underlying the ISS recommendation. Our ability to make this differentiation is limited: we know only some of the factors relevant to ISS recommendations and, given the large size of our data set (over 12,000 director votes) we are constrained in our ability to include all relevant factors due to the difficulty of gathering the requisite data. Our inability to control for all the relevant factors has the effect of overstating the impact of the ISS recommendations. With this caveat in mind, we estimate that an ISS recommendation shifts 13.1 percent of the votes for the median company. Because we could not include all relevant factors, this figure should be regarded as the upper bound of the true influence of ISS, rather than an estimate of its actual influence.

We refined this estimate to measure the overall influence by ISS using a different technique. The subscriber base of ISS includes most institutional investors, but few if any individual investors. The influence of ISS can thus be measured by estimating the differential in voting between individual and institutional investors. To do so, we collected for each firm, information about the percentage of shares held by institutional shareholders and the percentage held by (non-insider) individual shareholders. We then estimated the effect of an ISS withhold recommendation on each subgroup. As expected, an ISS withhold recommendation reduced the "for" vote cast by institutional shareholders by more (17.7 percent) than it did for individual shareholders (7.0 percent). Taking the 10.7 percent difference in the effect as a measure of the influence of ISS, and given the fact that institutional investors held on average 60 percent of the stock of the companies in our sample, we calculated that ISS swings on average 6.4 percent of the total votes. Considering both of these techniques, our best estimate is that an ISS recommendation shifts 6 percent to 10 percent of the votes.

Even this six percent to 10 percent figure, however, must be qualified in two respects. When ISS issues a "withhold" recommendation, it provides its subscribers with the principal reason for the recommendation. Rather than consistently voting with ISS, shareholders may do so selectively, depending on the reason for the recommendation. The converse, however, is not true. When ISS issues a "for" recommendation, it rarely provides further information that would lead its subscribers to vote "withhold." And it is not the case that all directors who receive "for" recommendations have unblemished records. For example, of 81 directors in our sample who missed at least 25 percent of the board meetings, 45 received a "for" recommendation from ISS.

This suggests that ISS "for" recommendations may be more influential than its "withhold" recommendations (in the sense that investors are less able to second-guess "for" recommendations). It also implies that ISS "withhold" recommendations may represent an informational focal point for large withhold votes. To be sure, some investors can and do gather their own information to supplement information provided by ISS and may decide to vote "withhold" even if ISS issues a "for" recommendation. But other investors may not be aware of that information. In contrast, if ISS issues a "withhold" recommendation, virtually every major institutional investor will be alerted to the problem that generated the adverse recommendation.

In our most recent study, we found substantial evidence that this "agenda-setting" dynamic is important.[2] For that study, we collected information on the votes by funds in a sample of 56 mutual fund families which, in the aggregate, accounted for approximately 50 percent of the domestic equities held by mutual funds. In our sample, only funds representing three percent of the sample assets followed 90 percent or more of the withhold recommendations issued by ISS, perhaps without any thinking on their own. But a much larger portion, accounting for 34 percent of the sample assets, followed 30 percent to 60 percent of the ISS "withhold" recommendations (and funds accounting for 10 percent of the sample followed 60 percent to 90 percent of the withhold recommendations). While some of these funds may have arrived at the same conclusion as ISS did completely independently, we believe that it is likely that many of these funds based their decision to vote "withhold" at least in part on information supplied by ISS. But the fact that these funds regularly fail to follow ISS "withhold" recommendations indicates that they apply their own analysis to the information provided by ISS.

We also found that, for a large number of funds, ISS withhold recommendations do not explain most of the fund's withhold votes. This is particularly true for the largest fund families, which exercise the greatest voting power. Thus, for funds accounting for 73 percent of the sample assets, less than 30 percent of the funds' withhold votes were cast in accordance with an ISS "withhold" recommendation. The remaining 70 percent of the withhold votes were cast on directors for whom ISS recommended a "for" vote. However, because these withhold votes were spread over a large number of different nominees, they tended not to result in very high withhold percentages for many nominees.

Consider, for example, the voting record of Putnam and Vanguard, two of the largest mutual fund families. Neither Putnam nor Vanguard follows ISS consistently, or even generally. Thus, Putnam withheld its vote for 671 director candidates in our sample, but ISS recommended a "withhold" vote for only 115 (or 17 percent) of those 671 directors. Similarly, Vanguard withheld its vote for 1435 director candidates in our sample although ISS recommended a "withhold" vote for only 345 (or 24 percent) of those 1435 directors. Yet it is true that in 45 of the 96 cases (or 47 percent) where *both* Putnam *and* Vanguard decided to cast withhold votes, these votes corresponded to an ISS "withhold" recommendation. ISS "withhold" recommendations appear to lead to a higher likelihood of multiple fund families withholding.

Even for funds that seem to adhere to ISS recommendations consistently, the power of ISS may be less than it appears. ISS regularly consults with its subscriber base in devising the policies it employs in making voting recommendations. Rather than imposing its own preferences, ISS pursues a strategy of conforming its policies to those of its subscribers. To be sure, some funds may follow ISS blindly, similar to readers of the New York Times who base their votes for city council members or local judges on a New York Times endorsement, without performing any independent analysis. But these votes may be preceded by a determination that, by and large, ISS recommendations, or the endorsements by the New York Times correspond to one's own view. And although ISS is the largest proxy advisor, it has competitors. Thus, a fund that is looking to follow someone blindly has a choice between following ISS, Glass Lewis, Egan Jones, Macro Consulting, or CtW Investment Group.

We do not want to understate the power of ISS. In particular, in uncontested director elections, a director who receives a "for" vote recommendation from ISS is virtually assured of receiving a respectable percentage of affirmative votes. But a director who receives a "withhold" vote recommendation is not doomed. Rather, whether such a director receives an embarrassingly high percentage of "withhold" votes hinges on additional factors.

In our studies, we were able to identify four such factors: whether the director missed more than 25 percent of the board meetings; whether Fidelity cast a withhold vote; whether a shareholder resolution was adopted at the prior year's annual meeting of the company and the company ignored the resolution; and whether the director was an outside director with certain business ties to the company *and* received a withhold vote from Vanguard. If ISS recommended "withhold" and at least one of these factors was present, the likelihood that the director received 30 percent or more withhold votes was 48 percent and the likelihood that he or she received a majority withhold vote was five percent. If ISS recommended "withhold" but none of these factors was present, the respective likelihoods were much lower, 18 percent and 0.5 percent.

Is ISS influential? The answer is clearly yes. But it is less influential than commonly asserted, and one needs to understand the reasons for this influence and the manner in which it is exerted. Only a small group of investors follow ISS without performing any independent analysis, and even these investors may do so because they have concluded that they generally agree with ISS. A much larger group of investors follows ISS selectively. The main source of ISS's influence derives from ISS providing, or failing to provide, relevant information to its subscriber base.

This power to choose the information that investors can easily access in deciding how to vote is important. But it is a far cry from the power to control the ultimate votes. This also means that ISS can be held to account, by its subscribers as well as by the portfolio companies it covers, for the accuracy of its information. Thus, while ISS is powerful, there are significant checks and balances that constrain its discretion. On the whole, because ISS dramatically reduces the cost to investors of obtaining the information that it supplies, the system of shareholder voting works better with an institution like ISS than it would without it.

Notes

1. Leo E. Strine, Jr., The Delaware Way: How We Do Corporate Law and Some of the New Challenges We (and Europe) Face, 30 Del. J. Corp. L. 673, 688 (2005).

2. The study is available in full at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1912772.