Are ISS Recommendations Informative? Evidence from Assessments of Compensation Practices

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Proxy advisors issue recommendations to institutional investors on how to vote on the nomination of board members and other corporate governance issues, such as executive compensation contracting. Research shows that proxy advisors' recommendations have a significant influence on Say-on-Pay voting outcomes and, consequently, on firm's governance choices.[1] As a result of their increasing influence on corporate governance practices, these advisors have come under scrutiny recently and have been the subject of Securities and Exchange Commission (SEC) reforms.[2] The demand for proxy advisory services is increasing due to greater institutional ownership, the volume and the complexity of shareholder proposals voted upon, and the greater reliance of institutional investors on proxy advisors to inform them on how to vote on shareholder proposals as a result of the 2003 SEC rule requiring them to disclose their proxy voting policies.[3] Thus proxy advisors are regarded as powerful. Yet, whether their recommendations are informative is an open question, particularly during the busy proxy season when they must issue recommendations for many firms in a short period of time.

The most influential proxy advisor with the largest market share in the U.S. is Institutional Shareholder Services (ISS). As a consequence of their influence, management and shareholder activists lobby ISS to endorse their respective positions. As mentioned by Delaware's Vice-Chancellor Leo Strine:

> *[P]owerful CEOs come on bended knee to Rockville, Maryland, where ISS resides, to persuade the managers of ISS of the merits of their views about issues like proposed mergers, executive compensation, and poison pills. They do so because the CEOs recognize that some institutional investors will simply follow ISS's advice rather than do any thinking of their own.*

ISS's dominant position in the advisory industry and thus the lack of competitive pressure and market discipline can impact the quality of their services. Moreover, ISS could exploit its

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[1] Say-on-Pay is a non-binding advisory vote required with the adoption of the Dodd-Frank Wall Street Reform and Consumer Protection Act, passed in 2010.

[2] In July 2020, the SEC issued final amended rule 34-87457, which requires, among other things, proxy advisors to disclose conflicts of interest, to provide recommendation materials to companies before or at the same time as recommendation are provided to their clients, and to allow clients access to companies' responses to their recommendations. The final rules excluded the proposed provision that companies be allowed to review and comment on recommendations *prior* to publication. On November 17, 2021, the SEC voted to propose amendments to the July 2020 rules eliminating the need for proxy advisors to make their recommendations available to companies.

[3] In 2003, the SEC required that mutual funds disclose their proxy voting policies or that they rely on the voting policies developed by an independent party, such as proxy advisors, to fulfill their fiduciary duties. (https://www.sec.gov/rules/final/33-8188.htm).

influential position by issuing negative recommendations so that companies feel compelled to buy its consulting services. Compounding the potential conflicts of interest are concerns that proxy advisors have limited accountability. Proxy advisors do not own equity in the companies in which they provide voting advice, nor do they have any fiduciary duty to the shareholders of those companies.

While some argue that proxy advisors' compensation assessments and voting recommendations are not useful as they *induce firms to adopt compensation contracts that reduce shareholder value,* research documents strong associations between their negative recommendations and voting outcomes. Therefore, it is important to understand if ISS recommendations are informative and when those recommendations may be less effective.

ISS' effectiveness at identifying lower quality compensation practices can be influenced by resource constraints during the busy season. Most firms have a December fiscal year end and thus their annual meetings are compressed in the short period of five weeks between the last week of April and the end of May, also known as the proxy season (approximately 60% of our sample firms have annual meetings during this period). ISS hires temporary, and potentially less experienced analysts, during the busy season, which can lower their assessment of the quality of compensation packages, especially given their complexity.

To study the quality of ISS recommendations, we require a measure that validates ex-post their recommendation. Compensation contracts are multifaceted, complex (level of pay, form of pay, performance measures used, and horizon over which to determine pay), and often idiosyncratic to strategic choices of organizations or to CEO abilities, making it difficult for the researcher to define an objective benchmark for compensation quality. And, ISS recommendations evaluate aspects of compensation practices that are not directly reflected in the level of pay or the components of the compensation contract (e.g. quality of the peers, communication practices of compensation committees or policies related to CEO succession and change in control). For these reasons, we take a different approach. Assuming that firm performance is influenced by the quality of its compensation practices (for example, high pay-performance sensitivity encourages the CEO to take actions that improve future performance), we expect that firms with low quality compensation practices exhibit lower industry-adjusted performance. We choose industry-adjusted *accounting* performance as our main measure to avoid confounding problems that *stock returns* raise. Investors might react to the issuance of an unfavorable recommendation rather than to the underlying compensation quality. In addition, total shareholder return was the metric that ISS used to evaluate firms up until 2018. As a result, ISS unfavorable recommendations are endogenously related to firms' stock market performance.

Using ISS Say-on-Pay (SOP) recommendations, we examine the association between their compensation recommendations and future firm's accounting performance. Under the assumption

that accounting performance is influenced by the quality of the compensation practices, an association between ISS negative recommendations and future lower accounting performance suggests that ISS evaluations identify low quality compensation practices. In particular, if ISS "Against" recommendation are informative of low-quality compensation practices, we expect this negative association to be significant when ISS is less busy.

Our article includes data on ISS recommendations for firms in the Russell 3000 from 2010 to 2016 fiscal year. We find that ISS negative recommendations are associated with lower future industry-adjusted accounting performance, but only for the subsample of non-December FYE firms, consistent with resource constraints during the December FYE proxy season influencing the quality of their recommendations. To further confirm that recommendations for non-December firms may be more informative to shareholders, we examine market reaction over the 13-day window prior to the annual meeting, when ISS Say-on-Pay voting recommendations become available to investors.[4] We find that non-December FYE firms receiving an "Against" recommendation exhibit negative returns, suggesting that the market perceives ISS negative recommendations to be informative of low quality compensation packages in the non-busy season. We do not find a similar result for the December FYE firms receiving an "Against" recommendation. While interpretating stock returns as an independent signal of the informativeness of ISS recommendations is difficult due to the necessary assumptions about both the quality of the signal and the prior beliefs of the shareholders, these results help corroborate our finding that ISS recommendations in the busy season may be less informative.

We also find that shareholders follow ISS "Against" recommendations and fail SOP votes in greater proportion during the non-busy season than during the busy season. The proportion of ISS Against recommendations that failed SOP votes during the non-busy season is 22%, which compares to 15% during the busy season suggesting investors also perceive their recommendation as being of higher quality during the non-busy season.

Collectively, our study informs the debate over the concerns about the activities of proxy advisors. Our findings that ISS recommendations can identify poor compensation practices only during the "non-busy season" suggests that ISS recommendations are of higher quality when the firm can devote more resources to their analyses. Therefore, our study suggests that compensation consultants should be particularly conscious when making compensation plan changes following ISS recommendations issued during the busy season.

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[4] ISS's policy is to make recommendations available to shareholders between 30 and 13 days before the annual meeting. We use the 13-day window prior to guarantee that information is available to investors. Shareholders can incorporate this information any time up to the meeting date. In robustness tests, we use the 30-day window before the annual meeting.