ISS: friend or foe to stewardship?

The impact of ISS on voting outcomes is material, but not so great as is commonly portrayed. Often investors just agree with what they have to say. Nonetheless, investors and ISS should work together to address issuer concerns to improve the market for stewardship and avoid counterproductive regulation.
The role of shareholder advisory firms

Shareholder advisory firms such as Institutional Shareholder Services (‘ISS’) have come under increasing focus in recent times. Accused of wielding power without accountability, they are increasingly being brought into the regulatory net. In the EU, such firms will come under the remit of the Shareholder Rights Directive, and will become subject to a code of practice with a regulatory underpinning. The UK Stewardship Code is likely to be extended in the new year more explicitly to cover the role of shareholder advisory firms. Although they are currently encouraged to report against the Stewardship Code, the Code is not very relevant to the role they play in supporting stewardship. The advisory industry is in the process of reviewing its own Best Practice Principles.

Why should there be such an interest in shareholder advisory firms, who after all only provide a service to asset managers and asset owners? The main controversy relates to the issuing of voting recommendations (which only some shareholder advisory firms provide – others just provide research). Voting recommendations are felt to have a major influence on investor decision making, which calls into scrutiny the accuracy of, and methodologies underpinning, the analysis the advisory firms undertake, and how they engage with companies.

Some issuers complain that ISS follows a mechanistic approach to voting recommendations, often based on a tick-box approach, which investors then follow unthinkingly. At its heart is the accusation that shareholders are outsourcing stewardship responsibilities to shareholder advisory agencies, who in turn are not fulfilling those responsibilities appropriately. As the dominant research provider in the UK, ISS has been in the cross-hairs of this accusation.
This same line of argument has led to vigorous debate in the US about whether shareholder advisory firms should be subject to greater regulation or restrictions, and also raised its head in the EU as part of the ESMA review of the industry and the Shareholder Rights Directive.

Of course, the fundamental questions that this raises should be addressed to asset managers: how can they say they are fulfilling their stewardship responsibilities if they are simply following a proxy adviser recommendation? Ultimately shareholders are responsible for voting the proxy. On the other hand, if in fact advisory agencies are genuinely influential on voting outcomes, it is right that safeguards are put in place in relation to their methodologies and operating model, to limit the risk of investors outsourcing stewardship judgements.

So the question of whether voting recommendations actually do drive voting behaviour is an important one, but not one that is easy to answer.

Can we be sure the recommendation is influencing the voting outcome, or do advisers just reflect the views shareholders would form in any event if they performed their own analysis? If this is the case, proxy agencies could be seen as playing an important market role in propagating views, including to those investors who do not have the time to undertake their own analysis, improving market efficiency.

In this paper we consider these questions in relation to ISS, the most influential agency in the UK. We focus on the remuneration vote, which provides plenty of incidence of recommendation and voting activity. Although not conclusive, we find strong indicative evidence that ISS voting recommendations do have an impact on UK voting outcomes, albeit smaller than is generally supposed: of the order of 10% to 15% points on average. This level of influence is material but not defining, and is much lower than the 30%+ impact often claimed.

However, it does seem that in some cases stewardship judgements are effectively being outsourced to ISS and some of the concerns of issuers are justified. While responsibility for this ultimately lies with shareholders, who after all decide how to vote, ISS needs to recognise the unique role it plays in the stewardship chain. Shareholder advisory firms play an important role in enabling investors to carry out stewardship cost-effectively. But shareholders and shareholder advisory agencies, and in particular ISS, should work together to resolve issuers’ concerns, otherwise unnecessary regulation, with unintended consequences, could follow, to the detriment of the market for stewardship as a whole.
There is no doubt that there is a strong correlation between ISS voting recommendations and voting outcomes. The table below shows the voting outcome for the advisory vote on the remuneration report for FTSE-100 companies over the past three years, split by ISS voting recommendation.

**Figure 1: Average level of vote against for FTSE – 100 remuneration reports 2015-17 split by ISS recommendation**

<table>
<thead>
<tr>
<th>ISS Rec.</th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
<th>Overall</th>
</tr>
</thead>
<tbody>
<tr>
<td>For</td>
<td>4%</td>
<td>4%</td>
<td>4%</td>
<td>4%</td>
</tr>
<tr>
<td>For#</td>
<td>5%</td>
<td>6%</td>
<td>6%</td>
<td>5%</td>
</tr>
<tr>
<td>Against</td>
<td>29%</td>
<td>32%</td>
<td>43%</td>
<td>33%</td>
</tr>
<tr>
<td>Abstain</td>
<td>19%</td>
<td>15%</td>
<td>0%</td>
<td>16%</td>
</tr>
</tbody>
</table>

Source: Proxy Insight. For# refers to an ISS recommendation to vote in favour of the resolution, but where an issue of concern has been identified.

This data is commonly used to justify statements such as “an ISS vote AGAINST recommendation will cost you a third of the vote” or “ISS is like a 35% shareholder”.

Proxy Insight, who provide detailed information on investor voting policies and voting records, have created an ISS Match statistic, which measures, for each shareholder, the probability that the shareholder will follow the ISS recommendation. The match statistic can be separated for different ISS recommendations. For example, an ISS Match statistic of 50% for AGAINST Recommendations shows that the shareholder follows the AGAINST Recommendation 50% of the time.

The table opposite shows the range of this ISS Match statistic for AGAINST recommendations for the largest 20 FTSE investors.

The median large investor follows an ISS vote AGAINST recommendation around half the time. The most devoted 10% follow this recommendation two thirds of the time. However, a quarter of large investors only follow ISS AGAINST recommendations a third of the time. This suggests that most large investors do think for themselves at least some of the time, but does still suggest the ISS recommendation has influence.

But we still can’t be sure. Correlation does not imply causation. Do investors unthinkingly follow ISS, or does ISS, on the whole, correctly identify issues investors are concerned about?

For example, low-quality company proposals will lead to ISS recommending a negative vote, but would have led shareholders to vote against even in the absence of the ISS recommendation. Therefore, the correlation between recommendations and votes overstates the extent to which ISS causes the voting outcome.
Causation?

A recent US academic study\(^1\) in a top quality peer-reviewed journal used an advanced statistical technique called “regression discontinuity” to unpick the causality behind the correlation.\(^2\) In the US, ISS used to operate a quantitative screen based on recent Total Shareholder Return (TSR) performance to determine whether companies should be investigated more closely and potentially receive an AGAINST vote recommendation. By looking at companies just above and below the threshold for this TSR screen, and controlling for other factors, the researchers were able to compare companies that were essentially identical, other than the ISS recommendation they received.

This enabled them to identify the causal impact of the ISS AGAINST recommendation, which they quantified as a 25% points reduction in voting support. In the UK context, this would be a very material impact, particularly given that a 20% vote against is now enough to have a company highlighted on the Investment Association’s Public Register of low votes.

Given that over a third of votes are typically cast against when ISS recommends as such, it seems intuitively likely that a similar level of voting impact applies in the UK. But we must still be cautious about drawing that conclusion. The UK has a different institutional environment to the US, particularly the US in 2010-11, the time period of the study. UK investors devote a significant amount of resource to stewardship activities, and a culture of consultation with companies on difficult pay issues is long established.

There are good reasons to think that UK investors will act more independently on pay votes than would have been the case for US investors seven years ago. On the other hand, particularly given the large proportion of the UK stock market held by US investors, the US evidence creates a strong presumption of at least some causal impact in the UK.

Unfortunately there is no UK analogy to the formulaic quantitative screen operated by ISS in 2010-11 in the US. We therefore cannot replicate Malenko and Shen’s study with statistical rigour. However, we can draw some strongly suggestive conclusions that enable us to interpret how likely the US conclusions are to apply in the UK.

Our main device for doing this is to analyse separately voting behaviour among the Top 10 shareholders in a company compared with the remainder of the shareholder register (which we refer to as “the Tail” of the register). If shareholders are unthinkingly following ISS, then we would expect the impact of an ISS AGAINST vote to be the same in the Top 10 as the Tail. In the same way, we’d expect a given shareholder to have a similar ISS Match Statistic regardless of where they appeared in a company’s register.

This analysis will not enable us to draw conclusions that have full academic rigour. But given the rigorous evidence from the US, they will be strongly suggestive.

---


\(^2\) For an excellent layman’s description of this technique see www.alexedmans.com/correlation
Top 10 versus the Tail

The table below shows statistics on the percentage of a company’s equity held by the Top 10 investors for large UK companies.

**Figure 3: Percentage of company’s equity held by Top 10 investors FTSE-100, 2017**

<table>
<thead>
<tr>
<th>Category</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lower Decile</td>
<td>25%</td>
</tr>
<tr>
<td>Lower Quartile</td>
<td>29%</td>
</tr>
<tr>
<td>Median</td>
<td>37%</td>
</tr>
<tr>
<td>Upper Quartile</td>
<td>44%</td>
</tr>
<tr>
<td>Upper Decile</td>
<td>52%</td>
</tr>
</tbody>
</table>

Source: Proxy Insight

Typically the Top 10 investors hold 37% of the company’s stock. Given that around three quarters of investors typically vote at a UK AGM, this means that the Top 10 represent roughly half the shares voted.

Using the Proxy Insight database, we analysed 40 FTSE-100 company remuneration report resolutions where ISS had recommended AGAINST (32 companies) or ABSTAIN (8 companies) (referred to as a “negative recommendation”) and where there was sufficient data to estimate the vote of the company’s Top 10 investors as compared with the Tail of the distribution.

**Figure 4: Distribution of voting outcomes (% vote against) for Top 10 and Tail for ISS AGAINST or ABSTAIN recommendation**

Source: Proxy Insight, PwC analysis

We focus the remainder of our analysis on these 40 resolutions with negative ISS recommendations.

We separately analysed how the Top 10 shareholders voted on the remuneration resolutions compared with how the Tail voted. The results are shown in the histogram above.

For these companies, the Top 10 is generally more supportive than the Tail (20% median vote against versus 35%), but there is a wider range in the level of support in the Top 10.

Over half of the time, more than 8 of the Top 10 shareholders voted for the resolution even with the negative ISS recommendation.

By contrast, for shareholders in the Tail voting against is much more likely. The level of vote against in the Tail is more typically between 30% to 40%. The vote against in the Tail is higher than the vote against in the Top 10 on three quarters of occasions.

Simple statistical tests suggest the hypothesis that the Tail votes against more than the Top 10 is highly statistically significant at around the 1% level, i.e. it is unlikely that the higher support we see in the Top 10 is purely chance.
The ISS impact is in the Tail of the shareholder register

Comparing how the Top 10 and the Tail vote on a resolution by resolution basis is also helpful, as shown below.

There is only a very weak correlation between voting behaviour in the Tail and the Top 10, and the range of voting outcomes is narrower in the Tail. This lack of correlation is suggestive of the ISS recommendation directing behaviour in the Tail. This is consistent with shareholders devoting time to stewardship when they are a Top 10 investor but being more inclined to follow ISS when they are in the Tail. For moderate levels of opposition amongst the Top 10 (e.g. up to 15% to 20%), the impact of the ISS recommendation on the Tail is typically an additional 15% to 20% points within that lower part of the register.

To explore this further, we can look at whether individual shareholders act differently depending on whether they are in the Top 10 or the Tail.
The chart opposite shows, for each of the major investors, the proportion of times they follow an ISS negative recommendation when they are a Top 10 shareholder compared with when they are in the Tail (we have restricted the analysis to cases where an investor has at least 5 cases of being in the Top 10 and 5 in the Tail to avoid distortion by single cases). Most investors are more likely to follow a negative ISS recommendation if they are in the Tail for a particular company compared to if they are in the Top 10 for that company.

Two thirds of shareholders follow ISS more as a Tail shareholder than they do as a Top 10 shareholder (i.e. more are in the top left of the chart), with a median 14% swing in their likelihood of following ISS in the Tail. Two shareholders simply appear to have a very limited record of voting against at all when they are in the Tail of the distribution – excluding these raises the median difference in propensity to follow ISS to 17% points between the Tail and the Top 10.
Important but not defining

So where does this leave us?

The difference in voting behaviour between the Top 10 and the Tail, including by the same shareholder, is strongly suggestive of a relationship between the ISS recommendation and the vote outcome. We have not proven this with absolute statistical rigour but, coupled with the US evidence, we can have a high degree of confidence that there is a causal impact. The question is how much?

Our analysis suggests that a negative ISS recommendation causes an extra 15% to 20% vote against in the Tail – which would equate to a 7% to 10% impact on the vote overall, given that around half of voting shareholders are typically in the Tail. However, the impact could be more than this, as we have not isolated whether there is an underlying impact on the Top 10 itself. Based on our experience, we would suggest that there is such an impact, but that it will be small. A few investors, even if they are a Top 10 investor, have a difficult time in not following the ISS recommendation. Either they are bound to follow it due to the terms of their mandates, or they have to follow an enhanced governance process to countermand it.

Set against this, we know from experience that most of the investors in our study just take the ISS recommendation as an input when they are towards the top of a company’s register and conduct their own analysis, which is consistent with the data shown here. Given the wide range of voting outcomes in the Top 10 when ISS recommends a vote against (including over a quarter of cases where the vote against is less than 10%), we estimate that the impact of the ISS vote AGAINST recommendation on the Top 10 of a register is only around 5% to 10% at most.

Moreover, Top 10 shareholders are quite willing to ignore the ISS recommendation. Simply getting a negative ISS recommendation cannot be blamed for a company losing a vote.

But ISS does have a real influence, which can make the difference between a minimal level of opposition and triggering the “material” vote against threshold of 20%. The ISS voting recommendation will be especially significant where a company has a dispersed shareholder base (and hence long Tail) or where a significant proportion of investors are from the US, and are more likely to be bound by policy to follow ISS.

Overall, this suggests a best estimate for the causal impact of an adverse ISS voting recommendation in the UK at 10% to 15% points on average. This is much lower than the 25% point impact found in the US, but is still material, particularly in the context of 20% vote against being seen as “significant”.

But the idea that ISS is “equivalent to a 35% shareholder” is lazy. The impact is less than half that. Companies need to accept that a large vote against is often not down to ISS, but down to the fact that shareholders didn’t like what they were doing, and they just happened to agree with ISS.
What needs to happen?

So although the impact of ISS is commonly overstated, it is real and material. Although this is ultimately down to how investors use ISS recommendations, ISS also needs to recognise its influence in the investment chain. It is in the interests of all parties to show voluntary progress, to avoid regulation that could be costly, have unintended consequences, and ultimately inhibit competition. What should be done?

1. Investors need to take ownership for voting decisions. Unthinkingly following a proxy agency recommendation is not fulfilment of stewardship responsibilities and instead investors should conduct their own analysis, particularly if they are going to vote against a resolution. Where ISS recommends a vote against, investors who are not doing their own analysis should give companies a proper hearing, and should consider finding out the views of other top shareholders in the company, engaging collectively.

Investors need to take responsibility for creating demand for a diverse market of advisory services that support strong stewardship, rather than just seeking the lowest cost solution. As buyers of the service, investors will ultimately determine whether the focus is on stewardship quality or cost.

2. Companies need to be thicker skinned. They need to stop complaining if their top investors vote against a proposal – it’s often because they didn’t like it, not simply because ISS recommended an against vote. And if the 20% vote against threshold for the IA’s Public Register is genuinely triggered by the impact on the Tail of an ISS vote AGAINST recommendation, with the Top 10 investors supportive, then be prepared to explain this and not be derailed by it.

3. Consultants need to stop talking about ISS as if they are a shareholder. They do appear to have a causal impact on voting outcomes, but at less than half the level commonly stated. Consultants also need to advise companies where their underlying shareholders are likely to have material concerns, rather than hiding behind the excuse of the ISS vote.

4. ISS also needs to make changes, and should recognise it has special responsibilities given its dominance. While voting responsibility must sit firmly with shareholders, ISS must recognise how its recommendations are used and their causal impact on voting outcomes. This is not how stewardship is meant to work.

While this is the fault of those investors who use the recommendations in an unthinking way, shareholder advisers have a responsibility to introduce safeguards to ensure that stewardship works across the market as a whole. So how could they make things better?

- ISS should be prepared to give clearer indications during consultation with companies where there is a strong possibility of a negative voting recommendation arising.
- In the event of ISS determining a vote AGAINST recommendation, they should provide for a longer period for fact checking than the 24-36 hours that is commonplace and should be prepared to have a call with the company or Remuneration Committee chair to ensure full understanding.
- Where one or more of a company’s Top 10 shareholders has expressed an intention to support the proposals, ISS should be prepared to include this information, at the request of the shareholder and company, in their report.
- A major concern of issuers is where ISS is perceived to stray into areas of strategic judgment when making voting recommendations. This is most commonly in the areas of incentive outcomes compared with performance and in relation to remuneration design, where proposals may not clearly contravene voting guidance but where judgement is required on the voting outcome based on commercial context. ISS is arguably ill-equipped to provide firm recommendations in such cases, particularly if these are followed deterministically by some investors. To avoid the risk of inadvertent outsourcing of stewardship judgements, ISS should introduce a category of FOR STRATEGIC JUDGEMENT for such cases, to ensure that the shareholder themselves is required to decide.
• We have written elsewhere about the problems with the ISS P4P quantitative pay-for-performance methodology. If this methodology is going to play a bigger role in decision making it should be subject to review by leading academic and practitioner experts in order to resolve the flaws within it, which lead to justifiable issuer consternation.

There is much about engagement on executive pay in the UK that works well. Shareholder advisory firms can be useful contributors to the effective and efficient functioning of the system. Firms like ISS, Glass Lewis, IVIS, Manifest and PIRC provide comprehensive, consistent analysis in an efficient way to help asset managers and asset owners discharge their stewardship responsibilities.

However, issuers have significant concerns that stewardship in this area is not always operating as it should, and that ISS in particular has a level of influence that brings with it responsibilities, and requires enhancements to their operating model. Although the extent of that influence is frequently overstated, our research suggests it is still material, with a negative ISS recommendation appearing to cause a 10% to 15% increase in negative voting outcome. As clients of the service, it is investors who are best placed to bring about change. However, we believe it is in the interests of shareholder advisory firms like ISS themselves to take the initiative. Moreover, the dominant position of ISS, and the apparent causal impact of its voting recommendations, brings with it special responsibilities.

The industry as a whole has the opportunity to put at the heart of its revised Best Practice Principles the role shareholder advisory firms play in helping clients fulfill stewardship responsibilities. In this way we can preserve and enhance effective functioning of the system and diffuse demands for regulation. Heavy handed intervention in the market is likely to be undesirable, and is as likely to impose barriers to entry and to diminish competition as it is to solve problems. This would not be in anyone's interests. But without voluntary change, it may well be where we end up.