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DO ISS VOTING RECOMMENDATIONS CREATE SHAREHOLDER VALUE?

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PROXY ADVISORY SERVICES

Many institutional investors rely on a proxy advisory firm to assist them in voting company proxies and fulfilling the fiduciary responsibility they have to vote in the interest of beneficial shareholders.[1] The largest proxy advisory firm is Institutional Shareholder Services (ISS) whose clients have about $25 trillion in assets under management.

There are potential benefits to obtaining voting recommendations from a proxy advisory firm. These firms provide an examination of corporate governance issues (such as director elections, equity compensation plans, structural changes to the board, and charter and bylaw amendments) that might be beyond the expertise of certain investors. This is particularly true for funds that lack staff resources to dedicate to individual proxy items across all companies they are invested in. The recommendations of proxy advisory firms also provide a second opinion to large institutions that do their own proxy analysis.

At the same time, there are potential drawbacks to relying on proxy advisory firms. First, these firms seem to take a somewhat inflexible approach when evaluating governance matters that does not take into account the unique situation, objectives, or business model of the companies they review. As such, their recommendations might reflect a one-size-fits-all approach to governance and the propagation of "best practices" that are typically not supported by the research literature. Second, proxy advisory firms may not have sufficient expert staff to evaluate all items subject to shareholder approval, particularly complex issues such as equity compensation plans, say on pay, and proposed acquisitions.[2] Finally, to our knowledge, there is no rigorous evidence that proxy advisory firm recommendations are correct or that they increase

[1] For a discussion of the proxy advisory business and the fiduciary duties, see Latham & Watkins, LLP, "Proxy Advisory Business: Apotheosis or Apogee?" Corporate Governance Commentary (Mar. 2011).

[2] For example, ISS has 600 professional staff, including primary data collection, research and analysis, technology and client services. Research staff provided recommendations for more than 37,000 shareholder meetings in 2009. See RiskMetrics Group, Form 10-K, filed Feb. 24, 2010.

Professor David F. Larcker and Brian Tayan prepared this material as the basis for discussion. Larcker and Tayan are co-authors of the upcoming book *Corporate Governance Matters*. The Corporate Governance Research Program is a research center within the Stanford Graduate School of Business. For more information, visit: http://www.gsb.stanford.edu/cgrp/.

shareholder value. To this end, some corporate directors suggest that their recommendations are arbitrary and not in the interest of shareholders.[3]

EXCHANGE OFFERS

It is difficult to examine the impact of proxy advisory firm voting recommendations on shareholder value because the algorithms and data used by these firms are considered proprietary. This lack of transparency means that there is not an accessible database that can readily be used by researchers to study their impact on corporate outcomes. However, for a variety of reasons, it is possible to examine the influence of proxy advisory firms in one area of voting: exchange offers. An exchange offer (or repricing) is a transaction in which employees holding stock options are allowed to exchange those options for new options, restricted shares, or (less frequently) cash. Exchange offers occur when stock options are trading out-of-the-money to such an extent that it is unlikely that they will become profitable in the near future.

The board of directors initiates the exchange process by evaluating the distribution of employee option holdings, the potential incentive and retention effects, the impact on shareholders, and the cost of implementation. Shareholder approval to implement an exchange may or may not be required, depending on the terms of the equity plan under which awards were initially granted. If shareholder approval is not required, the board can approve and implement an exchange. If shareholder approval is required, the board must seek approval at either the regular annual meeting or a special meeting. Even when a plan is implemented, however, employees are not required to accept the offer for either vested or unvested equity holdings (see **Exhibit 1**).

Exchange offers are controversial matters. On one hand, they can be an effective way to restore value to equity awards that has been lost due to market forces (such as recession or industry downturn) that are outside employees' control. When successful, exchange offers renew the promise of financial reward if the firm is successful and reduce voluntary turnover among key employees who might otherwise leave to work at other companies. On the other hand, exchange offers can signal a culture of entitlement. Frequent repricings encourage the expectation that equity awards will pay out regardless of performance. Exchange offers also create a shareholder relations challenge in that investors might question why employees receive sweetened compensation when they themselves have suffered steep losses.

The largest proxy advisory firm, ISS, has developed publicly disclosed guidelines that it uses to determine whether to recommend a vote in favor or against a proposed exchange. ISS takes into account factors such as the stock's historical trading pattern, the stated reason for the exchange, the relative value offered through the exchange, whether surrendered options are cancelled or can be reissued, whether officers and directors are allowed to participate, and the vesting schedule, terms, and price of the new options. For example, ISS will recommend against any exchange offer in which named executive officers or directors are allowed to participate or when new options vest in less than six months (see **Exhibit 2**).

The recommendation of ISS is not inconsequential. Bethel and Gillan (2002) find that an unfavorable recommendation from ISS can reduce shareholder support by 13.6 percent to 20.6

[3] Aaron Lucchetti, "Companies Fight Back on Executive Pay," *The Wall Street Journal*, Feb. 7, 2011.

percent, depending on the matter of the proposal.[4] Morgan, Poulsen, and Wolf (2006) find that the impact is greater than 20 percent on compensation-related issues.[5] Survey data supports the perception of influence. In a 2010 survey by Towers Watson, 59 percent of corporate officers believed that proxy advisors have significant influence on executive-pay decisions at U.S. companies.[6] Similarly, a 2010 study by the Center on Executive Compensation found that 54 percent of companies had changed or adopted a compensation plan or policy in the previous three years primarily to meet the standards of a proxy advisory firm.[7]

In a recent working paper, Larcker, McCall, and Ormazabal (2011) examine the impact of ISS voting policies on 272 exchange offers during 2004 to 2009.[8] They find that 39 percent of shareholder-approved plans that are reviewed by ISS are compliant with ISS guidelines. When the sample is expanded to include plans that do not require shareholder approval, the authors estimate that only 23 percent are compliant. The discrepancy suggests that companies alter the terms of a plan to gain ISS approval when a shareholder vote is required.

More importantly, these researchers observe a positive stock price reaction to exchange offers, suggesting that shareholders view these proposals as value increasing. However, the stock price reaction is significantly less positive when the exchange offer is constrained to meet ISS guidelines. The authors also find that future operating performance is *lower* and executive turnover is *higher* when the exchange program is constrained in the manner recommended by ISS. These results indicate that ISS recommendations on stock option exchanges do not increase, and in fact actually decrease, shareholder value.

WHY THIS MATTERS

1. Mutual funds have a fiduciary responsibility to vote their shares in a manner that is free from conflicts of interest that might exist between the fund investors and fund management. These funds can satisfy their fiduciary responsibility to vote their shares using the recommendations of proxy advisory firms. Do proxy advisors have appropriate incentives to invest sufficient resources to verify whether their voting recommendations are actually creating shareholder value?

2. Proxy advisory firm recommendations are influential in the voting process, particularly in matters relating to executive compensation and equity programs. Should shareholders and board members require rigorous empirical evidence that ISS guidelines are value increasing

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4 Jennifer E. Bethel and Stuart L. Gillan, "The Impact of Institutional and Regulatory Environment on Shareholder Voting, *Financial Management (*2002): 29–54.

5 Angela Morgan, Annette Poulsen, and Jack Wolf, "The Evolution of Shareholder Voting for Executive Compensation Schemes," *Journal of Corporate Finance* 12 (2006): 715-737.

6 Towers Watson, "With Say on Pay Looming: Companies Move to Further Tighten the Link Between Executive Pay and Performance," Towers Watson's Executive Compensation Flash Survey, Jul. 2010. Available at: http://www.towerswatson.com/assets/pdf/2473/TowersWatson-EC-Flash-survey-NA-2010-16671-v4.pdf.

7 Cited in: Center on Executive Compensation, "A Call for Change in the Proxy Advisory Industry Status Quo," Jan. 2011.

8 David F. Larcker, Allan L. McCall, and Gaizka Ormazabal, "The Role of Proxy Advisory Firms in Stock Option Exchanges," Stanford Rock Center for Corporate Governance at Stanford University working paper No. 100 (Apr. 15, 2011). Available at: http://ssrn.com/abstract=1811130.

before they are willing to constrain compensation policies and practices to gain a favorable recommendation?

3. The Larcker, McCall, and Ormazabal study examines one only specific set of ISS guidelines. Do these results generalize to other ISS voting guidelines?

4. No meaningful competition has entered the proxy advisory market since the major regulatory changes in 2003. It appears that existing proxy advisory firms enjoy significant protection through barriers to entry. Is this desirable for the public interest?

Exhibit 1
Examples of Exchange Offers

Intel Corp (Shareholder approval required and ISS recommended a vote in favor)

Terms of the exchange program (Mar. 23, 2009):

- Officers and directors are not eligible
- Only stock options with strike price greater than the 52 week high and granted prior to the 12 months preceding the exchange are eligible
- Exchange will be approximately value-for-value
- New awards will carry a new 4-year vesting schedule
- Surrendered stock options will be cancelled and not re-issued

Shareholder meeting, program approved (May 20, 2009)

- 2,946,103,151votes in favor (~82%)
- 649,063,498 votes against (~18%)

Tender offer initiated, term sheets and instructions provided to employees (Sep. 22, 2009)

Tender offer closed (Oct. 30, 2009):

- 217,436,251 (~66% of those eligible) were accepted for cancellation
- 83,046,296 new options were granted in return

Limelight Networks (No shareholder approval required and there was no ISS recommendation)

Terms of the exchange program (Apr. 14, 2008):

- Officers and Directors are not eligible
- Options granted within the past year will be eligible for exchange
- Employees can receive 1 share of restricted stock for every 2 options surrendered (not value-for-value for some options)
- New awards will vest semi-annually over 2 years (shorter than the original vesting)

Tender offer initiated, term sheets and instructions provided to employees (May 15, 2008)

Tender offer closed (Jun. 16, 2008)

- 2,002,100 (~55% of those eligible) were accepted for cancellation
- 1,001,051 new restricted stock units were granted in return

Sources: Intel Form PRE 14A filed Mar. 23, 2009 with the SEC, Form 10-Q filed Aug. 3, 2009, and Form SC TO-I/A filed Nov. 5, 2009; Limelight Networks Form SC-TO-C filed Apr. 14, 2008 and Form SC-TO-I/A filed Jul. 14, 2008.

Exhibit 2
ISS Guidelines for Exchange Offers

Vote CASE-by-CASE on management proposals seeking approval to exchange/reprice options taking into consideration:

- Historic trading patterns;
- Rationale for the repricing;
- Value-for-value exchange;
- Treatment of surrendered options;
- Option vesting;
- Term of the option;
- Exercise price;
- Participation.

If the surrendered options are added back to the equity plans for re-issuance, then also take into consideration the company's three-year average burn rate.

Vote FOR shareholder proposals to put option repricings to a shareholder vote.

ISS Consideration	**ISS Policy**
Historic trading patterns	Recommend against any exchange program that includes options with a strike price less than the 52 week high
Rationale for the repricing	Recommend against any exchange that includes options granted in the prior year
Value-for-value exchange	Recommend against any plan in which the exchanged options have value less than the awards offered in return
Treatment of surrendered options	If the total equity compensation program plan cost is too high (as measured by a proprietary cost model), recommend against an exchange that allows share recaptured in the exchange to be used for future awards
Option Vesting	Recommend against any exchange in which new award vesting schedules are less than the greater of 6 months and the original award vesting schedule
Term of the option	Recommend against any plan in which the term of new stock options is greater than the term of the original options
Exercise Price	Recommend against any plan in which replacement options have an exercise price less than or equal to the current stock price (not applicable to restricted stock)
Participation	Recommend against any plan in which named executive officers or directors are allowed to participate

Source: Institutional Shareholder Services, US Proxy Voting Guidelines Summary (2006), Available at: http://www.usbank.com/pcg/pdf/US2006SummaryGuidelines.pdf.