

AGENDA

Opinion

Criticism Distorts Value ISS Provides to Boards

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Last month, as the new federal requirement for say on pay took effect, the **Center on Executive Compensation (CEC)** issued a white paper that includes a well-reasoned critique of **Institutional Shareholder Services**. Titled “A Call for Change in the Proxy Advisory Industry Status Quo,” the white paper criticizes ISS for a lack of transparency regarding its rating models. It also argues that ISS’s corporate consulting services pose a conflict of interest, and that the organization has become too powerful.

As shareholders and directors assess these criticisms, they should consider ISS’s long-term record. Clearly, that record is one of doing far more good than harm. The organization’s positions have benefited both shareholders and boards at many companies over the past 10 to 15 years by helping them rein in excessive executive compensation. In eradicating or tamping down some of the worst pay practices, the organization has brought more rationality — indeed, more sanity — to executive compensation.

ISS has actually made directors’ jobs easier. An example lies in ISS’s long-standing opposition to excessive golden parachutes. Many directors have long had reservations about parachutes that paid CEOs three times their annual cash compensation and excise tax gross-ups while accelerating the vesting of their options and restricted stock. Now, more parachutes call for a multiple of two times annual compensation, and more are of the double-trigger variety — predicated not just on a change in control, but also on the additional trigger of the executive losing his or her job. Moreover, many stipulate that there will be no accelerated vesting if existing equity is replaced by the new entity.

ISS’s tenacious opposition to excessive parachutes has empowered boards to make their change-in-control severance provisions more reasonable and appropriate. This has allowed boards to avert pent-up shareholder opposition and resentment that could lead to director no-votes, rejection of compensation plans in shareholder votes (say on pay) and resulting negative headlines.

The Center on Executive Compensation white paper characterizes ISS’s role as a consultant to companies as a conflict of interest. (The depiction stems from ISS’s practice of charging companies for detailed information on how it derives their ratings and on how many shares might be authorized for their stock plans.) Yet the ratings that ISS assigns aren’t affected by such

consulting relationships. Regardless of whether a company chooses to engage ISS's consulting services or not, the ratings it receives are the same. Hence, there's no conflict.

Because ISS keeps its rating models close to the vest as proprietary information, some companies have criticized them as a black box. In a perfect world, these models would be opened up for all to see and use. Despite this lack of transparency, the ISS generally produces ratings that are fair and consistent.

One reason for this consistency is that ISS's rating methodologies are formulaic. As some aspects of compensation programs don't fit neatly into variables, these ratings sometimes miss the mark. When this happens or, when companies object to their ratings on other grounds, they are free to mount investor relations campaigns to counter negative effects. This new era of say on pay requires more communication about compensation with shareholders anyway; companies' objections to ratings could be part of this dialog.

The Center on Executive Compensation white paper states that say on pay gives more clout to an organization that is already too powerful. There's no denying that ISS has considerable power. Yet this power is by no means inherent; it stems from the voluntary participation of investor clients. To this extent, ISS standards could be viewed a reflection of shareholders' preferences.

Nor is ISS's power a given. If too many of its investor clients were dissatisfied, the resulting attrition would likely fuel the growth of a more desirable alternative. The fact that this isn't happening speaks to the value that investors see in the organization's services.

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