



A dialogue with Gary Retelny, president and CEO of Institutional Shareholder Services

On January 14–15, 2016, members of the Audit Committee Leadership Network in North America (ACLN) met in New York for their 30th stand-alone meeting. In one session, they were joined by Gary Retelny, president and CEO of Institutional Shareholder Services (ISS), to discuss the proxy advisory industry.

This *ViewPoints* synthesizes the key points discussed in the meeting. It also includes background information and perspectives that members shared before the meeting.¹ For further information on the network, see “About this document,” on page 9. For a full list of participants, see Appendix 1, on page 10.

Executive summary

ACLN members discussed the following topics with Mr. Retelny:

- **ISS and the proxy advisory industry** (*page 2*)

Investors and other stakeholders rely on ISS and other proxy advisory firms to help fulfill their corporate governance obligations. The core of ISS’s business is to advise institutional investors on proxy voting issues. ISS is transforming into a global governance company that provides a range of services to different constituents. Audit committee chairs and Mr. Retelny discussed these services, ISS’s plans for growth, and ways that management and boards can work with investors and proxy advisers to ensure that they are making decisions based on accurate information.

- **ISS’s process and analysis** (*page 4*)

In order to meet its institutional investor-clients’ demands, ISS undergoes a regular, detailed process to understand major governance issues and make voting recommendations. ISS also works directly with large investors to help them establish and implement custom voting policies. To ensure the quality of its analysis, ISS engages regularly with companies and other market participants. Mr. Retelny emphasized that ISS relies exclusively upon publicly disclosed information to make its ultimate voting recommendations.

- **Specific policies and voting recommendations** (*page 7*)

A number of key corporate governance issues have caught the attention of institutional investors and have therefore become a priority for ISS. In particular, Mr. Retelny emphasized that issues like proxy access, overboarding policies, board refreshment, and director independence are front of mind for investors today.

¹ *ViewPoints* reflects the network’s use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments are not attributed to individuals or corporations. Italicized quotations reflect comments made in connection with the meeting by network members and other meeting participants.

For a list of discussion questions for audit committees, see Appendix 2, on page 11.

ISS and the proxy advisory industry

In recent decades, regulatory pressure and investor demand have led proxy advisory firms to play a meaningful role in corporate governance. ACLN members and Mr. Retelny addressed the scope of ISS's business and the ongoing demand for its services.

ISS's business and growth

Mr. Retelny provided members with an overview of ISS's history, business model, and priorities, noting that today, the firm has over 900 employees, operates in 17 countries, and has annual revenue around \$130 million. He emphasized that *"ISS is a global governance company, not just a proxy adviser – though proxy advice was how we got our start."*

ISS provides institutional investors with research and advice on governance issues, guidelines and recommendations on specific proxy items, and a proxy-voting platform. Mr. Retelny explained that ISS also advises corporations, provides investors with class-action securities recovery services, and provides sustainable and responsible investing (SRI) services through its newly acquired subsidiary ISS-Ethix (formerly Ethix SRI Advisors).²

ACLN members were interested in ISS's own governance and ownership. In 2014, Vestar Capital Partners purchased ISS from MSCI, which had in turn acquired the firm as part of its purchase of RiskMetrics, the firm that bought ISS in 2007.³ Mr. Retelny explained, *"ISS had a number of owners over the years. That made it hard for long-term planning and stability. We wanted to end the merry-go-round and bring stability to the business. Now, for the first time since I joined, ISS is a standalone business with its own charter, strategy, and business possibilities around the world."*

ACLN members asked Mr. Retelny about ISS's plans for growth. One audit chair asked, *"I assume with a private equity owner [Vestar], you are expected to grow and deliver value. How do you plan to do that?"* Mr. Retelny explained that because ISS's core proxy advisory business presents limited growth opportunities, ISS is focused on growing in other areas. This includes ISS's work with corporate issuers, especially outside the United States, to "design, manage, and measure their corporate governance programs" and its work with investors to develop policies for how they consider environmental, social, and governance (ESG) factors and screen for ESG risks.⁴

One particular growth area that interested members is ISS's work with data and analytics. Mr. Retelny said that institutional investors want to tap into ISS's data to help better understand the companies in which they invest. One example that was of particular interest to ACLN members relates to ISS's data about corporate

² Institutional Shareholder Services, ["ISS, Ethix Clients to Receive Integrated Environmental, Social, and Governance \(ESG\) Solutions,"](#) news release, September 15, 2015.

³ ["ISS History,"](#) Institutional Shareholder Services, accessed January 25, 2016; Cogent Compensation Partners, ["Cogent Alert: The Rebranding of ISS"](#) (Houston, TX: Cogent Compensation Partners, 2010).

⁴ ["ISS Corporate Services Overview,"](#) ISS Corporate Solutions, accessed January 25, 2016; ["ISS-Ethix,"](#) Institutional Shareholder Services, accessed January 25, 2016.

directors. Mr. Retelny explained, *“Investors are keen on having a product that allows them to make judgments regarding directors serving on boards. We are working to develop a metrics-based system that will incorporate information on directors. Investors today keep lists of directors that trigger warning bells; this database will help make that process more formal.”* Some members worried that such a database might discourage directors from serving on higher-risk boards, such as those at companies in financial distress or in the midst of a turnaround. Members also encouraged Mr. Retelny to work with directors to ensure the accuracy of the information; Mr. Retelny said that is ISS’s intention.

The demand for proxy advisory services

Despite its growth in other areas, ISS’s proxy advisory services remain the core of its business. ISS dominates the proxy advisory market, with more than 60% of market share in the United States.⁵ And ISS’s proxy advisory work is not limited to the US market. Mr. Retelny said, *“We are the largest proxy adviser globally, by far. In the US, we compete primarily with Glass Lewis and a couple other small firms. Outside the US, we compete with strong regional providers.”* He added that ISS differentiates itself from some of its competitors by offering an integrated process that includes vote processing and execution, not just research and advice. According to a 2013 study, ISS’s investor-clients manage a total of \$25 trillion in investment assets.⁶

Noting that ISS and its competitors perform a useful function for investors, ACLN members discussed three primary reasons why proxy advisory services are in demand:

- **Volume of proxy proposals.** EY’s Center for Board Matters calculated that for companies in the combined Russell 3,000 and S&P 1,500 indices, there were 2,889 annual meeting proxy statements filed in 2015, and they included 24,850 management proposals and 585 shareholder proposals.⁷ Investors rely on ISS and other proxy advisers to help process all of this data. Mr. Retelny explained that assisting investors with analyzing 38,000 proxies around the globe *“is the factory part of ISS.”* He continued, *“We have a huge amount of data on companies, and we are able to put new information from the proxies through screens to look for changes from prior years or areas of concern.”* He added that ISS also formats the information in a way that makes it more uniform and easier for investors to process.
- **Concentration of meetings.** Beyond the sheer volume of information in proxies, the concentration of annual meetings – held primarily in the second quarter of the calendar year – makes proxy voting a logistical challenge for institutional investors. Proxy advisory services help ease this burden by enabling clients to outsource the processing and management aspects of the proxy process. Among the services ISS provides in this regard are receiving proxy ballots, working with custodian banks, executing votes on clients’ behalf, and maintaining vote records.⁸

⁵ James K. Glassman, [“Regulators Are a Proxy Adviser’s Best Friend.”](#) *Wall Street Journal*, December 17, 2014.

⁶ David F. Larcker, Allan L. McCall, and Brian Tayan, [“And Then a Miracle Happens!: How Do Proxy Advisory Firms Develop Their Voting Recommendations?”](#) Stanford Closer Look Series (Stanford Graduate School of Business, February 25, 2013), 1.

⁷ Communication to Tapestry Networks from the Center for Board Matters, EY, December 11, 2015.

⁸ [“Proxy Voting Services.”](#) Institutional Shareholder Services, accessed January 25, 2016.

- **Laws and regulations.** Securities and Exchange Commission and Department of Labor rules attach fiduciary duties to proxy voting.⁹ As a result, institutional investors have an obligation to vote in the best interest of plan participants and beneficiaries and often use proxy advisory firms to assist. One member asked, *“What are your ongoing lobbying efforts to create demand for your proxy advisory services?”* Mr. Retelny responded, *“We do no lobbying on this front. We have spent time talking with Congress and regulators, but only at their request.”*

ISS’s process and analysis

ISS follows a detailed process to set its proxy voting guidelines, evaluate company proxies, and make voting recommendations for its clients. ACLN members discussed that process with Mr. Retelny and considered ISS’s influence on proxy voting.

Policies and recommendations

Mr. Retelny discussed how ISS develops and amends its proxy voting guidelines. ISS explains its annual review as follows:

The policy review and update process begins with an internal review of emerging issues and notable trends across global markets. Based on data gathered throughout the year (particularly from client and issuer feedback during proxy season), ISS forms policy committees by governance topics and markets. As part of this process, the policy team examines academic literature, other empirical research, and relevant commentary. ISS also conducts surveys, convenes roundtable discussions, and posts draft policies for a review and comment period. Based on this broad input, ISS’s Global Policy Board reviews and approves final drafts and policy updates for the following proxy year. Annual updated policies announced in November apply to meetings held on and after February 1 of the following year.¹⁰

In the meeting with ACLN members, Mr. Retelny emphasized that this process includes outreach to many stakeholders, not just ISS clients: *“We go out broadly and solicit comments and usually get 400–600 comments. We hear from everyone, including companies, compensation consultants, gadflies, and institutional investors.”* He explained that once the information-gathering process is complete and ISS finalizes its policies, it produces a frequently asked questions document to ensure that all stakeholders are clear on any changes from the previous year. He added, *“From the company perspective, we don’t want to be viewed as a black box, just making recommendations. ISS publishes its standards so you can get a sense of how we will address an issue.”*

Mr. Retelny stressed that ISS’s policy is just a baseline for ISS’s proxy voting recommendations; individual issues are addressed on a case-by-case basis. He said that when reviewing an ordinary proxy, *“We start our process by putting the data through a quantitative screen to compare it against our policy. That process is*

⁹ Charles M. Nathan and Parul Mehta, *The Parallel Universes of Institutional Investing and Institutional Voting* (Rochester, NY: Social Science Research Network, 2010), 3.

¹⁰ Institutional Shareholder Services, *Executive Summary: Proxy Voting Guideline Updates and Process* (Rockville, MD: Institutional Shareholder Services, 2014), 3.

followed by a qualitative review that leads to a recommendation. If both the screen and the review lead to a negative recommendation, it is reviewed again before we finalize our recommendation.” All told, he said, this process leads to a recommendation against at least part of an S&P 500 company’s proxy less than 10% of the time.

ISS also works with its institutional investor-clients to develop and implement their own custom policies, which often yield recommendations that differ from those issued under ISS benchmark policies. According to ISS, the majority of shares that are voted by its clients via its voting platform fall under these custom recommendations.¹¹ Mr. Retelny added, *“Our clients have their own world view, particularly the larger ones. We help them with voting and execution, and help find items that they think are important based on their custom policies. If our review triggers a negative recommendation for them, even if it does not trigger a negative recommendation from ISS, we flag it for them to take a closer look.”*

One member asked, *“Do you aggregate the views of your custom clients and compare them to your own policies? Since those are usually the biggest shareholders, it seems like their positions would be an important data point for what is good governance.”* Mr. Retelny said that while ISS informally considers what its clients include in their custom policies, it is hard to draw conclusions because investors’ governance philosophies differ.

Engagement with management and boards

In addition to its review of proxy statements and other corporate filings, ISS also gathers information through direct engagement with corporate issuers. ISS explains its engagement philosophy on its website.¹² In 2012, the company set up a Feedback Review Board designed to serve as an additional channel of engagement for stakeholders.¹³ A 2015 proxy season survey of over 150 companies by Nasdaq and the Center for Capital Markets Competitiveness found that “companies asked advisory firms to provide input into recommendations 47% of the time, and advisory firms permitted that input 53% of the time.”¹⁴

Mr. Retelny told ACLN members that the nature of ISS’s engagement is changing rapidly: *“We used to send out a report and give a company 24–48 hours to respond. They might not have liked the timeframe, but at least they knew what was coming and they had a chance to correct factual errors.”* Now, companies are more proactive in their engagement with ISS. Mr. Retelny explained, *“Many companies are engaging with us year round. The best way to do it is to come to us outside of proxy season with an issue you want to discuss. Our people will talk to you, consider the issue, and think it through.”* While much of ISS’s engagement is done at the request of the company, in special situations ISS reaches out to all parties involved to get their perspectives before issuing a recommendation. Mr. Retelny said, *“In a contentious deal or*

¹¹ Institutional Shareholder Services, *Executive Summary: Proxy Voting Guideline Updates and Process* (Rockville, MD: Institutional Shareholder Services, 2014), 3.

¹² “FAQs: Engagement on Proxy Research,” Institutional Shareholder Services, accessed January 27, 2016.

¹³ Institutional Shareholder Services, *“ISS Raises the Bar for Transparency and Responsiveness,”* news release, March 29, 2012.

¹⁴ Center for Capital Markets Competitiveness and Nasdaq, *2015 Proxy Season Survey – Public Company Experience During the Current Proxy Season* (Center for Capital Markets Competitiveness and Nasdaq, 2015).

contentious proxy fight, we try to talk to everyone to get a sense of what is going on. It is very different from the normal proxy process.”

ACLN members observed that independent directors are increasingly involved in company interactions with proxy advisory firms. One member asked, *“How is your engagement with directors changing?”* Mr. Retelny responded, *“Directors are much more vocal and assertive. Management used to lead the engagement with ISS, but now we are seeing lead directors, compensation chairs, and nominating and governance chairs engage directly with us, often without the CEO, and sometimes with no one from management.”* To date, ISS’s director engagement has generally not included audit committee chairs, but Mr. Retelny said that could change in the future as audit committee issues – such as risk oversight and audit partner rotation – come to the forefront for ISS’s clients.

While ISS finds value in direct engagement, Mr. Retelny emphasized that the firm relies on publicly available information to make its voting recommendations. He said, *“If you don’t disclose it publicly, ISS can’t use it. Management may tell us something during an engagement and we will include it in our report. But when we make recommendations, we only take into account information that is available to our clients.”*

Quality of analysis

Some critics claim that proxy advisory firms’ advice is not always of the best quality. According to the above-mentioned survey, among companies that had an advisory firm make a recommendation on an issue in the company’s proxy statement, only 25% “believed the proxy advisory firm carefully researched and took into account all relevant aspects of the particular issue on which it provided advice.”¹⁵

ACLN members were especially concerned that ISS’s process could lead to uninformed positions. One member raised a case where ISS issued negative recommendations against audit committee members following a cybersecurity breach: *“In a situation like that, where not all of the facts are out in the world, is ISS really competent to make that judgment?”* Mr. Retelny conceded that ISS does not always have all the facts, but he said that should not prevent it from issuing recommendations when deficiencies are apparent in what is disclosed. He explained, *“Something is usually disclosed about the board’s response. We look to see something that shows what you are doing to mitigate so that this doesn’t happen again. We aren’t going to take it against someone who is getting legal advice to be quiet. We get it. But when you say something, we will evaluate it.”*

Members also raised questions about factual errors in ISS reports. Mr. Retelny responded that ISS will correct factual errors when it is made aware of them: *“It is a myth that we don’t fix factual errors. We fix them. If the change leads to a change in recommendation, we will alert all of our clients that hold the security. But we don’t make changes when it is a difference of opinion.”* He advised ACLN members that if they identify an error in an ISS report, they should contact the ISS analyst whose name is disclosed in the

¹⁵ Center for Capital Markets Competitiveness and Nasdaq, *2015 Proxy Season Survey – Public Company Experience During the Current Proxy Season* (Center for Capital Markets Competitiveness and Nasdaq, 2015).

report directly. *“Write an e-mail to your analyst. I assure you those are read and discussed, even if you don’t get a response to your e-mail,”* he said.

Critics also worry that specific groups, such as activist investors, hold too much sway over proxy advisers. In a pre-meeting conversation, Mr. Retelny emphasized that activists do not have any special influence over ISS: *“Activists are treated in the same way as any other investor. There’s no privilege, no special relationship. We are lobbied by them as by others. We have been spoken of both very positively and very negatively by activist investors, sometimes the same one.”*

Specific policies and voting recommendations

ACLN members and Mr. Retelny discussed some of the specific policies and voting recommendations promulgated by ISS. Though ISS formulates policies on a range of issues and makes countless recommendations every year, some issues draw more attention and controversy than others. Issues receiving more attention are likely to be among those that ISS reviews and updates its policies on during the annual policy update process. Members and Mr. Retelny focused on the following prominent issues:

- **Proxy access.** Shareholders’ ability to add their own board nominees to a company’s proxy ballot became a prominent issue in 2015. The number of proxy access proposals voted on jumped from 18 in 2014 to 88 in 2015, and nearly 60% passed in 2015, versus 28% in 2014.¹⁶ Mr. Retelny said that proxy access is the rare topic that has near universal support from investors. *“This topic is on fire. It has gained more traction than any topic ISS has seen. Investors want to have this right. Outside the parameters of access for a coalition of up to 20 shareholders that holds 3% for three years to nominate 20–25% of the board, many investors will not support management,”* he said.

While Mr. Retelny considers proxy access a foregone conclusion at major US public companies, he questioned whether it would ultimately change board composition. He said, *“In the United Kingdom, proxy access is standard, and companies there think it is no big deal because it is almost never used. It is not trivial to get a big enough coalition to nominate directors, and then you still have to win.”*

- **Overboarding.** In its most recent policy update, issued on November 20, 2015, ISS made a change to its policy on director overboarding by reducing the maximum number of boards a non-CEO director can serve on from six to five. For directors who are sitting CEOs, the maximum remains two outside directorships. Mr. Retelny explained the rationale for this change: *“Demands on outside directors are escalating by leaps and bounds. We did a survey and found that many companies have lower restrictions on the total number of boards that their outside directors can serve on than what ISS is imposing. Institutional investors are concerned that directors have enough time to focus on the company.”* He made clear that this change should not discourage directors from serving on multiple boards, explaining, *“It is important to serve on more than one board to see good practices and bring them back to your other boards. It is just unrealistic to expect a director to serve on six or more public company boards and do a good job.”*

¹⁶ Sidley Austin, *Is Proxy Access Inevitable?* (New York: Sidley Austin, November 4, 2015), 2.

ACLN members shared Mr. Retelny's sentiments about the requirements of board service, but they raised concerns about the lack of nuance in ISS's approach. One member asked, *"Do you distinguish between the types of boards? For example, in the financial sector a board might have twice as many meetings as another company."* Mr. Retelny said that while he understands that service on each board is unique, institutional investors favor a bright-line test to assess overboarding.

- **Board refreshment.** ACLN members also brought up other board composition issues. One ACLN member asked, *"What do you get from your engagement with nominating and governance committee chairs?"* Mr. Retelny explained that ISS looks to ensure that boards are adding directors with new perspectives: *"We are looking for evidence that you are refreshing the board. Not who leaves or stays, but who comes in. Investors are interested in board diversity, both in terms of race and gender, but also diversity of expertise in areas like international business and cybersecurity."*

Mr. Retelny added that ISS does not have a specific policy on board refreshment – and failure to refresh the board does not trigger a negative voting recommendation. However, if the average tenure of a board exceeds 15 years, ISS recommends scrutiny to ensure that the board is independent of management and that turnover is sufficient to bring in new perspectives.¹⁷

- **Director independence.** Some members were concerned that ISS sets a different standard for director independence than those established by the New York Stock Exchange (NYSE) or NASDAQ. One member asked, *"Our governance committee appoints independent directors following the NYSE rules, then ISS comes back and says they are not independent. Why is your evaluation different?"* Mr. Retelny explained, *"The listing standards that exchanges put together are done in a competitive environment to encourage listing on their exchange. They are mandates for companies, not best practices. We consider what institutional investors consider to be good governance. In the vast majority of cases, our policies are similar, but there are differences that have to do with the views of investors. Our recommendation can create a dialogue on an issue where one might be necessary."*

Conclusion

Faced with the task of voting on many companies' proxies in a short period of time, institutional investors of all sizes continue to rely upon ISS and its competitors for both proxy voting advice and execution. ISS's reach is only expanding as it grows beyond its proxy advisory services into a global governance company. ACLN members recognized the importance of developing a relationship with ISS, both to ensure that their voices are heard in its policy process and to serve as a check on the accuracy of its work. Mr. Retelny, for his part, encouraged board directors to play that role and participate in the process.

¹⁷ Institutional Shareholder Services, *United States: Summary Proxy Voting Guidelines* (Rockville, MD: Institutional Shareholder Services, 2015), 18.



About this document

The Audit Committee Leadership Network is a group of audit committee chairs drawn from leading North American companies committed to improving the performance of audit committees and enhancing trust in financial markets. The network is organized and led by Tapestry Networks with the support of EY as part of its continuing commitment to board effectiveness and good governance.

ViewPoints is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, management, and their advisers as they endeavor to fulfill their respective responsibilities to the investing public. The ultimate value of *ViewPoints* lies in its power to help all constituencies develop their own informed points of view on these important issues. Those who receive *ViewPoints* are encouraged to share it with others in their own networks. The more board members, members of management, and advisers who become systematically engaged in this dialogue, the more value will be created for all.

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Appendix 1: Participants

Members participating in all or part of the meeting sit on the boards of over 25 public companies:

- Alan Bennett, Audit Committee Chair, Halliburton
- Les Brun, Audit Committee Chair, Merck
- Carolyn Dittmeier, Chairman Statutory Audit Committee, Generali*
- Marie Knowles, Audit Committee Chair, McKesson
- Mike Losh, Audit Committee Chair, Aon
- Wick Moorman, Audit Committee Chair, Chevron
- Chuck Noski, Audit Committee Chair, Microsoft
- Tom Schoewe, Audit Committee Chair, General Motors
- Dick Swift, Audit Committee Chair, CVS

EY was represented in all or part of the meeting by:

- Chris Holmes, Partner, National Director of SEC Regulatory Matters
- Steve Howe, U.S. Chairman and Americas Managing Partner
- Frank Mahoney, Americas Vice Chair of Assurance Services
- Ann Yerger, Executive Director, Center for Board Matters

* Member of the European Audit Committee Leadership Network



Appendix 2: Questions for audit committees

- ? What more would you like to understand about the business models used by ISS and other proxy advisers?
- ? What questions do you have about the nuts and bolts of the policy formulation process and the development of specific voting recommendations?
- ? What do you think drives investor demand for proxy advisory firm services?
- ? Do you believe proxy advisory firms have too much influence?
- ? What has been your experience regarding the quality of the advice provided by proxy advisory firms?
- ? How open to feedback has your company found these firms to be?
- ? Have you engaged directly with these firms as a board member? What was your experience in engaging with them?
- ? What proxy advisory firm policies and recommendations have the most impact? Which issues are especially important in the current environment?
- ? What policies and voting recommendations from proxy advisory firms have you found the most problematic? Where would you like to see changes?