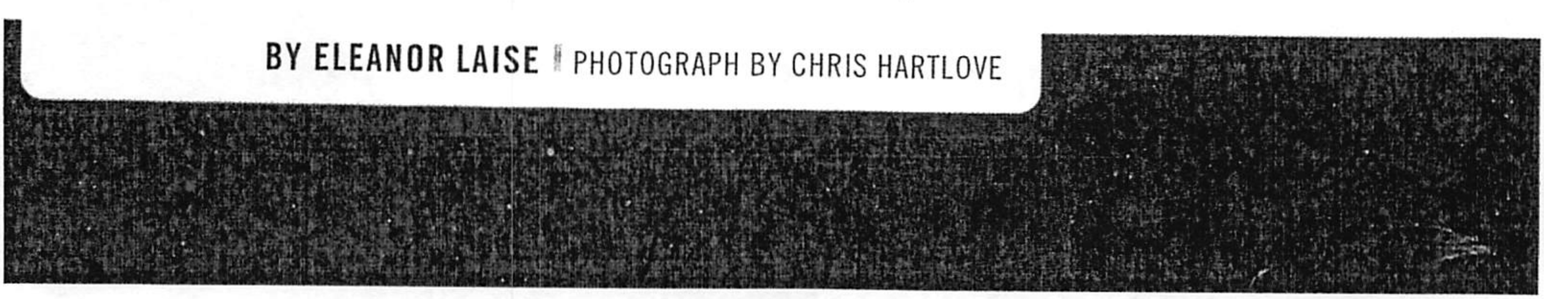
Note: The following Smart Money story is based on original Parish & Company research

Is This the Most INFLUENTIAL MAN on Wall Street

He may look more like a file clerk than a power broker, but Ram Kumar holds considerable sway over the stocks in your portfolio. As director of U.S. research at Institutional Shareholder Services, he can make or break a candidate's run for a board seat or even a multibillion-dollar deal such as the HP-Compaq merger. That's because many fund managers rely on ISS to tell them how to vote on shareholder issues. But is their trust misplaced? SmartMoney takes a hard look at how ISS operates.

BY ELEANOR LAISE | PHOTOGRAPH BY CHRIS HARTLOVE



Kumar went from temp to ISS research chief in four years: "I can't say this is something I groomed myself for."

Carly Fiorina was short on time. The Hewlett-Packard CEO, the most powerful businesswoman in the country, had exactly 22 days to convince HP's highly skeptical shareholders that her plan for a $19 billion merger with Compaq just might work. If she failed to make her case before the special shareholder meeting Mar. 19, she would be out of luck and possibly out of a job.

So on the afternoon of Feb. 25, Fiorina knew where she needed to be: in the Rockville, Md., headquarters of proxy advisory firm Institutional Shareholder Services. The target of her sales pitch: 33-year-old Ram Kumar, ISS's director of U.S. research. Never mind that Kumar is a law school dropout and former LSAT tutor who joined ISS as a temp just four years ago. As author of his firm's report on the HP-Compaq deal, he had the power to swing the vote.

It was Fiorina's second trip to ISS since the proxy fight started in December, and this time she wanted to make sure she got the firm's full attention. She walked into the cramped conference room alone, leaving behind her top executives, her lawyers and her briefing book. She didn't even bring any notes.

Her audience was small: just five ISS analysts, including Kumar. They, too, were geared up for the occasion, breaking their unwritten casual dress code to don jackets and ties. Fiorina, in her customary power suit, remained seated throughout the 90-minute meeting, coolly rehashing the same points she'd stressed to investors so many times before. The deal would strengthen every HP business unit, it would fill gaps in its product portfolio, and a team of 600 "cultural astronauts" would ensure the smooth integration of the two PC titans. It was a practiced presentation that failed to persuade many of HP's largest shareholders. But it won the hearts of the ISS analysts.

After the meeting, the analysts huddled to share their thoughts. The verdict on Fiorina's performance was unanimous: "She was very impressive," Kumar says. "She had a forceful personality, was in total command of the subject matter and always had a strong response."

The cozy tête-à-tête was arguably the most important meeting Fiorina held during her bitter three-month fight for Compaq. That's because ISS, situated some 235 miles from Wall Street in a drab, six-story suburban office tower surrounded by empty fields and half-built housing developments, has quietly evolved into a market power.

Never heard of ISS? Not many individual investors have. But there's no doubt it has a major effect on the stocks in your portfolio. Many institutional investors—mutual funds, pension funds and the like—rely heavily on ISS to tell them how to cast their ballots on shareholder votes. And since these investors represent a huge voting bloc at many public companies, key decisions such as who's in and who's out on corporate boards, the size of a CEO's pay package, and even the approval of multibillion-dollar mergers often fall largely into ISS's hands.

Last year, for instance, ISS's backing helped dissenting investors unseat the board at ICN Pharmaceuticals, and its stamp of approval ensured that the megamerger of First Union and Wachovia would go through. As for the HP-Compaq deal, there's no doubt ISS's recommendation played a decisive role there, too. According to HP estimates, ISS clients held 23 percent of outstanding shares—including 9 percent owned by index funds, which nearly always take ISS's advice. After Kumar gave his blessing, the merger won investors' approval by a margin of less than 3 percent.

But some on Wall Street are uncomfortable with ISS's wielding so much power, arguing the firm is simply not up to the task. Critics claim that ISS analysts—and Kumar in particular—don't have the skills or experience to dissect complex financial transactions and that ISS's reports are full of superficial, simplistic analysis. "ISS too often listens to a sales pitch from management, and they take what they say at face value," says hedge fund manager Phillip Goldstein, who has staged about a dozen proxy fights and won ISS support roughly half the time. "They're like someone who goes to see Siegfried and Roy and says, 'Wow, they really made an elephant disappear.'"

Though Kumar maintains that "management's view isn't given any more weight," ISS's track record on mergers and acquisitions shows that it buys into management's point of view surprisingly often. In an analysis of the 22 reports ISS has issued on contested deals over the past five years, SmartMoney found that it gave management its support in 19 cases—86 percent.

Even more troubling, ISS's operations are fraught with the kind of potential conflicts of interest that have plagued auditors and Wall Street analysts in recent months. For one thing, ISS sells consulting services to the very companies it purports to analyze objectively. And when it weighed in on its highest-profile deal to date, the HP-Compaq merger, ISS failed to point out one salient fact: that it is partially owned by a firm that has extensive business dealings with Hewlett-Packard.

If ISS has become too powerful, fund managers are partly to blame. Most institutional investors hold so many stocks that they don't have the time or inclination to look into every proxy issue. So they pay ISS—from $10,000 a year to well into six figures—to do the homework for them. And in this era of tainted Wall Street research and fuzzy financial statements, the reputation ISS has cultivated as an unbiased, objective research source has been an enormous boon for the firm. Richard Koppes, former general counsel for corporate governance heavyweight California Public Employees' Retirement System (Calpers), puts it this way: "An institution voting against the ISS recommendation better have a pretty good reason."

Initially, after corporate governance guru Robert A.G. Monks launched the firm in 1985, ISS stuck to making recommendations on S&P 500 companies. But when lawyer Jamie Heard took over as CEO in 1991, ISS began to expand its coverage. Today it follows nearly every U.S. public company and issues vote recommendations for 20,000 shareholder meetings each year. The 300-employee firm has annual revenue of about $35 million, offices in five countries covering more than 60 foreign markets—and one very youthful director of U.S. research.

In his four years at ISS, Ram Kumar has authored many of its most visible reports—including the one backing the First Union–Wachovia deal and another siding with corporate raider Sam Wyly's ill-fated bid to take over Computer Associates. Now, as research director, a job he assumed in March, Kumar signs off on every ISS domestic proxy report. What qualifies him to wield such power? Not much, at least on paper. Before joining ISS, he had no advanced courses in finance or economics, and never even owned a stock. "I can't say this is something I groomed myself for in school," Kumar admits. "It was something I fell into, which is typical of most people at ISS."

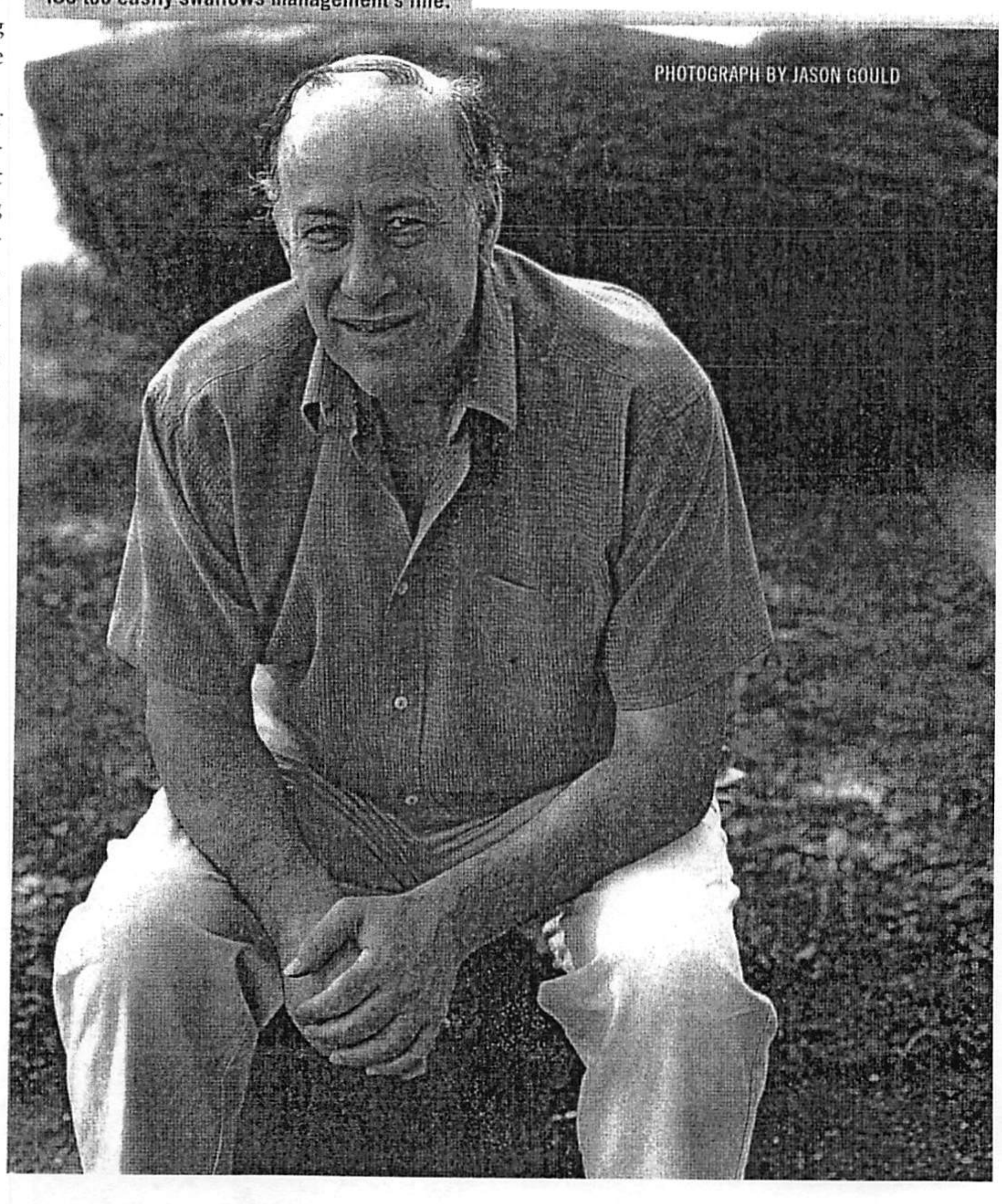
Indeed, many ISS analysts begin their careers the same way Kumar did: as a temp. Each spring, at the height of proxy season, ISS hires about a dozen people from temp agencies and puts them to work producing recommendations on such routine issues as uncontested director elections and stock option proposals, which make up about half of all ISS reports. They base their recommendations on formulas laid out in the firm's 8-inch-thick "proxy voting manual." ISS's stable of 25 permanent U.S. analysts, who do much of the same work, are usually pulled from this pool of temps. "We hire a decent number of people out of college who haven't had a job before," Kumar says. "You learn on the job." The most complex domestic reports, such as contested director elections and mergers, are left to Kumar and a team of two senior analysts—Bimal Patel and Vittorio Lara.

So how does ISS conduct its research? Surprisingly, the firm doesn't do any of its own financial analysis, nor does it even pay for the opinions of professionals who could supply such research. "In the vast majority of cases, it's not necessary," contends Kumar. And when it is, such as with a complex issue like the HP-Compaq deal, he argues, ISS receives plenty of free information from analysts and fund managers who follow the stocks. Why not run its own figures? Answering the question, Kumar sounds less than confident. "If we added our own numbers, it would be one extra set of numbers that aren't necessarily more correct than any other numbers."

Instead, ISS analysts turn to SEC filings and company Web sites for much of their research. Some sources Kumar has turned to are far from reliable. "Earlier in my senior analyst career, I tried perusing the message boards a lot, like Yahoo! and Raging Bull," he says. "It's kind of fun, but you don't get an awful lot out of it."

For high-profile issues, ISS also relies heavily on face-to-face meetings with company bigwigs and dissident shareholders. "People can't overestimate how important

Hedge fund manager Phillip Goldstein says ISS too easily swallows management's line.



PHOTOGRAPH BY JASON GOULD

it is to meet with the parties and question them," Heard says. But some shareholders and proxy solicitors who've sat in on these powwows say that while ISS analysts ask plenty of questions, they invariably focus more on corporate governance—their bailiwick—than on finance and shareholder value. When it comes to the bottom-line issues, they say, ISS tends to trust management's rosy predictions.

HP-Compaq one of the most exhaustively planned combinations ever."

That kind of logic baffles—and infuriates—some financial analysts. "Kumar said that half a million man-hours were spent on integration," says Bill Parish, a former stock analyst who now works as an independent investment manager in Portland, Ore. "Anyone who has spent time in the computer industry would say,

One Wall Street analyst describes Kumar's report on the HP deal as 'very superficial. I used to be a teacher, and if I had a student give me a report like that, I would have given him an F.'

The ISS report on the HP-Compaq deal, for example, made some critics suspect that Fiorina simply charmed Kumar's socks off. "The companies sent the top brass of their integration team," Kumar wrote in his report. "We were treated to a meticulous and exhaustively detailed presentation on the integration planning." He goes on to write: "It is hard to remain unimpressed in the face of such enthusiastic attention paid to the integration effort. Half a million man-hours of work have thus far been devoted to integration planning, which surely makes

'Who is this jerk?' It's like saying a million lines of code is better than 100 lines of code. It's such a sign of incompetence."

Though Kumar had three months to analyze the deal (versus the two-week time frame that's more typical at ISS for major issues), his report seems lightweight, even to the layman's eye. While he did include a section on "financial and strategic merits," nowhere does Kumar address the most striking aspect of dissident director Walter Hewlett's argument against the merger: that HP was paying 47.7 times 2002 earnings for Compaq—more than double the historical acquisition price for a computer company and more than double HP's own valuation.

"I used to be a teacher, and if I had a student give me a report like that, I would have given him an F," says Charles Wolf of Needham & Co., a top-ranked *Wall Street Journal* analyst who opposed the deal. The report was "very superficial. I would have appreciated something more on the economics of the merger and whether the merger itself made sense, not whether they were integrating well. But they may not have the people with the necessary background to do that."

Though HP shares have fallen 20 percent since shareholders approved the merger, ISS chief Heard stands behind Kumar's analysis, saying, "the important issue was the integration risk, and we did an excellent job analyzing that." Maybe, maybe not. In June, when Moody's downgraded the company's debt, it cited integration problems as a major reason.

The HP deal was not the only one that raised questions about ISS's business acumen. This spring, when Illinois investor Barrett Rochman tried to elect a dissident director to the board of American Bank, he says, ISS couldn't seem to grasp his reasons, which were based purely on the bank's fragile financial condition. "They didn't look at the loan department, they

SOME NOTABLE BAD CALLS FROM ISS... AND SOME GOOD ONES

1997 ↓

JUNE 9, 1997
ISS backs the reelection of directors at Baldwin Piano & Organ—despite weak profits. The board is "moving the company in the right direction," ISS declares. The incumbents win but soon strike the wrong chord: The stock has since sunk from $13.75 to less than a penny.

1998 ↓

JULY 16, 1998
ISS favors a merger between Western Resources and Kansas City Power & Light. Shareholders approve the deal. But the market doesn't share their enthusiasm, and the plan is abandoned 18 months later, after Western Resources shares lose more than half their value.

1999 ↓

JULY 12, 1999
A dissident investor nominates a new slate of directors to salvage Venator Group (now Foot Locker). But ISS sides with the board, saying it had "charted a definitive strategy for future growth." Oops. After the incumbents win, the stock falls 55 percent in seven months.

↓

JULY 29, 1999
After ISS backs the merger of Fleet Financial and BankBoston, the deal goes through. Since then Fleet has been forced to shut down its money-losing investment bank, its stock has fallen 35 percent, and the bank is now the subject of takeover rumors.

2000 ↑

MAY 5, 2000
ISS backs a dissident investor's director nominees at building-materials maker USG, saying the current board had entrenched itself with a poison-pill provision and needed a "fresh perspective." The incumbents are reelected anyway, but ISS can say "I told you so": The stock has plummeted 87 percent since then.

didn't understand cash flows and lending relationships, and they failed to read the balance sheet as closely as they should," says Rochman. During a 45-minute telephone interview, ISS had only two questions for Rochman: "What do you know about the company?" and "What do you think you can do?" Its review, he says, was "peripheral and perfunctory."

In the end ISS sided with management, and the incumbent directors were reelected. "They bought the dog-and-pony show," Rochman says. Kumar counters that ISS "looks at financial statements in every single case" in which a company's fiscal strength is questioned, as it was with American Bank.

Though Kumar argues that "we try to probe as deeply as possible the rationale behind each deal," ISS's limited staff size often forces it to take a cookie-cutter approach. It uses the same formula to evaluate all stock option plans, and instead of examining routine issues on a case-by-case basis, ISS relies on its in-house proxy voting manual. For example, it always opposes boards that stagger the election of directors. If it's covered in the manual, there are few exceptions—not even for a legendary investor like Warren Buffett.

Last year ISS raised eyebrows by recommending that shareholders not reelect Berkshire Hathaway's chief, arguing that the board's nominating committee was loaded with insiders. Institutional investors were outraged. "I don't care if Warren Buffett's whole family is on the board," Goldstein says. "He's not only a brilliant guy, he's making shareholders a lot of money, and that's the whole purpose of good corporate governance."

Responds Kumar: "If we made an exception for Warren Buffett, we'd be on a slippery slope where every company would start calling to tell us how important their CEO is and how we can't dare recommend withholding votes from him. It's just the application of a fixed policy."

But one former insider thinks ISS analysts are simply overworked—especially during the height of proxy season. David Drake, ISS's director of U.S. research until five years ago and now a managing director for proxy solicitor Georgeson Shareholder Communications, recalls that some ISS analysts who reported to him wrote as many as 13 reports a day. "It's organized as an assembly line to generate high volumes of proxy analysis," he explains. "Some of the text is canned, with the analyst having the responsibility to modify the prepared information to fit the situation they're dealing with."

That can lead to some embarrassing bloopers. One Wall Street insider recalls an ISS report on Goldman Sachs containing information that pertained to a completely different company. "It was clear the analyst was trying to get through a large volume of work and misinterpreted the proposals," he says, "and it was clear that he had excerpted language from another proxy analysis." Goldman Sachs, he adds, was "pretty steamed."

For the most part, ISS's Heard simply shrugs off the protests: "If we had 10 MBAs on our staff, I think people would still be making criticisms of our analysis because they were on the losing end." Still, the complaints, particularly those surrounding the HP-Compaq deal, have sparked some introspection at ISS. "People have asked whether we should have more capability in terms of having more Wall Street–style analysis," says Kumar. "It's something we're thinking about."

While ISS's thin research may be its most glaring problem, that isn't the only disturbing aspect of the way the firm operates. Over the years ISS has been branching further and further into consulting services, creating fertile ground for potential conflicts of interest. For a price, ISS will advise companies on everything from stock option plans to corporate governance guidelines. And to whom does it sell these services? Often the same companies involved in its proxy recommendations, including Hewlett-Packard.

ISS's executive-compensation consulting service, for example, promises "a review of your draft compensation proposal, a quantitative cost assessment of all continuing compensation plans, and a comparison to the voting guidelines applied by ISS and other institutional investors." Companies can also buy Web-based products from ISS that allow them to find out whether their stock option plans and corporate governance guidelines will meet ISS standards. They can use these tools to tweak their numbers until they come up with a plan likely to get ISS approval. More than 200 companies a year purchase such services from ISS—and they don't come cheap. Prices range from $15,000 for Web-based products to $33,000 for in-depth consulting.

Those kinds of arrangements make

2001

NOV. 1, 2000 Dissident shareholder Bettis Rainsford challenges the reelection of directors at Delta Apparel—until ISS opposes him. Rainsford abandons his fight, and Delta stock has since surged 43 percent.

APR. 15, 2001 Should legendary investor Warren Buffett be reelected to Berkshire Hathaway's board? Shockingly, ISS argues no, claiming too many insiders sit on the nominating committee. Shareholders wisely ignore ISS.

MAY 18, 2001 Unsatisfied with a stock climb of 8 percent in 12 months, ISS backs dissident director nominees at ICN Pharmaceuticals. Investors take the advice and vote in the challengers. Since then, shares have dropped 65 percent.

NOV. 26, 2001 Dissident investors nominate a slate of directors at medical-equipment maker Immucor. But ISS advocates leaving well enough alone, saying the "board is functioning properly," and investors agree. Good thing: The stock is up 303 percent.

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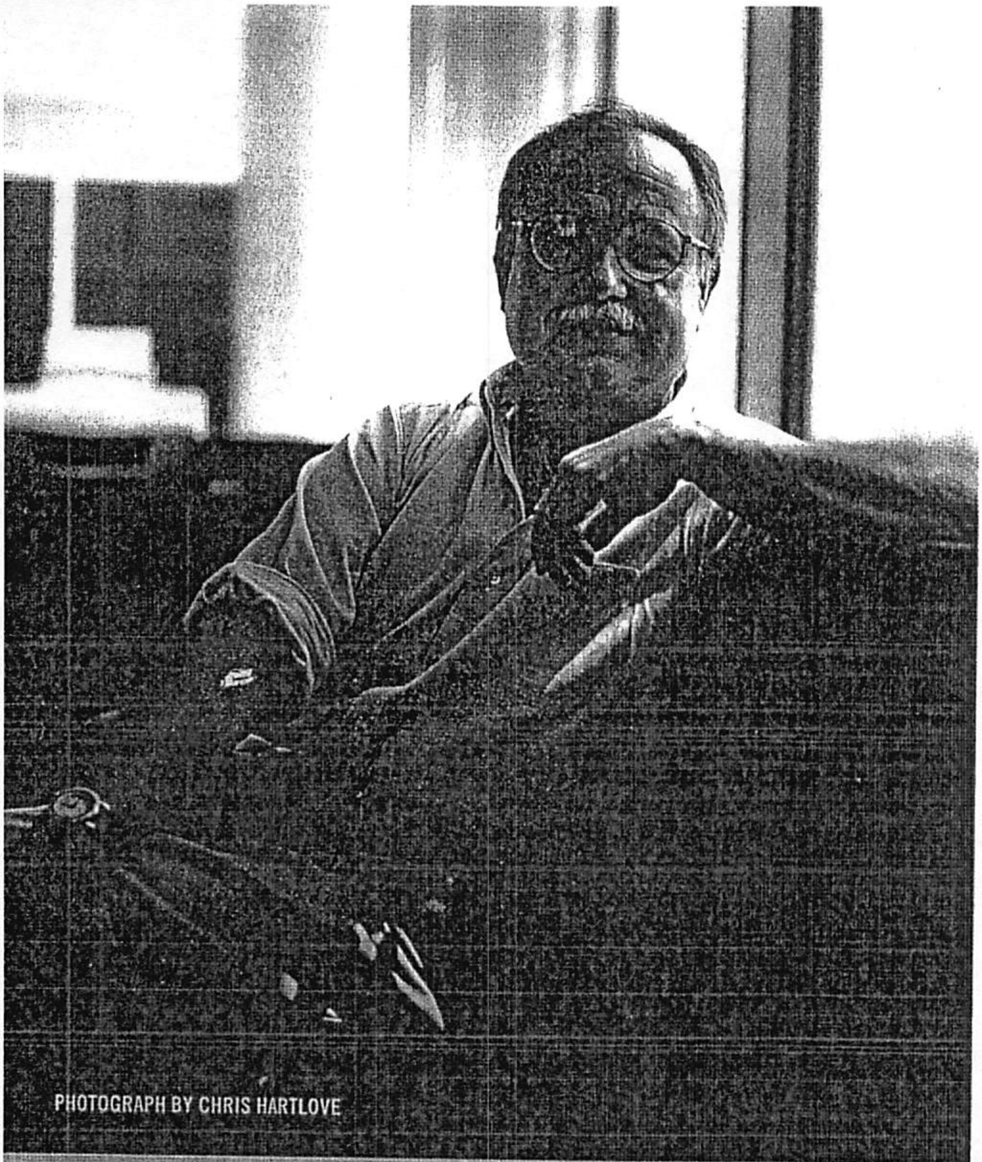

ISS chief Jamie Heard: "If we had 10 MBAs on our staff, people would still [complain]."

some critics wonder how evenhanded ISS can be in its reports. "The more businesses they get into, the more potential conflicts of interest they have," says James McRitchie, editor of the online newsletter *Corporate Governance*. Heard responds that ISS reports note if the company in question has purchased services from ISS, and that all consulting clients must acknowledge in writing that buying services from ISS doesn't guarantee them a favorable recommendation. "We have a completely separate staff that does the corporate work," Heard claims.

But sometimes the lines get blurred. Take ISS's latest offering, the "corporate governance quotient," or CGQ, which scores companies on a wide range of governance criteria, from executive compensation to the number of accredited training programs attended by directors. The scores appear on the front page of ISS proxy reports, presented as just another element of ISS's objective research. But for a price, ISS will consult with corporations on how to boost their CGQ score. And the person in charge of selling that and ISS's other consulting services—Jill Lyons—is the same person in charge of producing the CGQ scores.

While ISS at least discloses its consulting relations in its proxy reports, it hasn't always been so forthcoming about other ties. Lack of full disclosure—an ISS pet peeve when it comes to other companies—threatens to taint even its most prominent report: the Hewlett-Packard deal. Thanks to a 2001 merger with Proxy Monitor, a former competitor, ISS is now partly owned by investment bank Warburg Pincus, and three of eight seats on the ISS board are held by Warburg Pincus partners. Yet ISS's report on the HP-Compaq deal fails to mention the ownership. The new ownership isn't even mentioned on ISS's Web site. The problem with that? Warburg Pincus has extensive business dealings with Hewlett-Packard, including joint ventures and partnerships in the software firms WebGain, BEA Systems and Eontec. The front page of ISS's report notes only that "Hewlett-Packard Co. has purchased goods or services from ISS during the past 24 months"—a generic reference to the consulting services.

Heard argues that the Warburg Pincus connection isn't a conflict for one simple reason: After the ownership change, the ISS board adopted a resolution stating that no director would interfere in any ISS policies or vote recommendations. "They've never told us how to recommend on any proposal," Heard says. As for disclosure, he says, "it was never a secret who owned the company. We would have told anybody who asked."

That argument doesn't float with Parish. "ISS really betrayed a lot of fund managers by not being forthright about their ownership," he says. If Warburg Pincus owns ISS, "terrific, just disclose it. But ISS is not independent. And HP management was aggressively marketing the ISS report as justification for the merger."

None of this criticism seems to faze Heard. "I think we're on a good path here," he says, gazing from ISS's office tower, which happens to face Hewlett-Packard's regional sales office. "We have a tremendous opportunity, given the post-Enron environment, to grow our business and to reach people who were not paying attention in the past to the kinds of issues we work on." He does add, though, that he's concerned by the fact that ISS is the only game in town. "We shouldn't have this to ourselves. People should have a choice. And the competition would be good for us. It would keep us on our toes."

Goldstein couldn't agree more. "Where you have a monopoly, you have less accountability. I don't think ISS feels any accountability, and that's the biggest issue in the market today." SM