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Understanding RiskMetrics Compensation "GRId"

As discussed in our memos of March 16, 2010 and May 13, 2010, RiskMetrics has recently released the guidelines for calculations under its Governance Risk Indicator (GRId) rating system. The GRId instructions include over 50 pages of compensation questions, the answers to which result in a stand-alone Compensation GRId rating.

The Compensation GRId questions and scoring generally reflect the substantive positions in RiskMetrics' corporate governance policies and proxy voting guidelines, but in some cases are more punitive. For example, the proxy voting guidelines penalize excise tax gross-ups only in new or materially amended agreements, but the Compensation GRId deducts even for existing agreements with gross-ups. More significantly, the rigid scoring system by its nature codifies the level of emphasis on particular issues. While we do not think the one-size-fits-all GRId approach provides a useful picture of governance practices, most public companies will, given the prominence of RiskMetrics, find it useful to familiarize themselves with the GRId guidelines and identify areas where points can be scored with little risk of substantive harm. For example, in a number of cases addressing an issue in the annual proxy statement may increase a company's score.

For U.S. companies, the overall Compensation GRId score is based on three sub-scores: short-term compensation (weighted only 3%), long-term compensation (weighted 32%), and "other" (weighted 65%). The GRId instructions provide individual question weightings within the subcategories. Notably, severance provisions account for 35% of the "other" score, thus representing almost 25% of the total Compensation GRId score.

As we did for the Shareholder Rights GRId, we have prepared an interactive spreadsheet that any U.S. company can use to calculate its Compensation GRId score and to identify the impact of a particular change in its compensation practices on the score. We note that both the questions and scoring standards for the Compensation GRId required some interpretation and judgment on our part, and we anticipate that RiskMetrics may clarify some of the ambiguities we identified in an updated technical document.

The inherent inability of the Compensation GRId to take into account each company's particular circumstances, as well as odd results in the scoring if companies do not offer certain compensation arrangements, raise very substantial questions regarding the utility of this tool for assessing the compensation practices of a U.S. public company. As with the Shareholders Rights GRId in the governance area, no rigid metric or bundle of metrics can substitute for the informed business judgment of a well-advised board or compensation committee as to what is necessary to attract, retain and incentivize talented management in a competitive and global market. In today's highly politicized environment, boards of directors and compensation committees must continue to do the hard, particularized work necessary to determine by what arrangements their companies can best prosper over the long term, even while being aware of the metrical systems by which their actions will be measured and evaluated.

Eric S. Robinson
Adam O. Emmerich
Jeannemarie O'Brien
David E. Kahan
Gordon S. Moodie
Justin S. Rosenberg