COMPENSATION COMMITTEE LEADERSHIP NETWORK
ViewPoints

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Compensation's relationship to culture and reputation

Wells Fargo's $185 million in settlements to resolve a multi-year fraud investigation began weeks of non-stop coverage and commentary about corporate culture, reputation, and governance. What would have been a remarkable series of events at any company was almost inconceivable at Wells Fargo, one of the best-run, most admired, and most heavily regulated companies in the world. Andrew Ross Sorkin summed up the disbelief well: "Given all the regulations in place and the billions of dollars poured into compliance efforts, how could something so staggeringly widespread and so blatantly corrupt have happened in the first place?"[1]

On November 3-4, 2016, members of the Compensation Committee Leadership Network (CCLN) addressed that question in Washington, D.C., observing how compensation and incentive programs can affect a company's culture and reputation. This issue of *ViewPoints* highlights the conversation on these interrelated and important topics.[2]

Overseeing company culture

Almost as soon as news of the Wells Fargo settlement broke, two competing explanations emerged. The company's leadership argued that these acts were antithetical to the company's culture. In his testimony before the U.S. House Financial Services Committee, then-CEO and Chair John Stumpf said, "Wrongful sales practice behavior in our retail banking business goes against everything regarding our core principles, our ethics, and our culture."[3]

Many have forcefully disagreed with that assessment. A former employee reacted to Stumpf's testimony bluntly, saying "It's a crock. They established the culture that made this happen – it comes down from the top."[4]

Members acknowledged the difficulty of overseeing the culture of large, global organizations and discussed two opportunities for the board to positively affect their own company's culture:

- Cultivate a trust-based environment
- Look for trouble

Cultivate a trust-based environment

It is critically important to create an environment in which people are comfortable sharing troubling information and bad news. Directors themselves are unlikely to witness most incidents that might uncover a

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[1] Andrew Ross Sorkin, "Pervasive Sham Deals at Wells Fargo, and No One Noticed?" *New York Times,* Dealbook, September 12, 2016.

[2] *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.

[3] Holding Wall Street Accountable: Investigating Wells Fargo's Opening of Unauthorized Customer Accounts, Hearing Before the House Financial Services Committee, 114th Congress (September 29, 2016)(testimony of John Stumpf, CEO, Wells Fargo & Company) YouTube.

[4] Stacy Cowley, "Wells Fargo Workers Claim Retaliation for Playing by the Rules," DealBook, *New York Times*, September 26, 2016.

problem within a company's culture and must rely on others to ask questions and bring concerns to the appropriate parties.

Success begins by creating a safe space for the CEO to share concerns with the board. Board members want CEOs to "*put their vulnerabilities on the table*," as one member said. Another member added, "*As a board, we want our CEO to tell us when something is keeping him awake at night. We don't jump on that.*"

Boards can also create a space for certain senior managers to share their thoughts about the company's culture. Meridian's John Anderson told network members that "*having senior management attend portions of executive sessions [without the CEO present] can give directors a good sense of company morale, culture, and engagement.*" One member said, "*Our CEO wants us to talk to his team and feel comfortable with what is going on. I've never [had private sessions with certain managers] and was skeptical. But I really like it and think it's indicative of a strong culture.*" Members found particular value in private sessions with the head of human resources before or after full committee meetings.

Members acknowledged that it is more difficult to know whether management is adequately demonstrating company values directly to the rank and file. Board members can ask for more information about existing compliance efforts. Following revelations about Wells Fargo, one member shared, "*We now meet separately with the chief compliance officer and all individuals' who are part of the control system.*" Another member looks for *"more information about how long our compliance officers spend in the field speaking to employees."*

It is important to ensure that ethics hotlines and related practices are effective, members said. *"Frontline people need to be comfortable to speak up … It starts with communicating it's okay to do it,"* one member said. Wells Fargo's hotline process has been criticized. According to one report, Wells Fargo fired at least 1,000 people each year between 2011 and 2013,[5] due in part to hotline calls, but because each claim was viewed individually, the company did not recognize the breadth of alleged fraudulent activity for some time.[6] More troubling are complaints that the hotline caused whistleblowers harm; several employees claim they were subject to retaliation shortly after they reported ethical violations to the hotline.[7]

Look for trouble

Some members think that being responsive to complaints is not enough; boards should actively look for issues within the company's culture. One member said, *"We do employee surveys every year and try to look not just at the summaries, but also at the [open responses], to look for themes."* Some members saw value in ensuring that the surveys happen annually and that the board has full access to them.

Statistics and data can also help identify areas where there might be trouble. One member said, "*We use data analytics to see if there is a region or a division that is out of the norm. The non-human mechanism helps identify where to ask questions.*" When discussing what changes the board had adopted in the wake of events at Wells Fargo, a member said, "*I've asked for more data analytics. It can be quite effective.*"

[5] Elizabeth Tippett, "This is How Wells Fargo Encouraged Employees to Commit Fraud," *New Republic*, October 7, 2016.
[6] Stacy Cowley, "At Wells Fargo, Complaints About Fraudulent Accounts Since 2005," *New York Times*, Dealbook, October 11, 2016.
[7] Matt Egan, "I Called the Wells Fargo Ethics Line and Was Fired," *CNNMoney*, September 21, 2016.

Another added, "*We are being asked to provide a tremendous amount of data to ensure another Wells isn't happening*."

In some cases, success itself may be a red-flag. Superior performance is not always a guarantee of great culture. One member said, *"If you are three or four times better than the competition, you need to understand why. As directors, we should worry if the numbers look too good."* Another member put it simply: "*If it's too good to be true, it's too good to be true."*

In retrospect, Wells Fargo's cross-selling was an indicator of wrongful sales practice. Had company leaders asked more questions, they might have uncovered the pressure that many employees felt to act unethically. According to an Associated Press report, "Wells Fargo employees, both current and former, say they spent every day frantically trying to persuade customers to open more accounts – not for any bonuses, but simply to keep their jobs."[8] One former San Francisco-based Wells Fargo personal banker recalled when a robbery forced the branch to close to the public. Through the ordeal, the employee said that the district manager was walking through the lobby encouraging people to cross-sell: "Don't think you're walking out or going home early even though we're closed for the rest of the day. Dial for dollars. Dial for dollars."[9]

Success may be deserved, of course, but members said it was important to reman vigilant. Perhaps the pressure to remain successful makes it easier for a culture to drift. In some cases, success leads to complacency. As one member said, *"Success and excellence can be leading indicators of a downturn because they can create a culture of arrogance."*

Avoiding risks in the committee charter

Choices the committee makes in its committee charter may also create risk. Even if a committee charter includes all legally required elements, it may not accurately reflect the full scope of what the committee does or obligate the committee to do more than it requires. One particular debate raised by the Wells Fargo situation is the level of the committee's responsibility for overseeing overall company pay and pay risk. The Wells Fargo Human Resources Committee charter states that "The HRC shall establish, in consultation with senior management, the overall strategy for the Company with respect to incentive compensation and shall oversee the Company's incentive compensation practices to help ensure that they are consistent with the safety and soundness of the Company and do not encourage excessive risk-taking."[10]

Safeguarding the company's reputation

The Wells Fargo situation raises important questions for members about how their boards and compensation committees evaluate reputational risk. Although the financial impact from the situation at Wells Fargo is relatively small (at present), concerns about reputational damage are much greater, and there have already

[8] Ken Sweet, "Wells Fargo Workers: Pressure to Sell Relentless, Pervasive," Associated Press, September 21, 2016.
[9] Chris Arnold, "Fired Wells Fargo Employees Allege Attempts to Blow the Whistle," NPR, October 14, 2016.
[10] Wells Fargo, *Wells Fargo & Company Human Resources Committee Charter*, November 18, 2014, pdf.

been immediate costs to the company. For example, JPMorgan analysts downgraded Wells Fargo's stock on worries about additional legal costs and reputational risk.[11] In addition, the Associated Press reported: "Distrustful customers are not opening as many checking accounts or applying for credit cards, and branch visits and meetings between customers and bankers are down, too."[12] When discussing the systemic damage that ensued in the wake of Wells Fargo, one CCLN member summarized, "*Reputational damage is the biggest thing companies have to worry about.*"

Reputation risks are material

There is a direct relationship between a company's reputation and its compensation policies. Item 402(s) of Regulation S-K requires companies to disclose whether the company's compensation policies and practices create risks that are reasonably likely to have a material adverse effect on the company as a whole.[13] Although the standard is quite high, the rule requires an evaluation of compensation policies and practices for all employees, not just senior executives.

In Wells Fargo's case, the effects of immaterial financial loss were nonetheless material to the company's reputation. Meridian's Mr. Anderson said, "*There will be a push for compensation committees to go deeper into all compensation plans. We are moving away from the dollar materiality issue and looking at the reputation risk and other things that can go awry.*" While discussing the growing trend toward greater visibility in all pay plans, one member said, *"Compensation committee risk analyses don't go low enough. We spend a lot of time looking at senior executives and what they are getting, but don't get into the details of the lower-level programs."*

Compensation committee decisions affect reputation

There are two areas in which executive pay also affects reputation, members said. The first is the reputational consequence of what might be seen as generous pay packages. One member said, *"When we make changes to our compensation plans, we have to balance our desire to do no harm in the retention area with our desire to avoid a disconnect with our investors. Sometimes that requires including the head of investor relations in compensation discussions."* Members added that compensation committees might also consider the customer perspective to identify cases when compensation may affect reputation.

There are also reputational effects associated with clawback decisions. Most members said that, unlike at Wells Fargo, their boards do not have authority to claw back executive compensation from managers whose conduct causes reputational harm to the company. Some are considering whether their boards should have this discretion. One said, *"Before Wells Fargo, we were only focused on holding executives to account in cases where we had to restate financials. Now, we are grappling with whether to expand our clawback provision."* Compensation chairs should also be cognizant of unintended consequences of strong clawback

[11] Tae Kim, "JP Morgan Downgrades Wells Fargo on Reputational Risk," CNBC.com, September 21, 2016.

[12] Ken Sweet, "After the Scandal, Wells Fargo's Damage Becomes Apparent," Associated Press, October 15, 2016.

[13] Title 17, Sec. 229.402(s), *Code of Federal Regulations, 2011* (Washington, DC, Office of the Federal Register), 418.

policies. Mr. Anderson cautioned, *"If you give yourself broad, discretionary provisions you may run into problems with stakeholders if you don't enforce them."*

"SEC updates interpretive guidance on non-GAAP financial measures" [14]

The US Securities and Exchange Commission (SEC) released new and revised guidance on May 17, 2016, on the use of non-GAAP financial measures. The focus of this guidance is on helping to ensure that companies using non-GAAP metrics do so in a manner that isn't misleading.[15] An article in *Corporate Secretary* magazine notes:

> The most significant change regarding equal prominence is that the GAAP number of any accounting metric must be included before the non-GAAP number. If a company decides to highlight a non-GAAP number in its headline, it must also include the GAAP number, which needs to come first. The prioritization of GAAP numbers over their non-GAAP counterparts extends to the use of charts and tables, as well as any discussion in the Compensation Discussion & Analysis (CD&A) section of the proxy statement. Companies will also be required to remove a positive financial metric where they have taken out a negative one and be consistent in comparisons between reporting periods.[16]

As many companies begin to prepare their first proxy statements following the guidance, members should be aware that many companies will need to revise sections that describe how executive compensation is warranted by company performance.

Overseeing crisis response

Some members said that the Wells Fargo case has caused them to think that independent directors need to play a more meaningful role in crisis management. When discussing the importance of early board engagement, one member said, "*The board should know what the game plan is once the crisis hits. Directors need to know there is sufficient substance and it's anchored properly.*"

Members extolled the value of advance planning, including having an updated crisis communication plan. One member said, "*My takeaway is that it's important to have a PR firm on hold and do a run-through with them.*" Others discussed the need to have formal table-top exercises in order to best identify any operational issues in advance. "*We want table-top exercises followed by an analysis of the identified gaps so we can discuss how to best fill them*," said one member. Members also recognized, however, that a more active board can blur the line between oversight and management. *"It can be challenging for a CEO to manage the crisis and manage the board,"* said one member.

[14] Patrick Higgins and Kevin Garry, "SEC Updates Interpretive Guidance on Non-GAAP Financial Measures," *pwc*, May 17, 2016.

[15] Chris Hamilton and Steve Seelig, "Executive Compensation Bulletin: Making Sense of the Debate on Non-GAAP Performance Measures for Executive Pay Plans," Willis Towers Watson, August 22, 2016.

[16] David Bogoslaw, "SEC Cracks Down on Non-GAAP Measures in Earnings Filings and Proxies," *Corporate Secretary*, July 7, 2016.

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The Wells Fargo case demonstrates that even the most successful company is susceptible to a crisis, and that one can happen when management and the board least expect it. CCLN members emphasized that boards can help minimize the potential for a damaging crisis by cultivating trust throughout the organization, looking for trouble, and understanding reputational risks. This will require compensation committees to understand the consequences of the pay programs used at all levels of their organizations.

About this document

The views expressed in this document represent those of the Compensation Committee Leadership Network. They do not reflect the views nor constitute the advice of network members, their companies, or Tapestry Networks. Please consult your counselors for specific advice.

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Contributing members

The following members participated in the meeting:

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- Marianne Harris, SunLife
- Kathy Hill, Moody’s
- Bill Kerr, IPG
- Annette Leckie, Meridian
- Karen Maidment, TD Bank Group
- Maria Otero, Herbalife
- Virginia Ruesterholz, The Hartford and Frontier
- Samme Thompson, American Tower

The following members took part in pre- or post-meeting discussions:

- Carl Berquist, Hertz
- Roxanne Decyk, Orbital ATK
- Mel Lagomasino, Coca-Cola and Disney
- Don Parfet, Masco
- Steve Reinemund, Marriott International