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One Take on the Report of the Independent Directors of Wells Fargo: Vote the Bums Out

Posted by Howell E. Jackson, Harvard Law School, on Saturday, April 22, 2017

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Next Tuesday, the 25th of April, the shareholders of Wells Fargo will meet for the first time since the news of the massive Wells Fargo mis-selling scandal broke last September when the firm was hit with penalties of $185 million for opening 1.5 million bank accounts and issuing 565,000 credit cards for customers without their consent. [1] In recent weeks, the two leading proxy advisory firms have recommended negative votes for many of the directors serving on the Wells Fargo Board at the time the fines were announced, with Glass Lewis advocating negative votes on six of twelve continuing directors and ISS recommending the ouster of all twelve.

Just two weeks before the meeting date, the independent directors of Wells Fargo released a 110 page "Sales Practice Investigation Report," prepared with the assistance of the law firm Shearman & Sterling under the direction of four independent trustees: Duke, Hernandez, James, and Sanger, all four of whom have received negative vote recommendations from ISS and one of whom (Hernandez) has received a negative recommendation from Glass Lewis. [2] The Shearman & Sterling Report—and I call it that because the document has all the hallmarks of a carefully and cautiously drafted legal document—is illustrative of an increasingly common practice in the aftermath of financial scandal: the preparation and distribution of a nominally "independent" but "in-house" analysis of corporate practices that have resulted in widespread violations of law.

These reports share a common structure. First, there is an element of shock and awe: Attorneys from Shearman & Sterling declare that they received and searched thirty-five million documents, reviewed 1,000 investigations, conducted 100 interviews, and retained an outside expert on forensic consulting and data analysis. Then there is the identification of serious wrong-doing—but, conveniently, only by already departed personnel, in this case former Wells Fargo CEO John Stumpf and disgraced head of the Wells Fargo Community Bank Carrie Tolstedt, both of whom suffered additional clawbacks of compensation timed to coincide with the Report's release to facilitate wide-spread press coverage. Finally, reports of this sort are wont to conclude with a brief acknowledgment, explored in their final pages, of modest process failures on the part of key constituents—here, the Wells Fargo continuing directors—set out with an appearance of candor yet avoiding concessions that might give rise to subsequent litigation or enforcement actions. In the case of Wells Fargo, "the Board should have been more forceful in pushing Stumpf to change leadership [that is, fire Tolstedt sooner] so that the Community Bank could move forward more quickly." (p.17) If you have a taste for the genre, the Shearman & Sterling

Report is nicely executed. But if you are trying to figure out whether the Wells Fargo directors should be elected to another term of service, the Report needs to be unpacked with a more careful eye.

The Self-Serving and Silly

Let me start with aspects of the Report that are simultaneously self-serving and silly. On its first page, the Report asserts that "The Board only learned approximately 5,300 employees had been terminated for sales practice violations" with the public announcement of the fines in September 2016. The 5,300 figure is an eye popping one as it represents nearly two percent of the entire Wells Fargo workforce. And it may technically be true that the Board did not have that particular number until September of 2016 when the firm's $185 million penalty was made public. But what this factoid obscures is that the Board, earlier in the spring of 2016, had been informed that 2,000 to 3,000 firings—roughly one percent of the workforce—were due to sales violations. And that a full year before that, in the Spring of 2015, internal Wells Fargo investigations had already identified thousands of employee firings for sale misconduct but the Board apparently failed to corner the right personnel early on to get a realistic assessment of employee turnover rates. They simply took note of several hundred reported firings without digging further to find the full scope of the problem. To the extent that the directors did not discover the true scope of employee firings until so late in the process, one wonders whether this Board was doing its job.

Also in the silly category are implications sprinkled throughout the Report that John Stumpf's sunny disposition explains why sales abuse problems were not detected or corrected sooner: "Stumpf was by nature an optimistic executive who refused to believe that the sales model was seriously impaired." (p. 10) Apparently, the independent directors—many of whom had served on the Board with Stumpf for a full decade—were unable to resist their CEO's predilection to accentuate the positive. While interpersonal solicitude of this sort may be a good way to make friends at your country club, it is a poor standard for supervising the chief executive officer of a systemically important financial institution. If Stumpf had an optimistic disposition that hampered effective management, then the Board had a responsibility to account for that in their oversight of his leadership. The "sunny disposition" excuse may explain why the Board failed; it does not excuse the Board's failure.

One False Narrative: Mis-selling as a Byproduct of Customer Service

Moving from silly to serious, consider the larger narrative arch of the Shearman & Sterling Report. The root cause of the Wells Fargo selling abuses, according to the account, was the delegation of too much managerial responsibility to operating units like Tolstedt's Community Bank. "Run it like you own it" (p. 19) was apparently a corporate shibboleth and is repeated in the Sherman & Sterling Report as if to suggest that any problems in the retail banking unit were simply a byproduct of trying to be attentive to customer needs. The word "decentralized" and variants thereon appear twenty-three times in the Report, and many more times if one adds in synonyms. In practice, what this down-streaming of authority apparently meant at Wells Fargo was that both operational discretion and risk oversight were delegated to operating units. And when internal problems began to be detected—for instance from reports from the Community bank's own risk officers or critical letters from bank examiners—Tolstedt was seemingly empowered to suppress their elevation to higher-ups in the firm. While plans were afoot to shift towards more centralized risk management (as modern best practices dictate), **[3]** the risk oversight structure actually in place was inadequate, as the Shearman & Sterling Report candidly acknowledges:

> [A]s problems with sales practices in the Community Bank became more apparent in 2013-2015, Corporate Risk was still a work in progress and the [Enterprise-wide] Chief Risk Officer had limited authority with respect to the Community Bank. As events were unfolding, his visibility into risk issues at the Community Bank was hampered by his dependence on its group risk officer and he was essentially confined to attempting to cajole and persuade Tolstedt and the Community Bank to be more responsive to sales practice-related risks (p. 12).

Reading through these sections of the Report, one almost starts to feel sorry for the Wells Fargo Board, betrayed by a decentralized management team and ill-served by a corporate risk team not yet prepared for major league action. Still, one might reasonably ask why the Board did not examine its decentralization more expertly and reviewed its risk team's competence more appropriately. There are people who think that's exactly what corporate boards are supposed to do.

From a shareholder perspective, the failures of Wells Fargo's risk management function is made all the more galling because they'd suggested quite a different arrangement in prior SEC filings. For example, in the firm's 2013 annual report—the annual report outstanding when the mis-selling scandal was first picked up in *Los Angeles Times* reporting—the Board had assured shareholders that at Wells Fargo risk management was controlled at the top:

> Our risk culture also depends on the "tone at the top" set by our Board, CEO, and Operating Committee members. Through oversight of the three lines of defense, the Board and the Operating Committee are the starting point for establishing and reinforcing our risk culture and have overall and ultimate responsibility for oversight of our risks, which they carry out through committees with specific risk management functions. **[4]**

So back in 2013, the Board of Directors was ready to assume "ultimate responsibility" for the oversight of risk. But in the Shearman & Sterling Report of 2017, the Board has become an innocent victim of a risk management function that somehow failed to stand up on its own. As the Shearman & Sterling Report wistfully admits, "Wells Fargo should have moved toward the centralization of the risk function earlier than it did." This admission makes good sense, but needs the missing conclusion: that the failure to do so clearly falls at the feet of the firm's directors.

(Incidentally, current Wells Fargo CEO Timothy Sloan, whom the Shearman & Sterling Report exonerates as having limited managerial responsibilities with respect to Tolstedt—"[Before November 2015,] Sloan had little contact with sales practice matters" (p.11)—was a member of the Operating Committee identified in the 2013 Annual Report as being responsible for establishing and overseeing risk management; so clearly his responsibilities with respect to Tolstedt and her malfeasance were not nearly as circumscribed as the Report would have readers think).

A Second False Narrative: Vigorous and Effective Board Action After 2013

A second theme of the Shearman & Sterling Report is that the Board of Directors actually detected deficiencies in Tolstedt's management of the Community Bank well before public disclosures in September of 2016 and should be credited for their aggressive efforts in taking corrective action, suggesting that they had the matter just about wrapped up when news of the scandal broke publicly last September. According to the Shearman & Sterling Report, the Board began to focus attention on sales practices in the Community Bank shortly after a December 21, 2013, *Los Angeles Times* article on the subject. In advance of an April 2014 Board Risk Committee meeting, directors apparently indicated that they "wanted to hear from Tolstedt whether 'the pressure of cross sell goals cause bad behavior,'" but "Tolstedt's presentation was removed from the agenda when she was summoned to jury duty." (p. 68) Apparently, it was a long trial, because Tolstedt does not make it back to the Risk Committee on this issue—at least in the Shearman & Sterling account of Board actions—until a year later in April 2015. Reportedly, the Committee members found her presentation wanting: "too superficial and optimistic." (p. 103) The next month, following the filing of a lawsuit against Wells Fargo by the City of Los Angeles that alleged illegal sales practices, the Board further ramped up its attention to the problem of mis-selling, resulting in another Tolstedt presentation to the Risk Committee, of which the directors were "highly critical." (p. 105) Many more meetings followed later in the year, with outside experts starting to be called in and evidence mounting that the directors variously "felt blindsided," (p. 105) had "vigorously questioned" management representatives, (p. 106), and, by December 2015, coming to the "view that Tolstedt could no longer effectively lead the Community Bank." (p. 107)

So far, so good, one thinks, reading through this section of the Report. But, suddenly—at the top of page 108 (of a 110 page document), the plot takes an unexpected turn. On February 23, 2016, when the Board's Human Resources Committee meets to determine compensation for top executives, including Tolstedt, it turns out "the reaction of the Board members to Tolstedt is a complicated one"! Concerns about Tolstedt, apparently, are limited to members of the Risk Committee (chaired by Hernandez, who was also on the committee overseeing the Shearman & Sterling Report). "Most other directors, while believing that she had been overly optimistic and minimized problems, were not yet that critical," and were willing to allow her to stay in her leadership position at least several more months while her performance could be assessed. So, in the spring of 2016, as the Board was receiving detailed accounts of thousands of sales force firings, and more than two years after the Risk Committee began to focus on the problem of wide-spread inappropriate sales practices, Wells Fargo shareholders were informed that Carrie Tolstedt would be the third-highest paid employee at the firm. **[5]** So much for Board oversight.

And One Great Big Whopper

One final and egregious misstatement in the Shearman & Sterling Report concerns the point of time at which the Wells Fargo directors became aware of mis-selling problems within the organization. On its second page, the Report asserts "Sales practices were not identified to the Board as a noteworthy risk until 2014," and then back on page 97, the assertion is repeated: "Prior to 2014, sales practice or sales integrity issues were not flagged as noteworthy risks either to the Board of Directors as a whole or to any Board committee." If one parses carefully the discussion that follows, the basis for this assertion is the content of internal reports circulated to the Board's Risk Committee, which classified risks in various categories, such as high or medium. Mis-selling practices apparently did not get placed into the high category until after the *Los Angeles Times* story appeared in December 2013. So, the fine lawyers at Shearman & Sterling apparently reasoned that the Board must not have been on notice of these problems until 2014 and hence the report proceeds under the assumption that the Board had no responsibility to investigate the matter before then.

This is an outrageous position but one that the Wells Fargo Board has adopted in accepting the Shearman & Sterling Report.

And, here's how you can tell it's outrageous. Just google the phrase "Wells Fargo retail banking sales practices" with a time restriction of before 2014. (If you don't know how to do this, just ask anyone under 30.) On the first page of results, you'll see accounts of a July 20, 2011, consent order against Wells Fargo by the Federal Reserve Board imposing an $85 million civil penalty based on allegations that internal compensation arrangements would encourage Wells Fargo sales personnel to steer borrowers that qualified for prime mortgage into subprime products that were more profitable for Wells Fargo. **[6]** In other words, Wells Fargo paid a substantial fine in 2011 based on allegations of incentive-based mis-selling to customers.

For readers willing to forgive the Wells Fargo Board for failing to recall a monetary sanction that only ran to eight digits, the next year—that is in 2012—in what was widely reported to be the federal government's second largest fair lending enforcement action to date, Wells Fargo entered into a settlement with the Justice Department requiring Wells Fargo to pay $184.3 million in compensation to qualified minority borrowers who were steered into subprime loans. (The total monetary amounts involved in this action were actually higher than in Wells Fargo's September 2016 settlement). A Justice Department press release accompanying the announcement of the settlement explained:

> The United States' complaint … alleges that, as a result of Wells Fargo's policies and practices, qualified African-American and Hispanic wholesale borrowers were placed in subprime loans rather than prime loans even when similarly-qualified non-Hispanic white borrowers were placed in prime loans. The discriminatory placement of wholesale borrowers in subprime loans, also known as "steering," occurred because it was the bank's business practice to allow mortgage brokers and employees to place a loan applicant in a subprime loan even when the applicant qualified for a prime loan. **[7]**

No doubt, CEO Stumpf with his ever optimistic demeanor emphasized to the Board that the firm had entered into the settlement without admitting liability and perhaps even chided the government for relying on statistical evidence to support its claims, but the Wells Fargo Board of directors were most certainly on notice of serious allegations of sales misconduct at the firm well before 2014.

Perhaps the most charitable interpretation of the Shearman & Sterling Report's statement about the directors' knowledge prior to 2014 is that they had no idea before then that Wells Fargo was also mis-selling its retail banking services to white folks.

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The Shearman & Sterling Report makes many excuses for the Board not having done its job. But read with care, the Report can and should be understood as a devastating critique of the Board's work. Deconstructed, the Shearman & Sterling Report reveals a Board that failed to follow up on serious and widespread wrong-doing at Wells Fargo. This Board let their organization and their shareholders down. Were I a shareholder of Wells Fargo, I would definitely vote the bums out.

Endnotes:

[1] **https://www.consumerfinance.gov/about-us/newsroom/consumer-financial-protection-bureau-fines-wells-fargo-100-million-widespread-illegal-practice-secretly-opening-unauthorized-accounts/**. For illustrative press coverage at the time, see The High Cost of Wells Fargo's Sales Practices, Financial Times, Sept. 13, 2016.
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[2] **https://www08.wellsfargomedia.com/assets/pdf/about/investor-relations/presentations/2017/board-report.pdf**
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[3] "[Among the] primary responsibilities [of a board of a financial institution] … (a) reaching agreement on a strategy and risk appetite with management, (b) choosing a CEO capable of executing the strategy, … [and] (d) obtaining reasonable assurance of compliance with regulatory, legal, and ethical rules and guidelines and *that appropriate and necessary risk control processes are in place*." Group of Thirty, Toward Effective Governance of Financial Institutions 20 (April 2012) (emphasis added) (**http://group30.org/publications/detail/155**).
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[4] **https://www08.wellsfargomedia.com/assets/pdf/about/investor-relations/annual-reports/2013-annual-report.pdf** (excerpt from page 51).
(go back)

[5] **https://www08.wellsfargomedia.com/assets/pdf/about/investor-relations/annual-reports/2016-proxy-statement.pdf** (reporting Tolstedt's 2015 total compensation at $9,050,000, tied for third highest senior executive along with three others, a slight improving in Tolstedt's ranking from 2014 when she was the fourth highest paid executive). See also **https://www08.wellsfargomedia.com/assets/pdf/about/investor-relations/annual-reports/2015-proxy-statement.pdf**.
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[6] **https://www.federalreserve.gov/newsevents/pressreleases/enforcement20110720a.htm**.
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[7] **https://www.justice.gov/opa/pr/justice-department-reaches-settlement-wells-fargo-resulting-more-175-million-relief**.
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