# CtW Investment Group

September 23, 2016

Stephen W. Sanger
Lead Director, Wells Fargo & Co.
420 Montgomery Street
San Francisco, California 94104

Dear Mr. Sanger:

Federal regulators' recent enforcement action against Wells Fargo for creating millions of fake accounts without customers' knowledge or permission evinces the board's troubling lack of attention to the company's human capital management practices. It also shows the risks such practices pose to the company's reputation, operations, and long-term value.

We are particularly concerned that the widespread creation of false accounts arose in response to sales and cross-selling goals set by the company's employment policies and that the board failed to adequately address the effects of those polices when they were reported in the *Los Angeles Times* over three years ago. Consequently, while Wells Fargo has revealed in the wake of this scandal that approximately 5,300 employees have been terminated since it first became aware of fraudulent account creation, we believe that the board must quickly take further steps to address the risks created by its human capital management policies.

The board should expeditiously:

- Exercise its discretion under the executive clawback policy to recover at least part of the remuneration received by former executive Carrie Tolstedt from 2011 to 2016.
- Add two new directors who have demonstrated a deep understanding of and commitment to effective human capital management practices, as demonstrated by extensive relevant professional experience in academia, consulting, and/or corporate management.
- Commission a comprehensive review of Wells Fargo's human capital management practices by an appropriate external organization, under the supervision of the Human Resources Committee, with particular focus on:
    - Assessing the fit or lack thereof between incentive pay, performance review, and retention and promotion policies, on the one hand, and the company's long-term strategic goals, on the other.
    - Measuring the risk that explicit incentives presented by pay, evaluation, and promotion policies encourage unethical behavior.
    - Recommending both immediate changes to company policies and practices, and methods to ensure that the board and senior management are provided on an ongoing basis with reliable, uncoerced, systematic feedback concerning those policies and practices from front-line employees who are assured they will not be subjected to retaliation for providing such feedback, as well as training for supervisors and managers on non-interference and non-retaliation.

If the board fails to act quickly to contain the damage from the false accounts scandal, including adopting the steps outlined here to address the long-term consequences of its human capital management practices, we will be unable to support the re-election of directors at next year's annual meeting.

The CtW Investment Group works with union-sponsored pension funds to enhance long-term stockholder value through active ownership. These funds have over $250 billion in assets under management and are substantial Wells Fargo shareholders.

**Failures at Many Levels Led to False Account Scandal**

Despite the company not disclosing the Consumer Financial Protection Bureau's (CFPB) ongoing investigation or a pending settlement with regulators prior to the September 8th announcement, Wells Fargo managers clearly understood for several years that the considerable pressure on front-line service workers and their managers to hit sales goals had led to the creation of false accounts. This appears especially true for goals regarding the cross-selling financial products to retail customers.

Even before the December 2013 *Los Angeles Times* article that prompted the LA City Attorney's office to begin its investigation, Wells Fargo management recognized that its high-pressure sales culture was generating fraudulent practices: There are indications that as far back as 2009 Wells Fargo executives recognized that certain ambitious sales programs – such as "Jump into January" – were generating fraudulent accounts. In February 2011, Chairman and CEO John Stumpf reportedly received an email from a 22 year veteran of the company explaining how the appearance of growth in new accounts could be faked; this employee was subsequently terminated. Also in 2011, employee satisfaction surveys reportedly found that bank employees were uncomfortable with instructions from management to push customers to buy products. In 2012 the community banking unit began to investigate suspicious practices in areas with high levels of customer complaints, such as Southern California. These investigations reportedly led to the firing of 200 employees in February 2013.

Over the following year, the board and management took action in response to these signals and at the behest of regulators— including increased risk management standards in the community banking divisions, modification of some sales goals, and an internal investigation by Accenture and Skadden, Arps on which the board was reportedly updated. We further note that Wells Fargo employees delivered petitions with over 10,000 signatures to the board at both the 2014 and 2015 annual meetings that urged the board to recognize the link between Wells Fargo's high-pressure sales quotas and the fraudulent opening of accounts without customer permission. These petitions called on Wells Fargo to cease using these high-pressure quotas. Furthermore, reporting in the *New York Times* indicates that even after the company began to recognize the problem and provide ethics training that warned against creating false accounts, the continued sales pressure from management overwhelmed the ethical training. Worse still, when employees either refused to sell customers products they did not want, or reported fraudulent account creation to the Wells Fargo ethics line, they were subject to discipline including termination. It is deeply unfortunate that the board did not take the concerns expressed by front-line customer service workers more seriously

Moreover, we see little indication that that Wells Fargo management and its board has recognized that its high-pressure, punitive corporate culture is one that breeds fear of penalty in employees—not trust that they can honestly share their views. Worse still, the steps that Wells Fargo has taken so far—including allowing Community Banking executive Carrie Tolstedt to retire with approximately $124 million in severance and accumulated equity—have been inadequate and send exactly the wrong signal: only front-line employees will pay the price for Wells Fargo's flawed sales incentives and sluggardly response to the associated risks.

Successfully restoring Wells Fargo's reputation as an honest, trustworthy, and responsible corporate citizen will require much more decisive and thoroughgoing action to redirect the corporate culture away from high-pressure sales combined with the threat of high turnover, and toward a high-quality of service model that emphasizes customer satisfaction over short-term and unsustainable profits.

**Claw Back Compensation for Carrie Tolstedt**

Ms. Tolstedt was the senior executive responsible for the community banking division during the period when high-pressure sales goals ramped up, fraudulent account creation became rampant, and signs of trouble generated an inadequate response. We note that since 2008, when Ms. Tolstedt took over the community banking division, the success of her unit in achieving apparently high levels of growth, including increased cross-selling, was repeatedly cited by the board as justifying her annual long-term incentive payments. Over the 2011-2015 period, these payments to Ms. Toldstedt totaled over $6.8 million. Additionally, during these years Ms. Tolstedt received over $28.5 in equity grants. According to Wells Fargo's clawback policy, both of these forms of compensation are subject to clawback at the discretion of the board's Human Resources Committee in the event that "a senior executive has engaged in misconduct, including in a supervisory capacity, that results in significant financial or reputational harm to the Company."

We believe that the recent settlement with regulators clearly qualifies as "reputational harm" to the company, and we think the board erred in allowing Ms. Tolstedt to retire in July without requiring her to surrender some portion of these payments. After all, neither management nor the board seems to have any compunction about firing over 5,000 front-line service workers who were found to have created fraudulent accounts in order to meet excessively demanding sales goals. It seems hypocritical in the extreme to apply a different and much more lenient standard to executives than that applied to typical Wells Fargo team members; indeed, we suspect that doing so threatens to fatally undermine any sense of "team" that remains among front-line workers at the company. We therefore urge the board to take prompt action under Wells Fargo's clawback plan to require Ms. Tolstedt to return at least a significant portion this compensation.

**Recruit of Least Two New Directors with Experience in and Commitment to Human Capital Management**

While the board was reportedly informed of the internal investigation begun in 2013, the lackluster response to apparently very widespread misconduct strongly suggests to us that the current board lacks the capabilities to understand and apply best practices in human capital management. In particular, the fact that the very quantitative sales goals that spurred fraudulent account creation were not dropped until after the regulatory settlement was publicly announced shows that the current board lacks the knowledge and self-confidence to draw the needed connections between pay, promotion, and retention practices (including incentives and "goals") on the one hand, and key strategic corporate objectives (such as avoiding reputational damage and regulatory fines) on the other.

We note that Wells Fargo's board includes seven directors (out of twelve) who have served for at least 10 years, two of whom have served on the board for over 18 years. Like many advocates for improved governance, we encourage boards to begin identifying new candidates to replace existing directors when their tenure on the board approaches a decade, and we are increasingly reluctant to re-elect directors who have served on a board for multiple decades.

While Wells Fargo has many former and current corporate executives on its board, none of these individuals is identified as having any particular experience or expertise in overseeing human capital management specifically, let alone guiding an organization through a period of difficulty that requires restructuring its recruitment, retention, evaluation, and motivation practices for the entire workforce. In the current circumstances, that sort of experience and expertise is precisely what Wells Fargo needs but unfortunately lacks. The board should, in dialog with institutional shareholders, expeditiously identify at least two such director candidates who can join the board promptly and stand for election at next year's annual meeting.

**A Comprehensive and Unrestricted Review of Wells Fargo's Human Capital Management Practices**

Press reports indicate that Wells Fargo executives recognized at least as early as 2013 that ambitious sales goals were generating problems in the form of fraudulent customer accounts. These reports suggest that executives and directors took some modest action to modify sales goals, investigate the extent of the problem, and to monitor the situation on an ongoing basis. It should be apparent that these steps were inadequate, as Mr. Stumpf's announcement that Wells Fargo will cease using product-based sales incentives as of January 1, 2017 clearly demonstrates.

We suspect that the inadequate response from the Wells Fargo board partly reflects that lack of experience in human capital management discussed above, but also reflects the key role that product based sales incentives, and the associated cross-selling of financial products to retail customers, played in Wells Fargo's overall corporate strategy. Indeed, the rapid increase in banking products per customer over the past decade has, according to Mr. Stumpf and other executives, been central to the banks increased profitability and strong competitive position. As such, we can understand that the board would be reluctant to undertake an overhaul of the employment practices apparently generating that increase in cross-selling, but in the wake of the false accounts scandal that is precisely what Wells Fargo must do.

Consequently, we believe that the company needs to reach well outside its comfort zone and bring in an organization expert in evaluating human capital management practices that can provide a comprehensive review of Wells Fargo's existing practices across the company, and recommend needed changes. We believe that this review, supervised by the Human Resources Committee and disclosed to shareholders on completion, should specifically consider the multiple interactions between long-term company goals and the incentives presented to front-line customer service workers, with an eye toward understanding the risks that explicit incentives can be either "gamed" by managers and workers, or that those incentives will encourage actions that undermine Wells Fargo's long-term value.

In particular, this review should propose more effective mechanisms to generate feedback, communication, and ongoing dialog between management and front line workers, which seems clearly to have been lacking in the community banking division in recent years. In our view, honest feedback from employees is invaluable to managers, but can be extremely difficult to generate when workers are not convinced that providing such feedback won't result in their being penalized. It seems clear from the thousands of Wells Fargo employees who signed petitions delivered to the board in 2014 and 2015, as well as the many former employees who reported abuses only to be subject to retaliation. Ensuring that in the future all Wells Fargo employees believe that they can report unethical or abusive practices, either individually or collectively, without fear of retaliation should be a paramount concern for the board going forward.

**Conclusion**

Wells Fargo emerged from the 2008-2009 financial crisis as one of the strongest banks in the United States. Having mostly avoided the risky and often irresponsible lending, securitization, and underwriting practices that severely damaged other large banks, Wells Fargo has up until recently enjoyed steady growth as well as a burnished reputation for capable risk management. It now appears that this advantage has been partly squandered, and Wells Fargo has its work cut out for it in re-establishing a reputation for trustworthiness with customers, shareholders, and regulators. We have outlined what we believe to be necessary steps in that process, and urge the board to quickly commit to implementing these proposals in order to demonstrate its commitment to needed change. Absent such a commitment, we would likely find ourselves unable to support the re-election of incumbent directors at next year's annual meeting.

We would be happy to discuss our recommendations with you at your convenience. Please contact me at (202) 721 6027 to pursue such a dialog.

Sincerely,

Dieter Waizenegger
Executive Director