# KIM: High time to sharpen executive pay clawbacks

Mickey Kim
October 22, 2016


Whether you're looking at a mutual fund or company stock, you want to see the management team having a significant amount of their own "skin in the game" through a large commitment of personal financial resources. While this doesn't guarantee success, at least you know the managers' financial interests are aligned with yours.

Wells Fargo bank has been embroiled in a firestorm of criticism over revelations of "widespread illegal" sales practices that included opening as many as *two million* deposit and credit card accounts *without customers' knowledge*. Wells branches were apparently given production targets for selling customers ***multiple*** bank products. "Cross selling" is a popular initiative in the banking industry, meant to boost profitability in an environment of slack loan demand and low interest rates.

As often happens with ideas that make good business sense (i.e. cross-selling), Wells' incentive structure apparently led to poor employee behavior, as many employees felt pressure to sell customers multiple products or services to keep their jobs or earn bonuses tied to sales goals. According to The Wall Street Journal, Wells CFO John Shrewsberry said the bank's issues resulted from "people trying to meet minimum goals to hang onto their job."

Wells agreed to pay a fine of $185 million. Under withering Congressional questioning, CEO John Stumpf said 5,300 employees had been fired over five years due to improper selling, including bankers, managers and bosses of those managers. Importantly, his implicit message was these were the actions of "bad employees," so nobody from the senior management team was involved or would be held responsible.

In other words, the shareholders get stuck paying the fine and the top executives skate free. Sound familiar?

According to an article in The New York Times, economists call this "perverse incentive," whereby managers are encouraged to take big risks because they can earn huge bonuses if the risk works out. On the other hand, if the action bombs, shareholders are left holding the proverbial bag. It's the ultimate "heads I win, tails you lose" proposition.

This is a serious corporate governance issue, but there is little agreement on how to make management financially accountable for its actions and decisions. If you try to recover (i.e. "clawback") compensation already paid through legal means, the scope of bad behavior is typically narrow and the burden of proof high. Companies with voluntary codes of ethics calling for compensation clawbacks often find boards of directors hesitant to enforce them.

Enter the ***binding code of ethics***, as proposed by Greg Zipes in an article he wrote for the Michigan law journal, "Ties That Bind: Codes of Conduct That Require Automatic Reductions to the Pay of Directors, Officers, and Their Advisors for Failures of Corporate Governance." http://www.msujbsl.com/sites/default/files/Zipes%20Article.pdf

According to Zipes, the standard binding code would rely on a specific, easily identifiable event to trigger its application and require an ***automatic*** action against the corporate agent, such as clawback of compensation, in the event of a breach. Further, the intentions of the corporate agent of even their knowledge of the bad acts would be irrelevant. Zipes argued this would lead managers to institute stronger controls.

The second and possibly more interesting part of Zipes' plan is publicizing the binding code to enable consumers and investors to "shop" at complying corporations.

---