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Memorandum

Potential for Legislation to Increase Enforcement Authority for Federal Banking Agencies and Expand Claw-Back of Executive Compensation

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In rare bipartisan action, the Senate Banking Committee passed proposed legislation intended to address risk and other governance shortcomings at banking organizations and expand the authority of the federal banking agencies to take action against mismanagement by executive officers, including by clawing-back incentive compensation upon bank failure.

Last week, on June 21, 2023, in a rare show of cross-party collaboration and reflecting the continuing fallout from the recent bank failures, the Senate Banking Committee advanced a modified version of the Recovering Executive Compensation Obtained from Unaccountable Practices Act of 2023, or "RECOUP Act," on a vote of 21-2.

Corporate Governance

If enacted, this legislation would require insured depository institutions and holding companies with more than $10 billion in total consolidated assets to include specific governance and accountability standards in their organizing documents and bylaws, including provisions:

- Establishing requirements for senior executives and directors related to risk management, responsiveness to supervisory matters and to matters raised by federal or state banking agencies;
- To ensure that senior executives and directors are "implement[ing] reporting or information systems or controls and oversee[ing] such systems appropriately and prudently;" and
- To ensure that management does not "deviate from sound governance, internal controls, or risk management," and that there is "appropriate long-term risk management tailored to long-term economic conditions."

These proposed requirements go beyond the OCC's current Heightened Standards for Large Financial Institutions, as well as the enhanced governance requirements established under the Dodd-Frank Act and implemented by regulation. While generally consistent with the overall regulatory and supervisory guidance framework already applicable to banking organizations, it is unclear whether these detailed and formal compliance and audit-like review structures and processes would actually be expected to be included in the charter and bylaws themselves, which would be inconsistent with U.S. corporate practice, rather than in policies adopted pursuant to the charter and bylaws. Regardless of the location, careful distinctions would need to be

made between the responsibilities of directors and those of management, which the broad language of the proposed legislation does not do.

Claw Backs

Importantly, the legislation would also permit the board of directors, or the FDIC as receiver or conservator, to claw back any bonus, incentive-based or equity-based compensation received by a senior executive of either the bank or its holding company or profits realized by a senior executive on the sale of bank or holding company securities during the 24 months preceding the failure and receivership of the bank. The proposed statutory language does not condition the possible claw-back of compensation on wrongdoing, negligence or breach of duty by the senior executive. The legislation defines a "senior executive" for these and other provisions of the bill as an individual who has "oversight authority for managing the overall governance, operations, risk, or finances" of the bank or holding company, including both senior officers (CEO, CFO, CRO, general counsel, etc.) as well as certain directors, including the board chair and any insider directors.

Removal and Monetary Penalties

The RECOUP Act would also expand the current authority of the federal banking agencies to pursue suspension or prohibition orders against senior executives to specifically include situations where those individuals failed to carry out their responsibilities for governance, operations, risk or financial management. Currently, the federal banking agencies must establish that an institution affiliated party either showed personal dishonesty in their actions or demonstrated "willful or continuing disregard" for the safe and sound operations of the bank or holding company. This legislation would allow the federal banking agencies to pursue these remedies if they can establish "gross negligence" by a senior executive officer in the performance of these duties.

The proposed legislation would also add two new standards for removal if a senior executive officer of an insured depository institution fails to either (1) appropriately implement financial, risk, or supervisory reporting or information system or controls, or (2) oversee the operations of those reports, systems or controls. These two standards are not qualified by any standard of care and would be a material deviation from current practice.

Additionally, the legislation would also increase the maximum daily civil money penalty for actions that can result in a suspension or prohibition to $3 million, up from $1 million, and allow the federal banking agencies to pursue such penalties if a senior executive officer "recklessly" violates the law, breaches a fiduciary duty or engages in an unsafe or unsound practice.

It should be noted that the proposed requirements do not specifically exclude foreign banks that qualify as bank holding companies in the United States under the Bank Holding Company Act from any provisions that apply to "depository institution holding companies" or their senior executive officers and directors. It is not clear how these provisions would be implemented with respect to the extraterritorial operations of these banking organizations.

Failed Bank Acquisitions By Largest Banks

The proposed legislation also includes an unrelated provision that would limit the ability of the federal banking agencies to approve another failed bank acquisition similar to the recent acquisition of First Republic. The provision would not allow the federal banking agencies to approve an acquisition using emergency procedures that is submitted by a banking organization that is above the national or state deposit caps if there is another viable bidder that does not exceed the deposit caps. However, the provision would still permit the federal banking agencies to approve such a transaction if there are no other viable applications to acquire the failed bank and the FDIC has determined that the transaction is the only application pending that would permit the FDIC to comply with the least-cost resolution requirements and avoid serious adverse effects on the economy. In theory, this proposed change would require the FDIC to prioritize bids from smaller bidders (or perhaps groups of bidders) even if they are not the least-cost resolution over a lower-cost bid by one of the largest banking organizations.

Overall, this proposed legislation is a product of the moment (in terms of both policy objectives and speed of drafting) and that is evident in its use of broad and vague terms. Given the bipartisan nature and obvious public appeal of punishing culpable executives of failed or troubled banks, the RECOUP Act may ultimately be adopted in some form by Congress. However, the current version raises a number of interpretive and operational questions as well as serious due process issues for affected executive officers that merit consideration.

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