

The RECOUP Act passes the Senate Banking Committee

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As the RECOUP Act advances through Congress, there should be a deeper look at the removal and corporate governance provisions, which have been largely ignored by the business press. These changes would have a significant impact on the senior executives at a broad swath of U.S. and foreign banking organizations, not just those that fail.

The Recovering Executive Compensation Obtained from Unaccountable Practices (RECOUP) Act, designed to hold senior executives at banking organizations accountable, has broad and unusual bipartisan support, passing out of the Senate Banking Committee by a 21-2 bipartisan vote. As the bill advances, we believe there should be a deeper look at certain of its provisions that have not received attention or have been misunderstood in the business press. The media focus has been on a claw-back provision as applied to senior executives of failed banks, rather than the removal and corporate governance provisions that would apply broadly across the banking sector.

We believe that there should be more thought given to the potential impact of the senior executive¹ removal and corporate governance provisions. The expanded removal provisions would apply to the senior executives of every insured bank in the country, even well-managed and well-capitalized banks. The scope would include not only the largest banks, but also regional banks, community banks and the branches and agencies of foreign banks.² The new corporate governance provisions would apply to all depository institutions and their holding companies with total consolidated assets above \$10 billion. If enacted, these new standards would put major pressure on the talent management of a broad swath of healthy and well-managed banking organizations while, at the same time, hand significant new discretionary power to supervisory and enforcement divisions at the banking agencies. The desire to hold senior executives, especially those at failed banks, accountable is both understandable and good policy. But we believe that placing the entire banking sector's talent management at risk, while handing significant new discretionary power to supervisory and enforcement staff, should not be done lightly, nor without focused attention from Congress and policy makers.

Our key takeaways below focus solely on the removal and corporate governance provisions. A blackline of the relevant portions of the FDIA and Bank Holding Company Act, as would be amended by the RECOUP Act, can be accessed at the link [here](#) for those who wish to see the entire proposed changes in context.

Broadening the grounds for senior executive removals

Under the RECOUP Act, federal banking agencies would have additional grounds to remove a senior executive of any insured depository institution, not just failed banks, from office or prohibit such executive from participating in the affairs of that bank or any other insured depository institution. This type of authority to take away a person's capacity to make a living has long been narrowly crafted in relevant statutes and used by the enforcement staff only in limited and egregious circumstances.

The RECOUP Act would add four additional grounds, two of which are limited to conduct involving at least gross negligence, but two of which contain no real limitations. It is important to keep in mind that there is no judicial review of these determinations until after years of proceedings before an administrative law judge. Moreover, most of these matters settle by consent orders as individuals, even though covered by director and officer insurance, usually do not have sufficient resources to fight the government. Finally, in assessing the reasonableness of these new grounds, we note that

in many situations it is sufficient for the supervisory staff to threaten removal to prompt a senior executive to resign.

The four additional grounds are:

- Failure “to carry out the responsibilities of the senior executive for governance, operations, risk or financial management of an insured depository institution or business institution”³ where such failure is based on “gross negligence” in the performance of a senior executive’s duties. This new ground is in addition to the current standard of “willful or continuing disregard for safety and soundness.”
- Breach of any fiduciary duty (e.g., the duty of care or loyalty) owed to an insured depository institution, if the breach is determined to require grossly negligent, reckless, or willful conduct.
- Failure “to appropriately implement financial, risk, or supervisory reporting or information system or controls,” or failure “to oversee [the] operations” of such systems or controls at an insured depository institution; or
- Failure to oversee the financial, risk, or supervisory reporting or information system or controls, which have been implemented at an insured depository institution.

The wording of these last two grounds is particularly troubling. In the ordinary course of issuing Matters Requiring Attention or Matters Requiring Immediate Attention to banking organizations following examinations, it is not uncommon for the federal banking agencies’ supervisors to cite weaknesses or deficiencies in controls or in the oversight of those controls. If Congress does not place any additional limitations on these two grounds, the effective result will be to hand the federal banking agencies an unprecedented degree of discretion in determining when, in their view, a weakness or deficiency in the appropriate implementation or oversight of those controls warrants removing a senior executive and potentially barring such executive from working in the banking sector.

It seems clear that members of the Senate Banking Committee may have realized that these additional grounds go too far. The final version of the bill voted out of committee added a “Sense of the Congress” statement to the bill asserting that “sections in this Act should not be used to penalize senior executives of healthy financial institutions that are appropriately managed.” Unfortunately, this hortatory statement does nothing to implement any limits on the scope of these new grounds by the supervisory and enforcement staff of the federal banking agencies.

Confusing governance and accountability standards

The RECOUP Act would require all depository institutions—whether insured or uninsured—and their holding companies with more than \$10 billion in total consolidated assets to adopt governance and accountability standards in their bylaws (or an equivalent) “that promote safety and soundness, responsiveness to supervisory matters, and responsible management.” It is unclear whether the standards themselves would need to be in the bylaws or whether the bylaws merely need to require the standards. Earlier versions of the bill had required placement in the bylaws, and the version that the Senate Banking Committee advanced has introduced some confusion on this point. The standards require banking organizations to include:

- Policies for senior executives and members of the board relating to appropriate risk management and responsiveness to supervisory matters. This standard would require responding to federal banking agencies and state supervisors on a timely basis.
- Accountability and corporate governance mechanisms to direct (1) the implementation of reporting or information system or controls and oversight mechanisms; (2) lack of deviation from sound governance, internal controls or risk management; and (3) appropriate long-term risk management tailored to long-term economic conditions.

Our view is that these provisions, which would federalize many aspects of corporate governance that until now have been addressed by state law, are likely to lead to confusion. How are state law fiduciary duties to be interpreted? Who evaluates what is sound governance and by what standards? When and how does the business judgment rule apply to any board decisions on these matters? Will these highly discretionary and qualitative judgments be left to supervisory staff as business as usual matters or to enforcement staff?⁴ How would these standards interact with existing risk management governance requirements, policies, procedures and agency guidance?⁵

The drafters of these provisions have not taken into account that bylaws of banking organizations are governed by state law. Holding companies are creatures of state law, as are state-chartered banks. National banks are also permitted to choose to follow the corporate governance provisions of certain States as set forth in their bylaws, to the extent not inconsistent with applicable federal banking statutes or regulations, or bank safety and soundness.⁶

In our view, it would be better to eliminate these provisions from the bill and direct the banking agencies to assess whether these standards exist already in current statutes, regulations or guidance, or whether such regulations or guidance should be updated. The rush with which the RECOUP Act has been drafted makes the risk of conflict with state

law and existing regulation, and confusion about scope, virtually inevitable.

Application of removal and corporate governance provisions to foreign banking organizations

The press and commentary have also not picked up that the removal and corporate governance provisions would also apply to foreign banks operating in the United States.

- **Removal Provisions.** A foreign banking organization is subject to the removal provisions of the RECOUP Act if it has a U.S. insured depository institution subsidiary or an insured or uninsured state or federal branch or agency in the United States.⁷
- **Corporate Governance Provision.** The corporate governance provisions would apply to foreign banking organizations that have a U.S. insured depository institution subsidiary, federal or insured branch, U.S. bank holding company (BHC) subsidiary, including a BHC that qualifies as an intermediate holding company (IHC), where any such entity has more than \$10 billion in total consolidated assets. Although the corporate governance provisions of the RECOUP Act are intended to apply to any “depository institution” and “depository institution holding company,” presumably these provisions would apply only to any such entity incorporated in the United States and are not intended to apply, for example, to a foreign banking corporation’s top-tier BHC outside the United States. It would be helpful for such a clarification to be reflected in any final version of the RECOUP Act.

Civil monetary penalty

The RECOUP Act also amends the civil money penalty provisions of the FDIA to include a provision requiring senior executives to pay an up to \$3 million per day fine⁸ in the case that they “recklessly” (1) commit violations of law, regulation, certain final or temporary orders, conditions imposed by, or written agreements of a federal banking agency; (2) engage in any unsafe or unsound practice in conducting the affairs of such depository institution; or (3) breach any fiduciary duty, which knowingly or recklessly results in a substantial loss to such institution or substantial pecuniary gain or other benefit to such senior executive as a result of the violation, practice or breach.

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- ¹ The term "senior executive" – a term separately defined from an institution-affiliated party used elsewhere in the Federal Deposit Insurance Act (FDIA) – includes any "individual who has oversight authority for managing the overall governance, operations, risk, or finances of a depository institution or depository institution holding company." Such individuals would include the president, CEO, COO, CFO, CRO, CLO, chairman of the board, inside board members or any person with an equivalent position at a depository institution or its holding company (as determined by that institution).
- ² We use the term banking organization to refer to these institutions for simplicity.
- ³ The term "business institution" is not defined in the FDIA.
- ⁴ We believe that there is a significant difference between providing banking supervisors with appropriate discretion in areas of traditional and core examiner competence, such as credit quality, liquidity and interest rate risk, all of which share a quantitative core, and giving them wide discretion in an area such as corporate governance, which is more qualitative, requires expertise in applicable state corporation laws, and is first and foremost an area in which a banking organization's shareholders have a legitimate interest.
- ⁵ For example, the risk committee and risk management framework and governance requirements contained in the Federal Reserve's Regulation YY, the OCC's Heightened Standards, 12 C.F.R. Appendix D to Part 30, and Federal Reserve supervisory guidance, such as SR 95-15 (Rating the Adequacy of Risk Management Processes and Internal Controls at State Member Banks and Bank Holding Companies) and SR 16-11 (Supervisory Guidance for Assessing Risk Management at Supervised Institutions with Total Consolidated Assets Less than \$100 Billion).
- ⁶ See 12 C.F.R. § 7.2000(b). National banks can choose to follow the corporate governance provisions of the law of any State in which the main office or any branch of the bank is located, the law of any State in which a holding company of the bank is incorporated, the Delaware General Corporation Law or the Model Business Corporation Act.
- ⁷ The scope of the application of this removal provision to foreign banking organizations stems from the fact that "insured depository institution" is defined in the FDIA as including the uninsured U.S. branches or agencies of a foreign bank for purposes of Section 8 of the FDIA.

⁸ Although the RECOUP Act looks as if it would be increasing the per day fine for Tier 3 civil monetary penalties from \$1 million to \$3 million, with the inflation multiplier, the ceiling on such penalties is currently \$2,202,123 per day. See Office of the Comptroller of the Currency, Notification of Inflation Adjustment for Civil Money Penalties, 87 Fed. Reg. 1657 (Jan. 12, 2022), <https://occ.treas.gov/news-issuances/federal-register/2022/87fr1657.pdf>.