By Kristen E. Burgers

RECOUP Act Advances to Senate

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The Senate Committee on Banking, Housing and Urban Affairs voted 21-2 on June 21, 2023, to advance the bipartisan Recovering Executive Compensation from Unaccountable Practices (RECOUP) Act of 2023 to the full Senate. The legislation was introduced by Sens. Sherrod Brown (D-Ohio) and Tim Scott (R-S.C.) following the collapse of several regional banks earlier in 2023. Among other things, the RECOUP Act would allow the Federal Deposit Insurance Corp. (FDIC) to claw back all or part of incentive-based compensation and stock profits received by bank executives during the two years before a bank failure.

Background

The RECOUP Act is intended to address bank risk-management issues that came to the forefront in March 2023 after the collapse of California's Silicon Valley Bank (SVB), California's First Republic Bank and New York's Signature Bank. In the aftermath of these successive failures in a short period of time, analysts blamed market segmentation and risky management practices by each of these banks.

SVB focused its banking activities on entrepreneurs and venture capital-backed health care and technology companies. On March 10, 2023, federal regulators closed SVB after a traditional bank run on deposits occurred following an announcement that the value of SVB's bond portfolio had dropped due to rising federal interest rates. Two days later, federal regulators closed Signature Bank, which banking industry experts considered a "crypto-friendly" bank. Signature Bank's failure was precipitated by the withdrawal by depositors of billions of dollars in the wake of the FTX bankruptcy and subsequent collapse of the crypto market.

Less than one week later, amid much fanfare, First Republic received a $30 billion rescue package from 11 large lenders, including Bank of America, Citigroup, J.P. Morgan Chase and Wells Fargo, each of which deposited $5 billion. On May 1, 2023 (amid much less fanfare), First Republic was seized by regulators, then sold to J.P. Morgan Chase. The failure of these banks in rapid succession eroded consumer confidence and caused ripple effects throughout the economy. For SVB alone, the FDIC had to provide $20 billion from a government deposit insurance fund to depositors.

Banks Incentivized Risk Through Executive Compensation

Following these failures, disturbing trends emerged. In each case, the banks had adopted risky management practices and incentivized such practices through performance- and equity-based compensation for bank executives. SVB CEO Greg Becker received compensation valued at $9.9 million in 2022 and sold $3.6 million in SVB stock in the days before its closure.[1] Signature Bank CEO Joseph DePaolo received compensation valued at $8.8 million in 2022 and sold millions of dollars of company stock in the weeks and months before its closure.[2] In the last reported compensation data for First Republic, then-CEO (and founder) Jim Herbert received a salary of $900,000 and bonus compensation valued at $9.2 million in 2021, and sold $4.5 million in First Republic stock in the first two months of 2023.[3]

The issue of incentivizing risk through executive bonus compensation in the banking industry is not new. It was a hot-button topic during the financial crisis of 2008, when giants Lehman Brothers, AIG and Washington Mutual failed. However, a study of the 2008 financial crisis did not find any empirical data supporting a correlation between excessive risk-taking and the financial crisis.[4] The study examined 98 banks that were part of Standard & Poor's 1500-stock index at the end of 2006. The patterns revealed by the study contradicted public perception: The banks that gave their CEOs the greatest incentives for excessive risk-taking fared better, on average, than others.[5]

The issue of insider trading also is not new. In 2000, the SEC adopted Exchange Act Rule 10b5-1, which provides an affirmative defense for corporate insiders and companies to buy and sell company stock according to a trading plan. In December 2022, the Securities and

1 "Bipartisan Bill Allowing Failed Bank Executives' Pay to Be Clawed Back Clears Key Committee Hurdle," Office of Sen. Jack Reed Press Release (June 21, 2023), *available at* reed.senate.gov/news/releases/bipartisan-bill-allowing-failed-bank-executives-pay-to-be-clawed-back-clears-key-committee-hurdle (unless otherwise specified, all links in this article were last visited on July 31, 2023).

2 *Id.*

3 Dan Ennis, "First Republic Execs to Forgo Bonuses This Year," *Banking Dive* (March 23, 2023), *available at* bankingdive.com/news/first-republic-executives-forgo-bonuses-vested-compensation-herbert-salary/645714.

4 Rüdiger Fahlenbrach & Rene M. Stulz, "Bank CEO Incentives and the Credit Crisis," *J. of Fin. Econs.* (Aug. 12, 2010), Charles A. Dice Center Working Paper No. 2009-13, Fisher College of Business Working Paper No. 2009-03-13, Swiss Finance Institute Research Paper No. 09-27, ECGI-Finance Working Paper No. 256/2009, *available at* ssrn.com/abstract=1439859.

5 *Id.*

Exchange Commission (SEC) adopted amendments to Rule 10b5-1 to close perceived loopholes.[6] Significantly, the amendments include a "cooling-off period" of generally 90 days before trading can commence under a Rule 10b5-1 plan.

The amendments also require directors and officers to certify at the time of the adoption of a new or modified Rule 10b5-1 plan that they are not aware of any material nonpublic information about the issuer or its securities, and are adopting the plan in good faith and not as part of a plan or scheme to evade the prohibitions of Rule 10b5-1. The amendments became effective on Feb. 27, 2023.

The FBEC Act Is Introduced First

In March 2023, prior to the introduction of the RECOUP Act, Sens. Elizabeth Warren (D-Mass.), Catherine Cortez Masto (D-Nev.),[7] Josh Hawley (R-Mo.) and Mike Braun (R-Ind.) introduced the Failed Bank Executives Clawback (FBEC) Act. Its key provisions include the following: (1) a requirement that the FDIC claw back from bank executives all or part of the compensation they received over the five-year period preceding a bank's failure; (2) an expansion of the clawback authority in the Dodd-Frank Act to apply to any bank that comes under FDIC receivership rather than only those resolved under the FDIC's Orderly Liquidation Authority; and (3) a mandate that investors in a failed bank's holding company should bear the losses of the insured depository institution. The Senate Banking Committee held a hearing on the FBEC Act in May 2023, but has not yet acted on it. The FBEC Act cannot move on to consideration by the full Senate until the Senate Banking Committee has voted to advance it.

6 "SEC Adopts Amendments to Modernize Rule 10b5-1 Insider Trading Plans and Related Disclosures," Sec. & Exch. Comm'n Press Release (Dec. 14, 2022), *available at* sec.gov/news/press-release/2022-222.

7 Sens. Warren and Cortez Masto are both members of the Senate Banking, Housing and Urban Affairs Committee.

Key Provisions of the RECOUP Act

The RECOUP Act is widely viewed as a compromise of the FBEC Act. Key provisions of the RECOUP Act include the following:

- authority for the FDIC to claw back all or part of the bonus and equity-based compensation (but not salary) and profits from the sale of bank stock received by key bank executives, board chairs and inside directors during the two years prior to a bank failure;
- authority for bank regulators to ban or remove bank executives who fail to appropriately oversee and manage their banks;
- imposition of fines and penalties of up to $3 million on bank executives who are found to have ignored warnings and enforcement actions from regulators;
- requirement that banks adopt corporate governance and accountability standards in their bylaws that promote responsible management; and
- exemption for small banks with assets under $10 billion.

Twelve Democrats and nine Republicans on the Senate Banking Committee voted to pass the bill. Only two senators — Thom Tillis (R-N.C.) and Bill Haggerty (R-Tenn.) — voted against the bill. The RECOUP Act will now advance to the full Senate for consideration. If it is passed by the Senate, it will move to the House of Representatives, where initially it will be taken up by the House Financial Services Committee.

A recent survey of 1,239 "likely" voters by Data for Progress shows bipartisan support for bank executive compensation reform. Of those surveyed, 81 percent think that CEOs of large banks make too much income, including 85 percent of Democrats, 84 percent of Independents and 75 percent of Republicans. Sixty-six percent of those surveyed (including 77 percent of Democrats, 67 percent of Independents and 55 percent of Republicans) think banks are taking too much risk and support increased regulations to protect the economy.[8] Despite apparent support for reform among voters and bipartisan support among lawmakers, the future of the RECOUP Act is still uncertain. abi

8 June 2023 Survey, Data for Progress, *available at* filesforprogress.org/datasets/2023/6/dfp_banking_ceo_compensation.pdf (survey conducted May 13-14, 2023).