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Federal Reserve Board Proposes Revised Process for Appeal of Material Supervisory Determinations

New Guidelines Would Reduce Levels of Appeal From Three to Two and Expand the Ombudsman’s Role in Safeguarding Institutions From Retaliation

BACKGROUND

On February 27, 2018, the Board of Governors of the Federal Reserve System (the “Board”) proposed new guidelines (the “Proposed Guidelines”) governing internal appeals of material supervisory determinations and an updated Ombudsman policy that would enhance the role of the Ombudsman, particularly with respect to claims of retaliation.¹ The Proposed Guidelines would revise and provide additional detail to the existing guidelines (the “Current Guidelines”), issued in 1995 pursuant to Section 309 of the Riegle Community Development and Regulatory Improvement Act of 1994. The Proposed Guidelines represent the latest in a series of recent Federal Reserve proposed guidances relating to enhancement of the supervisory process.²

The Board is accepting comments on the proposed new guidelines until April 30, 2018.

DISCUSSION

Both the Current Guidelines and the Proposed Guidelines grant institutions subject to Federal Reserve oversight (primarily bank and savings and loan holding companies, state member banks, and state-licensed branches of foreign banks) the right to an informal appeal of decisions on any material matter relating to the examination process (“material supervisory determinations”), except for those matters for which an alternative, independent appeals process exists, such as for formal enforcement actions.

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The proposed revisions would modify the Current Guidelines in three main respects. First, they would restructure the appeals framework by reducing the levels of review from three to two,³ modifying the reviewers at each level and providing greater detail regarding the record to be established and the standard of review to be applied. Second, and potentially of most importance, the revisions would formalize and expand the Ombudsman's role in safeguarding institutions from retaliation for submitting an appeal. Third, the Proposed Guidelines would introduce an expedited review of material supervisory determinations that lead an institution to become critically undercapitalized so that the review can be completed within the 90-day period by which a receiver must be appointed or other action must be taken under the Prompt Corrective Action ("PCA") framework.

The changes that are proposed to be made reflect feedback received from institutions and the Board's observation of how the Current Guidelines have operated in practice. The revisions aim to improve and expedite the appeals process, particularly for institutions in troubled condition. The Board's intent is to strike a balance between institutions' interests in a swift but substantive review of material supervisory determinations and the institutions' and the Board's interest in the efficient use of limited resources.

A. LEVELS OF REVIEW

The Proposed Guidelines would replace the current appeals framework. Under the Current Guidelines, the first level of review is carried out by a panel comprised of a person or persons selected by the same Reserve Bank that made the supervisory determination, but who (a) did not participate in the material supervisory determination; (b) do not directly or indirectly report to the person who made the material supervisory determination; and (c) are qualified to review the material supervisory determination. Employees of that Reserve Bank are eligible to sit on the initial level appeals panel under the existing process.

The Proposed Guidelines would similarly provide for initial review by a panel formed by three Reserve Bank employees, but they would be selected by the director of the appropriate division of the Board (Supervision and Regulation or Consumer Affairs) or an officer designated by such director. The Proposed Guidelines would impose similar requirements for membership, except that: (a) instead of not having "participated" in the determination, members may not have been "substantively involved" in any matter at issue;⁴ (b) instead of being "qualified" to review the determination, members are required to "have relevant experience to contribute to the review"; and (c) members may not be employed by the Reserve Bank that made the material supervisory determination.

As with the Current Guidelines, the Proposed Guidelines would permit the review panel to hold an informal meeting in which the supervised institution may present testimony and other information to the panel. The review panel would be allowed to ask questions of those present at the meeting but would not be permitted to conduct cross-examinations. As with the Current Guidelines, the Proposed Guidelines would not establish any discovery rights.

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Although the Current Guidelines are silent on the record to be formed by the initial review panel, the Proposed Guidelines provide that such record must include at a minimum: (a) the original decision being appealed; (b) the materials submitted by the institution in connection with the appeal; (c) the materials identified by the Federal Reserve staff as relevant to the material supervisory determination being appealed, including workpapers; and (d) the decision of the initial review panel. The initial review panel may also supplement the record by soliciting the views of outside parties, including staff from the Board, the Reserve Banks and other supervisory agencies, or by conducting additional fact-finding.

Unlike the Current Guidelines, the Proposed Guidelines specify the standard of review to be applied at each appellate level. Importantly, the initial review panel's decision would be made "as if no previous determination had previously been made."⁵ The panel would not be permitted to defer to the judgment of the Reserve Bank that made the original decision, but would be permitted to rely on any examination workpapers developed by the Reserve Bank or materials submitted by the institution if, in the judgment of the panel, it would be reasonable to do so.⁶ The initial review panel would also be required to consider whether the material supervisory determination was consistent with the Board's policies and applicable laws and regulations and supported by the record.

The Current Guidelines provide that the initial review must be completed within 30 calendar days of the filing of the complete appeal, while the Proposed Guidelines would grant the panel 45 calendar days from when the appeal is received. The Proposed Guidelines would permit the panel to extend the deadline for issuing a notice of decision by up to 30 days if it determined that the record was incomplete and additional fact-finding was necessary. When reaching a decision, the panel would have the option to continue, terminate, or otherwise modify the material supervisory determination at issue or remand consideration of the material supervisory determination to the original examiners to allow them to consider additional evidence.

The supervised institution would have 14 calendar days from the notice of decision to submit a request for a second and final appeal. The final appeal would be reviewed by three individuals selected by the director of the appropriate division of the Board (under the Current Guidelines, the second instance of appeal would have been decided by the President of the Federal Reserve Bank that made the initial determination). The three members would include at least two Board employees, at least one of whom would be an officer of the Board at the level of associate director or higher. In addition, the Board's General Counsel would appoint an attorney to advise the final review panel in the exercise of its responsibilities. None of the three members or the attorney would be permitted to be employed by the Reserve Bank that made the material supervisory determination under review, to have been members of the initial review panel, to have been personally consulted regarding the issue being determined and provided guidance or to directly or indirectly report to a person who made the material supervisory determination under review.

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Like the initial review panel, the final review panel would be permitted to carry out an informal meeting, but no facts not included in the record could be introduced at the meeting. The final review would be limited in scope to the record upon which the initial review panel made its decision, and the final review panel's standard of review would be whether the decision of the initial review panel was reasonable – a deferential standard.

The final review panel would have 21 calendar days to deliver a final decision. The panel would be permitted to continue, terminate, or otherwise modify the material supervisory determination at issue or remand consideration of the material supervisory determination to the original examiners to allow them to consider additional evidence.

The final review panel's decision would be published with the appropriate redactions (or in summary form), but the record (including the initial review panel's decision) would remain confidential supervisory information. Under the Current Guidelines, the Board's practice is to not make appeals decisions public, even in redacted form. This revision would bring the Board's practices in line with those of the Federal Deposit Insurance Corporation ("FDIC") and the Office of the Comptroller of the Currency ("OCC"), which publish redacted decisions or summaries on their websites.⁷

The Proposed Guidelines would eliminate the third level of review contained in the Current Guidelines, which is a review of the material supervisory determination by the appropriate Governor.

B. ENHANCED ROLE FOR THE OMBUDSMAN AND RETALIATION SAFEGUARDS

The Proposed Guidelines and a proposed Ombudsman Policy would reinforce the Board's existing policy prohibiting retaliation against supervised institutions who choose to submit an appeal of a material supervisory determination. Among other measures, the proposals would allow the Ombudsman to attend hearings or deliberations as an observer, if requested by the institution or Federal Reserve personnel, and track complaints made by regulated institutions in order to identify and report patterns of issues. The Ombudsman is also authorized to mediate retaliation complaints in the first instance, to investigate and determine the merits for those retaliation complaints that cannot be resolved informally, and to report to the relevant Board Committee, Division Director, and Reserve Bank's head of Supervision concerning such investigations and resulting findings. The Ombudsman is also required to contact institutions that have filed appeals six months after their resolution and proactively inquire as to whether the institution believes it has been subject to retaliation.

Institutions may also enlist the assistance of the Ombudsman informally to facilitate the resolution of a complaint concerning a supervisory determination, either in lieu of, or prior to the filing of, a formal appeal.

C. EXPEDITED REVIEW OF MATERIAL SUPERVISORY DETERMINATIONS RELATING TO OR CAUSING AN INSTITUTION'S CRITICAL UNDERCAPITALIZATION

Under the PCA framework, within 90 days of an insured depository institution becoming critically undercapitalized, the relevant federal banking agency must appoint a receiver or take such other action that the Board, with the FDIC's concurrence, considers would better achieve the purposes of the PCA. Although these actions under the PCA framework would not be appealable under the Guidelines, decisions that might lead an institution to become critically undercapitalized, such as reclassification of loans, would be appealable. Accordingly, the Proposed Guidelines would introduce an accelerated process in that situation. If for any reason the appeal is not completed prior to the 90-day deadline, the existence of the outstanding appeal would not prevent the Board from taking the actions required by the PCA framework and the appeal would be rendered moot.

D. REQUEST FOR COMMENTS

The Board seeks comments on all aspects of the Proposed Guidelines and Ombudsman Policy and, in particular, on (i) the standards of review that are proposed for the two review levels; (ii) the nature and composition of the review panels; (iii) the record that the panels may consider; and (iv) the expedited timeline that is proposed in light of the PCA framework. Comments are due until April 30, 2018.

IMPLICATIONS

The Board's current appeals process is more cumbersome, less transparent, and with fewer safeguards for independence than the other federal banking agencies' procedures. These obstacles, as well as concerns about retaliation, have made institutions supervised by the Federal Reserve reluctant to avail themselves of their appeal rights. The Proposed Guidelines appear to represent a recognition that the Board's existing appeals process can be effectively streamlined without unnecessarily infringing on supervisory decision-making. Particularly important are the specification that at the initial appeal level the determination being challenged is reviewed *de novo*, the proposal that initial appeal will not be heard by employees of the Reserve Bank that made the determination, and, potentially, the reinforced anti-retaliation provisions. Ideally, this will lead to more consistent application of policy and decision-making throughout the Federal Reserve System. Similarly, the decision to publish redacted summaries of the decisions will provide further information on supervisory standards to the benefit of the industry and the public.

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ENDNOTES

- ¹ Board of Governors of the Federal Reserve System, Proposed policy statement; request for comments, *Internal Appeals for Material Supervisory Determinations and Policy Statement Regarding the Ombudsman for the Federal Reserve System*, 83 Fed. Reg. 39, 8391-96 (the “Proposed Policy Statement”).
- ² For a discussion of the Federal Reserve’s prior proposals, for a new LFI rating system, revised supervisory expectations for banking organization boards of directors and supervisory expectations for effective senior management, respectively, see our memoranda to clients, “Federal Reserve Proposes New Rating System: Federal Reserve Proposes to Establish a New Rating System for the Supervision of Large Financial Institutions Designed to Align with the Supervisory Program for Those Institutions and to Enhance the Clarity and Consistency of Supervisory Assessments” (August 7, 2017), *available at* https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Federal_Reserve_Proposes_New_Rating_System.pdf; “Federal Reserve Proposes to Refocus Expectations for Banking Organization Directors on Core Responsibilities: Proposal Recognizes the Distinct Role of the Board as Compared to Management and the Adverse Impact of Unduly Extensive Requirements on the Board’s Attention and Effectiveness” (August 7, 2017), *available at* https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Federal_Reserve_Proposes_to_Refocus_Expectations_for_Banking_Organization_Directors_on_Core_Responsibilities.pdf; and “Federal Reserve Proposes Guidance to Clarify Supervisory Expectations Related to Risk Management for Large Financial Institutions” (January 8, 2018), *available at* https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Federal_Reserve_Proposes_Guidance_to_Clarify_Supervisory_Expectations_Related_to_Risk_Management_for_Large_Financial_Institutions.pdf.
- ³ The OCC and FDIC appeals processes also include multi-level reviews.
- ⁴ A similar standard would apparently not be applied to the director who appoints the panel.
- ⁵ Proposed Policy Statement at 8392.
- ⁶ Neither the OCC nor the FDIC guidelines specify that the standard of review is on a *de novo* basis.
- ⁷ FDIC decisions are available at <https://www.fdic.gov/regulations/laws/sarc/sarcappeals.html>. OCC decisions are available at <https://www.occ.treas.gov/topics/dispute-resolution/bank-appeals/summaries/index-summaries.html>.

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