VIA E-MAIL TO REGCOMMENTS@FHFA.GOV

January 25, 2011

Alfred M. Pollard, Esq., General Counsel
Attention: Comments/RIN 2590-AA37
Federal Housing Finance Agency, Fourth Floor
1700 G Street, N.W.
Washington, D.C. 20552

Re: <u>Proposed Regulation on Voluntary Mergers of Federal Home Loan Banks</u>

Dear Mr. Pollard:

The twelve Federal Home Loan Banks ("FHLBanks") are writing to comment on the Federal Housing Finance Agency's ("FHFA") proposed regulation on Voluntary Mergers of Federal Home Loan Banks published on November 26, 2010 ("Proposal" or "Proposed Rule").[1] The Proposal states that it would establish the conditions and procedures for the consideration and approval of voluntary FHLBank mergers, as provided by the Housing and Economic Recovery Act of 2008 ("HERA"). The FHLBanks appreciate the FHFA's attention to this topic and welcome the FHFA's invitation to provide comments on all aspects of the Proposal.

A. <u>Section 1278.1 -- Definitions</u>

1. <u>Merger Definition</u>. The definition of "Merger" in the Proposed Rule is broadly worded to encompass any type of combination, including a traditional merger, consolidation or purchase and assumption agreement, and may involve one or more target FHLBanks and one or more surviving FHLBanks. We support this broad definition, which will facilitate a variety of types of combinations and transactions.

2. <u>Disclosure Statement</u>. The Proposal would require each Constituent Bank to provide a Disclosure Statement to its members in connection with a proposed merger transaction. As defined in the Proposal, the Disclosure Statement is a written document that contains all of the items that a Bank would be required to include in a Form S-4 Registration Statement under the Securities Act of 1933 when prepared as a prospectus, if such a prospectus were required to be provided to shareholders.

We agree that the SEC's merger disclosure requirements as contained in Form S-4 will serve as a useful guide for merging FHLBanks to follow in determining the appropriate and material items to disclose to their member shareholders in seeking a vote on a merger. However, a high level review of the requirements of Form S-4 reveals a number of requirements that are clearly not applicable to FHLBank mergers, such as information about proxy voting and the impact of abstentions and broker-nonvotes on the

[1] 75 Fed. Reg. 72751

shareholder quorum. Given the fundamental differences between FHLBanks and public companies, we think it is likely that the parties to a merger will find additional inapplicable provisions when they go through the detailed review of Form S-4 required to draft a Disclosure Statement. Consequently, we request that the definition of "Disclosure Statement" be modified to include the phrase "to the extent applicable" between the word "contains" and the word "all" in the first line thereof.

Without limiting the generality of the comment contained in the prior paragraph, we note that certain requirements of Form S-4 are also requirements of Form 10-K with which the FHLBanks are not required to comply, by virtue of "No-Action" letters received from the Securities and Exchange Commission, and we note certain items in those "No-Action" letters are embodied in HERA. We request that the final rule make clear that the FHLBanks will not be required to include in their Disclosure Statements any information that they would not be required to include in their Forms 10-K.

Finally, we note that in the preamble, the FHFA states that much of the information in the Disclosure Statement may be supplied through incorporation by reference to the FHLBanks' periodic reports filed under the 1934 Act. Incorporation by reference would significantly reduce the cost of preparing and mailing the Disclosure Statement, and we appreciate the FHFA's willingness to permit the merging FHLBanks to take advantage of this approach to disclosure. However, the ability to incorporate SEC reports by reference into a Disclosure Statement that will not itself be filed with the SEC as a registration statement requires regulatory authority; the FHLBanks will not be able to rely on the incorporation by reference authority contained in the SEC's Form S-4. We therefore request that the final rule explicitly authorize the FHLBanks to incorporate information contained in their SEC reports by reference into the Disclosure Statement, to the same extent that such information could be incorporated by reference into a Registration Statement on Form S-4.

B. Section 1278.3(a) – Requisite Director Vote

The Proposal requires that a merger agreement between two or more FHLBanks must be approved by a majority of a quorum of each FHLBank's board of directors. We believe that the rule should permit each FHLBank to establish director voting requirements under its by-laws. This would be consistent with the approach to merger voting taken by most corporation statutes. Accordingly, we suggest that section 1278.3(a) read as follows: "(a) Has been authorized by the affirmative vote of a majority of a quorum of the board of directors of each Constituent Bank, or such higher standard for approval as may be set forth in the bylaws of each Constituent Bank, at a meeting on the record, and has been executed by authorized signing officers of each Constituent Bank; and".

C. Section 1278.3(b) – Terms and Conditions of the Merger

We have several comments and suggestions on Section 1278.3(b) of the Proposal.

1. Section 1278.3(b)(4) – Board of Directors Composition. The Proposal seeks comment on how best to address the process for constituting a combined board of directors of two or more merging FHLBanks. Given the unique and specific characteristics of each of the FHLBank districts, the preferences and nature of the membership and the fiduciary duty of the boards of directors involved in such transactions, we believe that the composition of a resulting FHLBank's board of directors following a merger should be left to the FHLBanks involved in the transaction. Thus, we encourage the FHFA to leave sufficient flexibility in the regulation to enable the Constituent Banks to propose, through the merger agreement and the merger application: (i) the size and composition of the combined board immediately following the merger, and (ii) a plan for a subsequent gradual transition to a smaller board through the annual designation of directorships. We believe that the combined institution should have the flexibility to allow more detailed governance matters to evolve over time, including the number and composition of board committees and the responsibilities to be delegated to those committees. As a result, we do not believe that governance plans at this level of detail should be required as part of the merger agreement or merger application.

2. Section 1278.3(b)(7) – Representations and Warranties. We agree that an important part of any merger agreement will be the representations and warranties made by the parties to the agreement. This section of the agreement, together with the related disclosure schedules, will provide each party with disclosure of all material information about the other party necessary to enable each party to make an informed decision about whether to enter into the agreement. There is a reference in this section of the Proposed Rule that representations and warranties might also be made by officers, directors and employees. Because officers, directors and employees are generally not expected to sign representations and warranties in their individual capacities as part of corporate mergers, we suggest that the FHFA clarify the rule to make it clear that representations and warranties made by the officers, directors and employees of the merging FHLBanks are made on behalf of, and in their capacity as officers, directors and employees of, the merging FHLBanks. Accordingly, we suggest the following revisions to this section (emphasis added): "(7) A statement of the representations or warranties, if any, made or to be made by any Constituent Bank, or its officers, directors, or employees on behalf of and in their respective capacities as officers, directors and employees of the merging Constituent Bank."

3. Section 1278.3(b)(8) – Legal or Accounting Opinions. Often, if legal opinions are required in connection with a merger, they are described in the merger agreement as conditions to the closing, but are not obtained until after the merger agreement is signed. As a result, we suggest that the tense in this section be revised in recognition that these opinions may be obtained either before or after the merger agreement is signed. We further suggest that accounting opinions be included in this section as well, since these

kinds of opinions are also often required in connection with a merger. Accordingly, we suggest the following revisions to this section (emphasis added): "A description of the legal or accounting opinions or rulings, if any, that have been or are required to be obtained or furnished by any party in connection with, or as a condition to the consummation of, the proposed merger."

4. Section 1278.3(b)(9) – Termination of Merger Agreement. This section sets forth certain circumstances under which the boards of directors of the Constituent Banks may terminate a merger agreement prior to its effective date, with the concurrence of the FHFA. We have two comments on this section.

First, the inclusion of this provision in the final regulation could be interpreted as limiting the circumstances under which the merger agreement may be terminated prior to the effective date, although we do not believe that was the intent. We request that this section be modified to make clear that the parties to the merger agreement may also negotiate the inclusion of additional termination rights. For example, corporate and bank merger agreements typically permit the parties to terminate if (i) the other party fails to fulfill its covenants or materially breaches a representation or warranty, whether or not such breach was intentional; (ii) the conditions to close have not been met by a particular "drop dead" date, or (iii) the other party suffers a material adverse change in its financial condition (whether before or after the shareholder vote). Other termination rights may be negotiated on a case-by-case basis, depending upon the circumstances.

Second, regarding the specific termination provisions included in Section 1278.3(b)(9) of the Proposal, we agree that the parties to the merger agreement should be able to terminate the merger agreement under those circumstances. We question, however, the purpose of the regulatory concurrence required for such a termination. As a practical matter, we recognize that the FHFA would not likely withhold its concurrence in connection with a request to terminate a merger agreement when a member vote has been obtained by means of a material misstatement, omission or misrepresentation, or fraud, or when a significant adverse event has occurred following the member vote. However, it seems that if the parties to the agreement (particularly the party that is not responsible for the issue) desire to terminate the merger agreement for one of these reasons, they should be able to do so and not be required to proceed with the merger, regardless of whether they have obtained regulatory concurrence for their termination decision.

5. Section 1278.3(b) -- Reference to Other Documents. The Proposal could be read to require that the merger *agreement* has to describe the material terms of the governing documents that are listed in Section 1278.3(b), such as the Continuing Bank's proposed organization certificate, by-laws and capital structure plan. Instead -- for simplicity, consistency and clarity -- these documents should just be *attached* to the merger agreement as exhibits. Moreover, the merger agreement and its exhibits should be *attached* as Appendices to the Disclosure Statement, which itself would describe these documents generally -- i.e. only the most material and any extraordinary terms of each.

D. 1278.4(a)(7) – Merger Application – Pro Forma Financial Information

The Proposal requires that the merger application filed with the FHFA include pro forma financial statements for the Continuing Bank, in such form as would be required to be included in the Disclosure Statement. The preamble to the Proposed Rule asks for comment on whether the pro forma information provided in the merger application should mirror the disclosure in the Disclosure Statement, or whether the merger application should include more extensive pro forma information (up to a three-year projection). As further explained below, we believe that the Disclosure Statement pro forma financial information should be limited to historical combined pro forma data (rather than forecasted information). However, if the FHFA believes it is appropriate to have forecasted financial information as part of the merger application, then to the extent such information is prepared by the Constituent Banks, it should allow such information to be filed on a confidential basis and deem such information to be exempt from public disclosure under the Freedom of Information Act ("FOIA") and the FHFA's implementing regulations (12 C.F.R. Part 1202).

The disclosure requirements applicable to the Disclosure Statement are incorporated by reference to the SEC's Registration Statement on Form S-4 under the Securities Act of 1933. However, the preamble to the Proposed Rule goes a step further than just requiring the substantive disclosure included in a Form S-4 Registration Statement by suggesting that the Constituent Banks might, at their option, provide to members a 12-month forecast, including balance sheet and income statement projections. We recognize that Regulation S-X, which sets forth the substantive financial statement requirements for SEC registration statements, permits registrants, at their option, to include in their prospectuses a 12-month financial forecast, in lieu of a pro forma combined condensed statement of income. However, this "option" is negated if historical pro forma combined financial information is required by GAAP. See 17 C.F.R. §210.11-03(d). Since GAAP would require the disclosure of historical pro forma combined financial information in these circumstances, the Constituent Banks would not have the option (if Form S-4 were applicable) to include a financial forecast *in lieu of* historical pro forma combined financial data, nor would the Constituent Banks be required under Form S-4 to send such a financial forecast *in addition to* the historical pro forma combined financial data.

We note that the FHLBanks have never previously released publicly to their members, or otherwise, forecasted results regarding their operations, as the process of income forecasting is an imperfect science at best and could lead to misplaced reliance by members or investors on such forecasts. Moreover, we are not aware of any other disclosure regime that requires public disclosure of financial forecasts, whether in connection with a merger or otherwise. As a result, we agree with the approach taken in the Proposal to include in the Disclosure Statement only the pro forma financial information that is required by Form S-4 (i.e., historical combined pro forma Financial Data, subject to any applicable SEC "No-Action" exemptions and HERA provisions), and strongly urge that the Proposed Rule not be modified to require the inclusion of forecasted results in the Disclosure Statement.

As for the merger application, we see no reason why the information provided to the FHFA needs to be identical to that provided publicly to the FHLBanks' members. Indeed, we believe that, as the prudential regulator of the FHLBanks, the FHFA *should* have the ability to assess on a confidential basis[2] the Constituent Banks' forecasted post-merger balance sheet and income statement to the extent the Constituent Banks have prepared such forecasts. As for the length of the forecast, we note that the shorter the time horizon, the more reliable the forecast will be. We therefore suggest that to the extent any forward-looking pro forma information is prepared, such information should be limited to either a twelve-month period, or to a period ending on December 31 of the first full calendar year following the signing of the merger agreement.

E. Section 1278.4(a) – Merger Application

1. Confidentiality. The Proposal does not address whether a merger application would be subject to public disclosure pursuant to FOIA and the FHFA's implementing regulations (12 C.F.R. Part 1202) or otherwise. We believe that, given the sensitive and confidential nature of a merger transaction, much of the merger application would be exempt from disclosure under various provisions of FOIA, including confidential commercial and financial information, personnel matters and examination or supervisory information. We request that the FHFA provide in new Part 1278 that the Constituent Banks may submit the confidential portions of the merger application in a separate binder labeled "Confidential" and that such information will be exempt from disclosure in response to FOIA requests. The final rule should also provide examples or categories of information which will be accorded confidential treatment.

2. Identification of Directors and Senior Executive Officers. Section 1278.4(a)(vi) of the Proposal requires that the names of the proposed directors and senior executive officers of the Continuing Bank be included in the merger application. Because certain decisions may not yet have been made by the Constituent Banks at the time of submission of a merger application to the FHFA, we request that the rule allow the Constituent Banks to submit a merger application without such information and the opportunity to provide supplemental information to the FHFA when such information becomes available.

3. Staff Reductions. Section 1278.4(a)(1)(vii) of the Proposed Rule requires the Banks to include in the application "a description of all proposed material operational changes including, but not limited to, reductions in the existing staffs…" We believe that specific staffing decisions should be decided by the new leadership and combined board of directors at such time as is appropriate during the transition period, which may extend well after the time of submission of the merger application and even after the closing of the merger. We request that the Proposed Rule be modified to make clear that specific staff reduction information on an individual basis is not required as part of the merger application. Of course, the FHFA would receive confidential aggregate estimated

[2] See discussion of confidentiality of merger application in Section E below.

information to the extent that the Banks submit a forecasted income statement; such a forecast would be based upon various stated assumptions that would include expected "cost saves" in salary and benefits.

F. Section 1278.5/1278.7 -- Merger Application Approval Process

The time between the announcement of a proposed merger and its closing may be a difficult and sensitive time for the Constituent Banks (especially for the "disappearing" entity). Employees may be uncertain of their future and the Constituent Banks are at some risk of losing valuable staff resources. In addition, an overly burdensome or lengthy process could discourage the consideration of potential mergers. As a result, we believe that the regulations should be written to facilitate as streamlined an approval process as possible.

The Proposal sets forth a two step merger application regulatory approval process: (1) a preliminary merger application approval by the FHFA; and (2) final approval by the FHFA following member ratification. We believe that the two step process would add unnecessary time to the merger process and is not necessary to provide the FHFA with the assurances it needs prior to closing the merger. We suggest that the final rule instead be written to be consistent with the process followed by the Federal banking regulators.

For bank mergers, a single regulatory approval is granted, and such approval is made subject to written conditions that must be met by the applicants (and certified to the bank regulator) before closing the merger. In addition, the bank regulator must endorse articles of merger or a revised organization certificate as the final step in the merger process. This gives the bank regulator a role in the closing process and assurance that the closing will not occur unless all conditions are met.

Consistent with the Federal banking agency process, under the Proposal a merger cannot be effected before the FHLBanks have filed with the FHFA (i) evidence of satisfaction of all approval conditions; and (ii) an organization certificate for the Continuing Bank (which must be accepted by the FHFA). Since these provisions of the rule already provide the FHFA with the ability to confirm satisfaction of approval conditions, and to have a role in the closing (by virtue of accepting the Continuing Bank's organization certificate), we believe that the extra step of a "final approval" is unnecessary. We believe that a single approval with conditions for closing will result in a more timely and certain process without depriving the FHFA of necessary regulatory oversight.

G. Section 1278.6 -- Ratification by Bank Members

The FHLBanks support the inclusion of a process for Bank members to vote on a proposed merger involving their Bank. This is consistent with the FHLBanks' cooperative structure and corporate governance practices generally.

In addition, with regard to the mechanics of member voting, the Proposal makes two statements that could be construed as inconsistent with current law regarding member voting rights which should be clarified in the final rule.

First, the preamble states "[A]n institution that owns Bank stock, but that is not a member of the Bank, such as an institution that acquired its stock in connection with the acquisition of a Bank member, is not entitled to vote its stock in an election for directors because it is not a member of the cooperative." This could be construed as inconsistent with the FHLBank Act, which established voting rights as of the record date (i.e., December 31 of the year preceding the election). See 12 U.S.C. § 1427(b)(1). The Federal Housing Finance Board ("Finance Board") previously stated that voting rights are determined as of the record date and that events occurring subsequent to the record date do not alter those rights. See 63 Fed. Reg. 65683, at 65685 (November 30, 1998). Specifically, the Finance Board stated that "if a member merges into a nonmember subsequent to the record date but prior to the election,…the successor may vote [the merged member's] shares" even though the successor is not a member. See id.

Second, the preamble states "[S]tock held by a member in excess of the statutory cap, i.e., the average required stock holdings for members within its state, is not entitled to be voted in the election of directors." While this is generally true, the Finance Board previously provided guidance explaining the effect a post record date acquisition of a member by an acquiring member has on voting rights. "[I]f a member that has reached the maximum number of votes that a single member may cast in an election acquires by merger or consolidation another member that was entitled to vote in the election, and in the same state, as of the record date, the resulting member would be entitled to cast its own votes, as well as those of the acquired member, but only in the election occurring in the year of the merger. Thereafter, the voting rights of the member would be determined by the number of shares it was required to hold as of the next following record date." See id. at 65686.

The FHLBanks request that the FHFA clarify that it intends that voting rights in connection with a merger shall be determined as of the record date, as is the case with director elections (including in accordance with guidance provided in 63 Fed. Reg. 65683), and that events subsequent to the record date do not alter the voting rights.

H. <u>1278.7((b)(1)(ii) – Consummation of the Merger and "Body Corporate" Language</u>

The language in this section that deems the Continuing Bank to be "a body corporate" upon the acceptance of the organization certificate by the FHFA could be interpreted as meaning that the Continuing Bank is a new entity, rather than the continuation of one of the two Constituent Banks. For a transaction in which one Bank is merging into another Bank, we believe that the regulation should instead make clear that, upon consummation of the merger, the legal existence of the Continuing Bank will continue in effect uninterrupted and that the organization certificate accepted by the FHFA represents the amended and restated organization certificate of the Continuing Bank.

* * * *

We appreciate your consideration of these comments.

Sincerely,

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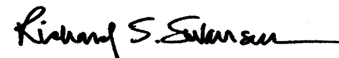

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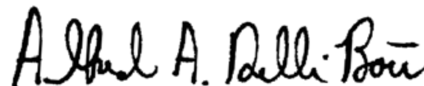

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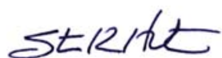

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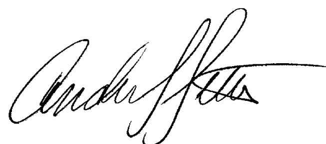

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