FHLB Chicago
Federal Home Loan Bank of Chicago

VIA EMAIL TO REGCOMMENTS@FHFA.GOV

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Fourth Floor
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Attention: Comments/RIN 2590-AA08

Re: Proposed Rule on Golden Parachute and Indemnification Payments

Dear Mr. Pollard:

The Board of Directors of the Federal Home Loan Bank of Chicago ("Bank") is writing to comment on the Federal Housing Finance Agency's ("FHFA") proposed rule on Golden Parachute and Indemnification Payments published on June 29, 2009 (the "Proposal"), which is intended to implement portions of Section 1114 of the Housing and Economic Recovery Act of 2008 ("HERA") that are to be codified at 12 U.S.C. § 4518(e).[1] The Bank welcomes the opportunity to comment on the Proposal.

I. Golden Parachute Provisions

We appreciate the FHFA's prompt action to propose more detailed rules regarding the final golden parachute rule that it published on January 29, 2009.[2]

We recognize and appreciate that the golden parachute portion of the Proposal draws a range of points from the Federal Deposit Insurance Corporation's ("FDIC") regulation on Golden Parachute and Indemnification Payments, which is codified at 12 C.F.R. Part 359 ("FDIC Rule"), and addresses suggestions that were contained in comment letters which were submitted by the Federal Home Loan Banks ("FHLBanks") in response to the interim final rule on golden parachute payments.[3] We offer the following comments and recommendations on the golden parachute portion of the Proposal.

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1 74 Fed. Reg. 30975 (to be codified at 12 C.F.R. pt. 1231).

2 74 Fed. Reg. 5101.

3 73 Fed. Reg. 53356 (Sept. 16, 2008), and amended at 73 Fed. Reg. 54309 (Sept. 19, 2008) (removing and reserving sections 1231.3 and 1231.4) and at 73 Fed. Reg. (Sept. 23, 2008).

A. <u>Provide Guidance and Clarification on Certain Timing Issues</u>

We request that the Proposal address a number of issues that may confront an FHLBank. In this regard, the final rule should address the following matters:

- that a healthy FHLBank — *i.e*, one that is not subject to any of the triggering events listed in paragraph (1)(ii) of the definition of "golden parachute payment" in proposed section 1231.2 ("Triggering Event") (including an FHLBank which had previously been subject to a Triggering Event, but is no longer subject to a Triggering Event), — need not obtain the approval of the FHFA Director ("Director") to enter into an agreement that could potentially result in a "golden parachute payment" in the event that a Triggering Event later occurs;[4]

- that if an individual begins to receive golden parachute payments under an agreement prior to the occurrence of a Triggering Event, the subsequent occurrence of a Triggering Event would not have any effect on the continuation of such payments, and the FHLBank would not be required to seek approval of the Director to continue the payments;[5] and

- that if an individual's employment terminates after a Triggering Event that is then resolved so that when the employment ends no Triggering Event is in effect, the approval of the Director is not required to make payments to that individual.

B. <u>Clarify that the Director May Approve an Agreement that Provides for a "Golden Parachute Payment" with a Current Employee of an FHLBank that is Subject to a Triggering Event</u>

Proposed section 1231.3(b)(1)(ii) expressly refers to the possibility that an FHLBank that is subject to a Triggering Event, or that is seeking to avoid being imminently subject to a Triggering Event, may obtain approval from the Director to enter into an agreement with a new hire that provides for a golden parachute payment. We request clarification that the Director under the authority of proposed section 1231.3(b)(i)

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[4] As we understand the proposed rule, if an individual entered into an agreement that was not subject to the Director's approval because no Triggering Event had occurred and then terminated his or her employment after a Triggering Event occurred, the FHLBank can seek the Director's approval to make such golden parachute payments to the individual by making the filing described in proposed section 1231.6, and the Director may grant such approval under proposed section 1231.3(b)(i).

[5] The FDIC clarified this point in its golden parachute regulation by providing that a condition for a payment being treated as a golden parachute payment is that it is an amount that <u>becomes</u> payable to an employee whose employment is terminated at a time when a triggering event under the FDIC golden parachute rule is in effect. 12 C.F.R. § 359.1(f)(iii)(A).

may likewise approve an agreement with a current employee of an FHLBank that is subject to a Triggering Event that provides for a golden parachute payment.

The final rule should clarify that, in any circumstances in which an agreement that provides for a golden parachute payment has been approved by the Director, no further approval by the Director under proposed section 1231.3(b) or otherwise will be required to make a golden parachute payment under the agreement.[6]

C. Clarify the Definition of Benefit Plans for FHLB's

The Proposal defines the term "benefit plan" by reference to section 3(1) of the Employee Retirement Income Security Act of 1974 as amended ("ERISA"). While we agree the this is an appropriate definition, we note that the Department of Labor ("DOL") has taken the position in Advisory Opinion 96-07A, that a FHLBank is "an entity described in section 3(32) of Title 1 of ERISA –*i.e.*, an agency or instrumentality of the Government of the United States," and is therefore exempt from ERISA under section 4(b)(1). Accordingly, we recommend adding " without regard to section 4(b)(1) thereof (29 U.S.C. 1003(b)(1)" after the parenthetical citation of "(29 U.S.C. 1002(1))" in the definition of "benefit Plan".

D. Confirm the Meaning of the Term "Compensation" for Purposes of the Golden Parachute Payments Rule

The Proposal does not define the term "compensation." The final rule should be modified to expressly include the definition of "compensation" that is set forth in section 1303 of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, as amended ("1992 Act"):

> The term "compensation" means any payment of money or the provision of any thing of current or potential value in connection with employment (emphasis added).[7]

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[6] Proposed section 1231.3(b)(1)(iii) provides that a regulated entity may agree to make a golden parachute payment under an agreement, which provides for severance payment not to exceed 12 months salary, in the event of a change of control, provided that the regulated entity shall obtain consent of the Director prior to making such a payment. This provision should be modified to expressly provide that approval for a payment under such an agreement could also be sought from the Director prior to the FHLBank entering into the agreement.

[7] 12 U.S.C. § 4502(6). The FHFA used the same sentence from the definition of compensation in the 1992 Act in its proposed definition of "compensation" in its recently proposed regulation on executive compensation. 74 Fed. Reg. 26989 (to be codified at 12 C.F.R. § 1230.2) (June 5, 2009).

Since the term "golden parachute payment" is defined in section 1318(e)(4) of the 1992 Act and in proposed section 1231.2 as a "payment (or any agreement to make any payment) in the nature of compensation by any regulated entity" (emphasis added), the express inclusion of a specific definition of compensation in the final rule will ensure that the term "golden parachute payment" will only apply in the circumstances that Congress intended.

This confirmation would make it clear that the final rule covers only payments "in the nature of compensation" and does not apply under any circumstances to other non-employment payments. Such non-employment payments include debt service payments from an FHLBank to the Office of Finance, payments of advance proceeds, dividends, deposit account withdrawals, and AHP funds from an FHLBank to a member institution, and payments to other parties (including payments to FHLBank directors) who may be considered to be an entity-affiliated party, but such payments are not connected with an employee relationship with an FHLBank.

E. Modification of Definition of Nondiscriminatory Severance Pay Plan or Arrangement

Paragraph (2)(v) of the definition of golden parachute payment in proposed section 1231.2 excludes from that definition a severance payment made pursuant to a nondiscriminatory severance pay plan or arrangement that generally does not exceed base compensation paid to the employee during the 12 months preceding termination of employment. We request that the FHFA revise this provision to instead limit the amount of the payment to the employee's current annual base salary as long as the FHLBank has not increased the employees base salary in anticipation of termination of employment. The definition of the term "nondiscriminatory" in proposed section 1231.2 provides that a nondiscriminatory plan may provide different benefits based only on objective criteria that are applied on a proportionate basis (with a variance in severance benefits relating to any criterion of plus or minus 10%) to groups of employees consisting of not less than the lesser of 33% of employees or 1,000 employees. The reference to 1,000 employees was taken from the definition of nondiscriminatory in the FDIC Rule.[8] The FDIC Rule applies to depository institutions and holding companies – many of which have tens of thousands of employees. In contrast, the FHLBanks' staffs are comprised of less than 400 employees. In recognition of the difference in employee size between the FHLBanks and the entities regulated by the FDIC, we recommend that, the FHFA delete the provision prohibiting a variance in benefits of more than plus or minus 10% in the final regulation. Alternatively, we suggest that the 33% threshold in the Proposed Rule be reduced to 20% and the "1,000 employees" be reduced to 50 employees or to such other smaller percentage and number that the FHFA determines are appropriate in light of the relatively small size of the FHLBanks' staffs.

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8 12 C.F.R. § 359.1(j).

F. <u>Provide for Exclusion of Certain Payments in Connection With Negotiated Terminations of Employment</u>

As noted above, payments under certain qualified nondiscriminatory severance pay plans or arrangements are not considered to be golden parachute payments. It is possible that depending on particular circumstances, including whether an FHLBank has such a nondiscriminatory severance pay plan and the circumstances involving a particular employee, an FHLBank may wish to enter into a negotiated termination of an employee's employment with the FHLBank, pursuant to which the employee would receive a payment that does not fall within the terms of a nondiscriminatory severance pay plan or arrangement as described in the Proposal.

The final rule should make it clear that an FHLBank's agreement to make a payment not exceeding base compensation paid to the employee during the 12 months preceding a negotiated termination of his or her employment pursuant to a severance pay plan which does not meet the requirements of paragraph 2(v) is excluded from the definition of a golden parachute payment and thus would not require FHFA approval even if a Triggering Event were in effect with regard to the FHLBank. Such an exclusion would ensure that the FHLBank retains the flexibility to conduct its ordinary course personnel operations without the need for FHFA approval of customary limited payments in connection with negotiated terminations.

G. <u>Clarify that Unused Leave is Not a "Golden Parachute Payment"</u>

The final rule should clarify that the customary payment of unused annual leave in connection with the termination of employment does not constitute a "golden parachute payment." We believe that this could be appropriately addressed through an additional exclusion to the term golden parachute payment in paragraph (2) of the definition of that term in proposed section 1231.2.

H. <u>Qualification of Certain Bank Plans Under the Definition of Bona Fide Deferred Compensation Plan or Arrangement</u>

In addition, GAAP treatment of deferred compensation normally trails actual benefit accrual. Benefit accrual under SERPs and other deferred compensation plans is usually determined once a year, well after the end of the year, when a company prepares the annual actuarial valuation for the related qualified plan. The employer will adjust the GAAP liability at that time.

Paragraph (3)(vii) does not take into account that payments do differ from the accrued liability for GAAP purposes for the timing issues noted as well as for method of payment and discount rates. Particularly for SERPS, the language does not take into account that benefits may differ from GAAP because (a) lump sums under the SERP may differ in value from the FAS valuation amount (and if the qualified plan rates are used to compute the SERP lump sum, this will always be the case), and (b) discount rates under the SERP may be tied to an index that is different from the financial assumptions or may change at a different time from the financial assumptions. Thus, the following language should be added to the end of 3(vii) "... plus any additional benefit amounts accrued in the normal course under the terms of the plan as in effect no later than one year prior to any events since the most recent GAAP valuation and except for variations attributable to the calculation of benefits in the case of a SERP using actuarial assumptions and interest rates used for purposes of the associated qualified defined benefit plan."

Based on our reading of the Proposal, we understand that our Benefit Equalization Plan (the "Bank Plan") with the adjustments described above qualify as a "bona fide deferred compensation plan" as defined in the Proposal, and thus is excluded from the term "golden parachute payment" under paragraph 2(iii) of the definition of golden parachute payment in proposed section 1231.2.

Our Benefit Equalization Plan is comprised of a nonqualified deferred compensation plan component and a supplemental retirement plan component. The Benefit Equalization Plan was established primarily for the purpose of providing supplemental retirement benefits for a select group of highly compensated employees in excess of the limitations on contributions and benefits imposed by the Internal Revenue Code of 1986, as amended (the "Code"). Accordingly, the Benefit Equalization Plan qualifies under paragraph 2 with the adjustments described above of the deferred compensation plan definition.

For the Bank Plan, (i) the Bank recognizes compensation expense and accrues the related liability according to GAAP with no more than a one year trail; (ii) benefits accrue each period for current and prior service if a plan amendment is made; and (iii) benefit payments during the year reduce the accrued liability taking into account variations attributable to the calculation of benefits using actuarial assumptions and interest rates used for purposes of the associated qualified defined benefit plan. Accordingly, the Bank Plan meets the additional requirements set forth in paragraph (3)(iv), (vi), and (vii) with the adjustments described above of the deferred compensation plan definition.

I. Treatment of Nonqualified Deferred Compensation Plans and Supplemental Retirement Plans

Under paragraph 3(i) of the definition of bona fide deferred compensation plan or arrangement in proposed section 1231.2, a plan or arrangement that would otherwise qualify for an exclusion from treatment as a golden parachute payment would not qualify for such treatment, if the plan or arrangement were not in effect at least one year prior to the occurrence of a Triggering Event. Furthermore, under paragraph (3)(ii) of the deferred compensation definition, an increase in benefits payable under a qualifying plan or arrangement pursuant to an amendment made during the one-year period prior to the occurrence of a Triggering Event, would appear not to be excluded from the definition of a golden parachute payment.

Paragraphs (3)(i) and (ii) of the definition of bona fide deferred compensation plan or arrangement in proposed section 1231.2 should be modified to provide that these one-year rules be subject to waiver by the Director on a case-by-case basis. In any event, we believe that an FHLBank could apply for approval to make a payment with respect to the plan or increased benefits under proposed sections 1231.3(b)(1)(i) and 1231.6. Further, there should be an exception for amendments that have been made to comply with law. We suggest adding the following language to the end of Paragraph 3(ii): “provided further that changes for statutory compliance, such as Code Section 409A, should be disregarded in determining whether a plan provision has been in effect for one year."

J. Modify the Circumstances that Constitute a Triggering Event

The portion of proposed paragraph (1)(ii)(D) of the definition of golden parachute payment in proposed section 1231.2, which provides that “or the Federal Home Loan Bank or the Office of Finance is assigned a composite rating of 3 or 4 by FHFA,” should be revised to delete “3 or”. We note that the Federal Housing Finance Board Office of Supervision Examination Manual (“Manual”) draws a sharp distinction between a Composite 3 and a Composite 4 rating.[9] The Manual provides that the general policy in regard to a Composite 3 rated FHLBank is that supervisory action will be taken to address identified deficiencies or weaknesses. In contrast, the Manual provides that the general policy in regard to a Composite 4 rated FHLBank is that a formal enforcement action will be taken to address identified deficiencies or weaknesses. The restrictions of the golden parachute rule should not be triggered in circumstances that are not viewed as being serious enough to require formal enforcement action. Proposed paragraph (1)(ii)(D) should also be amended to clarify that it is triggered by the assignment in "writing" of the specified composite rating.

K. Consider Mitigating Factors in Determinations Regarding Approval of Golden Parachute Payments

Proposed section 1231.3(b)(2) should be modified to expressly provide that the Director will consider certain mitigating factors in determining whether to permit a golden parachute payment to be made. Such mitigating factors may include, among others, the individual’s history of beneficial contribution to the FHLBank, and cooperation with FHFA’s remediation efforts.

L. Grandfathering Considerations

The FHFA in the preamble to the Proposal stated that it recognizes that prior to the enactment of HERA, the regulated entities or the Office of Finance “may have entered into agreements that provide for golden parachute payments beyond that which <u>is proposed</u> to be permissible under section 1318(e) of the Safety and Soundness Act (12

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[9] Manual April 2007 at 5ROE.1.15.

U.S.C. § 4518(e)), and the proposed amendment (emphasis added)."[10] The FHFA further stated that it "intends that the proposed amendment would apply to agreements entered into by a regulated entity … with an entity-affiliated party on or after the date the regulation is effective (emphasis added)."[11]

Under the FHFA's preamble statements, restrictions on golden parachute payments under a new final rule adopted by the FHFA as a result of the Proposal will not apply to any agreement that provides for a golden parachute payment that is entered into prior to the effective date of a new final rule ("Grandfathered Agreement"). The Proposal does not discuss how the grandfathering provision would operate.

A Grandfathered Agreement should continue to be grandfathered for purposes of any final rule unless and until there is a material amendment to the Grandfathered Agreement. A material amendment for this purpose would include an extension of the term of the Grandfathered Agreement or an increase in the golden parachute benefits under the Grandfathered Agreement.

II. Indemnification Provisions

The Proposal includes proposed provisions regarding certain limitations on indemnification by regulated entities and the Office of Finance. The Proposal states that these indemnification provisions are substantially similar to the proposed indemnification provisions published on November 14, 2008 ("November Indemnification Proposal").[12] The Proposal indicates that the FHFA will consider comments received in response to the November Indemnification Proposal.

A. Expand Indemnification Authority for First and Second Tier Civil Money Penalties to the FHLBanks

The Proposal would grant Fannie Mae and Freddie Mac ("Enterprises"), the only two regulated entities in conservatorship, the discretion to indemnify their entity-affiliated parties against first and second tier civil money penalties.[13] This should be expanded to include all regulated entities that are not in receivership.

We agree with the FHFA's suggestion in the preamble to the Proposal that it is in the best interest of regulated entities in conservatorship to be permitted to indemnify entity-affiliated parties for the kinds of matters which form the basis for first and second tier civil money penalty liability. But we think this logic applies doubly for solvent

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[10] 74 Fed. Reg. at 30976.

[11] Id.

[12] 73 Fed. Reg. 67426.

[13] This provision is contained in paragraph (2)(iii) of the definition of prohibited indemnification payment in proposed section 1231.2.

regulated entities that have avoided conservatorship. In addition, 12 U.S.C. § 4636(g) (as amended by HERA) implies that all regulated entities are permitted to offer indemnification for first and second tier civil money penalties. The exemption for indemnifying entity-affiliated parties against first and second tier civil money penalties should also include legal or professional expenses attributable to the charges resulting in those penalties.

B. Allow for Indemnification Granted in Judicial Proceedings

Under the Proposal, an FHLBank's board of directors must specifically authorize indemnification payments made to an indemnitee. Corporate law in some jurisdictions recognizes another way in which a person may obtain permissible indemnification, specifically by obtaining a ruling from the judge before whom the underlying case was heard. The final rule should allow this alternative route to indemnification as well.

C. Clarify the Scope of Proposed Section 1231.4

The final rule should clarify that it requires a regulated entity to go through the proposed section 1231.4 process (which among other things requires specific findings by the regulated entity's board of directors) as a precondition to advancement of legal or professional expenses by the *regulated entity* to entity-affiliated party, but not in connection with the advancement of such expenses *by a third party insurer* under any commercial insurance policy or fidelity bond purchased by the regulated entity pursuant to paragraph (2)(i) of the definition of prohibited indemnification payment in proposed section 1231.2.

D. Partial Indemnification in Relation to Settlements and Formal Adjudications and Findings

Under the Proposal, the term "prohibited indemnification payment" shall not include "any reasonable payment by a regulated entity or the Office of Finance that represents partial indemnification for legal or professional expenses specifically attributable to particular charges for which there has been a formal and final adjudication or *finding in connection with a settlement that the entity-affiliated party has not violated certain laws or regulations or has not engaged in certain unsafe or unsound practices or breaches of fiduciary duty*, unless the administrative proceeding or civil action has resulted in a final prohibition order against the entity-affiliated party under section 1377 of the Safety and Soundness Act (emphasis added)."[14]

The definition of the term "prohibited indemnification payment" should not unduly restrict the potential to negotiate and consummate settlements with an entity-affiliated party. To the extent an entity-affiliated party is unable to obtain partial indemnification for legal and professional expenses which are not specifically or directly

[14] See paragraph (2)(ii) of the definition of prohibited indemnification payment in proposed section 1231.2.

related to the remedy provided in a settlement agreement, the entity-affiliated party's willingness to settle other charges with the FHFA may be adversely impacted. This may lead to unnecessary and wasteful litigation.

In this regard, settlements with federal financial regulatory agencies do not typically contain findings by the charging agency which exculpate the party settling the charges from wrongdoing with respect to some or all of the charges. They almost always contain statements to the effect that the person settling the charges "neither admits nor denies" the agency's allegations. As a result, the availability of partial indemnification in the Proposal may prove to be illusory.

In the case of either a settlement or a formal and final adjudication, the Proposal only allows indemnification for expenses specifically attributable to particular charges as to which the entity-affiliated party has been successful. As a practical matter, it will often be difficult, if not impossible, to precisely allocate expenses related, for example, to the review of documents, or the preparation for a deposition to a particular individual charge.[15] The principle sought to be addressed by this aspect of the Proposal would be better and more fairly effectuated by providing that legal and professional fees incurred may be reimbursed in proportion to the percentage of charges as to which the entity-affiliated party is entitled to reimbursement under the terms of the Proposal.

In light of the foregoing, the FHFA should revise the applicable exception to the definition of the term "prohibited indemnification payment" in section 1231.2 as follows:

> The term prohibited indemnification payment shall not include any reasonable payment by a regulated entity or the Office of Finance that represents partial indemnification for legal or professional expenses **[Delete the following bracketed text]** [specifically] attributable to particular charges for which there has been a formal and final adjudication **[Insert the following bracketed text]** [that the entity-affiliated party has not violated certain laws or regulations or has not engaged in certain unsafe or unsound practices or breaches of fiduciary duty], or **[Insert the following bracketed text]** [any matters which were the subject of a notice of charges which do not form the basis for any remedies imposed on the entity-affiliated party under the terms of a settlement with the entity-affiliated party,] [**Delete the following bracketed text**] [finding in connection with a settlement that the entity-affiliated party has not violated certain laws or regulations or has not engaged in certain unsafe or unsound practices or breaches

[15] In the FDIC's final rule, the FDIC acknowledged the difficulty in allocating expenses between different charges: "The FDIC recognizes that in many cases the appropriate amount of any partial indemnification will be difficult to ascertain with certainty." 61 Fed. Reg. 5926, 5929 (1996).

> of fiduciary duty] unless the administrative proceeding or civil action has resulted in a final prohibition order against the entity-affiliated party under section 1377 of the Safety and Soundness Act (12 U.S.C. 4636a) [**Delete the following bracketed text**] [.] **[Insert the following text]** [; provided that the amount of such permissible partial indemnification shall be determined by the ratio that is (a) the charges as to which the entity-affiliated party is deemed to be permitted to receive indemnification under this paragraph, to (b) the total number of charges.

As discussed above, the Proposal permits partial indemnification when there has been a final adjudication, settlement or finding favorable to the entity-affiliated party on some, but not all, charges, unless the proceeding or action resulted "in a final prohibition order" against the entity-affiliated party.[16] A "final prohibition order" is not defined, and we request clarification.

E. Indicate that a Regulated Entity Will Not be Rewarded for Denying Advancement of Legal Expenses or Penalized for Approving Them

In light of the policy concerns and constitutional principles animating both Judge Kaplan's decisions in the KPMG litigation[17] and the sections on advancement of legal fees contained in the Department of Justice's McNulty Memorandum,[18] the FHFA should clarify that it would not treat a regulated entity (i) more favorably for having denied an entity-affiliated party advancement of legal fees, or (ii) less favorably for having approved advancement of legal fees to an entity-affiliated party. A determination by a board of directors of a regulated entity under proposed section 1231.4(c)(1) should be made objectively and based solely on the merits of the entity-affiliated party's claim for indemnification.

F. Comments Regarding the Operation of the Proposal

The final rule (or its preamble) should describe in detail how the indemnification provisions would operate in practice. In that regard, we have set forth below a brief description of the issues that would likely need to be addressed by the board of directors ("Board") of a regulated entity following a request by an entity-affiliated party ("Individual") for indemnification (including an advancement of expenses).

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16 This provision is contained in paragraph (2)(ii) of the definition of prohibited indemnification payment in proposed section 1231.2.

17 See *United States v. Stein*, 435 F. Supp. 2d 330 (S.D.N.Y. 2006).

18 Memorandum from Deputy Attorney General Paul McNulty, Principles of Federal Prosecution of Business Organizations (2006).

Following the receipt of a notice of charges from the FHFA, and before any final order or settlement, the Individual may request that the Board agree to advance expenses under proposed section 1231.4(c) to cover any reasonable legal costs and other expenses to be incurred by the Individual in defending himself or herself against such charges. The Board may (but would not be required) to advance the reasonable expenses incurred by the Individual in defense of such charges. Before advancing any such payment, however, the Board would need to make a good-faith determination in writing after "due investigation" and consideration that (a) the Individual acted in good-faith and in a manner that the Individual reasonably believed to be in the best interests of the regulated entity,[19] and (b) making such payments would not materially adversely affect the safety and soundness of the regulated entity.[20] The Individual would be prohibited from participating in any way in the Board's discussion and approval of such payments, except that the Individual may present his or her request to the Board and respond to any inquiries from the Board concerning his or her involvement in the circumstances giving rise to the administrative proceeding or civil action.[21]

It is important to note that in making this good-faith/best interests determination, in the normal course, the Board will not have access to significant portions of the FHFA's investigative record that led to the filing of charges. Further, the Board's ability to conduct a "due investigation" into the conduct alleged in the notice of charges will necessarily be limited by the difference in its status, as compared to the status of the FHFA. For example, the Board would not have the power to compel third parties to testify, or to produce documents for its examination, as the FHFA does. In light of these considerations, our understanding is that the FHFA is not expecting that the Board conduct an investigation comparable to the FHFA's own investigation before agreeing to make an advancement of expenses to the Individual. Rather, the Board would be required to make a good-faith inquiry based on the information reasonably available to it to reach its determination that the Individual acted in good faith and in a way that he or she reasonably believed to be in the best interests of the regulated entity.

In the event that the Board advanced expenses to the Individual, the Individual would be required to agree in writing to reimburse the regulated entity, only to the extent that amounts are not covered by insurance or fidelity bonds, for the portion of any advanced indemnification payments made by the regulated entity that subsequently become prohibited indemnification payments pursuant to the application of paragraph (1) and (2) of the definition of prohibited indemnification payment in proposed section 1231.2.[22]

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[19] Proposed section 1231.4(c)(1)(i).

[20] Proposed section 1231.4(c)(1)(ii).

[21] Proposed section 1231.4(c)(2).

[22] Such an obligation should not arise until any applicable opportunity to appeal the findings in any administrative proceeding or civil action has expired and the findings have become final.

If an administrative proceeding or civil action instituted by the FHFA results in a final order or settlement that contains certain provisions specified in paragraph (1)(i)-(iii) of the term "prohibited indemnification payment" in proposed section 1231.2, the regulated entity would be prohibited from paying or reimbursing the Individual for the cost of any assessed amount or any other liability or legal expense with respect to the administrative or civil action, except to the extent that partial indemnification is permitted. The regulated entity would also be prohibited from maintaining insurance or a fidelity bond to pay or reimburse the Individual for the cost of any civil money penalty or judgment resulting from any administrative or civil action instituted by the FHFA under paragraph (2)(i) of the definition of prohibited indemnification payment in proposed section 1231.2.[23] Under paragraph (2)(i) of the proposed definition of prohibited indemnification payment, the regulated entity would not be prohibited, however, from maintaining insurance or a fidelity bond to pay or reimburse the Individual for the cost of any legal or professional expenses incurred in connection with such proceeding or action or the amount of any restitution to the regulated entity or receiver.

G. <u>Commencement of an Administrative Action</u>

We note that the proposed section 1231.4(a) of the November Indemnification Proposal provided that the indemnification provisions in proposed section 1231.4 would only apply after an administrative proceeding or civil action has been instituted by the FHFA "through issuance of a notice of charges under regulations issued by the Director."[24] Similarly, in promulgating the FDIC Rule, the FDIC stated that it considers a formal administrative action to be commenced by the issuance of a "Notice of Charges."[25]

Proposed section 1231.4(a) of the Proposal, however, now omits the words "through the issuance of a notice of charges under regulations issued by the Director" and instead provides that the section applies "only after an administrative proceeding or civil action has been instituted by the FHFA." The FHFA should confirm that for purposes of an administrative action the issuance of a notice of charges would continue to be the point at which the indemnification provisions of proposed section 1231.4 would be triggered, and that the filing of a complaint in a civil action would be the point at which the indemnification provisions of proposed section 1231.4 would be triggered.[26]

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[23] We note that the definition of prohibited indemnification payments does not cover actions by any party (whether governmental or private) other than the FHFA.

[24] 73 Fed. Reg. at 67426.

[25] 61 Fed. Reg. at 5930.

[26] As we understand the Proposal, any legal or other expenses incurred prior to the institution of an administrative proceeding or civil action would under no circumstances be deemed to be prohibited indemnification payments.

H. Grandfathering Considerations

The FHFA in the preamble to the Proposal stated that it recognizes that prior to the enactment of HERA, the regulated entities or the Office of Finance "may have entered into indemnification agreements that provide for indemnification beyond that which is proposed to be permissible under section 1318(e) of the Safety and Soundness Act (12 USC 4518(e)), and the proposed amendment (emphasis added)."[27] The FHFA further stated that it "intends that the proposed amendment would apply to agreements entered into by a regulated entity … with an entity-affiliated party on or after the date the regulation is effective (emphasis added)."[28]

Under the FHFA's preamble statements, restrictions on indemnification in certain circumstances under a new final rule adopted by the FHFA as a result of the Proposal will not apply to any agreement that provides for indemnification that is entered into prior to the effective date of a new final rule. The Proposal does not define what constitutes an "agreement" for purposes of this grandfathering treatment.

Section 7 of the Federal Home Loan Bank Act allows the FHLBanks to determine the terms and conditions under which an FHLBank may indemnify its directors, officers, employees or agents.[29] In this regard, similar to other FHLBanks and as is widespread among corporations in general, the Bank currently operates under an indemnification bylaw.[30] It is well recognized that persons who are covered by contractual indemnification bylaws have legally enforceable rights to indemnification and advancement that arise directly from those bylaws.[31] The bylaw provides, among other things, that the right to be indemnified or advanced expenses under the bylaw is a contract right based upon good and valuable consideration, pursuant to which the person entitled thereto may bring suit as if the provisions thereof were set forth in a separate written contract between the person and the Bank.[32] The Bank has not entered into separate indemnification agreements with its directors, officers or employees.

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27 74 Fed. Reg. at 30976.

28 Id.

29 12 U.S.C. § 1427(k).

30 "Probably the most common type of provision found in charter and bylaw documents is one which converts the permissive provisions of a state statute into a mandatory right which is automatically available to corporate officers, directors . . . " Berger and Kaufman, Director and Officer Liability, § 9.6.

31 *See e.g., Underbrink v. Warrior Energy Services Corp.*, Civ. Action No. 2982-VCP, 2008 Del. Ch. LEXIS 65 (Del. Ch. May 30, 2008) (holding that two former directors of a company were entitled to advancement of expenses under the terms of the company's bylaws); *Sassano v. CIBC World Markets Corp.*, 948 A.2d 453 (Del. Ch. 2008) (granting a former employee's claims for indemnification and advancement pursuant to the company's bylaws).

32 *See Advanced Mining Systems, Inc.* v *Lutin*, 623 A.2d 82, 83 (Del. Ch. 1992) (While permissive authority to indemnify may be exercised by a corporation's board of directors on a case-by-case basis, in fact most corporations and virtually all public corporations have by bylaw exercised the authority

The FHFA should clarify the final rule so that an indemnification bylaw provision that is expressly contractual in nature will be treated as an "agreement" for grandfathering purposes. If notwithstanding the foregoing, the FHFA determines that a contractual bylaw does not constitute an "agreement," the Bank requests that the final rule contain a 60-day delay of the effective date so that FHLBanks will have a reasonable opportunity to execute separate indemnification agreements that will be treated as grandfathered agreements.

In addition, the final rule should also confirm that any person who is covered (either by virtue of current or past service to an FHLBank) by an existing contractual indemnification bylaw provision will not be subject to any new restrictions on indemnification payments contained in the final rule that did not exist prior to the effective date of the final rule.[33] In this regard, modifications to an existing contractual bylaw should not affect the availability of grandfathering treatment. In contrast, an individual whose coverage under a contractual indemnification bylaw or a separate indemnification agreement that begins on or after the effective date of the final rule will be subject to any new limitations imposed under the final rule.

I. <u>Request for Regulation Regarding Law Applicable to Corporate Governance and Indemnification</u>

In connection with the FHFA's consideration of certain indemnification limitations on regulated entities under section 1114 of HERA, we note that currently there is a divergence between the regulations governing indemnification by the Enterprises, as compared to the FHLBanks. In 2002, the Office of Federal Housing Enterprise Oversight ("OFHEO") issued a rule addressing the corporate governance of the Enterprises ("Enterprises Corporate Governance Rule"). This rule required each Enterprise to designate a body of law that it would use for corporate governance practices and procedures: (i) the law of the jurisdiction in which the principal office of the Enterprise is located, (ii) the Delaware General Corporation Law, or (iii) the Revised Model Business Corporation Act ("RMBCA").[34] OFHEO stated that the Enterprises

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recognized by Section 145 of the Delaware General Corporation Law in their bylaws so as to mandate the extension of indemnification rights in circumstances in which such indemnification would be permissible under Section 145).

33 We note that 12 C.F.R. § 908.6(i) currently provides that an FHLBank shall not reimburse, indemnify or otherwise compensate directly or indirectly any executive officer or director for a third-tier civil money penalty imposed under the pre-HERA version of 12 U.S.C. § 4636. Thus, an individual subject to a grandfathered FHLBank contractual indemnification bylaw or a separate indemnification agreement would be permitted to receive indemnification of a first or second- tier civil money penalty under 12 U.S.C. § 4636(b)(1)-(2) and would not be subject to any limitation on advancement or ultimate indemnification of legal or other expenses or judgments incurred in connection with an administrative proceeding or civil action brought by the FHFA.

34 12 C.F.R. § 1710.10. A similar rule has been adopted by the Office of the Comptroller of the Currency with respect to national banks and by the Office of Thrift Supervision with respect to federal

were authorized to operate under the indemnification requirements set forth by the elected body of state law or the RMBCA.[35]

The regulations issued by the Federal Housing Finance Board do not contain any provision addressing the law applicable to the corporate governance procedures or indemnification for the FHLBanks. Accordingly, we request that the FHFA promulgate a regulation applicable to the FHLBanks to allow them to select an applicable body of law for purposes of corporate governance practices and procedures, and indemnification consistent with the Enterprises Corporate Governance Rule.

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If you have questions or need clarification with respect to these comments, please feel free to contact Mary Jane Brown, Senior Vice President at (312) 565-5744.

On behalf of the Bank, we appreciate your consideration of these comments.

Sincerely,

P. David Kuhl

P. David Kuhl
Chairman of the Board

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savings institutions. 12 C.F.R. § 7.200 (OCC); 12 C.F.R. § 552.5(b)(3) (OTS). The rules provides that the corporate governance practices and procedures of each Enterprise shall comply with applicable federal law and regulations and shall be consistent with safe and sound operations. The rule further provides that to the extent not inconsistent with the preceding sentence, each Enterprise is to select the practices and procedures of one of the three identified bodies of law.

35 67 Fed. Reg. 38361, 38369 (2002).