FHLBank
San Francisco

**Dean Schultz**
President and
Chief Executive Officer

July 29, 2009

VIA EMAIL TO REGCOMMENTS@FHFA.GOV AND FEDERAL EXPRESS

Alfred M. Pollard, Esq.
General Counsel
Federal Housing Finance Agency
1700 G Street, N.W., Fourth Floor
Washington, D.C. 20552
Attention: Comments/RIN 2590-AA08

Re: Proposed Rule on Golden Parachute and Indemnification Payments

Dear Mr. Pollard:

The Federal Home Loan Bank of San Francisco ("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.

### A. Provide Guidance and Clarification on Certain Timing Issues

The Proposal does not clearly address a number of important 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

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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. 54673 (Sept. 23, 2008).

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. 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

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) 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. 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"):

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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)(1)(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 becomes 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).

[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.

> 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]

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 the payments to whom are not connected with an employee relationship with an FHLBank.

### D. Modification of Definition of Nondiscriminatory Severance Pay Plan or Arrangement

First, 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. The definition of the term "nondiscriminatory" in proposed section 1231.2 provides that a nondiscriminatory plan or arrangement 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 each generally employ fewer than 400 individuals—and most employ fewer than 300. We believe that some FHLBanks have plans that make reasonable distinction among groups of employees that would not comport with the provision of the proposed definition of "nondiscriminatory." Accordingly, we suggest that the 33% threshold in the Proposal be reduced to 20% and the "1000 employees" be reduced to 50 employees. In addition, the FHFA should expressly clarify that the objective criteria can include pay levels or responsibility levels as well as service including service for other employers in similar businesses.

Second, for the purposes of determining what a nondiscriminatory severance plan is, the definition of nondiscriminatory contains the following limitation, "(with a variance in severance benefits relating to any criterion of plus or minus ten percent)." It is unclear how that rule would be applied. Does the rule require that the actual severance benefits payable (*i.e.*, the cash payment) to two different groups of employees be within 10%? If the rule requires that the actual dollar amount can only vary by 10%, then one group of employees must be paid a flat dollar amount and another group of employees can be paid that amount plus or minus 10%. Most severance plans are not written in that manner. Rather, in most industries, severance benefits are paid based on compensation times years of service and often take into account variables such as job classifications and officer status. A 10% variance would not permit a severance benefit formula based on compensation and years of service nor would it provide meaningful

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[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).

[8] 12 C.F.R. § 359.1(j).

flexibility for severance pay plans. We believe that the other restrictions placed on the severance pay plans—*i.e.*, the number of employees to be covered (as described in the preceding paragraph) and that no employee can receive a benefit in excess of 12 months base salary—are appropriate safeguards to ensure that excessive severance benefits are not paid by the FHLBanks. Accordingly, we request that the following language in the definition of "nondiscriminatory" be removed, "(with a variance in severance benefits relating to any criterion of plus or minus ten percent)."

Lastly, for the purposes of determining what constitutes a nondiscriminatory severance pay plan, the Proposal states, in relevant part, "no employee shall receive any such payment which exceeds the base compensation paid to such employee during the 12 months....immediately preceding the 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 employee's base salary in anticipation of termination of employment.

### E. Provide for Exclusion of Certain Payments in Connection With Negotiated Terminations of Employment

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 6 months preceding a negotiated termination of his or her employment or 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 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.

### F. Clarify that Unused Leave is Not a "Golden Parachute Payment"

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.

### G. Qualification of Certain Bank Plans Under the Definition of Bona Fide Deferred Compensation Plan or Arrangement

The definition of "bona fide deferred compensation plan" should be amended to take into account the differences in the treatment of accrued benefits under GAAP and the actual accrual and payment of benefits based on actuarial assumptions and valuations. The rule should also take into account ordinary plan expenses where assets are segregated in trust.

The definition currently permits payments from plans that segregate or otherwise set aside "assets in a trust which may only be used to pay plan and other benefits." Paragraphs (1)(ii) and 3(vi) of the definition in proposed section 1231.2 should be amended to include "and related expenses" after "benefits." This accounts for the fact that rabbi trusts often pay certain expenses.

To address issues associated with timing differences in the treatment of accrued benefits under GAAP and to ensure that benefit payments are not unfairly reduced due to these differences, the following language should be added to paragraphs 1(i) and 3(vi) of the definition after "GAAP":

> "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"

To address issues related to payment calculation differences associated with the timing issues and with variations in assumptions about methods of payment and discount rates under GAAP, the following language should be added to the end of paragraph 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. For purposes of this paragraph 3(vii), variations between (i) the actual benefit payable under the relevant plans and (ii) the liability computed in accordance with GAAP, that are attributable to differences between the actuarial assumptions and interest rates prescribed under the relevant plans and those used for GAAP purposes, shall be ignored."

## H. 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 or regulatory compliance, such as Code Section 409A, should be disregarded in determining whether a plan provision has been in effect for one year."

Under paragraph 3(vi) of the definition of bona fide deferred compensation plan, one of the requirements to qualify for an exclusion from treatment as a golden parachute payment is that assets are "otherwise set aside in a trust which may only be used to pay plan benefits, except that such assets...." Most trusts contain a provision that the assets of the trust may also be used to pay reasonable administration expenses. Accordingly, we propose that the rule be amended to add "and related expenses" after the words "plan benefits."

## I. 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.

### J. 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 relevant remediation efforts.

### K. 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 is proposed to be permissible under section 1318(e) of the Safety and Soundness Act (12 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 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. The Bank filed comments in regard to that proposal, and we provide our additional comments on the indemnification portions of the Proposal below.

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9 Manual April 2007 at 5ROE.1.15.

10 74 Fed. Reg. at 30976.

11 Id.

12 73 Fed. Reg. 67426.

### 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 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. Clarify the Scope of Proposed Section 1231.4

Proposed section 1231.4 should be clarified so that its procedural requirements apply to direct payments by the regulated entity to the entity-affiliated party, but not to payments by an insurance company to an entity-affiliated party for: (i) advancement of legal or professional expenses; or (ii) reimbursement of any restitution paid by the entity-affiliated party to the regulated entity. The Bank believes such a clarification is consistent with paragraph (2)(i) of proposed section 1231.2 which allows certain insurance policies to be purchased by the Bank.

### C. 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 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 exculpates 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.

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

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

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 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 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 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); 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.

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

On the basis of sound public policy and other considerations of fairness, 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.

### E. 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).

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

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[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).

manner that the Individual reasonably believed to be in the best interests of the regulated entity,[16] and (b) making such payments would not materially adversely affect the safety and soundness of the regulated entity.[17] 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.[18]

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.[19]

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.[20] 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.

### F. Commencement of an Administrative Action

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

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16 Proposed section 1231.4(c)(1)(i).

17 Proposed section 1231.4(c)(1)(ii).

18 Proposed section 1231.4(c)(2).

19 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.

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

action has been instituted by the FHFA "through issuance of a notice of charges under regulations issued by the Director."[21] 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."[22]

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.[23]

### G. 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)."[24] 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)."[25]

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 final rule should confirm that any person who is covered (either by virtue of current or past service to an FHLBank) by an existing separate indemnification agreement, 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.[26] In this regard, modifications to an existing indemnification agreement should not affect the availability of grandfathering treatment. In contrast, an individual whose coverage under 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.

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21 73 Fed. Reg. at 67426.

22 61 Fed. Reg. at 5930.

23 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.

24 74 Fed. Reg. at 30976.

25 Id.

26 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.

### H. Request for Regulation Regarding Law Applicable to Corporate Governance and Indemnification

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").[27] OFHEO stated that the Enterprises were authorized to operate under the indemnification requirements set forth by the elected body of state law or the RMBCA.[28]

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. The Bank believes that a choice of law pertaining to the Bank's internal governance matters is an important and complicated decision. Accordingly, we request that the FHFA consider initiating a notice and comment process to promulgate a regulation applicable to the FHLBanks that would allow establish a process for determining an appropriate choice of law, which would also reflect the FHLBanks status as cooperatively owned entities without private investors as shareholders. The FHFA could also consider whether to select differing bodies of governing law, or allow the FHLBanks to select different bodies of governing law, with respect to intern corporate governance practices and procedures applicable to a cooperative structure, and indemnification procedures of a corporate board of directors consistent with the final rule.

We appreciate your consideration of these comments.

Sincerely,

Dean Schultz
President and
Chief Executive Officer

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[27] 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 savings institutions. 12 C.F.R. § 7.200 (OCC); 12 C.F.R. § 552.5(b)(3) (OTS). The rule 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.

[28] 67 Fed. Reg. 38361, 38369 (2002).