FHLBANKS
A NATION OF LOCAL LENDERS

May 8, 2014

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Federal Housing Finance Agency
Constitution Center, Eighth Floor
400 7th Street SW
Washington DC 20024

Re: Comments/RIN 2590-AA59; Responsibilities of Boards of Directors, Corporate Practices and Corporate Governance Matters

Dear Mr. Pollard:

On behalf of the undersigned Federal Home Loan Banks (each an "FHLBank" and collectively the "FHLBanks" or "FHLBank System") we appreciate this opportunity to comment on the Federal Housing Finance Agency's (the "FHFA") proposed rule on Responsibilities of Boards of Directors, Corporate Practices and Corporate Governance Matters (the "Proposed Rule"). We respectfully submit the following comments for your consideration.

Designation of Sections of Law as Model for Board of Director Governance

The FHLBanks are concerned that the Proposed Rule could create potential ambiguity and confusion in Section 1239.3 by using the term "corporate governance" practices and procedures. In its broadest sense, the term "corporate governance" is concerned with the allocation of power and obligations among shareholders, directors and officers of a corporation.[1] By using the term "corporate governance," the FHFA raises uncertainty as to whether it intends to delegate the issue of defining shareholder rights, and obligations, to state courts and legislatures.

To avoid possible confusion, the FHLBanks suggest the FHFA adopt a narrower term, such as "board of director governance," to make clear that this section of the regulation addresses only internal board organization and authorities, and not other governance topics such as shareholder rights and responsibilities. Moreover, the FHLBanks suggest that they not be required to "elect to follow" a choice of law encompassing all potential provisions of the body of law that they reference, but instead be permitted to adopt a framework in which particular internal board

[1] Arthur Pinto, "An Overview of United States Corporate Governance in Publicly Traded Corporations," 58 Am. J. Comp. L. 257, 266 (2010).

governance matters in the FHLBanks' bylaws can be modeled after specific state law provisions without implying that the FHLBanks are bound by state law.

The FHLBanks recognize that the Proposed Rule mirrors the existing provision that is already applicable to the enterprises. However, the Federal Home Loan Bank Act ("FHLBank Act") creates a system that is compellingly different from that applicable to the enterprises, and warrants its own separate treatment.[2] The FHLBank Act established the FHLBanks as cooperatives, and gave members the enumerated powers to nominate and vote for directors, the right to apply for advances, and the right to receive dividends.[3] The court in *Fahey*[4] stated that the rights of FHLBank shareholders were limited to those powers specified in the FHLBank Act. Over the years, Congress has expanded the express rights in the FHLBank Act in some specific instances, for example giving Class B shareholders ownership of retained earnings,[5] and giving shareholders the right to vote on voluntary mergers.[6] But nothing has been done to cast doubt on the primacy of the FHLBank Act and regulations promulgated thereunder as the sole source of law governing the corporate affairs of the FHLBanks. As a result, the FHLBanks request that the Proposed Rule be modified to reduce the possible implication that the FHLBanks are being made subject to state law, and the potential uncertainty that might result from that implication.[7]

In addition, the FHLBanks request that the regulation expressly state that it is not creating additional rights in third parties. Other regulations governing the FHLBank System have expressly disclaimed that rights were being created for third parties. For example, see Duties of the OF Board. 12 C.F.R. § 1273.8(e) (stating "Nothing in this part shall create or be deemed to create any rights in any third party."). With other rules, the regulatory intent with respect to third-party rights was expressly set forth in the preamble to the regulation. For example, see Financial Disclosure by FHLBanks. 63 Fed. Reg. 39702 (July 24, 1998) (stating "Nothing in the proposed rule was intended to subject the Banks to the jurisdiction of any other agency, nor to confer any private right of action on any member or on any investor in Bank system securities."). Given the importance of this matter, the FHLBanks believe the FHFA should expressly affirm that the regulation does not create additional rights in third parties in the text of the regulation itself.

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[2] See 12 U.S.C. 4513(f)

[3] Act of July 22, 1932, Ch. 522, 47 Stat. 725, codified at 12 U.S.C. § 1421 *et seq.*

[4] *Fahey v. O'Melveny & Myers* 200 F.2d 420, 466-467 (9th Cir. 1952), *cert. denied,* 345 U.S. 952 (1953)

[5] 12 U.S.C. § 1426(h).

[6] 12 U.S.C. § 1446(b).

[7] The FHLBanks also note that, as opposed to large national banks and federal stock associations (which each have a similar regulation that gives them the permission, but not the requirement, to adopt such a corporate governance framework, see 12 C.F.R. § 7.2000 and 12 C.F.R. § 152.5(b)(3)), there is no holding company structure in the Federal Home Loan Bank System. These governance regulations as applied to large federal depository institutions raise no similar significant issues of uncertainty about shareholders because they have only one shareholder: their holding company. Those regulations only raise potential shareholder issues for small community banking organizations that avoid the expense of a holding company structure and operate as stand-alone depositories. The complexities faced by the FHLBanks in their governance go beyond those of small community banking organizations, and the rules are thus not readily transferrable without modification.

To implement the foregoing comments, the FHLBanks propose that a separate section of the regulation for the FHLBanks be adopted for the board of directors' governance procedures (principally bylaws), apart from the corporate governance provisions applicable to the enterprises, as set forth below:

(a) General. The board of directors' governance procedures for a Bank shall comply with the Bank Act, the Federal Housing Enterprises Safety and Soundness Act of 1992 as amended, federal regulations promulgated thereunder, and safe and sound banking practices.
(b) Other Sources of Guidance. To the extent not inconsistent with the Bank Act, the Federal Housing Enterprises Safety and Soundness Act of 1992 as amended, federal regulations promulgated thereunder, and safe and sound banking practices, a Bank may adopt board of directors governance procedures modeled after specific provisions of corporate law of the state in which the headquarters of the Bank is located, the Delaware General Corporation Law, Del. Code Ann. tit. 8 (as amended from time to time), or the Model Business Corporation Act (as amended from time to time). If a Bank elects to adopt board of directors governance procedures in the manner set forth in the preceding sentence, it may reference the specific sections of applicable law upon which a particular governance procedure is modeled. The reference to specific sections of applicable law is not intended to bind a Bank, or its directors and officers, to any of the other provisions of such state law.
(c) No Private Right of Action. This section shall not be interpreted to enlarge, or diminish, the rights of any member of a Bank with respect to its status as a shareholder in the Bank beyond those rights and privileges expressly recognized in the Bank Act, the Federal Housing Enterprises Safety and Soundness Act of 1992 as amended, and rules and regulations as previously adopted by the FHFA (or its predecessor). Nothing in this section is intended to subject the Banks to the jurisdiction of any other federal agency, state agency or instrumentality, or to confer any private right of action on any Bank member or on any holder of Bank stock.

Indemnification

The FHLBanks believe that the existing statutory clarity of the indemnification provision in 12 U.S.C. § 1427(k) should not be clouded by combining its governing regulation in this area with the regulations governing the enterprises. The FHLBanks believe the indemnification provision for the FHLBanks should be based on the statutory framework, which gives broad authority to boards of directors with respect to indemnification. To accomplish this, the FHLBanks propose the following indemnification provision:

(a) Indemnification. The board of directors of each Bank shall determine the terms and conditions under which such Bank may indemnify its directors, officers, employees or agents. A Bank may adopt board of directors' policy for making indemnification determinations and implementing indemnification payments. In doing so, a Bank may review the applicable provisions of the corporate law of the state in which the headquarters of the Bank is located, the Delaware General Corporation Law, Del. Code

Ann. tit. 8 (as amended from time to time), or the Model Business Corporation Act (as amended from time to time).

(b) A Bank is authorized to maintain insurance for its directors and any other officer or employee.

(c) Nothing in this section shall require a Bank to modify its existing indemnification terms and conditions, nor affect any rights to indemnification (including the advancement of expenses) that a director or any other officer, employee or agent has with respect to any actions, omissions, transactions, or facts occurring prior to the effective date of this paragraph.

(d) FHFA Authority. This section shall not be deemed to diminish the FHFA's authority under the Safety and Soundness Act to limit or prohibit indemnification payments in furtherance of the safe and sound operations of a Bank when an administrative proceeding or civil action is instituted by the FHFA resulting in a final order.

If there is one power Congress clearly and unequivocally reserved to the board of directors of the FHLBanks, it is the board's power to determine the terms and conditions under which an FHLBank may indemnify its personnel. 12 U.S.C. § 1427(k) ("The board of directors of each Bank shall determine the terms and conditions under which such Bank may indemnify its directors, officers, employees or agents.") This provision was added to the FHLBank Act by the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (Pub. L. No. 101-73, § 707 (Aug. 9, 1989) ("FIRREA")) and required the successor to the Federal Home Loan Bank Board ("FHLBB") to repeal a regulation of limitation which had constrained the boards of directors of the FHLBanks by imposing substantive standards on indemnification, and allowing the FHLBB 30 days to object to any indemnification of FHLBank personnel. 12 C.F.R. § 522.72(c) (adopted 53 Fed. Reg. 52653 (Dec. 29, 1988)).

As required by FIRREA, the indemnity regulation was repealed in 1990. *See* 55 Fed. Reg. 1393 (Jan. 16, 1990) ("Another change mandated by FIRREA is repeal of the indemnity regulation. The board of directors of each Bank will now determine the terms and conditions under which the Bank may indemnify its directors, officers, employees, or agents.").[8] Neither the Fannie Mae Charter Act nor the Freddie Mac Charter Act contains any provision addressing indemnification. These important differences between the statutory scheme applicable to the FHLBanks and the statutes applicable to the enterprises should be considered and addressed by the FHFA in fashioning the final rule.

The FHFA should also take into account that corporations chartered under state law, such as bank holding companies, have other methods beyond indemnification to protect directors from litigation risk that offer broader protection than indemnification. The Model Act permits certain exculpatory provisions to be included in the articles of incorporation eliminating director's liability for monetary damages to the corporation or its shareholders, with certain exceptions.

[8] Before it was repealed in 1990, the regulation had been re-codified in 1989 at 12 C.F.R. § 932.42. 54 Fed.Reg. 36757 (Sept. 5, 1989).

Rev. Mod. Bus. Corp. Act § 2.04(b)(4) Delaware law also contains a similar provision, and bank holding companies have asserted it as a defense in shareholder derivative actions.[9]

In addition to the regulatory language above defining the power of the FHLBanks to grant indemnification, the FHLBanks urge the FHFA to clarify in regulatory text the standards it will use when exercising its supervisory powers with respect to indemnification payments. The FHLBanks believe the FHFA should provide greater specificity on what factors it will consider in exercising its judgment as a safety and soundness regulator to limit or prohibit indemnification payments, pursuant to an "administrative proceeding or civil action instituted by the Agency which results in a final order,"[10] beginning with the factors specified at 12 U.S.C. § 4518(e)(2) and (3) such as the following:

- Did the person commit fraud, insider abuse, a breach of fiduciary duty, or a violation of law in a manner that had a material effect on the financial condition of the FHLBank;
- Was the person substantially responsible for the insolvency of the FHLBank; and
- Is the proposed payment made in contemplation of the insolvency of the FHLBank, and as a means of preferring one creditor over another.

While a safety and soundness regulator must retain some flexibility for future action, articulating specific standards has not, for example, unreasonably interfered with the federal banking agencies' ability to impose civil money penalties. The FHLBanks are very concerned about a chilling effect on the FHLBanks' ability to attract and retain directors, especially non-member independent directors, if prospective and current directors had to consider that their right to indemnification might be voided, even where their actions comported to a generally accepted standard of reasonableness. If an FHLBank adopts a reasonable indemnification plan for directors, for example, one modeled after Rev. Mod. Bus. Corp. Act §§ 8.51 and 8.52, directors should be assured that behavior that conforms to such plan will not result in the FHFA using its safety and soundness powers to void a payment made pursuant to such plan.

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[9] E.g., *In Re Citigroup Inc.*, 964 A.2d 106, 124 (Del. Ch. 2009) ("Additionally, Citigroup has adopted a provision in its certificate of incorporation pursuant to 8 *Del. C.* § 102(b)(7) that exculpates directors from personal liability for violations of fiduciary duty, except for, among other things, breaches of the duty of loyalty or actions or omissions not in good faith or that involve intentional misconduct or a knowing violation of law."). If the Finance Agency is basing its rule on the rules applicable to large, complex banking organizations, it also should consider the application of those rules in light of the other practices such organizations have to protect directors at those banking organization.

[10] See 12 U.S.C. 4518(e)(5)(A), which applies only to administrative proceedings of civil actions brought by the Agency directly.

The Proposed Rule is Overly Prescriptive on Structure and Governance

In the sections of the proposed rule pertaining to Board Committees (§ 1239.5), Risk Management (§ 1239.11), and the Compliance Program (§ 1239.12), the FHFA has proposed a prescriptive detailed rule approach to these important elements of governance and practices. The preamble to the Proposed Rule specifically invited comment on whether a principles-based approach would be a more appropriate means of addressing the underlying subject matter of the Proposed Rule. It is the view of the FHLBanks that a principles-based approach would provide a more effective and more efficient means of addressing the underlying safety and soundness concerns related to the committee structure of the board of directors, risk management practices and compliance program addressed in the sections cited above.

We also note that, unlike in compliance program requirements (§ 1239.12(a)) and audit program requirements (§ 1239.33(e)(2)), the FHFA has omitted the phrase "reasonably designed" in the risk management section, and believe that it should be inserted into section 1239.11(a) (1) as follows: "an enterprise risk management program that is reasonably designed to establish the regulated entity's risk profile."

Mandatory Committees

The Proposed Rule requires that each FHLBank establish a committee of the board of directors with responsibility for risk management, audit, compensation and corporate governance.[11] It is also directed that the risk management committee and audit committee "shall not be combined with any other committee."[12] The Proposed Rule invites comments with respect to a requirement that executive committees be mandatory. While individual FHLBanks may find utility in establishing executive committees, or authorizing an emergency committee that can act during a natural or other emergency, the FHLBanks find no need to require the formation of such committees.[13] Additionally, the FHLBanks would like the flexibility to combine the risk committee with other committees if the Board believes that doing so would be best for the organization. The FHLBanks believe that each FHLBank's board of directors should have the responsibility for designing its governance structure to take into account the different structures and risks at each FHLBank.

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[11] 79 Fed.Reg. 4414, 4425 (Jan. 28, 2014)(to be codified at 12 C.F.R. § 1239.5(b)).

[12] Id. For the risk committee, this requirement is essentially the same as the rule the Federal Reserve has adopted for the largest most complex banking organizations, which requires for those organizations, the risk committee has oversight of risk policies and "global risk management framework" as its "sole and exclusive function." 79 Fed.Reg. 17240, 17318 (Mar. 27, 2014) (to be codified at 12 C.F.R. § 252.33(a)(3)(ii)).

[13] To the extent the final regulation mandates that each committee of the board of directors have a charter, the FHLBanks suggest the language be modified to require charters only of permanent standing committees, not ad hoc committees formed by a board of directors, from time to time, to deal with specific issues.

Risk Management Structure Should Reflect Changes Made from Federal Reserve Proposed Rule to Final Rule

The Proposed Rule provides that (i) one member of the risk committee must have "risk management expertise" commensurate with the Bank's risk related factors, and (ii) members must have risk managerial experience with "practices and procedures."[14] The committee is directed to exercise oversight over "enterprise-wide risk management practices."[15] The Proposed Rule draws heavily from proposed regulations[16] promulgated pursuant to the Dodd-Frank mandate[17] to adopt enhanced supervision and prudential standards for financial institutions that are part of large and complex bank holding companies, including the establishment of risk management committees for covered institutions.[18] However, in the final rule applicable to complex banking organizations, we note that the Federal Reserve has eliminated the excessive "document, review and approve" risk practices formulation of its proposed rule and replaced it with "approves and periodically reviews the risk-management policies of the bank holding company's global operations and oversees the operation of the bank holding company's global risk-management framework."[19] The FHFA should reconsider its proposed rule in light of the changes made by the Federal Reserve to its final rule that replaced references to risk management "practices" with references to risk management "policies" and a risk management "framework".

Inappropriate Designation of Managerial Tasks to Board and Board Committees

The Proposed Rule improperly blurs the line between managerial functions and board of director functions, for example, by requiring directors to be responsible for FHLBank "procedures,"[20] requiring that the risk committee document practices of an FHLBank,[21] and requiring that the risk committee exercise oversight of "practices."[22] The Proposed Rule also essentially requires that risk committee members have risk management experience and existing background in risk

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[14] 79 Fed.Reg. 4414, 4425 (Jan. 28, 2014)(to be codified at 12 C.F.R. § 1239.11(c)(2)).
[15] 79 Fed.Reg. 4414, 4425 (Jan. 28, 2014)(to be codified at 12 C.F.R. § 1239.11(b)).
[16] E.g., 77 Fed.Reg. 594, 656 (Jan. 5, 2012) (proposed rule applicable to certain domestic institutions)(to be codified at 12 C.F.F. § 252.126). The risk management proposals of the Federal Reserve drew heavily upon the findings of the Senior Supervisory Group that during the financial crisis, the business line, treasury function and senior risk managers did not function in a coordinated manner on an enterprise wide basis. Id. at 622.
[17] Pub. L. No. 111-203 (July 10, 2010) §§ 165(b)(1)(A) and 165(h). Section 165(b)(1)(A) of the Dodd-Frank Act required the Federal Reserve to adopt enhanced risk-management standards for bank holding companies with total consolidated assets of $ 50 billion or more, and section 165(h) of the Dodd-Frank Act required the Federal Reserve to adopt regulations requiring publicly traded bank holding companies with total consolidated assets of $ 10 billion or more to establish risk committees.
[18] 77 Fed.Reg. 594, 656 (Jan. 5, 2012) (proposed rule applicable to certain domestic institutions) (to be codified at 12 C.F.R. § 252.126).
[19] 79 Fed.Reg. 17240, 17318 (Mar. 27, 2014) (to be codified at 12 C.F.R. § 252.33(a)).
[20] Proposed 12 C.F.R. § 1239.4(c).
[21] Proposed 12 C.F.R. § 1239.11(d)(1).
[22] Proposed 12 C.F.R. § 1239.11(b).

management.[23] The FHLBanks request that the FHFA give appropriate consideration to the factors imposed by the FHLBank Act and regulatory requirements for directors (eligibility criteria of member and independent directors, exclusion of FHLBank officers from eligibility, nominating, voting, and campaigning restrictions), and the manner in which those factors vastly reduce the ability of an FHLBank to sculpt the skill sets of its directorship compared to a large publicly traded bank holding company chartered under state law. The FHLBanks are concerned that the language of proposed 12 C.F.R. §1239.11(c)(2) could be broadly read to apply to all directors on that Committee, rather than having a single director with the *experience* mandated by the Federal Reserve's final rule on Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations.[24] In particular, the FHLBanks believe that the Finance Agency's reference in the preamble[25] to all members of the risk committee having "experience" in the application of risk management practices creates unnecessary uncertainty. At most, the FHLBanks believe that, as with existing 12 C.F.R. § 917.2(b)(3), directors serving on an FHLBank risk committee should be charged with obtaining a working understanding of risk management principles "within a reasonable time" after their appointment to such a committee. It should be noted when the Federal Reserve adopted its final rule, it amended some of the provisions that served as apparent models for the FHFA to make clear that the board of directors (and any committees) operate with *oversight* of management, not in lieu of management, by eliminating references to "practices" and replacing that term with "policies."[26]

The FHLBanks further urge the FHFA to clarify that boards are not responsible for reviewing and approving individual procedures. By changing the introductory section of the Prudential Management and Operations Standards ("PMOS") into one of the PMOS, the FHFA will be creating uncertainty as to whether boards are responsible for reviewing procedures, which we

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[23] Proposed 12 C.F.R. § 129.11(c)(2)(iii) and (iv).

[24] 79 Fed.Reg. 17240, 17249 (Mar. 27, 2014) ("The final rule requires only one member of the committee have experience in identifying, assessing, and managing risk exposure of large, complex firms. However, the Board would expect all risk committee members generally to have an understanding of risk management principles and practices relevant to the company.").

[25] 79 Fed.Reg. 4414, 4418 (Jan. 28, 2014).

[26] "Many commenters asserted that the proposed rule would inappropriately assign managerial and operational responsibilities to the risk committee. . . . In particular, some commenters asserted that the proposed requirement that the risk committee 'document, review, and approve the enterprise-wide risk-management practices of the company' would not be consistent with the proper scope of a committee of the board of directors because it would require the board to assume responsibilities typically performed by management. . . . In light of commenters' concerns, the final rule requires the risk committee to approve and periodically review the enterprise-wide risk-management policies of the company, rather than its risk-management practices." 79 Fed.Reg. 17240, 17247-17248 (Mar. 27, 2014). Id. at 17317 (to be codified at 12 C.F.R. §252.22(a) ("A bank holding company with any class of stock that is publicly traded and total consolidated assets of $10 billion or more must maintain a risk committee that approves and periodically reviews the risk-management *policies* of its global operations and oversees the operation of its global risk-management framework.") (emphasis added). Id. at 17318 (to be codified at 12 C.F.R. § 252.33(a)) ("A bank holding company with total consolidated assets of $50 billion or more must maintain a risk committee that approves and periodically reviews the risk-management *policies* of the bank holding company's global operations and oversees the operation of the bank holding company's global risk-management framework.") (emphasis added).

firmly assert is a management function. In Section 1 of the PMOS introductory section, the PMOS state:

> With respect to the subject matter addressed by each Standard, the board of directors is responsible for adopting business strategies, policies, *and procedures* that are appropriate for the particular subject matter. The board should review all such strategies, policies, *and procedures* . . . ." Appendix to Part 1236, General Responsibilities of the Board of Directors, Section 1.

We recognize that boards have certain oversight responsibilities, which may include instructing management to implement certain procedures, but development, approval, and periodic review of procedures is a squarely management function. The FHFA should make conforming changes in other sections of the PMOS to clarify that Boards are not responsible for "procedures," which reflect management's implementation of policies and tend to include much more detail than is appropriate for board involvement.

CRO and CCO provisions are too prescriptive and inappropriate

The FHLBanks believe that the Proposed Rule is too prescriptive where it requires the CRO to engage in "testing risk controls and verifying risk measures."[27] The CRO should not be responsible for testing the effectiveness of individual controls, nor should the CRO's responsibilities overlap with the role of the auditor. In addition to the text of the Proposed Rule, the FHLBanks find that the language of the preamble invites ambiguity where it states that the CRO's duties should include "managing risk exposures and controls."[28] The FHLBanks believe this potentially could be interpreted as imposing the task of ordering or executing transactions, which is not an appropriate role for the CRO. Similarly, in proposed section 1239.11(e)(3)(i), the CRO should not be responsible for "allocating" delegated risk limits, but rather should be responsible for "monitoring compliance with allocations of delegated risk limits."

In addition, the FHLBanks believe that the Proposed Rule is too prescriptive by requiring a Chief Compliance Officer ("CCO") to oversee the entity's compliance program. The FHLBanks feel that as long as there is clear responsibility for compliance with laws, rules, regulations and internal controls for areas such as legal, operational risk and financial reporting risk, complete oversight of the compliance program does not need to reside solely with a single CCO. Additionally, the FHLBanks do not support establishing a direct reporting requirement to the

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[27] 79 Fed.Reg. 4414, 4426 (Jan. 28, 2014) (to be codified at 12 C.F.R. § 1239.11(e)(3)(iii)).

[28] 79 Fed.Reg. 4414, 4419 (Jan. 28, 2014). The preamble also states that the CRO is "responsible for the risk management function." Id. at 4418. The FHLBanks believe that risk management is the responsibility for all departments within an FHLBank, and the CRO is responsible for monitoring, overseeing and aggregating the measurement of the risks taken by other departments.

chief executive officer from a single CCO.[29] The FHLBanks should have the flexibility to allow for compliance officers to report to other senior executives such as the CRO or the General Counsel.

Audit Committee Issues

The FHLBanks oppose any new audit committee membership requirements that would link a determination of a member director's "independence" to a specified level of capital stock or total advances of the director's member institution.

Pursuant to Section 38 of the Securities Exchange Act of 1934 (1934 Act), the FHLBanks are already subject to a capital stock threshold analysis for determining audit committee independence. Section 38 requires the FHLBanks to comply with rules issued by the Securities and Exchange Commission (SEC) under Section 10A(m) of the 1934 Act.[30] The rules issued by the SEC under Section 10A(m)[31] provide that a member of an audit committee must otherwise be independent and that a member is not independent if, among other things, the member is an "affiliated person";[32] and further provides a safe harbor for persons who are not beneficial owners of more than 10 percent of the voting stock of the company. Any new rule linking independence to a specified level of capital stock would be unnecessary because the FHLBanks are already subject to SOX 301 via Section 10A(m).

With respect to a requirement that would link a determination of a member director's independence to a specified level of total advances, the audit committee independence standard imposed on the FHLBanks' audit committee members under the current Finance Board rule 917.7(c) takes into account the fact that the FHLBanks were created by Congress; an FHLBank has a cooperative ownership structure; an FHLBank is statutorily required to have member directors who are either an officer or director of an FHLBank member; an FHLBank was created to provide its members with products and services; and an FHLBank's board of directors is statutorily required to administer the affairs of the FHLBank fairly and impartially and without discrimination in favor of or against any member borrower. Notably, the Finance Board's independence standards do not include as a disqualifying relationship any business relationships between a director's member institution and the FHLBank. Nothing has changed that would

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[29] 79 Fed.Reg. 4414, 4426 (Jan. 28, 2014) (to be codified at 12 C.F.R. § 1239.12).
[30] Section 10A(m) of the 1934 Act was added by Section 301 of the Sarbanes-Oxley Act of 2002 (SOX).
[31] See Rule 10A-3(b) under the 1934 Act.
[32] Rule 10A-3(e)(1) under the 1934 Act provides in part that a person affiliated with a specified person means a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with the person specified. The rule further provides that a person will be deemed not to be in control of a specified person if the person is not the beneficial owner, directly or indirectly, of more than 10 percent of any class of voting equity securities of the specified person and further states that this "safe harbor" does not create a presumption in any way that a person exceeding the ownership requirement controls or is otherwise an affiliate of the specified person.

warrant imposing a requirement that would link a determination of a member director's independence to a specified level of total advances and such a requirement would run counter to the FHLBanks' cooperative structure and statutory and regulatory scheme.

Rather than to link a determination of a member director's independence to a specified level of total capital stock or advances, the FHLBanks recommend that the Finance Agency regulation governing audit committee independence be revised to include a sentence that recognizes the FHLBanks' cooperative nature and the statutory and regulatory scheme governing the nature of the FHLBanks' capital stock, member advances and director responsibilities (including the responsibility to consider whether there are any material relationships that would impair a director's independent judgment). We suggest that the following sentence be added to the end of Section 1239.33(c): "For purposes of this rule, total capital stock held by and advances made to a member will not be deemed to be a disqualifying relationship."

We believe that rather than imposing a bright line threshold and automatically deeming a director "not independent" based on the mere fact of holding a certain level of capital stock or advances, this addition will enable an FHLBank's board of directors to consider whether the level of capital stock held by or advances made to the member is a material relationship that would impair the director's independent judgment for the purposes of complying with Section 1239.33(c) and other applicable independence rules. This addition is consistent the FHLBanks' cooperative nature and the statutory and regulatory scheme governing the nature of the FHLBanks' capital stock and member advances, and consistent with industry practice around a board of director's responsibility in making independence determinations.

The FHLBanks also oppose any requirement that would require a majority of audit committee members to be non-member directors. The FHLBanks believe that in order to have an effective audit committee, the FHLBanks need to have the flexibility to select the most qualified and skilled candidates, whether they are member or non-member directors.

In addition, the FHLBanks ask that the FHFA consider whether the current audit committee rule requiring a "balancing" of representatives among community financial institutions and other members, and member and independent directors (reflected at proposed 12 C.F.R 1239.33(a)(2)) should be revised to read as follows: "The audit committee shall include, to the extent practicable, a balance of representatives of: (i) community financial institutions and other members; and (ii) independent and member directors of the Bank." The purpose of this proposed adjustment is to provide a Board with flexibility in the event that there are qualified director candidates for audit committee service that might be prevented from service because an exact balance cannot be maintained.

For the same reasons discussed above regarding blurring the lines between management and oversight by the board of directors, the FHLBanks believe the term "procedures" should be stricken from the proposed provisions related to the audit committee's responsibilities in proposed 12 C.F.R. § 1239.33(e)(8).

Internal Controls

The FHFA asks "[w]hat regulatory approach would be best suited for addressing the topic of internal controls at the Banks and Enterprises, one based on general principles, or one that includes detailed requirements that prescribe particular steps that an entity should take in creating and operating a system of internal controls?" We believe that internal controls should be principles based and that the design and implementation will depend on the operations and complexity of the institution. The widely accepted COSO (the Committee of Sponsoring Organizations of the Treadway Commission) framework sets forth the requirements for an effective internal controls including components and relevant principles. The FHLBanks have followed the COSO framework and intend to adopt the most recent update of the framework. Therefore, we believe that the FHFA's regulation around internal controls should be principles based and not prescriptive to avoid any conflicts with the well accepted and established industry framework.

The FHFA asks. "If FHFA were to adopt a more principles-based approach to internal controls, what principles would be necessary to assure that regulated entities would establish and maintain an effective system of internal controls?" We believe COSO has developed a thorough and widely adopted principles-based approach for establishing a sound control environment. The most recent version (2013) of these controls is already becoming part of each FHLBank's Internal Control Framework. This is required as an SEC registrant.

The section on the compliance program should be amended to strike the phrase "internal controls" and replace it with "policies" so that it reads: "to assure that the regulated entity complies with applicable laws, rules, regulations, and policies." Internal controls themselves are designed to achieve compliance with laws, rules, regulations, and policies.

The FHLBanks believe that rather than reporting all control deficiencies to the board of directors and the FHFA, which would include deficiencies that are truly inconsequential, only control deficiencies that rise to the level of significant deficiencies and material weaknesses be reported, which would be consistent with the practice set forth in the SOX 302 certifications. Hence, we suggest that the term "control deficiencies in sections 1239.32(b)(3) and (6) be revised to only include significant deficiencies and material weaknesses in internal controls.

Code of Conduct

As SEC registrants, the FHLBanks are already subject to the requirement to disclose whether or not they have a code of conduct for its principal executive officer, principal financial officer, principal accounting officer or controller (in compliance with SOX 406) and any requirement to do the same is duplicative and unnecessary. Like with most SEC registrants, the FHLBanks all have a code of conduct for these "financial officers" that meets the criteria of SOX 406 and in many cases, the FHLBanks' "SOX 406" code applies to all senior officers. In addition, all FHLBanks have a code of conduct or ethics that apply to all their employees and directors. SOX 406 was intended to address financial fraud and was targeting financial officers and therefore, a broad rule requiring a code of conduct based on the criteria of SOX 406 does not appear warranted for all employees and directors.

Age Limits for Directors

For purposes of clarity, even though the proposed rule only establishes age limits for the service of the board of directors on the enterprises, the FHLBanks desire to state that they would not support a regulatory provision establishing age limits on directors at the FHLBanks, and that any age limits on service by a director should be established on a FHLBank-by-FHLBank basis.

Definitions

The FHLBanks also would like to comment on a number of definitions to be considered for the final rule.

- Credit Risk. The FHLBanks support the adoption of the definition of credit risk in the Proposed Rule in section 1239.2.

- Employee. The definition of "Employee" in section 1239.2 should be clarified to exclude any independent contractor who "works part-time, full-time or temporarily for a regulated entity."

- Material Weakness. The term "material weakness" should be defined in section 1239.2. We note the reference to material weakness in the definition of "Significant Deficiency" in that same section.

- Independent director. The term "independent director" would mean a different concept as applied to the enterprises and the FHLBanks. The use of the term "independent director" in 1239.33(b)(2)(ii) should be defined to clarify that this is based on the FHLBank Act usage, and that these are non-member directors.

Conclusion

The FHLBanks greatly appreciate the opportunity to comment on the Proposed Rule.

Sincerely,

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