FHLB Chicago

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January 12, 2015

VIA ELECTRONIC DELIVERY

Alfred M. Pollard, General Counsel
Attention: Comments/RIN 2590–AA39
Federal Housing Finance Agency
400 Seventh Street SW, Eighth Floor
Washington, D.C. 20024

Re: Notice of Proposed Rulemaking and Request for Comments—Members of Federal Home Loan Banks (RIN 2590-AA39)

Dear Mr. Pollard:

This comment letter responds to the Federal Housing Finance Agency's ("FHFA's" or the "Agency's") notice of proposed rulemaking ("NPRM") regarding Federal Home Loan Bank ("FHLB") membership, published on September 12, 2014. 79 Fed. Reg. 54848 (Sept. 12, 2014). The Federal Home Loan Bank of Chicago ("Bank") thanks the Agency for the opportunity to comment on its proposed rule. The NPRM proposes, *inter alia*, to create an entirely new membership location rule for insurance company applicants by revising the regulation's treatment of an applicant's principal place of business ("PPOB").[1] This comment letter responds specifically to the Agency's request for comments regarding an insurance company's PPOB[2] and sets out several enhancements to the NPRM's proposed rules.

The Federal Home Loan Bank Act ("FHLB Act"), 12 U.S.C. § 1424(b) (2012), states that the location of a member's PPOB determines the FHLB in which it may be a member. Since 1987, the term "principal place of business" had been defined in the membership regulation as the state where an institution "maintains its home office established as such in conformity with the laws under which the institution is organized." 12 C.F.R. § 1263.18(b) (the "home office test").

In 2012, the FHFA issued a regulatory interpretation indicating that sole reliance on an insurance company member's or applicant's state of domicile was insufficient when determining the appropriate district according to its "principal place of business." FHFA 2012-RI-02, 1 (Apr. 3, 2012) ("2012-RI"). However, the 2012-RI did not provide the FHLBs with a clear alternative test for determining an insurance company's PPOB. The tests proposed in the NPRM are an improvement on the 2012-RI and the Bank believes that, if amended as proposed herein, would provide a clear, simple, and easily applied PPOB rule.

[1] The NPRM notes that the amendments to the principal place of business regulation would apply prospectively and thus would not affect any existing FHLB members. NPRM at 54865.

[2] *See id.* at 54865–66.

Under the NPRM, an insurance company would be subject to one of three PPOB tests. Insurance company applicants would first be subject to the revised "general requirements" for establishing PPOB (the "revised home office test"). The applicant's district would be determined by "the state in which the institution maintains its home office established as such in conformity with the laws under which the institution is organized *and from which the institution conducts business operations*." NPRM at 54865 (emphasis added).[3]

Second, if an insurance company applicant does not have an actual "home office" established under the laws of its chartering statute, or it has such a ''home office'' but does not conduct business operations from that location, or it cannot satisfy the three-part test of 12 C.F.R. § 1263.19(c), the FHLB must "designate as the principal place of business the geographic location from which the entity *actually conducts the predominant portion of its business activities*." *Id.* (emphasis added) (the proposed "alternative test"). In doing so, the FHLB must assess the totality of the circumstances and objective factors, including: (1) the location from which the institution's senior officers direct, control, and coordinate its activities or (2) the locations from which the institution conducts its business. *Id.*

Third, for insurance company applicants that do not have any operations of their own, the NPRM proposes to designate the applicant's state of domicile as its PPOB.[4]

The FHFA states generally that the basis for the NPRM's approach to the PPOB tests is to ensure that an institution does not have its PPOB for FHLB Act purposes at a particular location where it does not actually conduct at least some business operations NPRM at 54865. The FHFA has taken the position that the interpretation set forth in the NPRM is supported by the reasoning set out in the Supreme Court's interpretation of "principal place of business" for diversity jurisdiction in *Hertz Corp. v. Friend*.[5]

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[3] See id. at 54865 ("Accordingly, the Banks would use [the proposed alternative test] only if an institution does not have an actual 'home office' established under the laws of its chartering statute, or it has such a 'home office' but does not conduct business operations from that location, or it cannot satisfy the three-part test of proposed §1263.19(c) for designating its principal place of business.") The 3-part test at 1263.19 (c) requires that all of the following criteria are met:

(i) At least 80 percent of the institution's accounting books, records, and ledgers are maintained, located, or held in such designated state;
(ii) A majority of meetings of the institution's board of directors and constituent committees are conducted in such designated state; and
(iii) A majority of the institution's five highest paid officers has its place of employment located in such designated state.

[4] Possible scenarios include if the insurance company maintains no physical offices of its own and has no employees of its own, which may occur if the company contracts out the actual operation of the insurance business to affiliated companies or to third parties, or if its senior officers are located at multiple locations in different states.

[5] 130 S. Ct. 1181 (2010). "FHFA believes that it should construe the Bank Act's reference to a member's 'principal place of business' in a similar manner to the way that the Supreme Court has construed that term." NPRM at 54866.

The Bank submits that a gap remains between the rules proposed in the NPRM and the three key elements needed in a membership location rule for insurance company members of the FHLBs. These key elements are: (1) the centrality of an insurance company's state of domicile, (2) safety and soundness principles that call for effective relationships between FHLBs and state Departments of Insurance, and (3) the need for the rule to be clear, simple, and predictable. If a change to the "home office test" is to be made, the Bank believes that any new test should be defined and structured to provide the FHLBs (which will ultimately apply the test) with sufficient guidance to effectively and efficiently determine the PPOB of insurance company applicants. The Bank's proposed revisions would allow the NPRM's insurance company PPOB rule to address these core issues while still meeting the goals that the Agency has sought to achieve through its rulemaking proceeding.

Centrality of an Insurance Company's State of Domicile

An insurance company's state of domicile is the state in which an insurance company is licensed to do business and operates under the state's insurance statutes as a "domestic" insurer, where it is subject to the regulation and supervision of its primary regulator. Moreover, numerous state Departments of Insurance recognize an office or a registered office of each of its domiciled insurance companies in its examination reports and statutory statement filing requirements as the "statutory home office" for the domiciled company. The domiciled company's articles of incorporation generally identify the address of this office but do not require that it be called a home office.

As the FHLBs have previously noted, an insurance company's state of domicile is central to the regulation, examination, insolvency regime, and creditors' rights with respect to the insurance company. *See* May 15, 2014 Memorandum to the Agency at pp. 12–14 attached hereto as Attachment 1. There is a substantial interrelationship between an insurer's insurance business and its pervasive and ongoing regulatory reporting obligations to its domiciliary Department of Insurance. Without such regular financial reporting and oversight, an insurer could not continue to operate its insurance business. An insurer's policies and other insurance product forms are required to be filed with and approved by the domiciliary state Department of Insurance prior to being issued. This domiciliary state review and approval is critical. *See id.*

Additionally, in applying its membership regulation to the definition of "principal place of business" in regard to an insurance company, the FHFA should consider the highly regulated nature of insurance companies and the recognition of the primacy of state law in the regulation of the business of insurance starting with the state regulator's designation of "domicile" or "home office". By federal law, under the McCarran-Ferguson Act, 15 U.S.C. § 1011 *et seq.*, regulation of insurance is left to the states. *See* May 15, 2014 Memorandum at 13 (citing *U.S. v. Fabe*, 508 U.S. 491 (1993) (noting that "Congress left the regulation of insurance to the states."). The FHFA should give deference to state actions such as a state Department of Insurance's recognition of a statutory home office for each of its domiciled companies. Further, even if a state does not expressly require that an insurance company maintain a physical presence within the state, but recognizes an office, including a registered office, as a sufficient physical presence to find

domicile, such recognition should satisfy the "home office" test as currently used in the FHFA regulations. Accordingly, the Bank submits that the proposed PPOB rules should be revised to better reflect the importance of an insurance company's state of domicile.

Safety and Soundness Principles Call for the Use of State of Domicile as the Primary Determining Factor in the PPOB Analysis

The principles of safety and soundness highlight the importance of a connection between applicants/members and their FHLB district. *See* May 15, 2014 Memorandum at 15–16. As part of safe and sound operations, the FHLBs must be "thoroughly familiar with the state insurance laws and regulatory framework for each state in which it has an insurance company member domiciled." *See id.* (quoting an FHFA Advisory Bulletin, AB 2013-09).

A membership location test that embraces the importance of an insurance company's state of domicile would also minimize the number of FHLB relationships that an individual state Department of Insurance will have to maintain. Each FHLB has its own capital stock, lending, and collateral requirements. Primary use of the state of domicile limits the number of different FHLB relationships in which an individual Department of Insurance must engage.

The Bank is concerned that the insurance company PPOB test, as proposed in the NPRM, could result in added confusion and complexity in the relationships between FHLBs and state Departments of Insurance. This would put a burden on these departments and on the FHLBs, which would need to work through the possible definitions, interpretations, and iterations of the proposed rule.

Importance of a Clear, Simple, and Predictable Membership Location Test

The legislative history of the FHLB Act indicates a preference for a simple, clear, and predictable rule regarding the districts of members. *See Hearings Before a Subcommittee of the Committee on Banking and Currency on S.2959*, 72nd Cong. 116–17, 359–60 (1932). During the hearings, a change was proposed to Section 4(b) of the FHLB Act and ultimately incorporated into the final legislation, to allow adjoining district membership only "if demanded by convenience and then only with the consent and approval of the [B]oard," as opposed to an automatic rule. *See id.* at 199. Additionally, the drafters of the FHLB Act took the nationwide scope of the insurance business into account. The discussion indicates the need to set a single state from which insurance company members would operate within the FHLB System. *See id.*

Moreover, although not directly applicable,[6] the fundamental principles discussed in the Supreme Court case cited in the NPRM, *Hertz Corp. v. Friend*, would be helpful in creating a rule to determine to which FHLB an applicant should belong. These principles of clarity, simplicity and predictability, are essential to the FHLBs' membership rules. *See* May 15, 2014 Memorandum at 7–10. A fundamental goal of the Supreme Court in *Hertz* was to unify disparate

[6] *See* May 15, 2014 Memorandum at 2–7.

interpretations of "principal place of business" as it related to diversity jurisdiction, so as to provide a "single direction" for the courts applying the rule. *See id.* The Court recognized the "need for certainty and predictability of result" as important to any jurisdictional test and knew that a simple rule would help ensure such certainty. *See id.*

The NPRM, and previously the 2012-RI, does not achieve the clear, simple, and predictable rules that are necessary for effective and efficient membership location tests. The FHFA's proposed rule would require FHLBs to analyze an insurance company applicant's business structure without clearly defining specific elements to consider to determine where the applicant conducts a "predominant portion of its business." This is a substantial change from the test that the FHLBs were required to use under the "home office test."[7] The Bank's proposed revisions to the FHFA's proposed rule better reflect the principles of simplicity, clarity, and predictability.

Proposed Enhancements to the NPRM's PPOB Tests

The Bank proposes the revisions below to bridge the gap between necessary key elements of a membership location rule for the FHLBs and the goals that the FHFA seeks to achieve in amending the membership regulations. The proposed enhancements to the insurance company PPOB rule embrace the importance of an insurance company's state of domicile, bolster the FHLBs' safety and soundness, and would improve the clarity, simplicity, and predictability of the rule, while recognizing and addressing the concerns of the Agency.

The NPRM raises as a rationale for amending the current regulations a belief that the current membership location tests would allow an insurance company applicant to qualify for membership in an FHLB based on a legal presence, but no other physical presence, in that FHLB's district. In light of the way some insurance companies are structured, however, with both executives and operations potentially located in multiple FHLB districts, the rule proposed in the NPRM is not a good fit for addressing this concern in a clear and workable fashion. The laws and insurance regulations of the domiciliary state govern the insurance company even if the insurance company does not have a "physical" business office in the domiciliary state. Thus, at a minimum, the insurance company would have its regulator and registered office (for service of process) located in the domiciliary state and maintain significant ongoing filing and regulatory contacts in such state.

The Bank proposes the following revisions to the PPOB rule contained in the NPRM. These proposals seek to expand upon the foundational rule proposed by the FHFA and address the key elements discussed above. The proposed amendments are also drafted with an understanding of the structures utilized by many insurance company members and applicants.

[7] Here, the Bank refers to the "home office test" as analyzed prior to the 2012-RI which focused on the state of domicile. As the FHLBs discussed with the Agency before this rulemaking proceeding, the 2012-RI was unclear and overly burdensome on the FHLBs and applicants, and contravened guiding principles found in the legislative history of the FHLB Act and the *Hertz* case. *See generally* May 15, 2014 Memorandum.

The "Default" Rule [Test 1 in the Attached Chart]:

Under the NPRM, the "default rule" for PPOB for an insurance company applicant is the company's home office established as such in conformity with the laws under which the institution is organized *and from which the institution conducts business operations*.[8]

The Bank recommends that the FHFA modify its proposed rule by revising the home office test to define "conducts business operations" specifically to include any of the following:

(i) the company has a business, operations, or sales office in the domiciliary state;

(ii) any company officer has his/her place of employment by the company in the domiciliary state; or

(iii) the company conducts any business in the domiciliary state, including selling policies or providing financial services from the state or in the state.

The addition of these specific definitions to the general "conducts business operations" term employed by the NPRM would provide the FHLBs with much needed guidance regarding the application of the proposed "conducts business operations" provision of the PPOB rule. Further, the definition would allow applicants to easily determine the appropriate FHLB to submit an application, thus, reducing the administrative burden on the FHLBs and applicants alike. Reducing costs and roadblocks in the membership application process are essential to building and maintaining a robust membership.

Defining "conducts business operations" to include these factors also recognizes the concerns of the Agency, and would ensure that an applicant's PPOB is not a "mere legal" presence, but an indication of at least some business contacts with the state. The Bank's proposed revision tracks the goal of the NPRM, but includes specific metrics for applicants and the FHLBs to employ when analyzing an applicant's PPOB. The added factors proposed by the Bank would provide clarity and predictability to the "conducts business operations" aspect of the PPOB rule. Such uniformity would eliminate the possibility that two or more FHLBs (or an FHLB and an applicant) could disagree as to the application of the PPOB rule in specific contexts. This again reduces uncertainty and potential future complications.

[8] *See* NPRM at 54879 (proposed 12 C.F.R. § 1263.19(b)).

Alternative to the Default Rule - Company without Own Operations [Test 2 in the Attached Chart]:

Under the NPRM, for an applicant that has no physical office or employees of its own, or that has senior officers in different states, the PPOB would be the applicant's state of domicile.[9] The Bank supports this proposal, which is consistent with previous interpretations the FHFA has made, as well as the key elements set out in this comment letter.

This test encompasses all three key elements highlighted by the Bank. Through this test, the NPRM proposes a clear, simple, and predicable solution that embraces the importance of an applicant's state of domicile. The Bank believes that Test 1 or Test 2 will cover a majority of insurance company applicant membership issues.

Predominant Portion of Business Activities Test for Insurance Companies [Test 3 in the Attached Chart]:

Under the NPRM, the FHFA has proposed that if neither the NPRM's revised home office test nor its three-part designation test applies to a particular insurance company applicant, then PPOB will be determined by the FHLB, applying an alternative "predominant portion of business activities" test.[10]

The NPRM, however, does not define what constitutes "a predominant portion" and only generally refers to limited examples of what "business activities" should be considered. The NPRM directs FHLBs to look to "the geographic location from which the institution actually conducts the predominant portion of its business activities" without defining "predominant portion" or "business activities."[11] The proposed rule would require the FHLBs to generally examine the "totality of the circumstances of the particular case." This forces the FHLBs to engage in a general business analysis – a type of analysis that the Supreme Court has found is "unusually difficult to apply." *See* May 15, 2014 Memorandum at 10. This creates complexities and ambiguities that the FHLBs' proposed revisions seek to avoid.

The Bank is concerned that the "predominant portion of business activities" test is too subjective. The Bank seeking to apply this alternative test may not be able to apply it consistently or uniformly, and the resulting confusion among the FHLBs and applicants may have a chilling effect on applications for membership and at the very least increase the burdens on applicants and FHLBs alike.

[9] *Id.* (proposed 12 C.F.R. § 1263.19(f)).

[10] *Id.* (proposed 12 C.F.R. § 1263.19(f)).

[11] NPRM at 54866

In place of the FHFA's proposed alternative "predominant portion of business activities" test, the FHFA should instead adopt a specific, objective three-factor designation test solely for insurance company applicants. An applicant seeking to use this test would certify to the FHLB in the district in which it is domiciled that it meets the criteria, and that FHLB's board of directors would then make the designation. The insurance company applicant would have to meet two of the following three tests:

i. A plurality of the employees of the company have their primary place of employment in the FHLB's district.

ii. A plurality of the company's senior officers with titles that include "Chief," "President," "Executive Vice President," "Senior Vice President," or "General Counsel" have their primary place of employment in the FHLBank's district. Officer titles below the level of "Senior Vice President" or "General Counsel" are not included in determining whether this factor is met.

iii. The location of the largest office (measured by number of employees of the applicant who work in such office) is in the FHLB's district.[12]

If the board of the FHLB in the district in which the insurance company applicant is domiciled fails to make the requested designation, the applicant would have the right to request that the FHFA make such designation, based on the applicant's certification with respect to at least two of these three tests.

In proposing this standard, the Bank seeks to respond to the concerns raised by the Agency in the NPRM. The NPRM stresses that a "mere legal presence" is not "sufficient to constitute a company's principal place of business for Bank membership purposes." NPRM at 54865. However, in seeking to ensure that more than a "mere legal presence" is met, the NPRM would create complexity and ambiguity.

The proposed rule would require the FHLBs and applicants to each define what constitutes "business activities" and what volume of these activities constitute a "predominant portion." The Bank proposes to amend the NPRM by replacing the term "predominant portion of business activities" with a clear, black letter factors test that requires no additional interpretation. These factors would provide clear and discernable metrics with which to assess the insurance company applicant's designated PPOB. Additionally, the Bank proposes that for insurance company applicants this test would also replace the current three-factor designation test at 12 C.F.R. 1263.18(c). The Bank believes that its proposed test better aligns with the nature and structure of insurance company operations than the existing three-factor test.

[12] If an applicant meets factor ii, then the applicant's state for FHLB director voting purposes would be the state in which it has the greatest number of senior officers. If the applicant does not meet factor ii, then its voting state would be the state in which it has the largest office under factor iii.

This proposal remains consistent with the current regulation's member-focused approach, reducing the burden on both the FHLBs and applicants that the currently-proposed alternative test would create. Similar to the current designation test, each insurance company applicant would work with the FHLB in designating the correct PPOB for its individual business structure. The Bank's proposed revisions thus remove uncertainty and complication from the membership location analysis.

The FHLBank's Proposed Revisions Unite the NPRM's Goals with the Three Key Elements of a Membership Location Rule for Insurance Companies

Taken as a whole, the three tests proposed by the FHFA, modified as described above, would fulfill the goal of a clear, simple, and predictable test for membership location for insurance company applicants while addressing the FHFA's stated concerns. The Bank believes that the proposed amendments are needed to make the NPRM's insurance company PPOB rule more workable.

As discussed above, an insurance company's state of domicile is an important location for the regulation and governance of the company—moreover, the use of the state of domicile follows from the fundamental questions of safety and soundness. Accordingly, the insurance company PPOB final rule should be drafted so as to embrace the state of domicile as an insurance company applicant's "home office" whenever possible in accordance with the FHFA's other concerns. Further, although not directly applicable, the underlying rationale of *Hertz*, as well as the legislative history of the FHLB Act, guides the FHFA towards a clear, simple, and predictable test for determining the appropriate district for an applicant to an FHLB. The NPRM's PPOB rule, as drafted, falls short of this goal, but provides a solid foundation upon which the Bank recommends these revisions to help the proposed rule, if finalized, meet all the requirements of an effective and practical membership location test.

CONCLUSION

The FHLB System benefits from clear and easy-to-apply membership rules. An insurance company's state of domicile is its legal and regulatory center. The primary membership location criteria should provide an unambiguous test, while preserving the importance of an insurance company's state of domicile and addressing the concerns raised by the FHFA. The membership rules must provide a simple and predictable metric for determining which FHLB district is appropriate for an applicant. The Bank's suggested revisions will enable the proposed rule to fulfill this goal.

Under the Bank's proposed revisions, the revised home office test would embrace the central role of the state of domicile while alternative rules would ensure that an insurance company applicant becomes a member in the appropriate district when it has no business ties to its state of domicile. The definition of "conducts business operations" proposed by the Bank will provide certainty to FHLBs and applicants applying the regulation. An insurance company specific designation test will provide a simple and straightforward alternative to the general rule.

For the reasons discussed above, the Bank respectfully requests that the FHFA adopt these proposed revisions to the membership rules contained in the NPRM.

Sincerely,

Matthew R. Feldman
President & Chief Executive Officer

Attachments

ATTACHMENT 1

PRIVILEGED AND CONFIDENTIAL
ATTORNEY WORK PRODUCT AND
ATTORNEY-CLIENT PRIVILEGES APPLY

Memorandum

TO	Federal Home Loan Banks	**DATE**	May 15, 2014
FROM	John Bowman, Ralph Sharpe, Peter Frechette	**EMAIL**	JEBowman@Venable.com
CC		**PHONE**	202.344.4669
RE	Interpretation of "Principal Place of Business"		

EXECUTIVE SUMMARY

You asked us to analyze a recent Federal Housing Finance Agency ("FHFA") interpretation of an insurance company's "principal place of business" as used in the Federal Home Loan Bank Act ("FHLBA"), 12 U.S.C. § 1424(b), to determine the district in which an institution may become a member of a Federal Home Loan Bank ("FHLBank"). The phrase "principal place of business" is defined in regulation to be the state where an institution maintains its "home office." 12 C.F.R. § 1263.18(b). An insurance company's state of domicile was traditionally used to determine its "principal place of business." However, a 2012 FHFA regulatory interpretation ("2012-RI") has interpreted the regulation based on a Supreme Court case on diversity jurisdiction, *Hertz Corp. v. Friend*, and required a multi-factor analysis. You asked us to analyze *Hertz Corp. v. Friend* and determine its applicability to the FHLBanks. Further, you asked us to analyze *Hertz Corp. v. Friend* under the state insurance regulatory regime and its impact on the guidance provided in the 2012-RI.

We first conclude that *Hertz v. Friend* does not apply to the FHLBA membership criteria. The Supreme Court defines "principal place of business" only as it relates to the test of federal court jurisdiction under 28 U.S.C. § 1337. Although *Hertz* does not apply, we conclude that the two tests—corporate citizenship for diversity jurisdiction and FHLBank membership criteria—share an underlying rationale of providing a clear, simple, and predictable test. We conclude, however, that the 2012-RI is inconsistent with this underlying rationale because it discards a simple and predictable test for a complex one.

Finally, we conclude that the use of an insurance company's state of domicile in the initial principal place of business analysis is consistent with the primacy of the domiciliary state as the insurance company's regulator, the resulting significant and ongoing contacts between the domiciliary state and the insurance company, as well as the critical nature of the state of domicile highlighted in the legislative history of the FHLBA and current FHFA regulatory guidance.

We recommend that the FHLBanks request that the FHFA modify, suspend, or revoke the 2012-RI as to insurance companies. We further recommend that the FHLBanks request that the FHFA return to a pre-2012-RI practice and understanding regarding the "principal place of business" of insurance company members and applicants. This request

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would recognize the critical importance of an insurance company's state of domicile as its primary regulator. Further, this request would allow the alternative three-factor test to remain a secondary alternative to the primary rule, but be interpreted in a manner that better reflects the realities of insurance companies organized in holding company structures.

ANALYSIS AND DISCUSSION

INTRODUCTION

The FHLBA states that the location of a member's "principal place of business" determines the FHLBank in which it may be a member. 12 U.S.C. § 1424(b). Since 1987, the term "principal place of business" had been defined in the membership regulation as the state where an institution "maintains its home office established as such in conformity with the laws under which the institution is organized." 12 C.F.R. § 1263.18(b). In 2012, the FHFA issued 2012-RI, indicating that sole reliance on an insurance company member's or applicant's state of domicile was insufficient when determining the appropriate district according to its "principal place of business." FHFA 2012-RI-02, 1 (April 3, 2012) ("2012-RI"). The FHFA has taken the position that the interpretation set forth in the 2012-RI is supported, perhaps even dictated, by the reasoning set out in the Supreme Court's interpretation of "principal place of business" for diversity jurisdiction in *Hertz Corp. v. Friend*, even though, prior to the 2012-RI, the FHFA and the FHLBanks had treated an insurance company's state of domicile[1] as its "home office," and thus as its "principal place of business."[2] The 2012-RI replaces this simple test with a more complex, multi-factor approach.

I. THE HOLDING IN *HERTZ CORP. V. FRIEND* DOES NOT SUPPORT THE "PRINCIPAL PLACE OF BUSINESS" ANALYSIS IN 2012-RI-02

A. *Hertz* Discusses Diversity Jurisdiction, with Factors and Policy Considerations That Do Not Apply to FHLBank Membership

In *Hertz Corp. v. Friend*, the Supreme Court resolved a Circuit split and held that a state-chartered corporation's "principal place of business," as used in the diversity jurisdiction statute, 28 U.S.C. § 1332, is the "place where a corporation's officers direct,

[1] The state in which the company is incorporated or chartered is known as the "state of domicile." Insurance companies elect a state of domicile, initially the state where the insurance company is originally licensed, and the company is considered a foreign insurer in every other state in which it is licensed and engaging in the business of insurance. 2-9 Appleman on Insurance § 9.02 (2013).

[2] This memorandum refers to this practice as the "state of domicile test."

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control, and coordinate the corporation's activities." 559 U.S. 77, 80–81 (2010).[3] *Hertz* interprets "principal place of business" within the structure and history of *federal diversity jurisdiction. Id.* at 80. The reasoning and policies underlying diversity jurisdiction are both distinct from and inapplicable to those that guide the Federal Home Loan Bank System ("FHLBS").

1. FHLBA, Legislative History, and Regulatory History Do Not Require Application of the Federal Diversity Jurisdiction Test

As an initial matter, the terms of the FHLBA neither define "principal place of business" nor refer to federal diversity jurisdiction as the basis for establishing FHLBank membership eligibility criteria to be used in determining the FHLBank district to which a membership applicant should apply. Additionally, the current FHFA membership regulations do not refer to or rely on federal jurisdictional standards for determining principal place of business for membership purposes. To address issues arising from interstate banking, from 1982 to 1987, the predecessor membership regulations referred to the definition in the federal jurisdictional statute in effect at that time as a basis on which an alternative FHLBank district for FHLBank membership could be requested by an applicant if it met those jurisdictional standards. *See* 47 Fed. Reg. 56314 (Dec. 16, 1982). The reference to the federal jurisdiction statute was replaced with a specific factors test in 1987, and all subsequent revisions to the membership regulations have articulated specific factors without referring to the standards for determining federal diversity jurisdiction. 52 Fed. Reg. 30140 (Aug. 13, 1987). Consequently, the federal jurisdictional definitions of principal place of business are not determinative for FHLBank membership purposes.

Since 1987, the membership regulations have provided for membership based on: 1) the "home office established as such in conformity with the laws under which the institution is organized" of the applicant, or 2) the applicant requesting an alternative designation and meeting the enumerated three factors for principal place of business designation as set forth in the membership regulation at 12 C.F.R. § 1263.18(c).

2. Federal Diversity Jurisdiction

The traditional policy behind diversity jurisdiction is to allow out-of-state defendants to avoid "local prejudice." *See Pease v. Peck*, 59 U.S. (18 How.) 595, 599 (1855); *Bank of the United States v. Deveaux*, 9 U.S. (5 Cranch) 61, 87 (1809) (Marshall, C.J.); *see also Corporate Citizenship*, 124 Harv. L. Rev. 309, 316 (2010). As the Supreme Court stated in *Pease*, "the theory upon which jurisdiction is conferred on the courts of the United States, in controversies between citizens of different States, has its foundation in the

[3] This memorandum refers to this test as the "*Hertz* test." It is also called the "nerve-center test," as the place described has been called the corporation's "nerve-center." *See, e.g.*, *Wis. Knife Works v. Nat'l Metal Crafters*, 781 F.2d 1280, 1282 (7th Cir. 1986).

supposition that, possibly, the state tribunal might not be impartial between their own citizens and foreigners." *Pease*, 59 U.S. (18 How.) at 599.

The goal of the diversity jurisdiction analysis is to determine standing under Article III of the Constitution. *Hertz*, 559 U.S. at 84. Courts seek to place a corporation's citizenship, but not, as in personal jurisdiction analysis, to determine whether the corporation has specific ties to the state. Rather, courts merely seek to determine if the corporation can properly be called a citizen of a state within the "diversity of citizenship" test. *See id.* at 87 (noting that the legislative history of 28 U.S.C. § 1337 indicates that principal place of business was added in an attempt to reduce the number of cases entering federal court through diversity jurisdiction). The application of "principal place of business" in the diversity jurisdiction context arose merely as a mechanism to expand corporate citizenship to reduce the number of federal diversity cases. *See id.* at 85–87.

Conversely, the goal of the FHLBA and related regulations is to determine the state in which an applicant has its "principal place of business" for determining which FHLBank district the applicant may join. To answer this question, FHFA regulations define "principal place of business" as the "state in which the institution maintains its home office established as such in conformity with the laws under which the institution is organized." 12 C.F.R. § 1263.18. As the 2012-RI notes, Congress "limits membership to the Bank in whose district the applicant maintains its principal place of business." 2012-RI at 2. However, as set out below, there is no legal requirement stemming from *Hertz* that requires the FHFA to apply the *Hertz* test to this limitation.

There is no basis to conclude that the Supreme Court intended its interpretation of "principal place of business" in the diversity jurisdiction context to become the universal interpretation of the phrase. *See Hertz*, 559 U.S. at 93 (citing *Comm'r v. Soliman*, 506 U.S. 168, 174 (1993) for an alternative definition of "principal place of business" within the context of tax law.) Although the Court uses its tax law definition of "principal place of business" as guidance, it provides a separate rule for diversity jurisdiction. *Compare Soliman*, 506 U.S. at 174 (describing a test that compares all locations where business is transacted to find "the 'most important, consequential, or influential' one"), *with Hertz*, 559 U.S. at 92 (applying an "actual center of direction, control, and coordination" analysis). Similarly, the Court acknowledges the varying definitions of "principal place of business" in bankruptcy law. *Hertz*, 559 U.S. at 89 (citing Friedenthal, *New Limitations on Federal Jurisdiction*, 11 Stan. L. Rev. 213, 223 (1959)) (indicating that there is "no rigid legal formula for the determinations of the principal place of business" under the Bankruptcy Act).

B. *Hertz* Has Not Been Universally Applied Beyond Diversity Jurisdiction and Should Not Be Applied to Determine FHLBank Membership Criteria

The "principal place of business" language, as used in 12 U.S.C. § 1424(b), must initially be distinguished from its use in 28 U.S.C. § 1332(c)(1). While 12 U.S.C. § 1424(b)

uses "principal place of business" to locate the one geographic district in which an applicant may join an FHLBank, 28 U.S.C. § 1332(c) contemplates corporations holding citizenship in *multiple* states: "A corporation shall be deemed to be a citizen of every State and foreign state by which it has been incorporated and of the State or foreign state where it has its principal place of business . . . ." 28 U.S.C. § 1332(c)(1). Thus, in conducting its analysis of "principal place of business," the Supreme Court examined only rules that could be applied to corporate citizenship *in addition to* the state of incorporation. The FHLBA, however, calls for a single state to be an applicant's "principal place of business."[4] Since 12 U.S.C. § 1424(b)'s "principal place of business" attempts to describe one location, rather than multiple locations, and needs to address factors such as state of domicile or state of incorporation, it is entirely dissimilar from the meaning of "principal place of business" in 28 U.S.C. § 1332(c)(1), which by its terms excludes consideration of state of domicile (since state of domicile is already separately included in the diversity jurisdiction analysis).

Thus, *Hertz* should *not* be extended beyond the question of diversity jurisdiction. *See Harris v. Rand*, 682 F.3d 846, 851 (9th Cir. 2012) ("*Hertz* provided a uniform test for courts to apply when determining the principal place of business for federal diversity jurisdiction purposes. . . . [*H*]*ertz* does not mandate more."). Indeed, in *Harris*, the Ninth Circuit stated that because *Hertz* governs diversity jurisdiction, it did not apply to the pleading requirement in subject matter jurisdiction. *Id.* at 851. Even within the wider scope of federal jurisdictional questions, the impact of *Hertz* is constrained to diversity jurisdiction.

Applying *Hertz* beyond the scope of diversity jurisdiction is "entirely illogical." *N. Va. Foot & Ankle Assocs., LLC v. Pentagon Fed. Credit Union*, RWT 10CV1640, 2011 WL 280983 *5 (D. Md. Jan. 26, 2011) (declining to apply *Hertz*). *North Virginia Foot & Ankle* examines the *Hertz* test's applicability to federally chartered corporations. *Id.* at *2. The court begins its analysis by noting that "this test, codified at 28 U.S.C. § 1332(c)(1), has never been held to allow federally-chartered corporations to invoke diversity jurisdiction." *Id.* In a situation similar to that presented by the 2012-RI, the plaintiff argued that a long-standing test should be "reject[ed] or greatly modif[ied]" according to the holding in *Hertz*. *Id.* at *3. In rejecting this request, the district court noted that, in the context presented by that case, it "would make no sense to apply a nerve center analysis . . . ." *Id.* at *5. Thus, federal courts have found no mandate to apply the *Hertz* test beyond the context of the federal diversity jurisdiction question for state-chartered corporations.

[4] The FHLBA mandates the districts include complete states only. 12 U.S.C. § 1423(a). Further, FHFA regulations confirm that "the principal place of business of an institution is *the State* . . . ." 12 C.F.R. § 1263.18(b) (emphasis added).

Beyond jurisdictional issues, courts have been even more hesitant to apply *Hertz*.[5] Analyzing "complex and far-flung corporate structures" as related to the Texas tax code, a Texas district court stated that *Hertz* should not be applied outside the universe of diversity jurisdiction. *See Balachander v. AET Inc. Ltd.*, CIV.A. H-10-4805, 2011 WL 4500048 (S.D. Tex. Sept. 27, 2011) (stating that "*Hertz* did not define the meaning of the phrase 'principal place of business' for any other purpose" than federal diversity jurisdiction). Here, the court examined "principal place of business" under diversity jurisdiction and under Texas personal-property taxation. *Id.* at *9. The Texas statutes did not define "principal place of business," and the court noted that the plaintiff cited "no authority suggesting that the definition is the same as under § 1332(c)(1)." *Id.*

There is no reason to look to *Hertz* for an interpretation of "principal place of business" when the FHLBA regulations and FHLBank practices already provide one—the "home office" test—that has been interpreted for years to refer to an insurance company's state of domicile. In an analogous context, a federal court has applied the "home office" test to determine a federally chartered institution's "principal place of business." In *Lehman Bros. Holdings, Inc. v. Universal American Mortgage Co., LLC*, the district court found that the "principal place of business" of Lehman Brothers Bank, FSB (predecessor of Lehman Brothers Holdings) was located in Delaware, despite "'a significant connection' to New York." No. 13-CV-00091-REB-KMT, 2014 WL 292858, *4 (D. Colo. Jan. 27, 2014). Here, the court held that defining "principal place of business" to be a member's "home office" "prevailed over any ordinary meaning of the term." *Id.* at 5; *see also Corning Glass Works v. Brennan*, 417 U.S. 188 (1974) (stating that technical words and phrases must be understood according to their peculiar meaning); *Shell Petroleum Inc. v. United States*, 182 F.3d 212 (3rd. Cir. 1999) (same).

While *Lehman Bros. Holdings* interprets "principal place of business" in terms of a federally chartered savings association, not an insurance company, it indicates the importance of the "home office" test. The court stated that "[g]iven the institutional nature of LBB as a federally chartered savings association *organized and governed by comprehensive federal regulation*, this particular regulatory definition must prevail over any ordinary meaning the term 'principal place of business' might have in other contexts." *See Lehman Bros. Holdings*, 2014 WL 292858, at 5 (emphasis added).

A similar case in the Delaware Supreme Court highlights the proposition that regulatory terms should be interpreted within their specific context. *See Lehman Bros. Bank, FSB v. State Bank Com'r*, 937 A.2d 95, 103 (Del. 2007). In this case, the court sought to

[5] Some courts and administrative bodies have applied the *Hertz* test to determine an entity's principal place of business for non-diversity jurisdiction issues, to "the extent that the concepts are similar." *See In re Fairfield Sentry Ltd.*, 714 F.3d 127, 138 (2d Cir. 2013) (concluding that a court may use a "debtor's 'nerve center,' . . . in determining a debtor's [center of main interest]," but these holdings appear to be in the minority). However, this memorandum concludes that, except for sharing goals of simplicity and predictability, federal diversity jurisdiction and the FHLBanks' districting system are not similar.

determine where a federal savings bank was domiciled for state tax purposes. *Id.* at 95–96. Using the regulatory "home office" test, the Delaware Supreme Court found that Lehman Brothers' "principal place of business" was Delaware because its "home office" was in Delaware. The court ignored a proposed "commercial domicile" analysis that looked to the fact that "[t]he Bank's executive officers are employed in New York, its board of directors meets exclusively in New York . . . ." *Id.* at 103. These cases highlight the importance of interpreting a term of art, such as "principal place of business," within its specific context, as well as distinctions between a regulated entity and an ordinary corporation.[6]

II. THE 2012-RI DOES NOT ACHIEVE *HERTZ*'S GOALS OF SIMPLICITY AND PREDICTABILITY

A. Federal Diversity Jurisdiction Determination and the FHLBA Share the Need for a Simple and Predictable Test

Although the *Hertz* test is appropriately limited to issues of diversity jurisdiction and has no applicability to the determination of membership criteria under the FHLBA, the Supreme Court's analysis and the history of the FHLBA nevertheless highlight a similar rationale: the desirability of a simple and predictable test. In *Hertz*, the Supreme Court focused on a "simplicity-related interpretive benchmark" contained in the legislative history of the diversity jurisdiction statute. *Hertz*, 599 U.S. at 95. The Court indicated that "the words 'principal place of business' should be interpreted to be no more complex than the initial 'half of gross income test,'" and disregarded any analysis that was more complicated. *Id.* "Simple jurisdictional rules . . . promote greater predictability." *Id.* Thus, the *Hertz* test seeks to achieve its two goals of simplicity and predictability by finding "a single location" that functions as the "most important 'place.'" *Id.*

Similarly, the legislative history of the FHLBA indicates a preference for a simple, clear, and straightforward rule regarding the districts of members. In discussion during the passage of the FHLBA, Congress noted the importance of geographically based membership. *See Hearings Before a Subcommittee of the Committee on Banking and Currency on S.2959*, 72nd Cong. 116–17, 359–60 (1932). Further, during the hearings a change was proposed to section 4(b) of the FHLBA, and ultimately incorporated into the final legislation, to allow adjoining district membership only "if demanded by convenience and then only with the consent and approval of the [B]oard," as opposed to an automatic rule. *See id.* at 199.

[6] Further, a recent line of cases has considered the "location" of national banks. *See, e.g., Wells Fargo Bank, N.A. v. WMR e-PIN, LLC*, 653 F.3d 702, 708–09 (8th Cir.2011) (examining the location of a national bank for diversity jurisdiction purposes and noting the ambiguous nature of the term "located"). Although the context of the case focused largely on the specific language in § 1348 and the reference to location of "main office," the discussion in that case underscores the difficulties that arise with a more ambiguous term such as "located." *See id.*; *see also Lowdermilk v. U.S. Bank, N.A.*, 479 F.3d 994, 997 (9th Cir. 2007); *Hicklin Eng'g L.C. v. Bartell*, 439 F.3d 346, 348 (7th Cir. 2006).

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Additionally, the drafters of the FHLBA took the nationwide scope of the insurance business into account. The discussion indicates the need to set a single state from which insurance company members would operate within the FHLBS:

> Mr. MONKS. I will use the Metropolitan Life Insurance Co. The Metropolitan Life Insurance Co. places a lot of loans all over the country. For instance, they make mortgages in Ohio and they take these mortgages back to New York. Would they have to make their loan through the New York bank, say, for instance, there was one there, loans could only be made in that district? Or would they have to join the 12 districts, if there were 12 districts? Where would they make their loan?
>
> Mr. O'BRIEN. In New York.
>
> Mr. MONKS. For mortgages from any State in the Union?
>
> Mr. O'BRIEN. Yes.

Id.

The Supreme Court has noted that a simple test provides a predictable outcome. In the context of diversity jurisdiction, predictability is a cornerstone of the *Hertz* test:

> Simple jurisdictional rules also promote greater predictability. Predictability is valuable to corporations making business and investment decisions. *Cf. First Nat'l City Bank v. Banco Para El Comercio Exterior de Cuba*, 462 U.S. 611, 621, 103 S. Ct. 2591, 77 L.Ed.2d 46 (1983) (recognizing the "need for certainty and predictability of result while generally protecting the justified expectations of parties with interests in the corporation").

See Hertz, 599 U.S. at 94–95. The FHLBanks also need predictable membership criteria. The lack of predictability increases the time and effort required to determine the appropriate district for an insurance applicant because the FHLBanks must weigh multiple factors, and are unable to provide definitive assurance to potential insurance company members that their weighting will not be subject to regulatory challenge.

B. The 2012-RI Is Not Consistent with the Rationale of *Hertz* or the Legislative History of the FHLBA Because It Does Not Present a Clear and Administratively Simple Interpretation of "Principal Place of Business" for Insurance Company Members of FHLBanks

1. The 2012-RI lacks simplicity

At the outset of *Hertz*, the Supreme Court stated that it "place[d] primary weight upon the need for judicial administration of a jurisdictional statute to remain as simple as possible." *Hertz*, 559 U.S. at 80. Simplicity remained a theme for the Court throughout the case. The Court states that "simple jurisdictional rules . . . promote greater predictability." *Id.* at 94. Predictability, the Court points out, is "valuable to corporations making business and investment decisions." *Id.* at 94–95. The *Hertz* test "points courts in a single direction, towards the center of overall direction, control, and coordination," which prevents courts from needing to "weigh corporate functions, assets, or revenues different in kind, one from the other." *Id.* at 95. This point is equally applicable to the FHLBS, since applicants and the FHLBanks need a clear rule to apply to the membership criteria to avoid duplicative and inefficient efforts.

The 2012-RI is at odds with the *Hertz* test's emphasis on simplicity. First, the 2012-RI complicates the FHLBanks' analysis by incorporating a diversity jurisdiction test that is itself still unsettled.[7] Second, the 2012-RI replaces a bright-line rule with a test that involves "*prima facie* evidence" and "other factors."[8]

2. The 2012-RI lacks clarity

The 2012-RI departs from the bright-line rule that was previously provided by the state of domicile test, and was similarly argued for in *Hertz*. The 2012-RI directs FHLBanks to "look to" the location of an insurance company's "business operations," without defining "business operations." This forces the FHLBanks to engage in an analysis that the Supreme

[7] Utilizing the *Hertz* test to determine the "principal place of business" of insurance companies would remain difficult. Despite addressing the importance of simplicity, *Hertz* still presents ambiguities that create divisions in the Circuits in other contexts. For example, courts disagree over the importance of factors such as a corporation's "day-to-day" activities under the *Hertz* test. *Compare Cen. W. Va. Energy Co. v. Mountain State Carbon*, LLC, 636 F.3d 101, 102–05 (4th Cir. 2011) (holding that day-to-day management of corporate operations did not constitute direction, control, and coordination for purposes of determining corporate citizenship), *with Centrue Bank v. Golf Discount of St. Louis, Inc.*, No. 10-cv-00016, 2010 BL 247460 (E.D. Mo. Oct. 20, 2010) (basing corporate citizenship on "the day-to-day direction, control, and coordination"). We suggest that insurance companies, which may have diffuse leadership and a wide scope of business, sometimes fall into the category of "hard cases" that the Supreme Court warned of in *Hertz*—the categories of companies to which the *Hertz* test is the most difficult to apply. *See Health Facilities of Cal. Mut. Ins. Co. v. British Am. Ins. Grp., Ltd.*, No. 10-cv-03736, 2011 WL 1296488 (C.D. Cal. Jan. 11, 2011). The state of domicile test, however, provides a simple and effective way to determine an insurance company's "principal place of business," and the 12 C.F.R. § 1263.18(c) factors provide an alternative analysis in the event that one is required by an applicant's particular situation, e.g., where, despite its selected state of domicile, an applicant may maintain no staff or operations in that state.

[8] The 2012-RI provides no guidance on how much weight the *prima facie* factors receive, or how "other factors" may apply if they contravene the *prima facie* factors. The 2012-RI notes that the FHLBanks may "consult with the FHFA for guidance"—creating another step for the FHLBanks and applicants.

Court in *Hertz*, on behalf of the federal courts, sought to avoid, since the general business analysis is "unusually difficult to apply." *See Hertz*, 559 U.S. at 90.

The 2012-RI requires FHLBanks and insurance applicants to consider a multitude of factors—some of them not identified—to determine an insurance company's "principal place of business." *See* 2012-RI at 3. The 2012-RI states that "a Bank should make such determinations based on *objective factors*" and "*a Bank may also rely on other factors* that indicate the location from which the institution actually conducts its business." *Id.* (emphasis added). As seen in *Hertz*, the consideration of a multitude of factors creates confusion—removing this confusion was a driving force behind the *Hertz* test's efforts to clarify diversity jurisdiction. *See Hertz*, 559 U.S. at 90–91. Instead of clearing up confusion, the 2012-RI has created more by replacing one factor (the state of domicile) with an unknown number of factors.

In some circumstances, the lack of clarity may create a greater burden on both the FHLBanks and potential insurance company applicants by creating uncertainty for an FHLBank as to which insurance company applicants it may approach to discuss membership in the FHLBank. The lack of clarity may also lead to an applicant being forced to restart the process with a different FHLBank, if the initial FHLBank determines late in the process that the applicant's "principal place of business" is not in the FHLBank's district. In addition to this potential chilling effect for some FHLBanks, the 2012-RI's lack of clarity could create a situation where the complicated rules are misused. As the Court in *Hertz* and the Federal Housing Finance Board ("FHFB") recognized, complex rules can lead to "gamesmanship" and "forum shopping." *Hertz*, 559 U.S. at 74 ("[C]omplex tests . . . encourage gamesmanship."); 58 Fed. Reg. 43522-01, 43534 (Aug. 17, 1993) (indicating the need, in the context of consolidations, to "ensure the stability of the FHLBank System by preventing 'forum shopping'"). Since the FHFA shares the goal of avoiding "gamesmanship" and "forum shopping," the 2012-RI's added complexity is counterintuitive.

In its holding, the Supreme Court acknowledges that the definition of "principal place of business" for diversity jurisdiction need not be perfect. *See Hertz*, 559 U.S. at 95. The FHLBA regulations also take this into account and provide an alternative test to designate an applicant's "principal place of business" in 12 C.F.R. § 1263.18(c). However, the 2012-RI confuses the application of this alternative test as well.

C. The 2012-RI Makes the Three-Part Designation Test Duplicative

The 2012-RI further complicates the membership analysis because it makes the alternative designation test duplicative. The 2012-RI suggests that a FHLBank may use the factors set out in 12 C.F.R. § 1263.18(c)(1) as part of its prima facie determination of an applicant's principal place of business. Applying these factors to an FHLBank's initial membership determination undermines the use of Section 1263.18(c)(1) as an alternative test.

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Post-FIRREA revisions to FHFB's regulations included a "designation" alternative to the "home office" rule. 12 C.F.R. § 1263.18(c); 58 Fed. Reg. at 43533 ("final rule changes the standards in the Finance Board's existing regulations that govern the designation of a member's principal place of business to a state other than the state in which it maintains its home office."). In discussion, the FHFB stated "[t]he Finance Board believes that the final rule should provide a means for institutions to transfer membership from one district to another district that is more appropriate or convenient through the establishment of reasonable procedures and standards for such transfers." 58 Fed. Reg. at 43534.

Under 12 C.F.R. § 1263.18(c), the current FHFA regulations allow members or applicants for membership to request that a state other than the state in which it maintains its home office be designated as its principal place of business—a secondary test. The 2012-RI contemplates use of the § 1263.18(c) factors in determining an applicant's principal place of business in the first instance—a primary test. 2012-RI at 4. The interpretation states that these factors provide *prima facie* evidence of the applicant's "principal place of business," but that other factors may be used to "indicate the location from which the institution actually conducts its business." *Id.*

Previously, the alternative designation test provided a solution to the situations that the 2012-RI sought to address—situations in which a company seeks to designate or redesignate as its "principal place of business" a state where it has significant business contacts *other than* the state of its "home office" (interpreted prior to the 2012-RI as its state of domicile).[9] For example, in a 1999 Regulatory Interpretation, the FHFB discussed Section 1263.18(c) in reference to a member's request to redesignate its principal place of business after a merger. FHFB 1999-RI-03 (July 21, 1999) ("1999-RI-13"). The FHFB recognized the potential issue later highlighted by the FHFA in the 2012-RI, but addressed it permissively, stating:

> Finance Board regulations recognize that in *certain circumstances* the location of an institution's home office may not necessarily be the same as the location from which the institution conducts its principal business operations. Accordingly, a member or an applicant for membership *may request* that a state other than that in which it maintains its home office be designated as its principal place of business . . . .

1999-RI-13 (emphasis added).

[9] For circumstances such as the specific insurance company situation that the FHFA was addressing in the 2012-RI, we suggest that the FHFA could interpret the three-factor test for redesignation contained in Section 1263.18(c) of its regulations in a manner that better reflects current business practices.

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As discussed below, insurance companies have strong regulatory ties to the state in which they are domiciled. Guidance in the FHFA Examination Manual[10] and a 2013 Advisory Bulletin[11] highlight the critical importance of focusing on an insurance company's state of domicile when determining membership. In the event that a member or applicant's "certain circumstances" require that the principal place of business be other than its state of domicile, Section 1263.18(c) provides a mechanism for the member or applicant to request a change in FHLBank membership. However, it is not clear how the alternative, secondary designation option would function now that the same factors are used in the primary determination of an insurance company's home office.

III. THE STATE OF DOMICILE TEST SHOULD BE USED INITIALLY TO DETERMINE AN INSURANCE COMPANY'S PRINCIPAL PLACE OF BUSINESS

A. The State of Domicile Test Embraces State Insurance Regulators' Use of "Home Office" and Role as an Insurance Company's Primary Regulator

1. FHFA membership regulations' use of the term "home office" should not be limited to express requirements of state insurance company statutes

The language of the FHFA's membership regulation defining "principal place of business" does not state that the applicant's "home office" must be designated as the "home office" in its articles of incorporation. Instead, the regulation states that the principal place of business shall be "the State in which the institution maintains its home office established as such in conformity with the laws under which the institution is organized."[12] *See* 12 C.F.R. § 1263.18(b). For insurance companies, this includes the central importance of an insurance company's state of domicile in addition to statutory "home office" requirements.

Numerous state Departments of Insurance recognize an office or a registered office of each of their domiciled companies in their examination reports and statutory statement

[10] FHFA, *FHLB Membership*, Examination Manual – Public 6 (March 2013) [hereinafter "FHFA Manual"], *available at* http://www.fhfa.gov/webfiles/25396/Federal_Home_Loan_Bank_Membership_Module_Final_Version_1.0.pdf.

[11] Collateralization of Advances & Other Credit Products to Insurance Company Members, AB 2013-09 (December 23, 2013), *available at* http://www.fhfa.gov/webfiles/25906/Collateralization_for_Insurance_Company_Lending.pdf.

[12] After the FIRREA amendments to the FHLBA, FHFB decided to retain the long-standing interpretation of "principal place of business." 58 Fed. Reg. at 43533.

filing requirements as the "statutory home office" for the domiciled company.[13] The domiciled company's articles of incorporation generally identify the address of this office but do not require that it be called a home office.

Insurance companies occupy a unique status as entities created, governed, and regulated by state law—including the public policy choices of such state law as reflected by the specific language and provisions of the state statute governing the incorporation of an insurance company applicant for FHLBank membership.[14] The state-chartered and state law-governed nature of insurance companies and the insurance business is recognized at the federal level through the McCarran-Ferguson Act, in which Congress declared that federal law would not preempt state insurance law unless the federal law expressly regulates the business of insurance. *See* 15 U.S.C. § 1011 *et seq.*; *see also U.S. v. Fabe*, 508 U.S. 491 (1993) (noting that "Congress left the regulation of insurance to the states.").[15]

In applying its membership regulation and interpreting "home office" in regard to an insurance company, the FHFA should consider the unique highly regulated nature of insurance companies, and the recognition of the primacy of state law in the regulation of the business of insurance. The FHFA should give deference to state actions such as a state Department of Insurance recognition of a statutory home office for each of its domiciled companies. Further, as discussed below, even if a state does not expressly require that an insurance company maintain a physical presence within the state, but recognizes an office, including a registered office, as a sufficient physical presence, the insurance company's state of domicile is central to the regulation, examination, insolvency regime and creditors' rights with respect to the insurance company.

2. An insurance company's state of domicile is its primary state for legal and regulatory matters

There is a substantial interrelationship between an insurer's insurance business and its ongoing regulatory reporting obligations to its domiciliary Department of Insurance.

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[13] *See, e.g.*, C.R.S.A. § 7-90-102; Neb. Rev. St. § 44-205.01; Ind. Code § 27-1-7-3; Mich. Com. L. § 500.5008; Nev. Rev. Stat. 693A.040. Even when an insurance company is not required to designate a home or principal office, however, the domiciliary state remains the primary regulator of the insurance company.

[14] The 2012-RI creates a new membership location test for insurance companies while the test for state-chartered depository institutions remains the same. The 2012-RI justifies this disparate treatment by stating that state statutes "typically" require that state chartered depository institutions "designate their home office in their chartering documents." 2012-RI at 1. This dichotomy, created by the 2012-RI, does not address those states that expressly require domestic insurance companies to designate and maintain a home office, or the role of an insurance company's domiciliary state as its primary regulator.

[15] Insurance companies are creatures of state law, licensed to do business and operate by their domiciliary state. Their powers derive solely from the state. Significant, ongoing regulation is necessary. This is not the case in regard to CDFIs, the other type of entity subject to the 2012-RI.

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Without such regular financial reporting and oversight, an insurer could not continue to operate its insurance business. Insurers' policies and other insurance product forms are required to be filed with and approved by the domiciliary state Department of Insurance prior to being issued. This domiciliary state review and approval is critical.[16]

Insurance companies are subject to pervasive and ongoing regulation and contact with their domiciliary states, including: a) being subject to comprehensive examinations and ongoing reporting requirements[17] and b) being required to obtain approval in regard to any acquisition, control, merger, or similar corporate action.[18] The corporate powers of a domiciled company, including its authority to borrow and pledge assets to secure such borrowings, are derived from and governed by the domiciliary insurance code. As insurance companies are chartered under state—not federal—law and subject to primary regulation, inspection, and supervisory oversight by their domiciliary state, the domiciliary insurance code is critical to an applicant's operations and the applicant's ability to become a member of an FHLBank and borrow from the FHLBank, as well as the FHLBank's rights and obligations as a secured creditor.

State Departments of Insurance also play a critical role in insurance company rehabilitation and insolvency. Most states provide the rehabilitator substantial financial control over the insurer, including the ability to manage and dispose of the insurer's property. *See* NAIC Insurer Receivership Model Act § 402(A); *see also, e.g.*, Ohio Rev. Code Ann. § 3903.14(b); 40 Pa. Stat. Ann. § 221.16(b); Tex. Ins. Code Ann. § 443.102(b). Further, creditor's rights regarding insurance companies are also governed by state law.[19]

[16] While insurance companies are also required to file their policy and other insurance product forms with states, outside of the domiciliary state, in which they sell such products, in recognition of the domiciliary state's role, some state statutes require only copies of the domiciliary state filings or will rely on the filings with the domiciliary state. Thus, on certain regulatory matters, other states typically will defer to the department of insurance in the domiciliary state.

[17] For example, in lieu of conducting its own financial examination of an insurer doing business in its state, a state's insurance department may accept an examination conducted by the department in the state in which the insurer is domiciled. *See* NAIC, Financial Regulation Standards and Accreditation Program 3 (2013).

[18] Insurance companies can and do change their state of domicile. However, unlike an ordinary corporation, redomestication of an insurance company must be accomplished via regulatory filings and state Department of Insurance approval. *See* NAIC Redomestication Model Bill (2006); *see also* N.Y. Ins. Law §§ 7120–7121; Cal. Ins. Code § 709.5. One of the primary causes of "redomestication" is merger and acquisition activity. Michael J. McNamara, et al., *In Search of Greener Pastures: An Examination of Insurance Company Redomestications* (2006), *available at* http://www.aria.org/meetings/2006papers/McNamara_Pruitt_Kuipers.pdf.

[19] 11 U.S.C. § 109 removes "domestic insurance companies from the bankruptcy code." *See also Sims v. Fid. Assurance Ass'n*, 129 F.2d 442, 448 (4th Cir. 1942), aff'd., 318 U.S. 608 (1943) ("Section 109(b) of the . . . Bankruptcy Code states that 'a person may be a debtor under chapter 7 of this title only if such person is not . . . a domestic insurance company'").

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3. The state insurance regulatory framework further distinguishes the FHLBA's use of "principal place of business" from the federal diversity jurisdiction context of Hertz

The importance of the primary regulator distinguishes the FHLBanks' situation from that discussed in *Hertz*. *Hertz* contemplates a focus on the officers of a corporation as the primary decision makers. *See Hertz*, 559 U.S. at 95 (focusing on the "top officers" that direct corporate activity). However, for troubled insurance companies, this primary decision maker becomes the domiciliary state regulator, acting as a receiver. Two FHLBanks recently dealt with state insurance commissioners acting as receivers or primary decision makers.[20] The success of those proceedings was greatly aided by "prompt conversation[s] with the receiver," including "introductory meetings" and regular conference calls.[21] "Open and regular" communication was essential.[22] This is consistent with the FHFA's guidance set out in Advisory Bulletin 2013-09, which states, "[i]t is important that each FHLBank be thoroughly familiar with the state insurance laws and regulatory framework for each state in which it has an insurance company member domiciled." FHFA AB 2013-09 (Dec. 23, 2013) ("AB 2013-09"). However, the 2012-RI draws emphasis away from the state of domicile, potentially complicating this process.

The FHLBanks must establish and maintain ties to the insurance regulators in the state where insurance company members are domiciled. This necessity weighs in favor of an interpretation of "principal place of business" that focuses on the state of domicile and provides a clear and simple rule for insurance company membership. Given the state insurance regulatory regime, "conformity with the laws under which the institution is organized" suggests that an insurance company's state of domicile should be considered the state in which it "maintains its home office," the interpretation that the FHFB appears to have intended at the time the regulation was promulgated.

B. The State of Domicile Test Enhances the FHLBanks' Responsiveness to the 2013 Advisory Bulletin Guidelines and Minimizes Burdens on State Departments of Insurance

The history of the FHLBA and regulations indicates a need for a connection between members and their FHLBank district. *See* 58 Fed. Reg. at 43534 (noting a "concern" that an institution may "transfer its membership to a district that might only have a tangential connection to the consolidated institution and its operations"). The importance of this connection is borne out in the FHLB Membership module of the FHFA Manual,

[20] *See* Peter Knight, et al., *Federal Home Loan Banks*, 22 The Ins. Receiver 12, 12–15 (2013).

[21] *Id.* at 14–15.

[22] *Id.*

which states, "the FHLBank should evaluate relevant laws for each state in its district from which it intends to accept insurance company members." FHFA Manual at 6. This connection is also highlighted in AB 2013-09, which states that "it is important that each FHLBank be thoroughly familiar with the state insurance laws and regulatory framework for each state in which it has an insurance company member domiciled." AB 2013-09 at 2.

The 2012-RI is inconsistent with the FHFA's guidance in AB 2013-09. AB 2013-09 itself points out the difficulty in reconciling its guidance with the outcome of the 2012-RI: "The domiciliary state of an insurance company member . . . will not necessarily be within an FHLBank's district because the location of FHLBank membership is determined by an insurance company's principal place of business, which may differ from the insurance company's state of domicile." *Id.* at 2. As the FHFA pointed out in its response to the FHLBank of Cincinnati, under the state of domicile test, few insurance company members fell into this category, since insurance companies rarely exercised the alternative designation test.[23] The 2012-RI, however, effectively establishes the Section 1263.18(c) alternative test factors as mandatory decision factors in the primary analysis.

A state of domicile test also minimizes the number of FHLBank relationships that an individual state Department of Insurance will have to understand. Each FHLBank has its own capital stock, lending and collateral requirements. A state of domicile test limits the number of different FHLBank relationships in which an individual Department of Insurance must engage. If a non-domicile test is applied, state Departments of Insurance will have to deal with more than one FHLBank, which can impose an additional burden on these Departments.

The AB 2013-09 guidelines are a useful tool for the FHLBanks. The emphasis on the importance of the domiciliary state insurance law and regulator highlights the utility and necessity of using the state of domicile test.

IV. THE FHLBANKS SHOULD REQUEST THAT THE FHFA PROVIDE GUIDANCE RETURNING INSURANCE COMPANY MEMBERSHIP LOCATION REQUIREMENTS TO A PRE-2012-RI STATUS

We recommend that the FHLBanks request that the FHFA modify, suspend, or revoke the 2012-RI, and request a return to the pre-2012-RI practice and understanding regarding the "principal place of business" of insurance company members. This request would recognize the critical importance of an insurance company's state of domicile as the location of its primary regulator, and would urge that the "home office" of an insurance company be its state of domicile, consistent with the pre-2012-RI practice and understanding.

[23] FHFA Nov. 26, 2013 letter to Andrew S. Howell, CEO, Federal Home Loan Bank of Cincinnati.

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We understand that the FHFA's Office of General Counsel has raised a concern that the pre-2012-RI practice would allow an insurance company to qualify for membership in an FHLBank based on a charter, but no other presence, in that FHLBank's district. In light of the way some insurance companies are structured, however, with both executives and operations potentially located in multiple FHLBank districts, the *Hertz* test is not a good fit for addressing this concern in a clear and workable fashion. It should also be noted that, while some insurance companies may not have the type of presence in their charter state to meet the *Hertz* test, nevertheless they do have some presence in their charter state and often it is a significant presence. Even an insurance company without a "physical" business office in its charter state would at a minimum have its regulator and registered office (for service of process) located in such state and maintain significant ongoing filing and regulatory contacts in such state.

As before the 2012-RI, an insurance company member or applicant can use the 12 C.F.R. § 1263.18(c) factors as an alternative test to designate its "principal place of business," particularly if the test is interpreted in a manner that better reflects the realities of insurance companies organized in holding company structures or within company affiliate structures. The FHLBanks' request would return this test to an alternative, rather than primary, role in the process to determine a member or applicant's FHLBank district.

CONCLUSION

As this memorandum discusses, the 2012-RI creates complexity and confusion when applied to insurance companies. The 2012-RI unnecessarily replaces the well-established practice of insurance regulators and the FHFA determining membership based on an insurance company's state of domicile, supplemented by the alternative designation test, with a vague "case-by-case" analysis that combines the alternative designation test with "other factors."

Hertz Corp. v. Friend does not compel the FHFA to change the FHLBank membership criteria. The *Hertz* case does not provide a reason or a basis to reinterpret "principal place of business" because it addresses an insular and unrelated topic—federal diversity jurisdiction.

Although it references "a recent Supreme Court decision"[24] (*Hertz*) as the reason for the reinterpretation, the FHFA diverges from the underlying rationale of *Hertz* by creating a more complicated and less predictable test. This directly contravenes the core principles of the *Hertz* test and the Supreme Court's goal in embracing it.

Finally, the 2012-RI is not needed. An insurance company's state of domicile meets the requirement of a "home office" under 12 C.F.R. § 1263.18(b). Further, the

[24] *Id.*

enumerated *prima facie* factors of "principal place of business" under the 2012-RI are, as the 2012-RI itself states, "already employ[ed]"—through the alternative designation test. Under the 2012-RI guidance, the exception swallows the rule. This runs counter to the Supreme Court's goal in *Hertz* of "administrative simplicity," as well as a reasonable use of the FHFA's regulatory authority.

ATTACHMENT 2

Principal Place of Business (PPOB) Decision Chart

Insurance Companies

Test 1—Addition to Proposed 12 C.F.R. 1263.19(b)—Definition of "Conducts Business" for an Insurance Company:	**Test 2– Domicile Test Per Proposed 12 C.F.R. 1263.19(f)**	**Test 3 Replace Predominant Portion Test of Proposed 12 C.F.R. 1263.19(f) with an Alternative 3 Factor Test for Insurance Companies (Must Meet 2 of 3 Factors)**
The insurance company meets any one (1) of the following: 1. The company has a business, operations or sales office in the domiciliary state. 2. Any company officer has his/her place of employment by the company in the domiciliary state. 3. The company conducts business in the state of domicile defined to include "sells policies" (including, without limitation, reinsurance policies or contracts of reinsurance) or provides financial services from or in the state of domicile. Resulting PPOB for FHLBank membership: If one of the factors is met, state of domicile.	Resulting PPOB for FHLBank membership: state of domicile	Proposed alternative 3-factor test: The insurance company would have to meet 2 of the 3 factors below: 1. A plurality of the employees of the applicant company have their primary place of employment in the FHLBank's district. 2. A plurality of the applicant's senior officers with titles that include "Chief," "President," "Executive Vice President," "Senior Vice President" or "General Counsel" have their primary place of employment in the FHLBank's district. Officer titles below the level of "Senior Vice President" or "General Counsel" are not included in determining whether this factor is met. 3. The location of the largest office (measured by number of employees of the applicant who work in such office) is in the FHLBank's district. Resulting PPOB for FHLBank membership: district where the insurance company meets 2 of the 3 stated factors. Also, if the applicant meets factor 2, then the applicant's state for FHLBank director voting purposes is the state in which it has the greatest number of senior officers. If the applicant does not meet factor 2, then the voting state is the state in which it has the largest office as measured by the number of employees.