December 21, 2016

VIA EMAIL TO REGCOMMENTS@FHFA.GOV

Alfred M. Pollard, Esq.
General Counsel
Attention: Comments/RIN 2590-AA68
Federal Housing Finance Agency
400 Seventh St., S.W.
Eighth Floor
Washington, D.C. 20219

Re: Proposed Rule on Indemnification Payments

Dear Mr. Pollard:

The eleven Federal Home Loan Banks ("FHLBs") and the Office of Finance ("OF"), the FHLBs' joint office acting as fiscal and paying agent, are writing to comment on the Federal Housing Finance Agency's ("FHFA") re-proposed rule on Indemnification Payments published on September 20, 2016 and corrected and extended on October 27, 2016, 81 Fed. Reg. 64357 & 74739 (the "Proposal"), which is intended to implement portions of Section 1114 of the Housing and Economic Recovery Act of 2008 ("HERA") codified at 12 U.S.C. § 4518(e). The FHLBs and the OF welcome the opportunity to comment on the Proposal. Please note that reference to "FHLBs" or a "FHLB" in this letter also includes the OF unless indicated otherwise.

The Proposal includes proposed provisions regarding certain limitations on indemnification payments made by regulated entities and the OF. The Proposal is the fourth version of a proposed rule on indemnification payments by a FHLB. The prior versions were published in 2008 and 2009.

(1) Scope of "Prohibited Indemnification Payment"

The concept of a "prohibited indemnification payment" is broadly described in the Proposal as a payment with respect to an administrative proceeding or civil action initiated by the FHFA, which would include actions for civil money penalties ("CMPs"), removal orders and cease & desist orders ("C&Ds"). The FHLBs are permitted to pay insurance premiums for policies covering legal fees and expenses of covered individuals but not for payment of CMPs or other judgments in favor of the FHFA.

The FHLBs agree with the FHFA's suggestion in the preamble to the Proposal that it is appropriate for regulated entities in conservatorship to be permitted to indemnify Entity-Affiliated Parties (as defined in 12 C.F.R. § 1231.2) for the kinds of matters which form the basis for first and second tier CMP liability. However, solvent regulated entities that are not subject to conservatorship should be afforded the same rights. More importantly, 12 U.S.C. § 4636(g) (as amended by HERA) expressly imposes a statutory limitation only on the regulated entities reimbursing or indemnifying an individual for third tier CMPs imposed under 12 U.S.C. §4636(b)(3). Consequently, the FHLBs believe the Proposed Rule, by prohibiting reimbursement and indemnification for *all* CMPs conflicts with and imposes a limitation beyond the limitations imposed by Congress for indemnification. The exemption for indemnifying Entity-Affiliated Parties against first and second tier CMPs should also include legal or professional expenses attributable to the charges resulting in those penalties.

In addition, the Proposal's indemnification and advancement of expenses standards are more stringent than typical state governance statutes, including those that were adopted by many FHLBs as governing such matters. For example, Delaware law permits advancement of expenses without any prior determination or investigation, permits insurance without restriction and partial indemnification at the discretion of a corporate board, the latter subject only to meeting the "best interests of the corporation" standard.[1] Many of the FHLBs have adopted Delaware or their headquarters' state law under the FHFA's governance rule (12 C.F.R. Part 1239) and thus should be able to follow those standards for indemnification of first and second tier CMPs.

(2) Advancement of Expenses - Prior Board Investigation and Determination

The Proposal would require an investigation and a determination by a FHLB's board of directors to advance expenses to a covered individual. In addition, an Entity-Affiliated Party must agree to reimburse advanced expenses if certain conditions are met.

The FHLBs note that the Proposal would allow third party insurance advancement of expenses without a board investigation and findings, under insurance or bonds purchased by the FHLBs.

The FHLBs believe that the Proposal's requirement of a prior board of directors' investigation of any advancement of expenses is excessive, time consuming, and unnecessary. At the advancement stage, sufficient facts are unlikely to be available for a board of directors to make the determination proposed in §1231.4(c)(1). A decision by a board of directors to disallow advancement of expenses at this premature stage may trigger litigation against the FHLB.

The best approach would be for the final rule to permit a FHLB to advance expenses pursuant to the procedures and requirements contained in the affected FHLB's

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[1] *See*, *e.g.*, Andrew M. Johnston et al., *Practitioner Note: Recent Delaware Law Developments in Advancement and Indemnification: An Analytical Guide*, 6 N.Y.U. J.L. & BUS. 81 (2009).

bylaws or other indemnity agreements and its adopted governance law pursuant to 12 C.F.R. §1239.3. The FHFA's 2015 final rule on the governance of FHLBs established a thoughtful and consistent process by which the FHLBs could identify laws to govern their indemnification practice, and mandated that the FHLBs amend their bylaws to implement these provisions. Practical conflicts and confusion are likely to result from efforts to reconcile the requirements of the Proposal with the laws that the FHLBs adopted to implement Section 1239.3, neither of which furthers safe and sound FHLB operation.

(3) D&O Insurance and CMPs

The Proposal does not allow insurance proceeds to pay or reimburse for CMPs or a judgment in favor of the FHFA. Specifically, while the Proposal does not prohibit the FHLBs from paying premiums for a professional liability insurance policy or a fidelity bond for directors and officers, it does prohibit the use of the proceeds of such policies to pay or reimburse an Entity-Affiliated Party for a judgment or CMP. The proceeds of such policies may, however, pay any legal or professional expenses incurred in connection with a FHFA proceeding.

The Proposal could be read to suggest that the FHLBs may not pay the premiums on these insurance policies to the extent they cover FHFA CMPs. The Proposal should be revised to explicitly allow the FHLBs to pay premiums on insurance policies even if they cover all civil fines (including potential FHFA fines), so long as the FHLBs do not actually use or permit the use of the insurance proceeds to cover FHFA fines. Without such clarification, the FHLBs may inappropriately be prohibited from paying premiums on insurance policies that cover civil fines outside the scope of the FHFA's authority.

If the FHFA accepts the comment in Section (1) above, then presumably professional liability insurance policies may cover Tier 1 and 2 CMPs without limitation.

(4) Partial Indemnification; Expenses

In the case of either a settlement or a final adjudication resulting in an order, the Proposal only allows indemnification for expenses specifically attributable to particular charges as to which the Entity-Affiliated Party has been successful (i.e. not admitted culpability, in the case of a settlement, or been exonerated, in the case of a final adjudication). As a practical matter, where there are multiple charges, it will often be difficult, if not impossible, to precisely allocate expenses (for example, expenses for the review of documents, or for the preparation for a deposition) related to a particular individual charge.[2] If there are multiple charges, and an Entity-Affiliated Party is unable to obtain partial indemnification for legal and professional expenses because such expenses are not specifically or directly related to a charge that the Entity-Affiliated Party

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

believes can be settled without an admission of culpability, or adjudicated without a finding of liability, the Entity-Affiliated Party's willingness to settle with the FHFA at all may be adversely impacted. This may lead to unnecessary and wasteful litigation.

The principle sought to be addressed by this aspect of the Proposal would be better and more fairly effectuated by providing that legal and professional fees incurred may be indemnified in proportion to the percentage of charges as to which the Entity-Affiliated Party is entitled to indemnification under the terms of the Proposal. The affected FHLB's board of directors should make any determination regarding apportionment in its discretion, as they are in the best position to do so.

In addition, the FHLBs believe that the text related to partial indemnification in proposed Section 1231.4(b)(2)(i) could be improved, particularly around what constitutes "exoneration." The FHLBs concur with the concept in proposed Section 1231.4(b)(2)(i) that an Entity-Affiliated Party need not repay advanced expenses that related to a charge for which the Entity-Affiliated Party is not found to be at fault. Rather than using the standard of whether a party is exonerated, the FHLBs recommend adopting a more conventional legal standard: whether the party is found to be liable, based on a judgment not subject to judicial review. The FHLBs do not believe FHFA intends to require an Entity-Affiliated Party to obtain a ruling explicitly stating they are "exonerated" (as opposed to not being found liable), and in any event are unaware of an administrative or judicial process by which an Entity-Affiliated Party could obtain a ruling as to their exoneration as a matter of course without incurring additional time and expense.

If the FHFA desires to retain the "exonerated" standard, it may be helpful to provide a hypothetical example of how we believe Section 1231.4(b)(2)(i) would and should apply to particular facts. Assume that:

(i) The FHFA initiates an investigation of an officer at an FHLB for three potential regulatory violations -- call them Claims A, B, and C. The FHLB's board of directors properly determines to advance expenses incurred by the officer relating to the investigation and any resulting proceeding.

(ii) Following the investigation, the FHFA issues the officer a notice of charges under 12 C.F.R. § 1209.23 that includes only Claims A and B, not Claim C.

(iii) Following discovery and hearings, the FHFA Director issues a final order that only indicates the officer's culpability for Claim A. The officer does not seek judicial review of the order prior to the legal deadline.

In such a case, we believe that under Section 1231.4(b)(2)(i), the officer should and would have an obligation to repay to the FHLB only the advanced expenses that specifically relate to (or, based upon our comment above, can be apportioned to) Claim A – and no obligation to repay advanced expenses relating (or apportioned) to Claims B or C. In Section 1231.4(b)(2)(i) terms, we believe that the officer would and should be considered "exonerated" of Claims B and C, even if the final order does not so expressly

state. Of course, to the extent that the FHFA later successfully issues a final order relating to Claims B and C, then, at that point, the officer would no longer be "exonerated" and the obligation to repay advanced expenses relating or allocated to those claims would be triggered.

The FHLBs seek confirmation that the above view is correct.

(5) Grandfathering of Existing Indemnification Provisions

Under the preamble to the Proposal, FHFA addressed the issue of grandfathering indemnification "agreements" and dismissed comments to the 2009 Proposal which argued that bylaw indemnification provisions should be included within the concept of grandfathered agreements. The regulatory text in the Proposal does not define what constitutes an "agreement" for purposes of this grandfathering treatment.

We reiterate the comment from the 2009 Proposal on this topic. Section 7 of the Federal Home Loan Bank Act (12 U.S.C. §1427) allows the FHLBs to determine the terms and conditions under which an FHLB may indemnify its directors, officers, employees or agents. In this regard, and as is widespread among corporations in general, all of the FHLBs currently operate under an indemnification bylaw. It is well recognized that persons who are covered by contractual indemnification bylaws have legally enforceable rights to indemnification and advancement that arise directly from those bylaws. The typical FHLB bylaw provides, among other things, that the right to be indemnified or advanced expenses under the bylaw is a contractual right although certain FHLBs may have different language. Most of the FHLBs have not entered into separate indemnification agreements with their directors, officers or employees.

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

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

(6) An Entity-Affiliated Party's Obligation to Repay Advanced Expenses – Timing

Under proposed Section 1231.1(b)(2)(i), an Entity-Affiliated Party has to repay expenses advanced by a regulated entity at the time when a proceeding "results in an order" and he or she is not exonerated. The problem is that such an order could be issued – and the funding of the Entity-Affiliated Party's defense completely cut off – before the legal process is complete. For example, Section 1209.6 permits the FHFA Director to issue a temporary cease and desist order against an Entity-Affiliated Party. If that happens, that would appear to be a proceeding that "results in an order" – and so the Entity-Affiliated Party would have to repay expenses advanced to date and presumably lose advancement of expenses still to be incurred in seeking judicial review of the temporary order and otherwise defending the ongoing administrative proceeding. The FHLBs recommend that "results in an order" be changed to "results in a final order not subject to judicial review."

The "not subject to judicial review" language should also be added to Section 1231.1(b)(2)(iii), to make clear that the obligation to repay advanced expenses would not arise prior to the resolution of any request for a judicial stay of a prohibition order in accordance with 12 U.S.C. § 4636a(g).

(7) Rule's Deterrent Effect on Serving as a FHLB Director

The FHLBs believe that continuing to attract and retain high quality experienced individuals to serve as directors is essential to the safe and sound operation of the FHLBs and ensuring that the FHLBs carry out their housing finance and community investment mission. The Proposal represents a departure from current corporate governance and indemnification practices that, if adopted as proposed, may deter such individuals from serving (or continuing to serve) on a FHLB or the OF board of directors. The broader policy implications of the Proposal on FHLB and OF governance should thus be considered.

On behalf of the FHLBs and the OF, we appreciate your consideration of these comments.

Sincerely,

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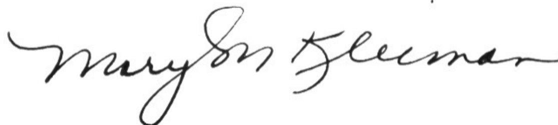

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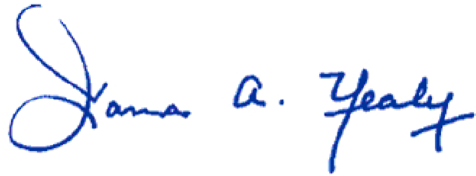

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