May 31, 2011

Alfred M. Pollard, Esq.
General Counsel
Federal Housing Finance Agency
Fourth Floor
1700 G Street, N.W.
Washington, DC 20552

Re: Comments/RIN 2590-AA42; Incentive-Based Compensation Arrangements

Dear Mr. Pollard:

On behalf of the undersigned Federal Home Loan Banks ("FHLBanks") we appreciate this opportunity to comment on the proposed rule on incentive-based compensation ("Proposal") under Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") issued jointly by the Federal Housing Finance Agency ("FHFA"), the Office of the Comptroller of the Currency ("OCC"), the Federal Reserve Board ("FRB"), the Federal Deposit Insurance Corporation ("FDIC"), the Office of Thrift Supervision ("OTS"), the National Credit Union Administration ("NCUA") and the Securities and Exchange Commission ("SEC") (collectively referred to as the "Agencies").

As discussed below, we do not believe that including the FHLBanks among the institutions subject to a final rule on incentive-based compensation ("Final Rule") is appropriate under Section 956 and the special circumstances of the FHLBanks. To the extent the FHLBanks are nevertheless included in the Final Rule, our comment also includes points that we believe should be modified or clarified in any Final Rule.

1. The FHLBanks Should Not Be Added to the List of Covered Financial Institutions Under the Final Rule.

Congress in enacting Section 956 expressly identified five categories of institutions to be treated as "covered financial institutions" ("CFIs") subject to regulations issued under Section 956.[1] None of these categories covers the FHLBanks and, although the Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac") were specifically identified in Section 956 as CFIs, the FHLBanks were not similarly identified. As Fannie Mae, Freddie Mac and the FHLBanks are regulated by the same regulator (established a mere

[1] These institutions are depository institutions, depository holding companies, registered broker-dealers, credit unions and investment advisors. Dodd-Frank Act Section 956(e)(2)(A)-(D).

two years earlier in the Housing and Economic Recovery Act of 2008 ("HERA")), it seems clear that Congress intentionally decided not to include the FHLBanks under Section 956.

Nevertheless, the Agencies now seek to include the FHLBanks in the Final Rule as CFIs under their general authority in Section 956(e)(2)(G) to designate "any other financial institution the appropriate Federal regulators, jointly by rule, determine should be treated as a covered financial institution for purposes of this section."[2] The explanation offered by the Agencies in the Proposal for overriding the clear intention of Congress is set forth in a single sentence: "The Agencies also propose including the Federal Home Loan Banks because they pose similar risks and should be subject to the same regulatory regime."[3] This sentence provides no support or analysis for its assertion, and in fact the historical record of Congressional committee hearings prior to enactment of the Dodd-Frank Act suggests that Congress recognized the exact opposite: that the compensation structures at the FHLBanks, which are not based on links to the value of capital, do not pose the same risk as those inherent at Fannie Mae, Freddie Mac or other entities that were the subject of hearings leading up to the legislation.

There are at least two compelling reasons that would have led Congress to determine not to extend Section 956 to the FHLBanks and that should lead the Agencies to determine not extend their Section 956(e)(2)(G) authority to the FHLBanks.

First, Congress in HERA has already developed an approach to the supervision of FHLBank executive compensation (including incentive-based compensation) that takes account of the cooperative structure of the FHLBanks. The compensation risks inherent to Fannie Mae and Freddie Mac support Congress' decision to apply the Section 956 provisions to Fannie Mae and Freddie Mac; the absence of such inherent risks at the FHLBanks likewise supports Congress' decision to preserve the existing FHLBank compensation oversight structure established in HERA by not designating the FHLBanks as CFIs.

Second, the executive compensation decisions at the FHLBanks are made under a special set of circumstances, as a majority of the members of the board of directors of each FHLBank are representatives of the FHLBank's member institutions. The board members who are in a position to set executive compensation are representatives of the institutions that have a direct interest in ensuring that executive compensation is not excessive and that FHLBank personnel do not have financial motivations to take

---

[2] The FHFA's proposed regulation uses the term "covered entity" rather than the statutory term "covered financial institution." 12 C.F.R. § 1232.3 (proposed).

[3] Incentive-Based Compensation Arrangements, 76 Fed. Reg. 21770, 21775 (2011).

inappropriate risks. By contrast, the public stock structures of Fannie Mae and Freddie Mac have led to historically very different compensation practices at those two institutions. Congress' awareness of the cooperative structure of the FHLBanks, including member control of the board of directors, further explains Congress' decision not to designate the FHLBanks as CFIs under Section 956.

1.1. Congress Has Already Established An Executive Compensation Regime for the FHLBanks in HERA.

Congress in enacting HERA gave clear authority to the FHFA in regard to the regulation of FHLBank compensation. Congress instructed the Director of the FHFA ("FHFA Director") to prohibit the FHLBanks from providing compensation (including incentive compensation) to any executive officer of a FHLBank that was not reasonable and comparable with compensation for employment in other similar businesses involving similar duties and responsibilities.[4] Congress authorized the FHFA Director to take into account any factors the Director considered relevant, including any wrongdoing on the part of an executive officer.[5] Given the comprehensive nature of the existing compensation regime for the FHLBanks as further described below, and the absence of the types of incentive compensation problems that arose at Fannie Mae and Freddie Mac (also discussed below), the FHLBanks should not be included as CFIs in the Final Rule.

Congress empowered the FHFA Director to require an FHLBank to withhold payment, transfer or disbursement of compensation to an executive officer, or to place such compensation in an escrow account, during the review of the reasonableness and comparability of such compensation.[6] At the same time, Congress expressly prohibited the FHFA Director from prescribing or setting a specific level or range of executive compensation.[7] Furthermore, in enacting HERA Congress required that the FHFA Director prior to promulgating any regulation that applies to the FHLBanks consider the differences between the FHLBanks on one hand and Fannie Mae and Freddie Mac on the other hand with respect to, among other things, the FHLBanks' cooperative structure.[8]

In response to the compensation provisions of HERA, the FHFA issued a proposed rule regarding executive compensation for executive officers of the FHLBanks

---

[4] 12 U.S.C. § 4518(a).

[5] 12 U.S.C. § 4518(b).

[6] 12 U.S.C. § 4518(c).

[7] 12 U.S.C. § 4518(d).

[8] 12 U.S.C. § 4513(f).

("FHFA Compensation Proposal").[9] The FHLBanks submitted detailed comments on the FHFA Compensation Proposal. The FHFA has not issued a final rule.

The FHFA in October 2008 directed the FHLBanks to provide the FHFA with at least four weeks' notice prior to taking any action in regard to the compensation of an FHLBank's five most highly paid executives.[10] This process remains in effect and results in an ongoing discussion between the FHFA and individual FHLBanks regarding executive compensation. Furthermore, in October 2009, the FHFA, citing the compensation authority given to the FHFA Director under HERA, issued an Advisory Bulletin titled "Principles for Executive Compensation at the Federal Home Loan Banks and the Office of Finance."[11]

1.2. Member Control Over Compensation Decisions at FHLBanks.

Each FHLBank is owned by its member institutions and is overseen by a board of directors elected by its members. A majority of the board of directors is comprised of "member" directors (directors or officers of member institutions). The remainder of the directors are independent directors (who cannot be directors or officers of a member of the FHLBank) who have experience in representing consumer or community interests or have knowledge of specified areas including accounting and financial management.

Compensation decisions are a critical aspect of the function of the FHLBanks' board of directors. The ability to provide compensation arrangements that allow the FHLBanks to attract and retain highly qualified executives is essential to the board's ability to ensure the effective operation of an FHLBank. At the same time, board members are acutely aware of the need to operate an FHLBank in a highly efficient manner and the need to be effective at fulfilling the FHLBank's missions for its members and the public, since all expenses reduce the earnings of the FHLBank and thus the amount available for dividends to members. Because compensation is a major element of FHLBank non-interest expenses, ensuring that executive compensation levels do not exceed the amounts necessary to ensure effective and efficient management of the FHLBank is a key focus of board attention.

By contrast, the public stock ownership structure of Fannie Mae and Freddie Mac, prior to being placed into conservatorship in September 2008, historically resulted in significant differences in incentive compensation practices at those two institutions

[9] 74 Fed. Reg. 26989 (2009)

[10] See letter from FHFA Acting Deputy Director Ronald Rosenfeld, Oct. 1, 2008.

[11] FHFA Advisory Bulletin 2009-AB-02 (Oct. 29, 2009).

compared to incentive compensation practices at the FHLBanks. For example, in 2006, the Office of Federal Housing Enterprise Oversight ("OFHEO") filed a notice of charges to recapture $91 million in compensation paid to the CEO of Fannie Mae from 1998 to 2003, of which $52 million was tied to achieving earnings-per-share targets, because during the period Fannie Mae engaged in fraudulent practices to manipulate reported earnings. OFHEO noted that Fannie Mae made the largest ever restatement of earnings by a public company (over $6 billion), and Fannie Mae itself paid a $400 million civil money penalty resulting from the misconduct of its senior officers. In 2003, OFHEO filed a notice of charges seeking to block $24 million in compensation to the former CEO of Freddie Mac because of improper earnings management designed to fulfill earnings expectations.

The FHFA was included in the agencies required to act under Section 956 because the necessary federal government infusions at Fannie and Freddie have been significant.[12] The FHLBanks have not required government infusions of capital, but rather as the FHFA has noted, served as a key source of liquidity during a significant time of financial distress.[13] The equity linked pay packages of CEOs at institutions which later required significant federal government infusions was a primary motivating factor for this legislation on incentive compensation. The FHLBanks do not have equity linked pay, and did not require federal government infusions.

1.3. <u>The Proposal Does Not Indicate that the FHFA Has Considered the Impact of the FHLBanks' Cooperative Structure As Required Under HERA</u>.

The FHFA Director is required to consider the differences between the FHLBanks on one hand and Fannie Mae and Freddie Mac on the other hand, with respect to, among other things, the FHLBanks' cooperative structure in issuing a regulation that applies to the FHLBanks. The Proposal, however, does not give any indication that the FHFA has made the consideration required by law.

As discussed above, the cooperative structure and the member control of the board of directors have a unique impact on compensation decisions at the FHLBanks and

---

12 The losses incurred by Fannie Mae have resulted in net government infusions of $87 billion since September 2008, and the losses incurred by Freddie Mac have resulted in government infusions of $64 billion since September 2008.

13 Federal Housing Finance Agency, Performance and Accountability Report (2009), p. 24 ("The FHLBanks played a critical role in providing financing to large and small member financial institutions during the second half of 2007, 2008, and the first part of 2009."). Some economists in the Federal Reserve System have expressed similar views. "The Federal Home Loan Bank System: The Lender of Next-to Last-Resort?" Adam Ashcraft, Morten L. Bech, and W. Scott Frame, Working Paper 2009-4 for the Federal Reserve Bank of Atlanta, p. 1 (February 2009).

are we believe directly relevant to whether the FHLBanks should be treated as a covered financial institution. We note that when the Financial Services Committee adopted House Report 111-236, which contained the statutory language that served as the basis for Section 956 on prohibiting unsafe incentive compensation structures, it specifically mentioned only one form of compensation, stock options.[14] Stock options and stock grants tied to achieving earnings-per-share targets for stock grants are not forms of compensation that the FHLBanks can provide, due to their cooperative structure.[15] We further believe that the differences in incentive-based compensation practices at Fannie Mae and Freddie Mac compared to that of the FHLBanks support what we argue was an intentional decision by Congress to include Fannie Mae and Freddie Mac but omit the FHLBanks as CFIs.

1.4. The Proposal Does Not Adequately Support the Treatment of the FHLBanks as Covered Financial Institutions

As discussed above, Congress, which carefully considered a comprehensive revision of the FHLBank System's operation and regulation in 2008 with the enactment of HERA, is fully familiar with the statutory scheme it created to regulate FHLBank compensation and the member-controlled cooperative governance model under which the FHLBanks operate. In this context, Congress' decision not to deem the FHLBanks CFIs cannot be treated as a mere oversight. The Proposal provides no indication to the public that the Agencies have considered the range of factors that should be evaluated when deciding whether to override a regulatory scheme for the FHLBanks that was tailored to address their unique situation. Nor does it provide an explanation of how the Agencies balanced those factors in a reasonable and rational way. Under the Administrative Procedure Act ("APA"), agency action is arbitrary and capricious and, therefore, invalid where an agency fails to "adequately explain" the reasoning behind its conclusions.[16] Accordingly, we respectfully request that the Agencies not include the FHLBanks as covered financial institutions in any Final Rule.

---

[14] House Report 111-236, Corporate and Financial Institution Compensation Fairness Act of 2009, Committee on Financial Services, p. 25 ("For purposes of this section, incentive-based compensation arrangements include, but are not limited to, stock options.")

[15] The hearing record setting forth the Congressional findings of fact that led to the adoption of section 956 of the Dodd Frank Act is in the following House hearings: Compensation Structure and Systemic Risk, Hearing before the House Committee on Financial Services, 111th Cong. 1st Sess., June 11, 2009. The testimony of witnesses, such as Lucien Bebchuk, is replete with references to the problems arising from compensation arrangement tied to the value of stock, or the value of options on stock. *Id*. at 43.

[16] *D & F Alfonso Realty Trust v. Garvey*, 216 F.3d 1191, 1195 (D.C. Cir. 2000) (quotation marks omitted).

2. The Proposed Three-Year Incentive Compensation Deferral Period Appears to Exceed the Agencies' Statutory Mandate and Is Overly Prescriptive.

To the extent that the Agencies determine, notwithstanding our comments in Section 1. above, to include the FHLBanks as CFIs, we urge the Agencies both on legal and policy grounds, as set forth below, to delete the proposed three-year mandatory incentive compensation deferral period from any Final Rule.

2.1. The Agencies May Have Exceeded the Statutory Mandate Under Section 956.

Section 956(b) of the Dodd-Frank Act directs the Agencies jointly to prescribe "regulations or guidelines" that prohibit CFIs from adopting any type of incentive-based payment arrangement that the Agencies determine would encourage inappropriate risks by such institutions. Section 956(c)(1) directs that the Agencies "ensure" that such standards are "comparable to the standards established under [Section 39 of the Federal Deposit Insurance Act ("FDI Act")] for insured depository institutions."

The compensation standards set forth in Section 39(c) of the FDI Act, to which the Agencies are directed, address in greater detail the compensation concerns addressed in Section 956(b) of the Dodd-Frank Act. In Section 39(c)(1) of the FDI Act the federal banking agencies are required to prescribe standards that prohibit any compensatory arrangement that would provide any executive officer, employee, director or principal shareholder of an insured depository institution with excessive compensation, fees or benefits or that could lead to material financial loss to the institution.

Section 39(c)(2) also provides that the compensation standards adopted by the federal banking agencies shall require the appropriate federal banking agency to determine whether the amount of compensation, fees or benefits are excessive on the basis that they are "unreasonable or disproportionate to the services actually performed" by the individual in question. In making this determination, the appropriate agency is required to take into consideration several specified factors.[17] Pursuant to Section 39(c),

[17] These factors are (i) the combined value of all cash and noncash benefits provided to the individual, (ii) the individual's compensation history at the insured depository institution and the compensation history at the institution of other individuals with comparable expertise, (iii) the institution's financial condition, (iv) comparable compensation practices at comparable institutions, (v) the projected total cost and benefit to the institution of post-employment benefits, (vi) any connection of the individual to any fraudulent act or omission, breach of trust or fiduciary duty or insider abuse with regard to the institution and (vii) other factors that the agency deems relevant. In addition, Section 39(c)(3) authorizes the federal banking agencies to adopt such other standards relating to compensation, fees and benefits as they may deem appropriate.

the federal banking agencies have adopted uniform guidelines ("Guidelines") that largely restate the provisions of Section 39(c) without significant alteration.[18]

In the Proposal, the Agencies have generally adopted the provisions of Section 39(c), as directed by Congress, and the Guidelines described above.[19] The Agencies, however, departed from the mandate of comparability with Section 39(c) of the FDI Act when they proposed a mandatory three-year incentive compensation deferral period ("Deferral Requirement"). Under proposed Section 1232.5(b)(2) all FHLBanks would be subject to a requirement that at least 50 percent of the annual incentive-based compensation of an executive officer must be deferred over a period of no less than three years, with the release of deferred amounts to occur no faster than on a pro rata basis.[20]

There is no discussion or reference in Section 39(c) or the Guidelines setting the amount of the annual incentive compensation of executive officers to be deferred, the appropriate length of a deferral or the adjustments to be made in regard to deferred amounts. In fact, the Agencies concede that the Deferral Requirement is taken from a source other than Section 39(c) or the Guidelines.

> Requiring deferral for executive officers *is consistent with international standards* that establish the expectation that large interconnected firms require the deferral of a substantial portion of incentive-based compensation . . . for certain employees for a fixed period of time not less than three years and that incentives be correctly aligned with the nature of the business, its risks, and the activities of the

---

[18] *See* 12 C.F.R. Part 30, Appendix A (OCC); 12 C.F.R. Part 208, Appendix D-1 (FRB); 12 C.F.R. Part 364, Appendix A (FDIC); and 12 C.F.R. Part 570, Appendix A (OTS).

[19] Proposed 12 C.F.R. § 1232.5(a) and (b)(1) (all references are to the FHFA version of the proposed rule) largely track the provisions of Section 39(c) and the Guidelines regarding excessive compensation and material financial loss considerations. Proposed 12 C.F.R. § 1232.5(b)(2) further sets forth three principles that must be addressed in order for a incentive-based compensation arrangement to meet the material financial loss prohibition contained in proposed Section 1232.5(b)(1). Under this requirement an incentive-based compensation arrangement must (i) balance risk and financial rewards, for example, by using deferral of payments, risk adjustment of awards, reduced sensitivity to short-term performance, or longer performance periods; (ii) be compatible with effective controls and risk management; and (iii) be supported by strong corporate governance.

[20] 12 C.F.R. § 1232.5(b)(3)(i)(A) (proposed). While Fannie Mae and Freddie Mac were expressly designated by Congress as CFIs and the FHLBanks are not, the proposed incentive compensation deferral requirement would not apply to Fannie Mae or Freddie Mac, but would apply to the FHLBanks. *See* 12 C.F.R. § 1232.5(b)(3)(i) (proposed).

> employees of the employees in question (emphasis added, footnote omitted).[21]

The Agencies were limited to adopting compensation standards comparable to those contained in another Congressional enactment – Section 39(c) of the FDI Act. The plain language of Section 956(c)(1) simply does not permit the Agencies to disregard this mandate and decide on their own initiative to apply international standards of their own choosing rather than Congressionally mandated standards. As such, the Proposal likely exceeds the scope of the Agencies' statutory mandate.

Under the well-established two-step *Chevron* doctrine, courts reviewing agency regulations ask "first whether Congress has spoken directly to the precise question at issue."[22] If it has, then any regulation that "runs counter to the unambiguously expressed intent of Congress" will be invalidated.[23] If it has not, then the court must determine whether an agency's interpretation is "reasonable" in light of the language of the statute, the statute's purposes, and the deference due to agency interpretations of the statutes they enforce.[24]

The Deferral Requirement would likely fail *Chevron* step one. As discussed above, Section 956(c) directs the agencies to "ensure" that incentive-compensation regulations are "comparable to" the standards established in the FDI Act. The Deferral Requirement, however, is inconsistent with this plain language because it bears no relationship to any requirement contained in the relevant FDI Act provisions. Accordingly, we respectfully request that the Deferral Requirement be deleted from any Final Rule.

2.2. The Deferral Requirement Is An Overly Prescriptive Approach.

The Deferral Requirement's approach to the regulation of incentive-based compensation should be rejected for sound policy reasons, which are demonstrated by the

---

[21] Incentive-Based Compensation Arrangements, 76 Fed. Reg. 21770, 21180. The international standards to which the Agencies refer are the Financial Stability Board's ("FSB") April 2009 Principles for Sound Compensation Practices and the FSB's September 2009 related Implementation Standards ("FSB Compensation Statements"). 76 Fed. Reg. at 21178

[22] *Shays v. Fed. Election Comm'n*, 414 F.3d 76, 96 (D.C. Cir. 2005) (quotation marks and ellipsis omitted).

[23] *Id.* (vacating rules because they failed *Chevron* step one); *see also, e.g., United States v. Larionoff*, 431 U.S. 864, 873 (1977) ("Regulations, in order to be valid[,] must be consistent with the statute under which they are promulgated.").

[24] *Id.* (quotation marks omitted).

same Interagency Guidance on Sound Incentive Compensation Policies[25] ("Banking Agency Guidance") that is cited by the Agencies.[26]

In the preamble of the Banking Agency Guidance, the federal banking agencies expressly determined that the guidance should be presented in a "principles-based framework" as the most effective way to address (i) the differences in the size and complexity of the institutions covered by the Banking Agency Guidance and (ii) the complexity, diversity and range of uses of their incentive compensation arrangements.[27] The Banking Agency Guidance, therefore, "[did] not mandate or prohibit the use of any specific forms of payment for incentive compensation or establish mandatory compensation levels or caps."[28] Rather, the forms and levels of incentive compensation were "expected to reflect the principles of the final guidance in a manner tailored to the business, risk profile, and other attributes of the banking organization."[29]

If the FHLBanks are included as CFIs in the Final Rule, we believe that the Deferral Requirement should be deleted, as discussed above. If the Deferral Requirement is retained in substance, we believe it should be clarified as discussed in Section 3 below.

3. Comments on Other Provisions of the Proposal.

To the extent that the Agencies determine to both include the FHLBanks as CFIs and to retain the Deferral Requirement, we believe that the Proposal raises interpretive and operational concerns that should be clarified. It is important that the Final Rule operate effectively in coordination with the existing compensation regulatory regime for the FHLBanks and avoid conflicts with other applicable regulations of the Internal Revenue Service and the SEC. To that end, we offer the following comments for the Agencies' consideration.

---

[25] 75 Fed. Reg. 36395 (2010). The Banking Agency Guidance was adopted by the FRB, the OCC, the FDIC and the OTS. The Banking Agency Guidance was not adopted under the authority of Section 39(c) of the FDI Act. *Id.* 75 Fed. Reg. at 36398.

[26] Incentive-Based Compensation Arrangements, 76 Fed. Reg. at 21173.

[27] *Id.* 75 Fed. Reg. at 36399. As stated therein, "the methods used to achieve appropriately risk-sensitive compensation arrangements likely will differ across and within organizations, and use of a single, formulaic approach likely will provide at least some employees with incentives to take imprudent risks."

[28] *Id.*

[29] *Id.*

3.1. Section 1232.5(b)(3)(i): The Proposal Should Clarify that Existing Incentive-Based Compensation Arrangements are Grandfathered.

The immediate application of the Deferral Requirement (Section 1232.5(b)(3)(i) of the Proposal) to existing incentive-based compensation arrangements would result in the disruption of the administration of our existing incentive-based compensation arrangements and could result in the violation of provisions of the Internal Revenue Code of 1986, as amended (the "Code"), or other applicable law or regulations. Accordingly, the Bank respectfully requests that the Final Rule provide flexibility regarding the implementation of the deferral requirement of Section 1232.5(b)(3)(i) of the Proposal so that such implementation may be done in a manner that does not disrupt the administration of existing incentive-based compensation arrangements and/or cause an FHLBank or any of its employees to violate any provision of the Code or other applicable law or regulation. In particular, we respectfully request that the Final Rule clarify that the Deferral Requirement apply solely to performance cycles that commence on or after 180 days after the Final Rule is promulgated.

We believe that immediate application of this section of the Proposal would require us to amend numerous incentive-based compensation arrangement documents. In addition, it would upset the existing contractual arrangements that we have established, with FHFA pre-approval as applicable, for our covered employees.

Furthermore, the immediate application of Section 1232.5(b)(3)(i) of the Proposal could result in severe adverse tax consequences for certain executive officers pursuant to Section 409A of the Code. Code Section 409A governs the taxation of non-qualified deferred compensation. If the requirements of Code Section 409A are not satisfied with respect to a non-qualified deferred compensation plan (a "Plan"), then the compensation deferred thereunder would be subject to immediate taxation when no longer subject to a substantial risk of forfeiture, plus the 20 percent additional tax (*i.e.,* a tax in addition to normal federal, state and local income taxes) and interest.[45]

In relevant part, Code Section 409A requires that a Plan must provide that deferred compensation may be distributed only upon the occurrence of certain permissible payment events, such as termination of employment or a specified date.[46] Code Section 409A also prohibits the acceleration or delay of the time or schedule of any payment under a Plan, except as provided in regulations by the Secretary of the Treasury (the "Secretary").[47] Imposing a deferral requirement on an existing incentive performance

---

[45] *See* 26 U.S.C. § 409A(a)(1).

[46] *See* 26 U.S.C. § 409A(a)(2).

[47] *See* 26 U.S.C. § 409A(a)(3).

cycle could cause violation of Code Section 409A, since any "redeferral" of deferred compensation can be accomplished only (i) by action taken at least one year prior to the originally-scheduled compensation payment date and (ii) if the new payment date is at least 5 years after the originally-scheduled payment date.

The Secretary, by regulation, provided that the adverse tax consequences of Code Section 409A would not apply to payments of compensation deferred under the Plan earlier than the payment events stated in the Plan, or to the acceleration of the time or schedule of any payment under the Plan, if such payment were made upon the termination and liquidation of the Plan.[48] However, one of the conditions of this exception is generally that any participant in the original (*i.e.,* the terminated and liquidated) Plan may not defer compensation under a Plan established by the same employer within three (3) years following the termination and liquidation of the original Plan.[49]

Certain of the FHLBanks have recently terminated their non-qualified deferred compensation plans. The executive officers of the FHLBanks who received deferred compensation payments upon the termination and liquidation of such Plans received such payments in reliance on the above regulation and, accordingly, the accelerated payment of non-qualified deferred compensation to such executive officers did not result in any adverse tax consequences to the executive officers.

However, if the FHFA requires the FHLBanks to immediately apply proposed Section 1232.5(b)(3)(i) to existing incentive-based compensation arrangements, then any executive officer who previously participated in a terminated Plan would be in violation of the regulation above that prohibits such person from deferring compensation under a Plan within three (3) years following the termination and liquidation of the original Plan. Accordingly, such executive officer would be subject to the 20 percent additional tax and interest with respect to any amount received from the existing incentive-based compensation arrangement.

The potential for disruption to our existing incentive-based compensation arrangements and for conflict with Code Section 409A and other applicable laws or regulations supports the FHFA providing flexibility on the implementation of the

---

48 *See* Treas. Reg. 1.409A-3(j)(4)(ix)(C).

49 Treas. Reg. 1.409A-3(j)(4)(ix)(C) states that "A [non-qualified deferred compensation] plan may provide for the acceleration of the time and form of a payment, or a payment under such plan may be made, where the acceleration of the payment is made pursuant to … [the employer's] termination and liquidation of the plan, provided that-- … The [employer] does not adopt a new plan … if the same [employee] participated in both plans, at any time within three years following the date the [employer] takes all necessary action to irrevocably terminate and liquidate the plan."

Deferral Requirement of proposed Section 1232.5(b)(3)(i). To require immediate implementation of the Deferral Requirement, particularly with respect to executive officers who have previously utilized the Plan termination regulation under Code Section 409A, and thereby cause such executive officers to incur severely adverse tax consequences, is unreasonable and unwarranted.

3.2. Section 1232.5(b)(3)(i): The FHFA Should Describe the Deferral Requirement in More General Terms.

The Proposal's Deferral Requirement is so specific that it does not leave room for a variety of incentive compensation arrangements that may be designed to achieve similar ends. For example, a covered entity may have a single incentive plan that provides for one annual incentive opportunity, with a deferral of a portion of that opportunity, or a single incentive compensation plan that is designed to include both short- and long-term components, with a portion payable in the year of grant (assuming that the annual incentive goals are met) and a portion held back and payable after the passage of time (assuming that longer-term conditions are met). Similarly, some employers divide their incentive compensation among multiple plans, some of which provide for incentive compensation based on short-term goals and others of which provide for incentive compensation based on longer-term goals. As drafted, the Proposal does not make clear how these different approaches would be treated. Moreover, the Proposal leaves unanswered questions about how extraordinary events (such as death, disability, termination of employment or change in control) may affect deferred amounts.

If the Agencies conclude that a Deferral Requirement should be retained, we respectfully request that Section 1232.5(b)(3)(i) be modified to refer to deferred arrangements in more general terms, in order to leave employers as much flexibility as possible in designing incentive compensation plans. We suggest the following language:

> "(i) *Deferral required for executive officers*. As part of appropriately balancing risk and financial rewards pursuant to paragraph (b)(2)(i) of this section, the overall incentive-based compensation for any executive officer established or maintained by a covered entity (except for covered entities in conservatorship or receivership, and limited-life regulated entities) must be designed so that:
>
> (A) at least 50 percent of such executive officer's targeted aggregate incentive-based compensation award is either deferred over a period of no less than three years, with payment of the deferred amounts to occur no faster than on a pro-rata basis over the deferral period, or is otherwise paid under a long-term incentive plan or long-term component of a combined incentive plan that extends for at least three years, with the payment of deferred amounts or long-term incentive payments to occur at the end of the three-year performance period, and

> (B) the payment of amounts deferred (or the payment of long-term incentive compensation amounts) shall be adjusted to reflect either actual losses or other measures or aspects of actual performance that are realized or become better known during the deferral period.
>
> Notwithstanding the foregoing, a covered entity's incentive compensation plans may provide for earlier payment of deferred amounts (or of long-term incentive payments) under specified circumstances outside the executive officer's control, such as involuntary termination of employment without cause, change in control, death or disability."

3.3. The FHFA Should Clarify that the Annual Form 10-K May Serve as the Report Required by Section 1232.4 of the Proposal.

The FHLBanks are subject to extensive compensation related disclosure obligations under the Securities Exchange Act of 1934. We request that the FHFA clarify in the Final Rule that the annual Form 10-K filed by an FHLBank (also referred to in this discussion as a registrant), which includes comprehensive information about the compensation awarded to, earned by, or paid to its named executive officers in the Compensation Discussion & Analysis ("CD&A") section of the Form 10-K[54] may serve as the annual report required by Section 1232.4 of the Proposal; provided, that any information required by Section 1232.4 but not contained in Form 10-K is separately submitted to the FHFA.

Clarifying that Form 10-K filed by each FHLBank may serve as the annual report required by Section 1232.4 of the Proposal will allow the FHFA to accomplish its stated goal of being able to make "an assessment of whether the structure or features of those arrangements provide or are likely to provide covered persons with excessive compensation, fees, or benefits to covered persons or could lead to material financial loss to the [FHLBank]."[55] This is because, as shown on the chart set forth in Exhibit A hereto, nearly all of the information required to be contained in Section 1232.4 of the Proposal is already required to be publicly disclosed by each FHLBank in the CD&A section of Form 10-K.

Allowing the Form 10-K filed by each FHLBank to serve as the annual report required by Section 1232.4 and requiring a separate report from an FHLBank only to the extent information required by Section 1232.4 is not contained in Form 10-K also would be consistent with the Agencies' stated intention to follow an approach that limits

[54] *See* 17 C.F.R. § 402(b).

[55] *See* 12 C.F.R. § 1232.4(a) (proposed).

"unnecessary reporting burden on covered financial institutions and leverages the existing supervisory framework for institutions."[58]

In addition, we note that the deadline for filing Form 10-K is the same as the proposed deadline for providing the report required by Section 1232.4 as mentioned in the preamble to the Proposal.

Finally, while the CD&A requires disclosure only regarding the named executive officers[62] of each FHLBank, and thus could potentially cover fewer individuals than would be covered by the report required by Section 1232.4 of the Proposal, we note that, to the extent the Form 10-K discussion does not contain any information required by Section 1232.4, supplemental disclosure to the FHFA could be made.

3.4. Section 1232.3 Definition of Executive Officer

We respectfully request that the definition of "executive officer" in Section 1232.3 of the Proposal be revised to read as follows:

> "*Executive officer* of a covered entity means: …
>
> "(2) With respect to a Bank:
>
> (i) A "named executive officer" within the meaning of 17 C.F.R. § 402(a)(3); and
>
> (ii) Any other officer as identified by the Director."

Our suggested revision to the definition of "executive officer" would provide a cross reference to the SEC's definition of "named executive officer" that is used for purposes of Form 10-K. Under our proposal, the FHFA Director would retain the authority to identify other individuals as executive officers. In general, however, we believe that coordinating the definition of "executive officer" with the definition of "named executive officer" for purposes of Form 10-K would be consistent with the Agencies' stated intention to follow an approach that limits "unnecessary reporting

---

[58] *Id.*

[62] *See* 17 C.F.R. § 402(a)(3), which generally defines "named executive officer" as all individuals serving as the principal executive officer ("PEO"), all individuals serving as the principal financial officer ("PFO"), the three most highly compensated executive officers other than the PEO and PFO who were serving as executive officers at the end of the last completed fiscal year, and up to two additional individuals for whom disclosure would have been provided as one of the three highest paid executives but for the fact that the individual was not serving as an executive officer of the registrant at the end of the last completed fiscal year.

burden on covered financial institutions and leverages the existing supervisory framework for institutions." Coordinating these definitions would simplify our reporting obligations. We also ask that the foregoing definition be used in any further proposed or final rule issued by the FHFA in response to the comments on the FHFA Compensation Proposal.

3.5. If Form 10-K May Not Serve as the Required Report, then We Request Clarification Regarding the Period Covered by the Report.

For the reasons stated above, we believe that it would be unnecessarily costly and burdensome to require a report pursuant to Section 1232.4 of the Proposal that duplicates material that the FHLBanks are already required to provide in Form 10-K. However, if the FHFA does not permit the Bank's Form 10-K to serve as the annual report required by Section 1232.4 of the Proposal, then we request clarification that the report required pursuant to Section 1232.4 of the Proposal is to contain a retrospective analysis (*e.g.*, a report filed in March 2011 would report on incentive-based compensation for 2010) and would not be prospective (*e.g.*, a report filed in March 2011 would report on incentive-based compensation for 2011). In this regard, as noted previously the preamble to the Proposal indicates that the Agencies intend to make the annual reports due within 90 days of the end of a covered financial institution's fiscal year. This implies that the report should contain information regarding the just completed fiscal year. In addition, the Proposal states that a covered institution is not required to report "actual" compensation of a covered person, further suggesting that the report is intended to be retrospective.[63]

3.6. Section 1232.3 Definition of Principal Shareholder.

The Proposal applies a range of requirements in regard to incentive-based compensation to covered persons, including "principal shareholders." Proposed Section 1232.3 defines a principal shareholder as an individual who, directly or indirectly, or acting through or in concert with one or more persons, owns, controls, or has the power to vote 10 percent or more of any class of voting securities of a covered entity.

This concept is not applicable in the case of an FHLBank. Ownership of voting securities of an FHLBank is not available to any individuals. Under the Federal Home Loan Bank Act and FHFA regulations only member institutions and their successors may hold FHLBank capital stock.[65] Member institutions have voting rights only with regard to the election of member representative directors from their home state and for independent directors with voting being limited based on the average number of shares

---

[63] *See* 12 C.F.R. § 1232.4(b) (proposed).

[65] 12 C.F.R. § 933.2(f)(2).

required to be held by members in the relevant state.[66] Accordingly, the concept of a party holding 10 percent or more of a class of voting securities of the Bank is not readily determinable in the corporate and regulatory structure in which the Bank operates. Retaining this language in the FHFA version of the Final Rule would not serve the purposes of Section 956 and would result in unwarranted confusion regarding the potential application of this term to individuals who hold ownership interests in member institutions or their parent holding companies or entities that are investors in such member institutions or parent holding companies.

In the Proposal the NCUA recognized that the concept of a principal shareholder was not applicable to the institutions that it supervises because of their particular structure and accordingly has proposed to not include the term principal shareholder in its version of the Final Rule.[67]

Consistent with the approach taken by the NCUA we request that the FHFA delete "principal shareholder" from the definition of "covered person" in Section 1232.3 and delete the definition of principal shareholder from Section 1232.3.

* * * * * *

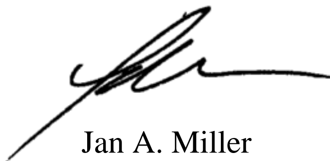
We appreciate your consideration of our comments.

Sincerely,

Federal Home Loan Bank of Atlanta

Scott C. Harvard
Chairman of the Board of Directors

Federal Home Loan Bank of Boston



Jan A. Miller
Chairman of the Board of Directors

---

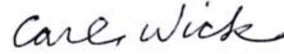
[66] 12 C.F.R. § 1261.5(b).

[67] Incentive-Based Compensation Arrangements, 76 Fed. Reg. at 21176.

Federal Home Loan Bank of Chicago

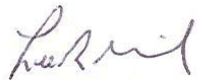
Thomas L. Herlache
Chairman of the Board of Directors

Federal Home Loan Bank of Cincinnati



Carl F. Wick
Chairman of the Board of Directors

Federal Home Loan Bank of Dallas



Lee Gibson
Chairman of the Board of Directors

Federal Home Loan Bank of Des Moines

Michael K. Guttau
Chairman of the Board of Directors

Federal Home Loan Bank of Indianapolis

Paul C. Clabuesch
Chairman of the Board of Directors

Federal Home Loan Bank of New York

Michael M. Horn
Chairman of the Board of Directors

Federal Home Loan Bank of Pittsburgh

Dennis S. Marlo
Chairman of the Board of Directors

Federal Home Loan Bank of San Francisco

J. Benson Porter
Chairman, EEO-Personnel-Compensation
Committee of the Board of Directors

Federal Home Loan Bank of Seattle

William V. Humphreys
Chairman of the Board of Directors

Federal Home Loan Bank of Topeka

Ronald K. Wente
Chairman of the Board of Directors

<u>Exhibit A</u>

Comparison of Section 1232.4 of the Proposal to the CD&A

Proposal Section	Proposal Requirement Description	Similar CD&A Requirement Description
Section 1232.4(c)(1)	"A narrative description of the components of the [FHLBank's] incentive-based compensation arrangements applicable to covered persons specifying the types of covered persons to which they apply."	Each registrant must provide a CD&A that describes, *inter alia*, "each element of compensation."[1]
Section 1232.4(c)(2)	"A succinct description of the [FHLBank's] policies and procedures governing its incentive-based compensation arrangements for covered persons."	Each registrant's CD&A may describe, *inter alia*, policies for (i) allocating between long-term and currently paid out compensation; (ii) for allocating between cash and non-cash compensation, and among different forms of non-cash compensation; (iii) long-term compensation, the basis for allocating compensation to each different form of award; (iv) how the determination is made as to when awards are granted; and (v) what specific items of corporate performance are taken into account in setting compensation policies and making compensation decisions. [2]
Section 1232.4(c)(3)	"A succinct description of incentive-based compensation policies and procedures specific to the [FHLBank's]: executive officers and other covered persons identified by the board of directors who individually have the ability to expose the [FHLBank] to possible losses that are substantial in relation to the [FHLBank's] size, capital or overall risk tolerance."	See the similar CD&A requirement description for Section 1232.4(c)(2) immediately above.
Section 1232.4(c)(4)	"Any material changes to the [FHLBank's] incentive-based compensation arrangements and policies and procedures made since the covered entity's last annual report."	No specific discussion of material changes to incentive-based compensation arrangements and policies and procedures since the last Form 10-K is required, but it is inherent within the items that must be described in the CD&A that any changes will be discussed.

---

[1] *See* 17 C.F.R. § 402(b)(1).

[2] *See id.*

Proposal Section	Proposal Requirement Description	Similar CD&A Requirement Description
Section 1232.4(c)(5)	"The specific reasons why the [FHLBank] believes the structure of its incentive-based compensation plan does not encourage inappropriate risks by the covered entity by providing covered persons with excessive compensation or incentive-based compensation that could lead to material financial loss to the [FHLBank]."	"[T]o the extent that risks arising from the registrant's compensation policies and practices for its employees are reasonably likely to have a material adverse effect on the registrant," the CD&A must include a discussion of "the registrant's policies and practices of compensating its employees, including non-executive officers, as they relate to risk management practices and risk-taking incentives."[3] Registrants must disclose, for example, "the registrant's risk assessment or incentive considerations, if any, in structuring its compensation policies and practices or in awarding and paying compensation."[4] The risk assessment discussion pertains to the registrant's employees, including non-executive officers, which is substantially the same as the scope of the requirement in Section 1232.4(c)(5).

[3] 17 C.F.R. § 402(s).

[4] *Id.*