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October 6, 2000

Manager
Dissemination Branch
Information Management and Services Division
Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552

Attention: Docket No. 2000-57

Re: Proposed Amendments to Conversion Regulations

Ladies and Gentlemen:

We are writing on behalf of our client, Hudson City Savings Bank ("Hudson City"), which is a New Jersey chartered stock savings bank, Hudson City Bancorp, Inc., which is the intermediate stock holding company for Hudson City, and Hudson City, MHC, which is the mutual holding company for Hudson City. On July 12, 2000 the Office of Thrift Supervision ("OTS") published a notice of proposed rulemaking governing mutual savings associations, mutual holding company reorganizations and conversions from mutual to stock form ("Proposed Regulations"). In Section 5 of the preamble to the proposed regulations, the OTS invites comment to the proposed regulations, including "How can OTS make the MHC form more attractive?" Set forth in this letter are Hudson City's comments.

Hudson City's mutual holding company reorganization, completed in July 1999, was under the jurisdiction of the Federal Deposit Insurance Corporation (the "FDIC"). This transaction was analyzed by the FDIC for compliance with the OTS mutual holding company and conversion regulations except to the extent the FDIC had conflicting regulations. This analysis is mandated by Section 303.163 of the rules and regulations of the FDIC. Due to this requirement any change to the OTS conversion or mutual holding company regulations will have a direct and material impact on all state chartered, FDIC insured mutual savings banks or stock form savings bank subsidiaries of mutual holding companies, such as Hudson City. For this reason we believe Hudson City's comments should be afforded no less consideration than those of a federally chartered savings association.

1. General

In the overview to the Proposed Regulations the OTS notes that it encourages consideration of the mutual holding company ("MHC") alternative for mutual institutions that elect to convert to stock form. Hudson City believes that the MHC form should be a viable and competitive business entity. If the OTS is attempting to promote the MHC form as a viable alternative to full conversion we applaud such attempt and our comments are designed to support such position. However, we believe that several aspects of the Proposed Regulations do not further that position. In fact, it appears that for the first time the OTS is taking the affirmative position to encourage savings institutions to remain in mutual form.

The OTS may have legitimate concerns about the ability of management to manage newly raised capital and the pressures of being a public company. However, these concerns do not warrant regulations that will be punitive to companies that do raise capital by severely restricting their ability to manage that capital. Rather, we support any regulations that encourage the strength and viability of the MHC form given the obvious difficulty of this form of entity in attracting investors. We believe that Hudson City, as one of the largest MHCs in the nation, is in a unique position to comment on the Proposed Regulations and suggest further enhancements to the MHC form to make it even more attractive as an alternative to full conversion. Since Hudson City had a relatively difficult time selling its stock in the offering when it reorganized into the MHC form, we believe that smaller institutions that convert to MHC form may encounter even more difficulty. Some of our suggestions apply to full conversions as well, as we believe that as a fundamental policy position it is up to the Board of Directors of each savings institution to choose its form of organization based on legitimate business considerations and not a discriminatory regulatory scheme.

We are commenting both on the Proposed Regulations as drafted and suggesting additional regulations or clarification of existing regulations and/or policies with respect to the MHC form and conversions in general. Our comments fall into three general categories. First, they are designed to make it more attractive and competitive to remain as an MHC. Second, since investors are obviously more comfortable with institutions that engage in full conversion, to make it easier and more cost effective to complete a second step conversion. Lastly, to make the regulations governing all conversions more attractive for institutions contemplating converting.

As a preliminary note, we fully support the redrafting of the OTS conversion regulations into a plain english format. They are now much easier to read and understand. We believe the OTS should take the next step and similarly redraft the mutual holding company regulations. Further, we strongly believe the OTS should complete the circle and prepare in plain english a comprehensive set of regulations for second-step conversions. Currently, such transactions are deemed by the OTS to be governed by Part 563, subject to such exceptions or interpretations that are included in any commitments required by the OTS of converting institutions or as are included in the OTS approval letter for the transaction. This procedure leaves open a greater possibility of inconsistent interpretations, one-time transactions and ad-hoc exceptions that may result in unfair differential treatment of converting institutions. A uniform published regulatory framework will create clarity not only for the institutions, but for investors who require regulatory certainty in order to continue to provide capital to the industry.

2. Issues with respect to remaining an MHC

A. Dividend Waivers

The OTS changed its policy regarding the ability of a mutual holding company to waive dividends in the interim rule (65 FR 43088) (the "Interim Rule") published simultaneously with the Proposed Regulations (65 FR 43088). The former policy focused on preventing windfalls to minority shareholders (63 FR 11361, 11363 (March 9, 1998)). This policy was enforced by requiring dilution of the minority shareholders upon their exchange of shares in a second step conversion, which the OTS states it has done only to the extent of waivers of excess or special dividends. (65 FR 43088). The Interim Rule represents an excellent beginning by the OTS for evaluating certain regulatory policies that have been viewed as inhibiting the economic viability of MHCs and thereby causing institutions to seek a full conversion to stock form rather than a mutual holding company reorganization. We believe the OTS, as the most experienced among regulatory agencies in conversions and mutual holding reorganizations, should take additional steps to persuade the Federal Reserve Board to take a similar position and rescind its policy of prohibiting any waiver of dividends by mutual bank holding companies.

B. Stock Benefit Plans

We support the OTS' efforts to provide MHCs with more flexibility in the use of equity compensation programs to attract, retain and appropriately incentivize their employees, management and directors. MHCs compete for human resources in labor markets with savings and community banks, other financial intermediaries and employers in other industries, both public and private. Of these employers, MHCs are the only stock-form entities that face permanent, artificial limits on the extent to which they may use stock options, restricted stock and other forms of equity compensation in their compensation program. This places MHCs at a competitive disadvantage relative to other employers in the markets for executive and other talent which can be eliminated only through a second-step transaction.

The proposed expansion of Section 575.8(b), which in effect permits an MHC to offer a stock option program covering up to 4.9% of its total outstanding shares, a restricted stock program covering up to 1.96% of its total outstanding shares and an ESOP for up to 3.92% of its total outstanding shares (generally, up to 4.9% if there is no restricted stock plan) is a step forward. It permits all MHCs the flexibility to offer some equity compensation whether or not it offers shares of its stock in a public offering and, if it does, without regard to the size of the offering. This alleviates pressure which MHCs might otherwise feel to raise excess capital through a stock offering in order to maximize its ability to offer competitive equity compensation programs.

However, even with the proposed expansion, section 575.8(b) continues to limit MHCs' equity compensation programs to half the level available to fully converted financial institutions 6 months after their conversion and, in contrast to the rules in effect for fully converted institutions, does not eliminate regulatory oversight one year after the conversion. Because an institution's need to offer a competitive compensation package is not related to the form of stock organization it chooses, we would encourage the OTS to take two more steps forward in achieving comparability between MHCs and fully converted institutions. First, we suggest that the OTS allow an MHC's minority stockholders, through the stockholder approval process, to determine the extent of the MHC's authority to use equity compensation beginning one year after the date of the MHC's first public offering of stock. Recognizing the absence of investor discipline in the case of an institution with no minority stockholders, regulatory oversight would be appropriate during any period that precedes an MHC's first public offering of stock. In keeping with the approach taken with fully converted institutions, such oversight would also be in effect for one year after the first public offering of stock. Second, until the first anniversary of an MHC's first public offering of stock, we recommend that an MHC be permitted to offer equity compensation opportunities as fully converted institutions during their first year of public ownership — that is, with percentage limits applied to the whole of its outstanding shares, rather than a theoretical maximum 49% public float. We believe that these additional changes would achieve greater comparability between MHCs and fully converted institutions without sacrificing appropriate regulatory and investor oversight of equity compensation practices.

C. Mergers and Acquisitions

In order for the mutual holding company form of organization to be truly competitive with a fully converted institution, it is essential that mutual holding companies be on a level playing field with their competitor institutions in their ability to engage in acquisitions. The area in which mutual holding companies are sorely lacking is their ability to use stock as consideration as part of a tax free reorganization. Under Section 575.7(d)(6) of the current regulations, a mutual holding company must first offer the shares of its publicly held stock subsidiary (the savings association or intermediate holding company) to the depositors of the converted savings association prior to the publicly held entity selling its stock to other members of the public. Historically, this requirement has been the basis for the argument that the publicly held entity may not use its authorized but unissued stock as consideration for an acquisition because it could result in dilution of the depositors' interest in the mutual holding company. This policy is in response to the perceived concern for the potential enrichment of insiders at the expense of the depositors when there is a minority stock issuance designed to result in a limited distribution of stock, such as a private placement (see 58 FR 44105). In recent years, the OTS has incrementally, but slowly, begun to move away from this theory. We have noted that Harris Financial, an institution that is currently engaged in a simultaneous MHC reorganization and acquisition, was recently permitted by the OTS to use a portion of its stock as part of the total consideration for its acquisition of another institution, such portion consisting of the extent to which the number of shares subscribed for in the subscription offering is less than the minimum shares in the offering range.

We believe it is time for the OTS to affirmatively recognize that the mutual holding company structure should not be an impediment to using stock as consideration in an acquisition transaction, and that such use is permissible as a matter of law and regulation. This will provide added flexibility for an MHC to engage in acquisitions that improves the overall financial condition and results of operation of its financial institution subsidiary thereby increasing the value of the institution to minority shareholders and depositors/members alike. There are procedures that can be taken to protect the depositors while engaging in such transactions. For example, the OTS could require a board of directors of a mutual holding company, when voting on the transaction, to affirmatively determine that the transaction is fair to the depositors/members of the mutual holding company and that the board members would be fully protected in relying on a fairness opinion received from a nationally recognized investment banking firm to that effect.

D. Charter of Intermediate Stock Holding Companies

In previous amendments to the mutual holding company regulations (63 FR 11361), the OTS permitted the creation of an intermediate stock holding company, which, among other things, would facilitate stock repurchases without resulting in adverse tax consequences. However, the OTS required that the intermediate holding company have a new federal charter rather than be chartered by any one of the fifty states. This use of a federal charter has been a source of great confusion for reorganizing institutions and investors alike. Although the provisions of the federal charter and bylaws are fairly straight forward, there is no comprehensive body of case law interpreting such provisions and establishing clear guidance on areas such as fiduciary duty and liability of directors.

We find it odd that the OTS created this rule specifically for intermediate stock holding companies while permitting holding companies for fully converted institutions to remain state chartered. Intermediate stock holding companies, as publicly held institutions, have more in common with holding companies for fully converted institutions than with the financial institution itself or the mutual holding company. The intermediate holding company is a 100% stock entity whose sole significant asset is usually a financial institution subsidiary, though it may also have other subsidiaries similar to those of standard holding companies. We recognize that the OTS may have some regulatory oversight concerns with an intermediate holding company, but these concerns can be handled through written commitments received from the intermediate holding company and its converted institution.

Directors of mutual savings associations, when considering whether to engage in a conversion transaction, carefully consider the liabilities associated with serving on a board of directors of a public company and evaluate the protections from such liability offered to them by the various corporate entities they can choose from. We do not believe that these protections should be different for an intermediate stock holding company and a holding company for a converted institution. Accordingly, we believe the OTS should reconsider its requirement that intermediate holding companies must be federally chartered.

3. Importance of second step conversion regulations

The decision by a financial institution to convert to stock form should be based upon the amount of capital it needs in order to implement its business plan and not upon the effect of regulations on such decision. The regulations governing conversions should be neutral with respect to whether to convert and what form to use and enable the decision to be based on legitimate business considerations with respect to capital raising. However, under the current state of the regulations several other factors have crept into the decision regarding whether to engage in a full conversion or an MHC reorganization.

In general, it appears that investors prefer investing in full conversions rather than mutual holding company reorganizations. This is so for a variety of reasons, including the overall increased liquidity of a full conversion, the enhanced prospects for the institution to be involved in a consolidation transaction, either as a buyer or a seller, and the enhanced prospect for overall growth and increased returns over a shorter period of time. Even the largest mutual holding company reorganizations that otherwise eliminate the liquidity concerns, such as Hudson City and Capital Federal Savings Bank, experienced significant investor disinterest. Based on Hudson City's experience when completing its reorganization and communications with its shareholders since then, it is clear that investors would like to see an enhanced opportunity for a mutual holding company to consider a second-step conversion. Historically, there has been a wide perception of significant obstacles to a second-step transaction including the regulatory imposed consequences of a dividend waiver (or the prohibition of dividend waivers by the FRB), the re-imposition of certain regulatory restrictions upon completion of a second-step transaction (discussed in more detail below) and the complete lack of a comprehensive regulatory framework for such transactions (discussed above). As a result, an institution may decide to engage in a full conversion at the outset.

The OTS has not directly addressed in the Proposed Regulations issues related to a second step conversion. We believe that these issues are of crucial concern to those institutions that are considering converting to stock form but are unsure whether to engage in a full conversion or an MHC conversion. Therefore, we believe that certain issues with respect to second step conversions should be addressed and liberalized. Also, many areas of oversight by the OTS are duplicative of federal securities regulation and/or listing regulations so there may be less need for review by the OTS. In addition, an MHC that has already been subject to OTS review during its time as an MHC is in a different position than a newly converted institution and should be free of the constraints that have been reimposed by the OTS upon completion of a second step conversion.

4. Specific issues with respect to second step conversions

A. Share Repurchase

Section 563b.3(g)(3), as revised in the Interim Rule, eliminates restrictions on stock repurchases by converted savings associations after the first year following conversion. Stock repurchases in the first year are still subject to OTS approval and such approval may only be given in "extraordinary" circumstances. Hudson City believes that an MHC that completes a second step conversion should not be subject to any additional OTS approval or oversight with respect to share repurchases. An MHC that has been repurchasing its shares for a period of time is in a different position than a newly converted institution. Shareholders have an expectation of the institution's flexibility to respond to market conditions by managing capital, including engaging in stock repurchase programs, in order to enhance shareholder value. Management is experienced in analyzing market and economic conditions and should be permitted to decide to repurchase stock that it believes to be undervalued in the market to send a positive message of confidence in the institution's future. In addition, the market will expect the institution to continue to repurchase shares consistent with past practice when and if the board deems it advantageous. Any loss of flexibility in the institution's ability to manage its capital would be detrimental to the performance of its stock in the market as well as the ability of the institution to attract investors should it desire to engage in a second-step transaction.

B. Stock Benefit Plans

Under Section 563b.500 of the Proposed Regulations, a converted savings association may implement a stock option plan or management or employee stock benefit plan no earlier than 12 months following conversion, which is substantially similar to Section 563b.3 (g)(4) of the current regulations. Pursuant to conditions generally set forth in the OTS approval letter of an MHC second step conversion, such regulation may become applicable to an MHC engaging in a second step conversion. Hudson City believes that an MHC engaging in a second step conversion should be permitted to seek shareholder approval of proposed stock benefit plans at the time of conversion from the then minority shareholders. If the minority shareholders approve such plan when the second step conversion is approved, options could be granted as of the effective time of the second-step conversion at the exchange price. Because of the fiduciary duty owed to existing shareholders of the savings association in determining the exchange price, there is no opportunity for abuse as the directors and officers receiving the grants are being treated no better than the minority shareholders.

C. Transfer Restrictions for Officers and Directors

Section 563b.505 of the Proposed Regulations, similar to Section 563b.3(c)(17) of the current regulations, provides that directors and officers who purchase conversion shares may not sell the shares for one year after the date of purchase except in the event of death. Officers and directors of an MHC that completes a second step conversion may become subject to this prohibition at the time of a second-step conversion by means of the conditions set forth in the OTS letter approving the second step conversion. We believe that no transfer restrictions should apply to officers and directors who exchange shares of a savings association or mid-tier holding company of an MHC for shares of the holding company of a fully converted savings association. For practical purposes, it is as if such officers and directors have held these shares for longer than a year. As insiders of a public company, such officers and directors are already subject to federal securities laws restrictions on purchases and sales of stock, such as insider trading restrictions under Section 10(b) of the Securities and Exchange Act of 1934 (the "Exchange Act"), the short swing profit provisions of Section 16 of the Exchange Act and Rule 144 of the Securities Act of 1933. In addition, most public companies have internal policies with respect to insider trading in company stock and permit such trading only during "window periods." It appears that additional OTS restriction is unnecessary. It may seem appropriate for such transfer restrictions to apply to shares of the holding company or savings association newly purchased by such officers and directors in the second step conversion.

5. Issues related to conversions in general

A. Business Plans

The imposition by the OTS of written standards for an acceptable business plan, which would affect full conversions, mutual holding company reorganizations and second-step conversions alike, is the one regulation the OTS has proposed that is the most perplexing, and perhaps the most difficult. No single requirement of this new business plan regulation should be pointed to as being the most burdensome (although we are sure several commenters will attempt to do so). The difficulty is in the totality of the emphasis of the OTS in evaluating business plans. By memorandum dated February 1, 1995 from Mr. John F. Downey, Director of Supervision, to the Regional Director of the OTS, the policy of the OTS on business plans was plainly evident: "[s]ome institutions may choose to convert for reasons other than increasing capital [emphasis added], . . . [t]hese are reasonable motivations and should be emphasized in the business plan." This memorandum was also very clear in requiring that business plans address deployment of conversion proceeds and that applications "may be denied" if this issue is not adequately addressed. The Proposed Regulations make it clear that if the institution can not demonstrate that it "needs" the conversion proceeds (12 CFR §563b.105(a)(3)), that the board and management have the "experience" and "expertise" to manage growth and expansion (Section 563b.105(a)(4) and (6)) and that a "reasonable return on equity" will be achieved (Section 563b.105(a)(7)), the business plan will not be accepted. These proposed standards are markedly different from the current standards of review. Surely, if these proposed rules had been in effect for the past twenty years there would have been very few stock conversions and there would be many more mutual institutions in existence today for it would be very difficult for a mutual institution to live up to all the standards of having a need, experience and expertise and guaranteeing a certain minimum return of equity that a bank regulator determines to be reasonable.

The OTS is charged by law with supervising the safety and soundness of federal savings associations. This is done primarily through the examination process and the application process. Nowhere in the preamble of the Proposed Regulations where the new business plan requirements are summarized do the words "safety and soundness" appear. It should be axiomatic that safety and soundness principles are at the heart of the business plan requirements; however, the substance of the rules indicates otherwise. When the business plan requirement was initially adopted (see 59 FR 61247 (January 1, 1995)), commenters urged the OTS (1) not to put itself in the position of deciding how much capital a business may need in future years, (2) not to require a converting institution to justify its need for capital in order to convert, and (3) not to use the business plan to deny conversions for other than safety and soundness concerns. In adopting this rule, the OTS addressed the commenters' concerns by providing that a conversion application may be denied where a business plan does not sufficiently address how the proceeds of the conversion will be deployed, raises safety and soundness concerns or does not address the convenience and needs of the community. The OTS did not consider using a business plan to deny an application because a "need" for capital has not been demonstrated. Furthermore, when adopting the current rule (specifically when addressing the convenience and needs provision) the OTS stated that the OTS does not intend to impose any specific allocation scheme on the proceeds from conversions or MHC stock offerings and the OTS agreed that the allocation of such proceeds is "largely a matter within the discretion of the converting association" (see 59 FR 61247 (January 1, 1995)). The spirit of deference to the business judgment of the board and management of a converting institution is conspicuously absent from the Proposed Regulations. The only conclusion that can be drawn is that the OTS has taken a new policy position against capital raising through conversion, particularly full conversion, by proposing the new business plan requirements. The OTS has not provided, and we do not see, any compelling reason why the new rules are necessary. We suggest the OTS revise its Proposed Regulations to amplify the procedures for submitting business plans and formalize certain information required to be included, and eliminate the elements that are prejudicial to the capital raising process. More importantly, if the Proposed Regulations do indeed indicate a policy shift of the OTS towards the capital raising process, as we believe they do, we request the OTS to reconsider.

Another aspect of the proposed business plan rules that is of particular concern is the treatment of stock repurchase plans. Section II.B. of the preamble to the Proposed Regulations states that the institution's business plan should not consider, among other things, the effect of returns of capital or repurchasing of stock in assessing the reasonableness of projected return of equity, even though these may indeed be factors considered by investors. Section 563b.105(b) of the Proposed Regulations codifies this view by providing that the institution may not project stock repurchases, returns of capital or extraordinary dividends in any part of the business plan. It is a reality of the market that a public company must be responsive to investors and the OTS acknowledges in the summary of the Proposed Regulations that investors may consider an institution's ability to manage its capital. The OTS, in prohibiting a well-established and recognized capital management technique, is forcing the institution to ignore its investors and the need for flexibility and prudent capital management. It seems overly harsh that the OTS will not permit an institution while putting together a business plan to consider capital management techniques which are legitimate concerns of investors.

In addition, the Proposed Regulations do not set forth a consistent view on this issue. While Section 563b.105(a)(i) of the Proposed Regulations provides that the business plan must clearly and completely describe projected operations and activities for three years following the conversion and subsection (b) thereof does not permit the institution to project repurchases in the business plan, Section 563b.515 has eliminated restrictions on stock repurchases by a converted savings association after the first year following conversion. Therefore, although a converted savings association is permitted to repurchase stock one year after conversion without the OTS approval, Section II.B. of the preamble to the Proposed Regulations states that institutions must follow their business plans and that any material deviation from an approved business plan will require prior written approval of the OTS (this is codified at Section 563b.115(d) of the Proposed Regulations). By refusing to let a business plan account for possible stock repurchases and requiring OTS approval of material deviations of the business plan, it is as if the OTS is giving with one hand and taking away with the other. The question that remains is whether the OTS deems a stock repurchase program entered into more than one year following conversion to be a material deviation from the business plan requiring a separate approval, contrary to the spirit of new Section 563b.515. We request that the OTS confirm that this is not the case.

B. Accelerated Vesting for Retirement

We note that Section 563b.500(a)(12) of the Proposed Regulations liberalizes the accelerated vesting of benefits to permit accelerated vesting upon a change of control of the converted savings association in addition to accelerated vesting for disability or death. Hudson City agrees with this revision and believes that accelerated vesting should also be permitted in the event of retirement that occurs at least one year after the conversion. Hudson City believes that the converted savings association is in the best position to decide on the characteristics of the plan necessary to achieve corporate objectives and to attract and retain individuals of outstanding competence. The OTS' current vesting standards give rise to unintended and detrimental influences on employees, officers and directors to whom equity compensation awards are granted. Under current regulations, it is impossible to grant any award, of any size, under a plan implemented within one year after a conversion that has less than a 5-year vesting schedule. As a result, individuals who are within 5 years of a customary retirement date must either be excluded from participation in these plans — a problematic approach under prevailing age discrimination laws — else be granted an award under which they are penalized financially if they do retire at the customary time. We believe it is detrimental to institutions to require that they operate under a regulatory scheme which has the effect of interfering with customary and prudent age-related succession planning. These concerns are not fully addressed by an institution's ability, with shareholder approval one year after conversion, to add retirement-related vesting to grants made previously. It is our understanding that recent changes in accounting standards applicable to stock option plans may, under certain circumstances, have adverse financial accounting consequences to the extent that they result in "modifications" of the outstanding stock options. In such an event it is possible that stock options which customarily have only a balance-sheet effect at exercise would also result in periodic compensation expense charges that are not customary, producing investor confusion in interpreting financial statements.

Historically, since shareholders have always approved this provision when put to a shareholder vote, a special meeting to approve amendments to the plan is an unnecessary expense. We suggest as an alternative that the plan provide for accelerated vesting for retirement with a provision that individuals who retire prior to one year following conversion cannot benefit from such provision.

C. Ratification of Stock Benefit Plans

We note that pursuant to Section 575.8(b)(5) of the Proposed Regulations governing MHC reorganizations that the OTS proposes to permit the savings association or mid-tier holding company of an MHC to adopt stock benefit plans at the time of reorganization but make no grants earlier than six months following the reorganization. Hudson City believes this time frame should also apply to full conversions instead of the longer one year time frame set forth in Section 536b.500 of the Proposed Regulations governing full conversions. There does not appear to be a valid reason for the discrepancy in timing of adoption and grant of stock benefits between an MHC reorganization and a full conversion.

We hope that the comments set forth herein are helpful in your efforts to further improve the regulations governing mutual savings associations, conversions and mutual holding company reorganizations. The executive officers of Hudson City and representatives of our firm would greatly appreciate the opportunity to discuss these comments in greater detail at your convenience. Please call Robert C. Azarow at (212) 912-7815 or Omer S.J. Williams at (212) 912-7432 if you have any questions regarding the foregoing or to arrange a conference with our client to discuss the foregoing.

Very truly yours,

THACHER PROFFITT & WOOD

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cc: David A. Permut, Esq.
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