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LUSE LEHMAN GORMAN POMERENK & SCHICK
A PROFESSIONAL CORPORATION
ATTORNEYS AT LAW
5335 WISCONSIN AVENUE, N.W., SUITE 400
WASHINGTON, D.C. 20015

TELEPHONE (202) 274-2000
FACSIMILE (202) 362-2902
www.luselaw.com

WRITER'S DIRECT DIAL NUMBER

(202) 274-2000

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Via Hand Delivery

Manager, Dissemination Branch
Information Management and Services Division
Office of Thrift Supervision
1700 G Street, N.W.
Washington, D.C. 20552
Attn: Docket No. 2000-56
Docket No. 2000-57

Re: Interim Rule With Request for Comment – Repurchases of Stock by Recently Converted Savings Associations, Etc.

Notice of Proposed Rulemaking - Mutual Savings Associations, Mutual Holding Company Reorganizations and Conversions from Mutual to Stock Form

Ladies and Gentlemen:

This letter contains our law firm's comments on the subject Interim Rule With Request for Comment (the "Interim Rule") and the Notice of Proposed Rulemaking (the "Proposed Rule") of the Office of Thrift Supervision (the "OTS"), each of which appeared in the Federal Register on July 12, 2000 (65 Fed. Reg. 43,092). In preparing our comments, we have circulated this letter among our state and federally chartered mutual institution and mutual holding company clients, and among other mutual holding companies and mutual savings institutions that may have an interest in this matter. Their comments have been incorporated in this letter, and we have listed on Exhibit A those institutions or mutual holding companies that are specifically joining us in this comment letter.

Our law firm has acted as counsel in connection with more than 50 mutual holding company reorganizations by both federal and state chartered savings institutions. We completed the first federal mutual holding company reorganization in 1991, and we completed the first "two-tier" mutual holding company reorganization using a mid-tier stock holding company. We have worked with, and been advocates of, the mutual holding company structure for many years and, as a result, we have considered at length various ways in which the structure may be enhanced.

I. <u>The Interim Rule</u>

We would like to applaud the efforts of the OTS in adopting the Interim Rule, which was effective July 12, 2000, regarding repurchases of stock by recently converted savings associations, mutual holding company dividend waivers and Gramm-Leach-Bliley Act Changes. The Interim Rule will assist recently converted institutions in managing their capital, and has been welcome news for stockholders and management. It will also reduce the uncertainty that has existed in recent years regarding OTS policy in this area. Moreover, the dividend waiver policy contained in the Interim Rule will enhance the mutual holding company structure without adversely affecting the interest of mutual members. It will clarify a regulatory standard that has been very confusing to management and stockholders of mutual holding companies and detrimental to the mutual holding company structure. As a result, it has also been detrimental to depositors and customers. As we have stated in the past, the uncertainty regarding the potential adverse impact of mutual holding company dividend waivers to minority stockholders in a "second-step" conversion transaction, as well as the Federal Reserve Board policy prohibiting mutual holding companies from waiving dividends, has probably been the greatest impediment to institutions forming mutual holding companies or remaining in the mutual holding company structure for an extended period of time.

We have only one suggested change to the Interim Rule relating to stock repurchases. Specifically, we believe that the one-year restriction on repurchases by "converted savings associations" should not apply to "second-step" conversions of institutions that already have issued stock in the mutual holding company structure or to incremental stock offerings by mid-tier stock holding companies or their savings institution subsidiaries. We are not aware of any purpose that would be served by applying OTS stock repurchase restrictions to companies that have been publicly traded for a period of time, particularly in the case of incremental stock offered by mutual holding company subsidiaries. In the case of a second-step conversion or incremental offering, management is already familiar with the issuer's responsibility as a public company, and the market is familiar with the issuer. Moreover, in many cases, the issuer will have already implemented a stock repurchase program, and no regulatory goal would be furthered by requiring that repurchases be suspended for a full year.

Accordingly, we recommend that Section 563b.3(g)(1) be amended, to provide that the one-year repurchase restriction applies only to the initial stock issuance or a standard conversion, to read as follows:

> "(1) No savings association may, for a period of one year from the first to occur of the completion of the conversion or the initial stock issuance pursuant to Section 575.7 of this chapter, repurchase any of its capital stock from any person, except that this restriction shall not apply to: . . . "

II. The Notice of Proposed Rule Making

We have attempted to divide our comments generally to those relating to the mutual-to-stock conversion rules, and those relating to mutual holding companies. Our detailed comments are provided below. However, in summary, we have recommended the following with respect to several of the more important provisions of the Proposed Rule:

- **Business Plans**.

  Although business plans are useful in helping management of a converting institution address how new capital will be reinvested, we are concerned that the plans under the Proposed Rule will be used as a policy tool to prevent standard conversions. We believe that the objective of the business plan requirements should be financial, *i.e.*, to encourage each converting institution to prepare a reasonable business plan for reinvesting capital raised in a conversion transaction. The decision to convert to stock form either in a standard conversion or mutual holding company reorganization (sometimes collectively referred to in this letter as a "conversion transaction") should remain within the business judgment of a board of directors and should not be second-guessed by the OTS. Moreover, the business plan requirements applicable to a second-step conversion by a mutual holding company warrant different considerations since management needs to take into account the interests of public stockholders. Management should be able to undertake a second-step conversion without concern that the OTS will reject its regulatory business plan. Otherwise the value of a mid-tier holding company's stock will be adversely effected, which would be detrimental to the mutual holding company structure. Accordingly, the business plan requirements of the Proposed Rule should either be eliminated or amended as described in this letter.

- **Mutual Holding Companies**.

  — **Stock Benefit Plans.** We support the additional flexibility granted to mutual holding companies to adopt new and additional stock benefit plans, which we believe will make the structure more attractive and sustainable in the long term. These additional stock benefit plans will also be in the best interests of customers and employees because they will enhance the ability of a mutual holding company to grow, provide better service and retain qualified employees and management.

  — **Indemnification/Limitation of Liability.** Federally chartered mid-tier holding companies need to be able to offer indemnification and limitation of director liability in their chartering documents, which is comparable to that routinely available under Delaware or other state law for state chartered mutual holding companies and all fully-converted stock holding companies.

— **Stock Issuances in Merger Transactions.** The Proposed Rule should specifically authorize mid-tier stock holding companies to issue stock as consideration in a merger transaction, so long as the mutual holding company owns a majority of the voting stock upon completion of the merger transaction.

A. Mutual-to-Stock Conversions

1. Business Plans

(a) General. As noted above, we enthusiastically support the changes contained in the Proposed Rule, particularly as they relate to modernizing and simplifying the mutual holding company structure. However, we believe that the most potentially troublesome aspect of the Proposed Rule relates to business plan requirements.

As a general comment, although the obligation to prepare a business plan as part of a mutual-to-stock conversion may help management to focus on ways that capital raised in a conversion transaction will be reinvested ***before*** the conversion actually occurs, we believe that the Proposed Rule places far too much emphasis on performance and needs-based criteria that should not be part of a Federal agency's standards for an acceptable business plan.

We believe that the OTS should encourage converting associations to prepare business plans that they intend to follow. Requiring a realistic business plan will focus management's efforts on preparing a plan that assists the converting institution in deploying the capital raised in the conversion transaction, rather than a plan intended solely to satisfy the OTS conversion application requirements. For example, by requiring that an institution specifically exclude transactions from its business plan that the company must realistically pursue, the Proposed Rule would actually discourage, and even prohibit a converting institution from preparing a realistic business plan that would assist it in executing a reasonable post-conversion business strategy. We believe that the OTS should ***require*** that the business plan include all transactions that the converting institution intends to pursue, including stock repurchases. The OTS focus should be on assisting associations in preparing a business plan, and encouraging them to model the actions that they intend to implement. It should not be on preparing a "needs-based", policy-driven document that a converting association has no intention of following.

Accordingly, although we have no objection to the OTS requiring each converting institution to prepare a business plan that discusses how the capital raised in a conversion transaction will be deployed, we are concerned that the business plan requirements of the Proposed Rule will be used to prevent mutual institutions from converting to stock form. The business plan requirements of the Proposed Rules appear to suggest that the only valid reason for converting to stock form or conducting a mutual holding company minority stock offering is to raise additional capital to support growth. There are other valid reasons for converting, including providing equity ownership for employees and management, and better positioning an association to achieve the size and operating efficiencies needed for growth, survival, potential business combinations, and continued customer support in the changing financial services industry. Mutual associations may not be acquired by stock institutions, and a mutual-to-stock conversion may be the most prudent course for associations that want to maximize their operating flexibility and strategic alternatives, regardless of their pre-conversion capital levels.

Our concerns regarding OTS intent with respect to the "needs-based" business plan requirements of the Proposed Rule are based on the language of the Proposed Rule itself, as well as the preamble to the proposal, particularly as they relate to demonstrating a reasonable return on equity and that the conversion proceeds will substantially meet the credit needs of an institution's proposed market area. Specifically, the Proposed Rule states that an association's business plan must, among other things:

1. Demonstrate that the plan for deploying conversion proceeds will substantially meet the credit and lending needs of the proposed market area. The Proposed Rule states that OTS will not approve a business plan that provides for a substantial investment in mortgage securities or other securities, except as an interim measure to facilitate orderly, prudent deployment of proceeds during the three years following the conversion, or the investment is part of a properly managed leverage strategy. (§563b.105(a)(2))

2. Demonstrate that the association has a reasonable need for new capital to support projected operations and activities. The association must show "opportunities are reasonably available in [its] proposed market areas to achieve [its] planned deployment of conversion proceeds." (§563b.105(a)(3))

3. Describe management's experience with response to prior growth and expansion. (§563b.105(a)(4))

4. Demonstrate that management and the board of directors have the expertise, staffing and controls to prudently manage growth. (§563b.105(a)(6))

5. Demonstrate that the association will achieve a reasonable return on equity commensurate with investment risk, investor expectations and industry norms, "without consideration of assumed, speculative stock price appreciation." The Proposed Rule specifically states that an association "may not project stock repurchases, returns of capital, or extraordinary dividends in any part of the business plan." (§ 563b.105(7)) The preamble to the proposal states that "[a]t a minimum, the projected return on equity should exceed, by a margin reflecting relative investment risk, the institution's rates on long-term certificates of deposit." (65 Fed. Reg. 43,094)

Section 563b.105(a) of the Proposed Rule requires a pre-filing meeting with the appropriate OTS Regional Office before a business plan or conversion application is filed, and the preamble to the Proposed Rule states that "the board of directors, or a committee including outside directors, should participate in the meeting" (65 Fed. Reg. 43,094) with the Regional Office. Section 563b.115 of the Proposed Rule further states that the OTS will not object to a business plan if it complies with Section 563b.105, and that an application for conversion may not be submitted until the OTS advises the converting association that it does not object to the business plan.

The preamble to the Proposed Rule states that the intent of the amendments relating to business plans is to require converting institutions to more carefully consider their future operations and to develop more realistic plans regarding how they intend to use conversion proceeds. However, we are concerned that the "needs-based", management expertise, and return on equity requirements of the proposal give each Regional Office far too much discretion to reject an institution's business plan, and, therefore, to deny an institution's right to convert to stock form. At the very least, the requirement increases the burden and costs associated with a conversion since the procedures that must be complied with may add significantly to the time necessary to complete a conversion.

While we believe that it is appropriate for the OTS to encourage institutions that are converting to stock form to consider the mutual holding company structure because, among other things, it raises less capital than a standard conversion and provides management more latitude and time to reinvest the capital at acceptable rates of return, the Proposed Rule does not appear to provide management and a board of directors the discretion to convert to stock form for any reason other than to raise capital to meet the credit and lending needs of a proposed market area. Any final rule adopted pursuant to the subject rulemaking (the "Final Rule") should specifically provide that an association may convert to stock form for reasons other than raising additional capital, including possible business combinations involving the converting association and the desire to establish equity ownership for employees, management and customers.

In other words, we believe that the Proposed Rule would have the effect of foreclosing the standard conversion option for most well-capitalized institutions that either (i) want to convert primarily to provide equity ownership for management, employees and customers, or (ii) have limited growth prospects and have reasonably concluded that an affiliation with another financial institution may be in the best interests of the institution. We recognize that no one can predict with certainty what the future prospects of community-based financial institutions will be. However, many experts, including management of many community-based financial institutions, predict that consolidation will continue.

Considering the specific language of the Proposed Rule regarding business plans, we are particularly concerned about the requirements of proposed Sections 563b.105(a)(2)-(a)(4), and (a)(6), and (a)(7).

(b) **<u>Meeting Lending and Credit Needs.</u>** Section 563b.105(a)(2) requires that the business plan demonstrate that the deployment of conversion proceeds will substantially serve to meet the lending and credit needs of an association's proposed market area, and states that a business plan that relies on investment in mortgage securities other than on an interim basis will not be approved. Unless an institution either operates in, or intends to expand into, a growth market area, it is unlikely that its business plan would be approved under the standards of Section 563b.105(a)(2). The second sentence of proposed Section 563b.105(a)(2) states that "OTS will permit investment in mortgage securities on other than an interim basis if it is part of a properly managed leverage strategy." This clause may be inconsistent with the requirement that the business plan demonstrate that the conversion proceeds will substantially serve the lending and credit needs of your proposed market areas.

Accordingly, we recommend that Section 563b.105(a)(2) be amended to simply require that an applicant demonstrate how the conversion proceeds may serve the credit and lending needs in its proposed market area, and by deleting the second sentence of Section 563b.105(a)(2) which states that OTS will not approve a business plan that provides for substantial investment in mortgage securities. Section 563b.105(a)(2), therefore, should be amended to read in its entirety as follows:

> "(2) Demonstrate that your plan for deployment of conversion proceeds may serve the credit and lending needs in your proposed market areas."

This change would not require that the proceeds will "substantially" serve the credit and lending needs of the proposed market area. Rather, it would simply require that the applicant show how the conversion proceeds may serve the credit and lending needs of the proposed market area. It would eliminate the authority of the OTS to reject a business plan that relies substantially on investing conversion proceeds in mortgage securities on an interim basis.

(c) **Need for New Capital.** Section 563b.105(a)(3) provides that a converting institution demonstrate it has a reasonable need for new capital to support projected operations, and it must show that there are opportunities reasonably available in the proposed market area to deploy the conversion proceeds. Converting institutions in limited growth markets may not be able to satisfy this provision, and would likely need to expand into adjacent markets either *de novo* or by acquisitions. In competitive markets, expansion by acquisition may be the only alternative, but an acquisition may not be available at the time of conversion. Moreover, an institution may prefer to convert to stock form before entering into merger discussions because of the complexity of a simultaneous conversion and acquisition. Similarly, an acquiree financial institution may be reluctant to enter into merger discussions with converting mutual institutions because of the market risks associated with completing a mutual-to-stock conversion.

Accordingly, Section 563b.105(a)(3) of the Proposed Rule should be amended as follows to eliminate any requirements to demonstrate "need" for new capital or to show that "opportunities are reasonably available" in the proposed market area:

> "(3) Demonstrate how the new capital will support projected operations and activities, and project which opportunities may be available in your proposed market areas to achieve your plan and deployment of conversion proceeds."

(d) **Experience in Managing Growth.** Section 563b.105(a)(4) requires management to describe its experience with respect to growth described in the business plan. The preamble to the Proposed Rule states that "OTS strongly encourages institutions with management that does not have sufficient or favorable experience with expansion to consider alternatives to full conversion." Most mutual institution managers have limited experience in managing growth other than by leveraging retained earnings. An institution that develops a reasonable plan for growth, and has a qualified management team, should not be prevented from converting because management does not have a track record for using significant amounts of new capital to leverage growth. We are not aware of any evidence to support the proposition that prior experience in leveraging or managing growth will necessarily provide better results. Good bank managers have been able to manage growth prudently even when they had no prior experience in reinvesting capital raised in a conversion transaction. Accordingly, we recommend that this section be deleted.

(e) **Management Expertise.** Similarly, Section 563b.105(a)(6) requires that the business plan demonstrate that management and the board of directors have the expertise, staffing and controls to prudently manage the activities and growth described in the business plan. Most institutions do not need to hire new management to complete a conversion or operate successfully as a publicly traded company. We agree that a mutual-to-stock conversion requires an institution to focus on financial performance, and to have an experienced financial officer and independent accountants with Securities and Exchange Commission ("SEC") experience. However, we do not believe that management should have to demonstrate that it has the expertise to manage the growth and new investment and other activities contemplated by the business plan. If an institution has an acceptable CAMEL rating, then OTS should assume that management will be able to invest the capital raised in a conversion in a prudent manner. Accordingly, we recommend that this section also be deleted.

(f) **Reasonable Return on Equity.** Lastly, Section 563b.105(a)(7) would require a converting institution to demonstrate that it will achieve a reasonable return on equity, commensurate with investment risk, investor expectations, and without regard to speculative stock price appreciation, stock repurchases, or extraordinary dividends. This proposed section may be the most troubling for converting institutions. Like the business plan requirements generally, it implicitly rejects the proposition that a mutual institution may convert to stock form for reasons other than growth or raising capital. In the preamble to the Proposed Rule, the OTS acknowledges that most savings institutions have limited growth opportunities where it states that:

> "Lack of opportunity, not capital, constrain the growth of mutual institutions. Opportunities may be limited by aggressive competition in the mutual institution's market area, unwillingness to venture into unfamiliar markets or products, or lack of adequate staff or appropriate expertise to manage new business." (65 Fed. Reg. 43,093)

Many management consultants would argue that institutions facing limited growth opportunities should not maintain the status quo. Rather, they should consider new products and services, growth and possibly consolidation with another financial institution that offers better growth opportunities for the institution and its employees. Growth and the prospect of advancement is an essential ingredient for attracting and maintaining qualified personnel to manage an institution. Any business plan requirement that effectively forces mutual institutions to remain in their current form will be counterproductive for customers and employees. A well-capitalized mutual institution that would like to preserve or increase its market options by being in stock form should not be precluded from doing so simply because it cannot demonstrate a reasonable return on equity.

Moreover, as a practical matter, we do not believe that the OTS should want to advise a converting institution what an appropriate return on equity should be. Moreover, encouraging higher returns on equity may be inconsistent with the objective of encouraging institutions to maintain strong capital levels. That is, we are concerned that institutions will need to leverage their balance sheets to produce higher returns on equity necessary to satisfy the OTS business plan requirements, but in doing so, they may be growing too quickly and at the expense of asset quality.

Stock repurchases and special dividends are time-tested capital management tools that have been used by stock companies in all industry sectors. Converting mutual institutions are different than most new businesses that go public because mutual institutions are already adequately capitalized and have established businesses. Therefore, it will always be more difficult for converting mutual institutions, particularly those that have significant pre-conversion capital, to demonstrate an adequate return on equity for the first few years after a conversion transaction. It is for this reason that stock repurchases and dividends are particularly important capital management tools that converting institutions need to incorporate in their business plans.

Accordingly, we recommend that Section 563b.105(b) be deleted and that Section 563b.105(a)(7) be amended as follows to simply require that the business plan include projected returns on equity, both with and without considering stock appreciation, stock repurchases and dividends:

> "(7) Include the projected return on equity, both with and without consideration of assumed speculative stock price appreciation."

(g) **Second-Step Conversions.** The Proposed Rule should clarify that the OTS will not necessarily apply the business plan requirements to second-step conversions. Mutual institutions that form mutual holding companies and sell stock in minority stock offerings raise substantially less capital compared to the capital raised in a standard conversion and, therefore, should be able to more easily satisfy the proposed business plan requirements. Moreover, if the mutual holding company has leveraged the capital raised in a minority stock offering, it may be well positioned to reinvest additional capital raised in a second-step conversion. However, a mutual holding company that has not successfully reinvested new capital may desire to convert to stock form simply to maximize its strategic options, such as an acquisition or merger. In such event, particularly if the prospects for attractive stockholder returns are limited, a second-step conversion may be warranted and prudent regardless of the projected returns that can be demonstrated in a business plan. Accordingly, we recommend that a new Section 563b.105(c) be added to provide that in evaluating a business plan under Section 563b.105(c), the OTS may consider other factors, such as prospects for growth and stockholder returns in the mutual holding company structure:

> "(c) OTS may take other factors into consideration, such as the interests of public stockholders, and may waive all or part of the requirements of paragraphs (a) and (b) above in the case of a conversion of a mutual holding company to stock form."

In summary, we believe that a business plan should have the financial and management objective of demonstrating to the OTS that management and the board of directors of a converting institution have carefully considered how it will invest the capital raised in a conversion transaction. It should not be used as a policy tool for determining whether conversion proceeds can successfully be deployed in the institution's market area, or to second-guess management's decision to convert. Management of each mutual institution should be able to determine for itself whether a conversion transaction is in the best interest of the institution.

We recognize that the OTS may prefer that more savings associations remain independent indefinitely. However, implementing "needs-based" and the other business plan standards contained in the Proposed Rule will be detrimental and inconsistent with the proposition that every mutual institution should have the option to convert to stock form. The changes and proposed changes to the regulations regarding mutual companies in the Interim Rule and the Proposed Rule, respectively, have made the mutual holding company structure more attractive, and will likely cause more converting mutual institutions to choose the mutual holding company rather than a standard conversion. However, we are also concerned that the business plan requirements of the Proposed Rule, if applied to second-step conversion transactions, would ironically have the effect of discouraging mutual holding company reorganizations. Lastly, the Proposed Rule's emphasis on managing capital, even if used as policy guidance only, will accomplish the OTS objective of helping converting mutual institutions to recognize the advantages of the mutual holding company alternative.

2. Mutual Capital Distributions

In the Proposed Rule, the OTS has asked for comment on whether to issue guidance regarding special capital distributions by mutual institutions. We note that most mutual institutions are authorized under their existing charter documents to make capital distributions to members, and we have advised periodically a number of mutual institutions on this issue. We believe that any distribution to members should be considered carefully, and we do not believe that the OTS should adopt regulations or issue guidance in this area. Moreover, we note that the Proposed Rule broadly refers to distributions of excess capital to "communities."

First, a non-recurring distribution to mutual members can never be equitable because it will never be made to all persons who should be entitled to receive the distribution. The excess capital of an institution that accumulates over a period of years results from the support and loyalty of all customers, including depositors and borrowers who are no longer customers of the institution. In a mutual institution, members do not purchase or sell their interests based on fair value, nor do they periodically receive distributions of excess capital. To be fair, such distributions would need to be made on an ongoing basis in much the same way as dividends are distributed to stockholders. However, we do not believe that most mutual institutions could sustain dividends based on their earnings. Accordingly, new depositors who receive capital distributions would receive a "windfall" if they were not customers of the institution at the time that the excess capital was created. In a stock institution, a stockholder is entitled to dividends and capital gain as long as he or she owns stock of the institution. When the stockholder sells or transfers his stock, the new owner is appropriately entitled to future distributions.

Second, a distribution to members may lead members to reconsider their interest in their mutual institution, including whether they should have the right to receive all the capital or stock of an institution upon its conversion from mutual to stock form. In other words, if they are entitled to receive an excess capital distribution, why are they not entitled to all the capital of an institution if it converts from mutual to stock form? The current mutual-to-stock conversion regulations have created a prudent, careful and workable balance between the interests of depositors, the public and the banking regulators, and these regulations could be jeopardized by excess capital distributions.

Lastly, we believe it would be inappropriate to distribute excess capital to the community. However, we support the right of institutions to make charitable contributions to their communities.

3. Stock Repurchases

The OTS Interim Rule eliminates restrictions on stock repurchases by converting savings institutions after the first year following a conversion transaction. We strongly support the stock repurchase standards of the Interim Rule, and have provided one comment asking that the OTS not apply any stock repurchase restrictions to institutions that conduct incremental stock offerings in a mutual holding company structure or a "second-step" conversion to stock form since they are already publicly traded. We are not aware of any OTS policy that would be served by applying the stock repurchase rules to such companies.

4. Charitable Foundations

Mutual institutions that desire to establish a charitable foundation in connection with a standard conversion or mutual holding company formation are currently required to request a waiver of the OTS conversion regulations. In the past, this waiver process has been time consuming and expensive to the converting association. Accordingly, we support the OTS proposal to incorporate current charitable foundation policies and practices into the conversion regulations. We also believe that the charitable foundation requirements in the Proposed Rule are workable with the exception of the following technical changes.

First, Section 563b.550 provides that an institution may make a contribution of conversion proceeds to a charitable organization if the Internal Revenue Service ("IRS") approves the charitable organization as a tax-exempt charitable organization under the Internal Revenue Code (the "Code"). However, if the charitable organization is one that is established by the institution in the conversion process, it is unlikely that it will have received approval of its tax-exempt status from the IRS at the time the contribution is made. It should be noted that a charitable organization has up to 15 months after incorporation to seek approval from the IRS of its tax-exempt status in order to have such tax-exempt status relate back to the date of incorporation. Moreover, once an application is submitted to the IRS, it may take up to six months to receive IRS approval. Consequently, we believe that proposed Section 563b.550(c) should be amended as follows to require that the contribution be conditioned on the receipt by the charitable organization of approval of its tax-exempt status within 15 months from its formation, and prior to the contribution's use or application by the charitable organization.

Proposed Section 563b.565(a) states that the organizational documents of the charitable organization must provide that the charitable organization's purpose is to serve and make grants in the local community. The charitable organization's primary purpose should be to make grants locally. However, contributions from the charitable organization to national charitable organizations, such as the American Heart Association and the American Cancer Society, should not be discouraged so long as the majority of the charitable organization's activities and benefits are local in nature. Accordingly, proposed Section 563b.565(a) should be amended as follows:

> "(a) The charitable organization's primary purpose is to serve and make grants in your local community."

We note that proposed Section 563.565(d) requires that, for at least five years after its organization, the charitable organization is required to reserve at least one seat on its board for a member of the board of directors of the institution that established the charitable organization. We would add that in the event of a change in control of the institution within the five-year period, a member of the acquiror's board would be substituted. Accordingly, proposed Section 563b.565(d) should be amended to add "or from the board of directors of an acquiror institution in the event of a merger or acquisition of your organization."

Proposed Section 563b.575(a)(2) requires that the charitable organization's organizational documents state that it must comply with all supervisory directives that the OTS imposes. We believe that this should be modified to make clear that it must comply with supervisory directives to the extent not inconsistent with the laws that govern the charitable organization's tax-exempt status, and such language should be added to the last sentence of proposed Section 563b.575(a)(2).

We recommend that the language of proposed Section 563b.575(a)(3) be modified to read as follows: "The charitable organization must annually provide OTS with a copy of the annual report that the charitable organization submitted to the IRS." This clarifies that the requirement is ongoing.

Finally, the limitation on contributing stock or cash in a mutual holding company structure set forth in proposed Section 575.7(d)(8) should be eliminated since this is a restriction under the Internal Revenue Code that may be amended from time to time, and should not be applicable to mutual holding companies. Compliance with applicable regulations of the Code should satisfy the OTS. Accordingly, the last sentence of the proposed Section 575.7(d)(8) should be amended by deleting the last sentence therein and amending the first sentence to read as follows:

> "(8) You may contribute a reasonable amount of shares or proceeds to a charitable organization that complies with §§563b.550 to 563b.575 of this chapter, provided such contribution does not result in any taxes on excess business holdings under §4943 of the Internal Revenue Code."

5. Demand Account Holders

We agree that both savings and demand account holders should have subscription rights in a conversion transaction. Both account holders are members of a federal savings association, and demand account holders are an important source of funds and earnings for savings institutions.

6. Revisions to Policies regarding Management Stock Benefit Plans

Current OTS regulations provide that stock benefit plans implemented less than one year after a conversion transaction may not provide for accelerated vesting in the event of retirement or a change of control of the converting association. We support the proposed amendment that would permit plans adopted within one year of a conversion transaction (but after six months from the closing of the conversion transaction) to provide for accelerated vesting in the event of a change of control. However, we would propose that such plans also authorize accelerated vesting in the event of retirement even if adopted within one year of a conversion transaction. Institutions currently go through the expense of amending plans to provide for accelerated vesting in the event of retirement or change in control, and we see no reason why the Final Rule should distinguish between retirement and change of control as it relates to vesting of benefits.

We do not agree, however, that the Final Rule should require institutions that amend their stock benefit plans more than one year after a conversion transaction to obtain stockholder approval of any amendments that do not conform to the requirements of Section 563b.500. Under current laws and regulations, stockholder approval of stock benefit plan amendments or new plans is required because of NASDAQ requirements or requirements under the Internal Revenue Code with respect to incentive stock option plans. We believe that the existing regulations under NASDAQ and the Internal Revenue Code, as well as any SEC requirements regarding disclosure to stockholders, adequately address the need to obtain stockholder approval of stock benefit plans or any amendments to such plans.

7. **Holding Company Formation**

We believe that current OTS policy authorizing holding companies to retain no more than 50% of the proceeds of a conversion transaction has been workable. However, we do not believe that there should be a fixed 50% of conversion proceeds limit on capital that may be retained by a holding company since there may be instances where it makes sense for a holding company to retain more than 50% of the conversion proceeds. Accordingly, we would recommend that Section 563b.105(a)(1) provide that: "The business plan must provide that the converted savings association must retain at least 50% of the gross conversion proceeds, unless a lesser amount is authorized by the Regional Director." This flexibility would give the Regional Director the authority to determine on a case-by-case basis whether the holding company parent of the converting association may retain more than 50% of the conversion proceeds.

B. **Mutual Holding Company Revisions**

As discussed above, we enthusiastically support the efforts of the OTS to make mutual holding companies "a more suitable, long-term alternative to a full conversion". The OTS has already accomplished this in part in the Interim Rule by eliminating any dilution to minority stockholders from dividends waived by mutual holding companies. We believe that had the dividend waiver regulation contained in the Interim Rule been adopted in the early 1990's, there would be many more large independent thrift institutions operating today. The new dividend waiver regulation will enable mutual holding companies to operate indefinitely, and it will make it easier for management, stockholders and customers to understand the mutual holding company structure. This, in turn, will make mutual holding companies a more attractive investment opportunity for stockholders and employees.

1. **Stock Benefit Plans**

(a) **Expanded Stock Options and Awards.** Section 575.8(b)(6) of the Proposed Rule provides that the number of shares or options issued under stock benefit plans adopted in connection with a minority stock offering may be based on 49% of the outstanding shares, regardless of the actual number of shares sold in the minority stock offering. Under current rules, mutual holding company stock benefit plans are based on the percentage of outstanding shares sold to minority stockholders. In other words, if an institution has sold 20% of its shares in a minority stock offering, then 10% and 4% of the minority shares (or 2% and 0.8% of the total outstanding shares, respectively) could be awarded pursuant to stock option and stock award plans. We agree that it makes sense for the OTS not to tie stock benefit plans to the percentage of shares sold in a minority stock offering. In other words, management and employees should not be penalized with respect to their ability to participate in stock benefit plans because the association has elected to limit the amount of capital raised in a minority stock offering.

As a practical matter, we note that most smaller mutual institutions that conduct minority stock offerings will elect to sell between 45% and 49% of their shares to increase the liquidity of the publicly held stock. With the two-tier mutual holding company structure, these institutions may conduct stock repurchases which will help manage capital, and at the same time provide a market for an institution's stock.

(b) **Timing of Stockholder Approval of Plans.** The Proposed Rule would allow a mid-tier holding company or subsidiary association to adopt stock option and restricted stock plans at the time of the mutual holding company reorganization, provided that no grants under the plans are made until at least six months following the reorganization. The delay would allow the stock price to settle in the marketplace before the institution makes the grants, and avoid the expense of a separate stockholders meeting.

We support the Proposed Rule change since it may eliminate the costs incurred by associations that adopt stock benefit plans within one year following a minority stock offering. However, we would note that unless the OTS also amends the conversion regulations to allow for accelerated vesting of stock benefits in the event of retirement, most institutions will be required to hold another meeting to amend their stock benefit plans subsequent to the first anniversary date of the minority stock offering.

(c) **Additional Stock Benefit Plans.** Section 575.7(d)(7) of the Proposed Rule would allow a mid-tier stock holding company or its subsidiary association to adopt additional stock benefit plans without requiring an additional minority stock issuance, provided 30 days prior notice is given to the OTS and the OTS does not object to the adoption of the plans. The preamble to the Proposed Rule states that the additional plans would be subject to certain restrictions, such as management ratings and majority ownership at the MHC level and other applicable regulatory requirements.

We strongly support proposed Section 575.7(d)(7) since it would enable mutual holding companies to award additional stock benefits to employees and management without having to undertake a full conversion to stock form or sell additional minority stock to the public. It would also enable mutual holding companies that acquire stock institutions to permit holders of stock options to exchange their options for options of a mutual holding company's subsidiary stock association or holding company. Like fully-converted stock holding companies, mutual holding companies need to be able to award additional incentive stock options and stock awards to existing and future employees, managers and directors after all awards have been made under existing stock benefit plans. These additional stock benefit plans would require the approval of stockholders who are the appropriate persons to determine whether such additional stock benefit plans should be adopted.

The preamble to the Proposed Rule states that among the factors that the OTS will consider when reviewing additional stock benefit plans are the purpose for creating additional plans, management ratings, or supervisory problems at the savings association. We agree that these are appropriate criteria for determining whether to object to additional plans. However, we do not believe that the OTS should condition the approval of additional stock benefit plans on the institution remaining in the mutual holding company structure. It is not clear from the proposal whether this is the intent of the OTS, but we do not believe that it would be useful to condition OTS approval of additional benefit plans on the institution remaining in the mutual holding company structure.

The objective of the proposed regulations is to make the mutual holding company structure more attractive for mutual institutions and existing mutual holding companies. This will encourage more institutions to opt for this structure as opposed to a standard conversion. This objective would not be served by imposing a condition regarding stock benefit plans that does not apply to fully-converted stock holding companies. It is important to keep in mind that if a mutual holding company adopts additional stock benefit plans and determines, for any number of reasons, such as an opportunity to acquire another institution, to convert to stock form, it would not be permitted to adopt additional stock benefit plans until at least six months after a conversion. At that time, stockholders of the fully-converted stock holding company would have the opportunity to approve or reject any additional stock benefit plans that management desires to implement. We believe that it is unlikely that management would quickly adopt additional stock benefit plans following a conversion because such plans would be a significant expense to the converted institution.

2. General Comments Regarding Improving the Mutual Holding Company Structure

We welcome the opportunity to provide additional comments regarding ways to improve the mutual holding company structure which are discussed in detail below.

(a) **Enhanced Indemnification and Limitation of Liability.** Current OTS regulations require that any federal association that forms a mutual holding company must charter the mid-tier holding company under federal law. The OTS model charter for mid-tier holding companies does not authorize the range of protections for directors and officers against unwarranted stockholder litigation that is now routinely available under various state laws including Delaware, Massachusetts, New York and Pennsylvania. In our experience, many state chartered savings banks have formed their mutual holding companies under state law primarily to take advantage of indemnification and limitation of liability available under state law, including limitation of director liability for breach of fiduciary care. In other words, fully-converted stock holding companies and state chartered mutual holding companies may chose their holding company charter from a number of different states, after comparing such things as director and officer liability and indemnification.

The exposure to litigation and liability is a serious concern for directors of all public companies, and liability insurance is often inadequate. Directors and officers of federally chartered mid-tier holding companies are at a significant disadvantage under the federal law because of the indemnification limitations under OTS rules and the unavailability of charter limitations on director liability. Accordingly, we would recommend that a new Section 575.14(c)(2) be added as follows to provide that any mid-tier holding company chartered under federal law may include indemnification and limitation of liability provisions set forth below or authorized under the law of the state where the mid-tier holding company is domiciled:

> "(2) **OPTIONAL CHARTER PROVISIONS.** In addition to the items required to be set forth in the charter of the subsidiary holding company under paragraph (c)(1), the charter may also contain any or all of the following matters or whatever limitation of liability and indemnification is available under the law of the state where the mutual holding company is domiciled:
>
> (i) A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director (i) for breach of duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; or (iii) for any transaction from which the director derived an improper personnel benefit.

(ii) A provision authorizing indemnification of officers, directors, employees and agents and the purchase of liability insurance, to the full extent permitted under Section 145 of the Delaware General Corporation Law, or the law of the state in which the subsidiary holding company is domiciled."

The language of proposed Section 575.14(c)(2), dealing with the liability of directors, is modeled after Section 102(b)(7) of the Delaware General Corporation law (the "DGCL"). The section was added in 1986 because corporations were concerned about their ability to attract and retain qualified directors. In response to such problem, the Delaware legislature decided that Delaware corporations should be authorized to include provisions in their certificates of incorporation limiting or eliminating the personal liability of directors for breach of the fiduciary duty of care. <u>Nearly all fully-converted stock holding companies have this provision in their charter or certificate of incorporation.</u>

A number of cases have considered the effect of provisions adopted under Section 102(b)(7) of the DGCL, and it has been workable and beneficial to corporations without impairing stockholder rights. For example, in *John Hancock Capital Growth Management v. Aris Corp.* [1990 Transfer binder] Fed. Sec. L. Rep. (CCH) ¶95,461 (Del. Ch. Aug. 24, 1990), the Court of Chancery granted summary judgment to the defendants, in connection with claims arising out of the sale by the defendant corporation of its principal assets. The plaintiff alleged that the transaction injured the corporation's stockholders by precluding an alternative transaction in which the corporation would have repurchased most or all of its bonds at a substantial discount. The board was charged with having been grossly negligent because it did not consider the alternative of repurchasing the bonds. The court found that plaintiffs' gross negligence claim was not cognizable in this instance because the corporate defendant's certificate of incorporation contained a section 102(b)(7) provision, and the plaintiff was left with only a duty of loyalty claim.

The Court of Chancery also granted a motion to dismiss a claim that directors had improperly timed the announcement of a proposed merger and had failed to disclose, or made misleading disclosure of, material financial information concerning an acquisition in *In re Dataproducts Corp. Shareholders Litigation.* [1991 transfer binder] Fed. Sec. L. Rep. (CCH) ¶96,227 (Del. Ch. Aug. 22, 1991). The court found that the timing claim was legally deficient in light of a section 102(b)(7) provision, which had the effect of exculpating the directors from liability for money damages for acts of gross negligence. With respect to the disclosure claims, the court held that these claims were also barred by Section 102(b)(7) insofar as they were directed against the directors.

The broader indemnification authority requested would enhance indemnification available under 12 C.F.R. § 545.121. It is necessary to provide officers and directors of mid-tier holding companies the same protection available under state law for stock holding companies and mid-tier stock holding companies so that they can vigorously resist what they consider unjustified claims and be secure in the knowledge that their reasonable expenses will be borne by the mid-tier holding company if they are vindicated. In addition, the broader indemnification authority would encourage capable persons to serve as corporate directors with the understanding that expenses incurred by them in upholding their responsibilities as directors will be borne by the corporation.

If the OTS permitted mid-tier holding companies to be chartered as state corporations (like fully-converted stock holding companies), and mid-tier holding companies of state chartered savings banks we would have no comments regarding indemnification and limitation of liability. However, the OTS requires that the mid-tier holding company be chartered as a federal corporation. Since the OTS believes that it is important for the mid-tier holding company to be a federal corporation, we see no reason why authorizing the broader limitation of liability and indemnification provisions described above would be inconsistent with that OTS objective. This should be the case particularly since the OTS currently regulates hundreds of stock holding companies chartered under state law that enjoy the foregoing indemnification and limitation of liability protection.

(b) **Charter Provisions Regarding New Business and Nomination Proposals.** The model federal mid-tier holding company charter permits new business and director nominations to be submitted to the secretary of the corporation no later than 30 days and 10 days, respectively, prior to the meeting of stockholders. Delaware corporations, for example, may require new business and director nominations to be submitted in writing at least 90 days prior to the meeting. This is a more realistic and workable time frame, and Sections 575.9(a)(4) and 544.5(13), (14) and (15) should be amended accordingly.

(c) **Additional Stock Issuances to Effect Acquisitions.** Although the OTS and the FDIC have specifically authorized mutual holding company subsidiaries to issue stock from authorized but unissued shares to acquire the shares of other financial institutions, we believe it would be appropriate to include a new sentence at the end of Section 575.10(a)(1) and (a)(4) to provide that a subsidiary stock holding company of a mutual holding company may issue stock to acquire one or more stock savings institutions or stock holding companies so long as the mutual holding company owns a majority of the outstanding shares of the combined institution following the acquisition. The amended section should provide that such stock may be issued either from authorized but unissued shares or shares held by the mutual holding company; provided that any shares held by the mutual holding company are first offered to depositors of the subsidiary savings institution. Lastly, the amended section should specifically provide that shares that have previously been sold to the public that have been repurchased by the subsidiary holding company (i.e., treasury shares) may be issued to stockholders of an acquiree institution so as to eliminate any confusion as to whether subscription rights attach to such shares.

"**(a) Acquisitions.**

(1) STOCK SAVINGS ASSOCIATIONS . . . . The subsidiary holding company or savings association may issue shares of its common stock to stockholders of an acquiree association in consideration of the merger or acquisition provided that (i) the mutual holding company owns a majority of the voting stock of the subsidiary holding company or savings association upon completion of the merger or acquisition, and (ii) if voting shares previously held by the mutual holding company are issued to stockholders of the acquiree association or its holding company, such shares have first been offered for sale to depositor members pursuant to Section 575.7(b) of this part."

"**(4) STOCK HOLDING COMPANIES . . . .** The subsidiary holding company or savings association may issue shares of its common stock to stockholders of an acquiree holding company in consideration of the merger or acquisition provided that (i) the mutual holding company owns a majority of the voting stock of the subsidiary holding company or savings association upon completion of the merger or acquisition, and (ii) if voting shares previously held by the mutual holding company are issued to stockholders of the acquiree holding company, such shares have first been offered for sale to depositor members pursuant to Section 575.7(b) of this part."

(d) **Vote of Members to Approve a Reorganization.** Section 10(o)(2)(b) of the Home Owners' Loan Act (the "HOLA") currently requires that where a mutual association has "holders of accounts and obligors who exercise voting rights" the reorganization must be approved by a "majority of such individuals at a meeting in accordance with the procedures prescribed by the association's charter and bylaws." We note that neither the HOLA nor the bylaws of any mutual association requires a majority vote of all the eligible voting members to approve a transaction. Rather, the HOLA and most federal mutual bylaws simply require a majority of those voting without restriction to use of existing proxies. Accordingly, we would recommend that Section 575.3(c) be amended to provide that a mutual holding company reorganization may be approved by a majority vote of the members voting in person or by proxy at a meeting where a quorum is present.

Moreover, we believe that notice to members of the reorganizing institution should only require a proxy and a brief letter summarizing the effect of the reorganization. We agree with the OTS that the interests of the members are not adversely affected by a mutual holding company reorganization, and no reorganization has been rejected by members. Obtaining a majority vote of all members, particularly for mutual holding companies that do not issue stock as part of the transaction, can be one of the most expensive aspects of a mutual holding company reorganization because of the need to engage a proxy solicitation firm to assist in obtaining a vote of a majority of the total eligible membership. It is interesting that no member vote is required for a merger of two mutual associations even though one institution disappears in the process. Moreover, a simple majority vote is required to convert a federal credit union to a federal savings association. **Accordingly, we strongly believe that a simple vote of the majority of the members in person or by proxy is fair to members and consistent with other voting requirements for mutual institutions. The interests of depositors are unchanged by a mutual holding company reorganization, and they would at all times retain the right to vote on any conversion of the mutual holding company from mutual to stock form.**

We believe that this change should be adopted as promptly as possible so that pending mutual holding company formations can avoid the additional costs and expense associated with obtaining depositor approval under current rules.

(e) **Denial of Subscription Rights in Second-Step Conversions.** In second-step conversions over the years, the OTS has required that the converting institution impose purchase limitations that include minority shares. For example, these limitations might state that the maximum purchase limitation is 10,000 shares, including shares received in exchange for minority shares purchased in the open market prior to the completion of the second-step conversion. We believe that this requirement may force companies to deny subscription rights to depositors if, for example, a depositor owns a sufficient number of minority shares that the shares he receives in exchange for his minority shares exceeds the maximum purchase limitations. We believe that this result is inequitable, and places the converting company in jeopardy of legal action by the member whose subscription rights have been denied. Moreover, we believe that mutual holding company reorganizations should encourage employees and management to accumulate stock ownership in their institution, so that they can exercise more control over their institution in the event of a second-step conversion, and this provision is contrary to that purpose.

C. Changes in Regulations That Would Make it More Attractive for Mutual Institutions to Stay in Mutual Form

We do not believe that there are any changes to existing regulations that would be necessary to make it more attractive for mutual institutions to remain in mutual form. The primary advantage of mutuality is the ability to operate and manage an institution without pressure from stockholders. We recognize, however, that the organizational discipline resulting from having stockholders can enhance the competitiveness of a savings association and promote changes that are necessary for the association to grow and survive in the long term. In recent years the OTS has authorized mutual institutions to adopt expanded benefit plans, including phantom stock plans, that are intended to make mutual institutions more competitive in attracting and maintaining qualified management and employees. We believe these policy changes have been implemented without new regulations.

With respect to capital raising alternatives for mutual institutions, our experience shows that the biggest obstacle to raising capital for mutual institutions is the cost of capital. Moreover, mutual institutions cannot raise equity capital, so that the "capital" they raise must ultimately be repaid. The cost of issuing subordinated debt securities or mutual capital certificates would clearly be prohibitive for smaller institutions and unavailable to many others.

We believe that the most effective way for a mutual institution to raise capital, without converting to stock form or even issuing stock to the public, is to form a mutual holding company and have the mutual holding company borrow funds from another financial institution, or issue debt or trust preferred securities. The proceeds of any borrowings can be contributed to the subsidiary association as tier-one capital. Any borrowings by the mutual holding company, of course, will be a liability of the mutual holding company, but will be contributed to the subsidiary bank as additional paid-in capital. The subsidiary association can use this capital to leverage growth and generate earnings. The OTS is in a unique position to offer mutual associations this option since the OTS does not have rigid capital requirements for holding companies.

* * *

We hope this comment letter is helpful in evaluating the proposed regulations, and we appreciate having the opportunity to offer our input on these important matters. Please do not hesitate to contact the undersigned at (202-274-2002), John Gorman (202-274-2001) or Ken Lehman (202-274-2009) of this office should you have any questions regarding this letter.

Sincerely,

Eric Luse

Enclosure
cc: Richard M. Riccobono, Deputy Director
David Permut, Counsel, Banking and Finance

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EXHIBIT A

Participating Institutions

Alamogordo Federal Savings and Loan Association, Alamogordo, NM
Brookline Savings Bank, Brookline, MA
First Federal Bank of North Florida, Palatka, FL
First Federal Savings and Loan Association of Alpena, Alpena, MI
Gaston Federal Bank, Gastonia, NC
Investors Savings Bank, Milburn, NJ
Leeds Federal Savings Bank, Baltimore, MD
Liberty Bank, Avenel, NJ
Oneida Savings Bank, Oneida, NY
Pathfinder Bank, Oswego, NY
Provident Bank, Montebello, NY
Strata Bank, Medway, MA
Sound Federal Savings and Loan Association, Mamaroneck, NY
The Bank of Greene County, Catskill, NY
Wayne Savings Community Bank, Wooster, OH