

November 25, 2008

BY FEDERAL EXPRESS AND EMAIL

Federal Housing Finance Agency
1625 Eye Street, NW
Washington, DC 20006
Attention: Public Comments/RIN 2590-AA03

**RE: Federal Housing Finance Agency Interim Final Regulation with Request for
Comments: Federal Home Loan Bank Boards of Directors – Eligibility and
Elections**

Ladies and Gentlemen:

The Federal Home Loan Bank of San Francisco (Bank) welcomes the opportunity to comment on the Federal Housing Finance Agency (Finance Agency)'s interim final rule (the Interim Final Rule) (12 C.F.R. Part 1261) with respect to the eligibility and election of Federal Home Loan Bank directors. We appreciate the Finance Agency's effort to expedite its rulemaking on this important topic in response to the Housing and Economic Recovery Act of 2008 (HERA).

We offer the following comments for your consideration:

▪ **Permit FHLBank Boards to Establish the Number of Public Interest Directorships.**

The Finance Agency requests comment on whether the Finance Agency Director or the FHLBank boards should establish the number of public interest directorships for each FHLBank. We support having the FHLBank boards designate the number of public interest directorships, as allowed by the Interim Final Rule, recognizing that the directors are in the best position to identify the skills and experience needed by the board as a whole.

Depending on the particular skills of incumbent directors and other considerations, such as the FHLBank's strategic goals or risk profile, a board may determine that oversight is enhanced by having a greater number of individuals with the qualifications of public interest directors. At other times, a board may determine that the interests of the Bank and its members are better served by having no more than the number of public interest directors required by statute and a greater number of independent directors with skills and experience in other areas that address the FHLBank's needs at that time. The

flexibility to make this determination enhances the board’s ability to ensure that the board as a whole possesses the optimum combination of skills and experience.

▪ **Clarify the Interim Final Rule’s Application of the Statutory Term Limitation.**

The Finance Agency seeks comment on the Interim Final Rule’s application of the consecutive full-term limitation in Section 7(d) of the Federal Home Loan Bank Act (Bank Act). The Bank Act, as amended by HERA, limits the service of directors chosen by election to three consecutive full terms; directors are then eligible for re-election two years after the end of the last full term.

- Based on the preamble to the Interim Final Rule, we understand the intent of the rule is to count as full terms (i) existing three-year terms of both member and independent directors expiring on or after December 31, 2008, and (ii) all four-year terms beginning after the effective date of HERA (July 30, 2008). Terms beginning after July 30, 2008 that are shortened to implement staggering are not intended to be counted as full terms; nor are they considered gaps in service.

Application of the rule as described would result in the following:

Term	Full or Shortened?	Counts for Consecutive Term Limitation?	Term Limitation Reached?
First Term: 1-1-03 to 12-31-05	Full	Yes	No
Second Term: 1-1-06 to 12-31-08	Full	Yes	No
Third Term: 1-1-09 to 12-31-11	Shortened to Implement Staggering	No	No
Fourth Term: 1-1-12 to 12-31-15	Full	Yes	Yes

However, the language of the Interim Final Rule does not clearly reflect this intended framework and outcome, and may result in inconsistent application of the rule.

Specifically, Section 1261.4(c)(2)(ii) states, “ Any three year term of office ending immediately before a term of office that is adjusted after July 30, 2008 to a period of fewer than four years and *any term of office commencing immediately following such adjusted term of office* shall constitute consecutive full terms of office” [emphasis added]. The italicized phrase, applied strictly, could mean that a

term of office immediately following a shortened term is a full term even though it may be less than a four-year term. This conflicts with Section 1261.4(c)(2)(i) which provides that a term of office that is adjusted after July 30, 2008 to a period of less than four years is not deemed to be a full term. To address these inconsistencies, Section 1261.4(c)(2)(ii), could be revised to state simply that terms shortened after July 30, 2008 to achieve staggering do not constitute full terms for purposes of applying the term limitations.

- Also, for consistency in applying the statutory term limitation provision to all classes of directors (including directors previously appointed by the Federal Housing Finance Board), and to correspond to the intent stated in the preamble, Section 1261.4(c)(2)(iii) should be revised to state that the service of any director through appointment or election for three years in a directorship with a three-year term of office existing on or before July 30, 2008, shall be deemed to be a full term.
- Finally, we suggest that the Final Rule include a table or chart displaying the various rules on term limitations. A graphical presentation will make this complex section of the regulations easier to follow and will assist in compliance.

▪ **Allow FHLBank Boards to Define Consultative Role of the Advisory Council.**

The Finance Agency seeks comment on whether it should require the Advisory Council to play any specific role in consulting with the board regarding independent director nominees, and whether the Finance Agency should prescribe procedures on how the consultation should take place.

We support the statutory change that gives the Advisory Council another avenue for assisting the Bank and our board in identifying and understanding ways the Bank might best serve the housing and community lending needs in the district. The Advisory Council's insight on the experience and qualifications of potential nominees for independent director positions will be valuable in the board's selection process.

At the same time, because the ultimate responsibility for nominating independent directors rests with the boards, we believe the board should have the right to specify the role of the Advisory Council in that nomination process, and to design a process that, in the board's judgment, best assists it in fulfilling its responsibilities. The form, content, and timing of advice that each FHLBank board needs from its Advisory Council will differ depending on the background and experience of the board and the FHLBank's process for identifying nominees. A process prescribed by regulation may not meet the unique requirements of each FHLBank. Rather, we support the flexibility provided by the Interim Final Rule which simply requires the board to consult with the Advisory Council, but does not constrain the board in terms of manner, timing or process.

- **Deem Existing Community Interest Directors to be Public Interest Directors Under HERA.**

The Finance Agency has asked whether it should apply HERA's requirement of an additional two years of relevant experience to current public interest directors. The Bank's public interest directors meet HERA's experience requirement, so application of the rule will not affect the Bank. However, from the perspective of the FHLBank system as a whole, we believe that the immediate benefit of continuity of service is greater than the benefit derived from two additional years of experience in the required areas, given the current economic environment.

- **Retain the Rule Permitting the Board to Nominate a Minimum of One Nominee for Each Independent Directorship.**

The Finance Agency has asked whether FHLBank boards should be required to nominate more candidates for independent directorships than there are positions to be filled, if the board determines that there are sufficient applicants who are both eligible and qualified. We believe the Final Rule should not be prescriptive in this area, and should allow boards to nominate as many or as few candidates as they feel appropriate and reasonable in any given election.

The responsibility to nominate independent directors, as required by HERA, now rests with the FHLBank boards. In carrying out that responsibility, the boards should be free to nominate the candidates who they feel are most qualified and who will contribute experience and skills that enhance board oversight. A rule requiring more nominees than directorships to be filled may force boards to nominate candidates who meet the minimum requirements for eligibility and qualifications, but who are not the most qualified considering the board's particular needs at the time. Also, such a rule potentially limits the board's role to that of a conduit, merely placing eligible, qualified candidates' names on the ballot, and minimizes the value of their experience and judgment in identifying the most highly qualified candidates.

At the same time, the rule should allow a board the flexibility to place any number of candidates on a ballot, taking into consideration the qualifications, skills and experience of the candidates who apply, balanced with a view toward offering members a choice of candidates when possible, feasible and consistent with the board's duties in selecting nominees. For these reasons, we believe the Final Rule should allow maximum flexibility in this area.

- **Do Not Require 20 Percent of Eligible Votes Cast to Elect Independent Directors.**

The Bank requests that this requirement be deleted from the Final Rule and allow the election of independent directors to be determined by a plurality vote of the members, the same way member director elections are determined. In the alternative, we recommend that the election be determined based on a minimum percentage of

all votes actually cast in the election. Finally, if the 20% rule is retained in the Final Rule, we recommend that it apply only where an FHLBank nominates only the number of candidates as there are positions to be filled in the election, and otherwise allow the plurality rule to govern.

Based on the preamble, we understand that the Finance Agency is using the 20 percent requirement to address a perceived risk that if a board nominates only one candidate for a single open position, the results of the election may not reflect the true choice of the members. The Bank recognizes this as a risk in almost any election decided by a plurality vote, however we believe the risk is minimized in the context of a cooperative structure like the FHLBanks. In addition, the 20% requirement is inconsistent with the Bank Act requirement that the election be decided by a plurality vote of the members at-large.

- The FHLBank Cooperative Structure Minimizes the Risk that Members Will Not Have a Meaningful Voice in the Election. The Finance Agency's concern may be appropriate for a corporation where most or all of the directors are nominated by each other without any shareholder input, and may include "insiders" (i.e., members of management). In contrast, FHLBank members directly nominate and elect 60 percent of the board. If members believe the board is nominating inappropriate candidates for independent directorships, they – unlike shareholders in a typical corporation – have regular opportunities, through the member director election process, to replace the majority of the board. In addition, no member of management can serve on the board of an FHLBank. This independence from management, together with a majority of directors nominated directly by members, is sufficient to mitigate the risk that members voting for independent directors will not have a sufficient voice in the outcome, or that boards selecting nominees will not act in the best interest of the Bank in carrying out that responsibility.
- The 20 Percent Requirement Is Inconsistent with the Bank Act. The Bank Act, as amended by HERA, provides that each independent director "shall be elected by a plurality of the votes of the members of the Bank at large..." (12 U.S.C. 1427(b)(2)(ii)). The meaning of "plurality" is well-understood in the context of corporate director elections. With plurality voting, a director who receives the most votes is elected without regard to the number of votes actually cast or eligible to be cast. The plain language of HERA does not support imposition of a percentage requirement. We recommend that the Final Rule delete the requirement, particularly in light of the increased likelihood of failed elections and delay that may result from applying it.

▪ **Clarify the Election Process following Failed Independent Director Elections.**

If the Finance Agency retains some percentage requirement for the election of independent directors, the Final Rule should more explicitly define the process for holding elections subsequent to an election in which a nominee fails to obtain the

required percentage of votes. For example, the rule should specify shortened time frames for delivery of independent director applications, review by the Finance Agency, and voting, so that the vacancy can be filled prior to the January 1 commencement of the directorship's term. The rule also should address the content of the report of election required by Section 1261.7(g) as it relates to failed elections. The rule also should permit a board to nominate the same candidate for a subsequent election, which an FHLBank might do if it believed that low voter participation, rather than shareholder disfavor of the candidate, was the real cause of the candidate's failure to receive 20 percent of eligible votes.

▪ **Conflicts of Interest Rules.**

The rule creates ambiguity about a director's ability to accept reasonable and customary entertainment and ordinary-course business gifts by deleting the prior rule's safe harbor for non-substantial gifts. Under the prior rule, prohibited "substantial gifts" are gifts of more than token value, entertainment the cost of which is unreasonable, non-customary and not accepted business practice, and any item or service for which the director pays less than market value. Any gift may have the appearance of influencing a director's actions, but only substantial gifts (as defined in the prior rule) are likely to do so. It would be better to adopt a rule with a workable standard. The rule also should be revised to permit explicitly member directors' receipt of gifts that are customarily given to other members as such gifts by their nature are not intended to influence a director's actions as a member of the board.

▪ **Bylaws and Independent Director Nominating and Election Procedures.**

The Bank requests the Finance Agency not require the FHLBanks to include detailed procedures in their bylaws for the nomination and election of independent directors. The Interim Final Rule is, effectively, the procedure. Therefore, the statutory requirement for inclusion of such procedures in the FHLBanks' bylaws can be satisfied with a reference to applicable regulations.

Thank you for your consideration of our comments.

Sincerely,



Dean Schultz
President and Chief Executive Officer