



REGULATORY INTERPRETATION 2001-RI-07

Date: July 25, 2001

Subject: Office of Finance Indemnification

Request Summary:

The Office of Finance (OF) has submitted a request for a Regulatory Interpretation (request) of a Federal Housing Finance Board (Finance Board) regulation that requires the OF to establish an indemnification policy for the benefit of the members of the OF board of directors, the Managing Director, and other officers, employees, and agents of the OF. *See* 12 C.F.R. § 985.7. The request poses four questions: (1) what, if any, limitations exist on the power of the OF board of directors to provide indemnification under section 985.7(e)(1); (2) how would the OF board of directors be required to reconcile any discrepancies between its indemnification policy and the indemnification policies of the Federal Home Loan Banks (FHLBanks); (3) whether the contract of insurance the OF obtains pursuant to section 985.7(e)(2) may cover its Financial Report Advisory Council (Council) members; and (4) if, and under what circumstances, the Finance Board may challenge, or a FHLBank may challenge or refuse to fund, any OF indemnification-related expenses. The request also seeks general guidance on any other position on indemnification that the Finance Board may have announced.

Background:

On June 2, 2000, the Finance Board adopted amendments to its rule governing the authority and operations of the OF. *See* Res. No. 2000-24 (June 2, 2000); 65 Fed. Reg. 36290 (June 7, 2000); *codified at* 12 C.F.R. part 985 (rule). Section 985.7(e)(1) of the rule requires the OF board of directors to indemnify its members, the Managing Director, and other officers and employees of the OF under such terms and conditions as shall be determined by the OF board of directors, provided that such terms and conditions are consistent with the terms and conditions of indemnification of directors, officers, employees, and agents of the FHLBanks generally.

On December 18, 2000, the Finance Board issued a notice of proposed rulemaking to amend its regulations to implement applicable provisions of the Gramm-Leach-Bliley Act of 1999.¹

¹ Section 2B of the Federal Home Loan Bank Act (Act), as amended by section 606 of the Federal Home Loan Bank System Modernization Act of 1999 (Title VI of the Gramm-Leach-Bliley Act of 1999, Pub. L. No. 106-102, 113 Stat. 1338 (Nov. 12, 1999)), confers on the Finance Board certain administrative enforcement powers with respect to the FHLBanks and the OF, including the authority to issue a civil money penalty. *See* 12 U.S.C. § 1422B(a)(5) (the civil money penalty provision in section 2B(a)(5) of the Act is incorporated by reference from section 1376 of Subtitle C of Title XIII of the Housing and Community Development Act of 1992, Pub. L. No. 102-550, 106 Stat 3991 (Oct. 28, 1992) (*codified at* 12 U.S.C. § 4636)). As proposed, the Finance Board's enforcement regulation would bar indemnification in civil money penalty cases, stating that a FHLBank "shall not reimburse, indemnify, or

Among other things, the proposed amendments would prohibit an FHLBank from indemnifying any individual in connection with a civil money penalty assessed under section 2B of the Federal Home Loan Bank Act (Act).

In the context of the OF board of directors' review of the existing OF indemnification policy, which was adopted on August 19, 1997, the request seeks guidance on the OF's indemnification authority in light of these recent and proposed changes to the OF regulation. The OF is seeking this guidance because it does not know what positions the Finance Board may have taken on individual FHLBank indemnification policies, either on a safety and soundness basis through the examination function or otherwise. Further, the OF board of directors seeks to ascertain how the language of section 985.7(e) would be interpreted and enforced if the OF's review discloses differences between the FHLBanks' respective indemnification policies.

Analysis or Discussion:

1. Scope of Indemnification Authority

The rule contains relatively few significant limitations on the OF's indemnification authority, and provides the OF board of directors with ample discretion to revise the OF's indemnification policy to ensure consistency with the Act, the rule, and applicable Finance Board resolutions, as well as the FHLBanks' indemnification policies. Sections 985.7(e) and 985.2(a) of the rule establish and define the scope of the OF board of directors' authority to provide indemnification to members of the OF board of directors, the Managing Director, officers, employees, and agents. 12 C.F.R. §§ 985.2(a) and 985.7(e). The rule requires the terms and conditions for indemnification adopted by the OF board of directors to be consistent with the terms and conditions governing the FHLBanks' indemnification policies. 12 C.F.R. § 985.7(e)(1). Section 985.7(e)(2) of the rule requires the OF board of directors to adopt an indemnification policy and to supplement that policy with a contract of insurance. The rule also requires the FHLBanks to pay all of the expenses of the OF, including any costs of indemnification. Under section 985.5(a) of the rule, the FHLBanks are responsible for jointly funding the OF's expenses "including the costs of indemnifying the members of the OF board of directors, the Managing Director, and other officers and employees of the Office of Finance, as provided for in this part." 12 C.F.R. § 985.5(a). A corollary provision of the rule makes clear that all expenses incident to indemnification of the members of the OF board of directors, Managing Director, or other officers and employees of the OF must be treated as expenses of the OF to be reimbursed by the FHLBanks. 12 C.F.R. § 985.5(e). Finally, the rule includes a general corporate powers provision that confers upon the OF the same incidental powers the FHLBanks have under section 12(a) of the Act. 12 U.S.C. § 1432(a); 12 C.F.R. § 985.2(a).

The OF's indemnification authority thus derives additional support from the broad incidental authority of the FHLBanks under section 12(a) of the Act to exercise "all such incidental powers, not inconsistent with the provisions of this chapter, as are customary and usual in corporations generally." 12 U.S.C. § 1432(a). Under the rule, the OF would have the same general corporate powers to make employment decisions and contracts, "to select, employ, and fix the compensation of such officers, employees, attorneys, and agents as shall be necessary for the transaction of [its] business," and "to define their duties, require bonds of them and fix the

otherwise compensate directly or indirectly any individual for any penalty that may be assessed against such individual under [the civil money penalties rule.]" See 65 Fed. Reg. 78994, 78999 (Dec. 18, 2000) (*to be codified at* 12 C.F.R. § 908.6(i)).

penalties thereof.”² Providing indemnification for such individuals would be incidental to the authority to hire and manage staff, and well within the customary and usual powers of corporations. Therefore, under the rule, the OF would have the same powers and duties as corporations generally have to define and provide indemnification for its directors, officers, employees, and agents, coextensive with the authority of the FHLBanks under section 12(a) of the Act.

In the same vein, and as with the FHLBanks, the OF’s indemnification authority is limited by the scope of the usual and customary indemnification powers of corporations generally. Thus, any bar to, or any limitation on, corporate indemnification authority would act as a bar to, or a limitation on, the OF’s indemnification authority. So, for instance, no indemnification should attach to violations of federal securities laws, fraud, self-dealing, criminal acts, dishonesty, intentional misconduct, or gross neglect of duty. Additionally, as noted, the Finance Board has proposed a rule prohibiting the reimbursement or indemnification of any individual in connection with any civil money penalty that may be assessed under the Finance Board’s proposed administrative enforcement rule.

The OF board of directors should exercise its best business judgment in revising its indemnification policy to ensure consistency with the rule. In particular, the OF board should ensure that covered OF board of directors members, officers, employees, and agents are indemnified “to the extent not prohibited by law.”

2. The OF’s Indemnification Policy Must be Consistent with FHLBank Policies

Section 985.7(e)(1) of the rule requires the OF board of directors to adopt indemnification terms and conditions that “are consistent with the terms and conditions of indemnification of directors, officers and employees of the [FHL]Bank System generally.” As stated in its request, the OF has indicated that its review of the individual FHLBank indemnification policies may uncover differences among those policies that could call into question how section 985.7(e) will be interpreted and enforced. The OF should be guided by section 7(k) of the Act, which requires the board of directors of each FHLBank to determine the terms and conditions under which the FHLBank may indemnify its directors, officers, employees or agents (12 U.S.C. § 1427(k)), and by common law limitations on corporate indemnification authority as discussed above. If an FHLBank were to exceed any common law limits on indemnification, that would be contrary to safe and sound operations.

The OF board of directors is responsible for setting the terms of its indemnification policy consistent with the rule and the additional authority discussed herein. The incidental authority under section 12(a) of the Act that provides indemnification authority to the FHLBanks is made applicable to the OF pursuant to section 985.2(a). The OF board of directors should exercise its best business judgment in applying these authorities and reconciling any discrepancies it may discover. If, in the course of its analysis, the OF board of directors is unable to reach a conclusion as to a specific question or problem, then the OF board of directors may seek further guidance from the Finance Board.

² 12 U.S.C. § 1432(a). Section 7(k) of the Act *directs* the various boards of directors of the FHLBanks to indemnify their respective directors, officers, employees and agents and to “determine the terms and conditions under which such Bank may indemnify its directors, officers, employees, or agents.” *See* 12 U.S.C. § 1427(k). Even if the FHLBanks were not expressly authorized under section 7(k) to indemnify their directors, officers, employees, and agents, they would have authority to do so under the incidental powers clause.

3. The OF's Director and Officer Liability Insurance May Cover the Council Members.

The request notes that the OF board of directors established a Financial Report Advisory Council consistent with the guidance provided in Finance Board Regulatory Interpretation No. 2000-RI-26.³ The Council comprises the twelve FHLBank presidents and assists the OF in carrying out its responsibilities for publishing the combined financial report under section 985.6(b) of the rule. The request asks whether the Council members may be indemnified under the contract of insurance the OF is required to obtain under section 985.7(e)(2). Given the role played by the Council and that the rule would not prohibit the OF from providing such coverage, the OF's contract of insurance may cover the members of the Council in their duties attendant to the preparation and publication of the combined financial report, so long as the scope of the indemnification coverage is consistent with such coverage as may be authorized under the applicable Finance Board regulations.

4. There May be Limited Circumstances Under Which a FHLBank May Refuse to Fund OF Indemnification Expenses

The request asks whether any circumstances may exist whereby the FHLBanks could challenge or refuse to fund indemnification expenses. As a general matter under the rule, the FHLBanks are *required* to pay the OF's costs of indemnification. Specifically, and as outlined more completely under item number 1, section 985.5(a) of the rule requires the FHLBanks to jointly fund the OF's expenses "including the costs of indemnifying the members of the OF board of directors, the Managing Director, and other officers and employees of the OF, as provided for in this part." Section 985.5(e) of the rule makes clear that all expenses incident to indemnification of the members of the OF board of directors, Managing Director, or other officers and employees of the OF shall be treated as expenses of the OF to be reimbursed by the FHLBanks. Any refusal on the part of any FHLBank to fund legitimate indemnification costs could constitute a violation of the rule and could provide grounds for an examination, investigation, or supervisory sanctions by the Finance Board. On the other hand, there may be circumstances under which a FHLBank could be justified in refusing to satisfy the expense, such as if indemnification costs were paid in violation of Finance Board regulations, policies, or other applicable law. Under similar circumstances, the Finance Board could seek to challenge such payments. It is impossible to predict with certainty in advance of the event, other than as a general precept, any specific circumstances under which this would occur.

Conclusion:

The scope of the OF board of directors' authority to provide indemnification is quite broad and is limited only by the requirements of consistency, the best business judgment of the members of the OF board of directors, and the relatively few limitations contained in the Act, the rule, applicable Finance Board resolutions, general corporate principles of indemnification, and the FHLBank System's indemnification policies generally. The OF board of directors may request further assistance, in the event it encounters specific issues or questions. The indemnification policy required under section 985.7(e)(2) of the rule may cover the members of the Council. Finally, apart from any limited circumstances that may be presented as discussed above, there are no circumstances under which any FHLBank may arbitrarily decide not to fund the OF's legitimate costs of indemnification.

³ The OF board of directors established the Council under the authority of 12 C.F.R. § 989.3, acting in conformity with a recent Finance Board Regulatory Interpretation (No. 2000-RI-26).

A Regulatory Interpretation (*Procedures for Requests and Applications*, Resolution No. 98-51, Federal Housing Finance Board of Directors, October 28, 1998) may be relied upon by the requestor subject to modification or rescission by action of the Board of Directors of the Finance Board.