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FEDERAL HOUSING FINANCE AGENCY

12 CFR Part 1231

RIN 2590-AA68

Indemnification Payments

AGENCY: Federal Housing Finance Agency.

ACTION: Final rule.

SUMMARY: The Federal Housing Finance Agency (FHFA or Agency) is adopting this final rule establishing standards for identifying whether an indemnification payment by the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), any of the Federal Home Loan Banks (collectively with Fannie Mae and Freddie Mac, the regulated entities), or the Federal Home Loan Bank System's Office of Finance (the OF) to an affiliated party in connection with an administrative proceeding or civil action instituted by FHFA is prohibited or permissible. This final rule applies to all regulated entities, each Federal Home Loan Bank, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation and the OF. It does not, however, apply to any regulated entity operating in conservatorship or receivership, or to a limited-life regulated entity.

DATES: This rule is effective on **[INSERT DATE 30 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

FOR FURTHER INFORMATION CONTACT: Mark D. Laponsky, Deputy General Counsel, Mark.Laponsky@fhfa.gov, (202) 649-3054; or Peggy K. Balsawer, Associate General Counsel, Peggy.Balsawer@fhfa.gov, (202) 649-3060 (these are not toll-free numbers), Office of General Counsel; Federal Housing Finance Agency, Constitution Center, 400 Seventh Street, SW, Washington, DC 20219. The telephone number for the Telecommunications Device for the Hearing Impaired is (800) 877-8339.

SUPPLEMENTARY INFORMATION:

I. Background

FHFA published an Interim Final Rule on Golden Parachute and Indemnification Payments in the **Federal Register** on September 16, 2008 (73 FR 53356). Subsequently, it published corrections rescinding that portion of the regulation that addressed indemnification payments on September 19, 2008 (73 FR 54309) and on September 23, 2008 (73 FR 54673). On November 14, 2008, a proposed amendment to the Interim Final Rule was published in the **Federal Register** (73 FR 67424). FHFA specifically requested comments on whether it would be in the best interests of the regulated entities to permit indemnification of first and second tier civil money penalties where the administrative proceeding or civil action related to conduct occurring while the regulated entity was in conservatorship. The public notice and comment period closed on December 29, 2008. On January 29, 2009 (74 FR 5101), FHFA published a final rule on Golden Parachute Payments. On June 29, 2009 (74 FR 30975), FHFA published a proposed amendment to that 2009 Golden Parachute final rule. At the same time, FHFA re-proposed the November 14, 2008 proposed amendment on indemnification payments (2009 re-proposal). The 2009 re-proposal noted that comments received in response to

the November 14, 2008 publication on indemnification payments would be considered along with comments received in response to the 2009 re-proposal. The golden parachute provisions of the rule were re-proposed in 2013 (78 FR 28452, May 14, 2013), adopted in final form in 2014 (79 FR 4394, Jan. 28, 2014), and codified as 12 CFR 1231.1, 1231.2, 1231.3, 1231.5, and 1231.6. Amendments to the golden parachute provisions of the rule were proposed on August 28, 2018 (83 FR 43801).

On September 20, 2016, FHFA again re-proposed a rule on indemnification payments to affiliated parties (2016 re-proposal, or proposed rule), redrafting the proposed rule to make it simpler and easier to understand. After an extension, the comment period expired on December 21, 2016.[1] The substance of the 2016 proposed rule did not change from the 2009 re-proposal, other than to replace a provision concerning indemnification payments by regulated entities in conservatorship with one that clearly states that the regulation does not apply to such entities.[2] FHFA further clarified that it does not consider indemnification payments to be subject to FHFA rules and procedures related to compensation, including 12 CFR part 1230.

The final rule generally adopts the 2016 re-proposal's approach to the indemnification provisions of the Federal Deposit Insurance Corporation's (FDIC) counterpart regulation. *See* 12 CFR part 359. Like the FDIC's regulation, and consistent with the Director's statutory discretion to "prohibit or limit any . . . indemnification

[1] *See* 81 FR 74739 (Oct. 27, 2016).

[2] While the 2016 re-proposal proposed to except from the rule entities operating in conservatorship or receivership and limited liability regulated entities (LLREs), it did not expressly address its application to an institution that is rehabilitated in conservatorship and emerges other than through receivership and liquidation. Consistency with the rationale underpinning the exception demands that the exception should apply with respect to an administrative proceeding or civil action initiated by FHFA after rehabilitation if the subject conduct occurred during a conservatorship or receivership.

payment,"[3] the final rule creates a presumption that indemnification payments for costs, expenses, fees, and penalties by a regulated entity or the OF to affiliated parties are impermissible in connection with an FHFA-initiated administrative proceeding or civil action. As required by section 4518(e)(2) of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, as amended (the Safety and Soundness Act, or the Act),[4] the rule sets forth criteria and standards constituting the "factors" that the Director has determined are to be used to "prohibit or limit" indemnification payments through this regulation. In application, each institution (whether a regulated entity or the OF) is required to ensure that no indemnification payments under this rule are made unless the criteria and standards are met.

II. Technical Corrections

In the process of drafting this final rule, FHFA staff observed that the definitional section of the existing Golden Parachute and Indemnification regulation required a technical correction to align it with the Safety and Soundness Act. *See* proposed § 1231.2; 12 U.S.C. 4518(e). The section of the Act explicitly authorizing the Director to prohibit or limit golden parachute and indemnification payments, applies to payments made to "affiliated parties" and does not mention "entity-affiliated parties." The Act does not define "affiliated parties." FHFA had adopted the term "entity-affiliated party" and defined it for use in the rule. To align with the Safety and Soundness Act, the correct reference should be to "affiliated party." In this final rule, FHFA is replacing the term "entity-affiliated party" with the term "affiliated party," without any change to the

[3] 12 U.S.C. 4518(e)(1).

[4] *See* 12 U.S.C. 4501 *et seq*.

substantive definition. The existing definition of "entity-affiliated party" will be the definition of "affiliated party" for the purposes of this final rule to effect this technical correction.[5]

FHFA is also making some minor, non-substantive changes to the rule text based on staff's determination that the words "conditions for" should precede the phrase "prohibited and permissible indemnification payments" in proposed § 1231.1 to conform the semantic construction of the final rule's purpose to its other operational provisions; and staff's determination that changing the phrase "the cost" to "any cost" in clause (2) of the definition of "liability or legal expense" in § 1231.2, and adding the word "a" in clauses (3) and (4) of § 1231.4(c) would be more consistent and grammatically correct.[6]

III. Comments on the 2016 Re-Proposal

In response to the 2016 re-proposal, FHFA received a public comment from one citizen and a joint comment letter from the 11 Federal Home Loan Banks and the OF. FHFA gave careful consideration to all issues raised by the commenters.

A. Public Comment from a Citizen

A very brief comment from a member of the public was limited to agreeing with the proposed rule's exclusion of coverage for regulated entities in conservatorship. The commenter opined that because the Enterprises are in conservatorship, indemnification payments should be permitted, but that claw backs should be used to avoid excessive

[5] Throughout this final rule "entity-affiliated party" has been replaced with "affiliated party" (unless the context requires retaining the former term) to reflect the technical change made to the regulation. The change in term has substantive effect in the proposed golden parachute amendments, see 83 FR 43801, 43808-09 (Aug. 28, 2018).

[6] The Agency also made minor grammatical changes to proposed § 1231.4(b)(2)(i) to reduce the text's awkwardness in light of other substantive changes made to the exoneration standard discussed later in this preamble.

indemnification. Though the intended scope of the comment was not clear, the commenter referred to "servicing agreements the GSEs have with issuing banks" and to the "conservatorship agreements." The comment reflects an apparent understanding of the import of excluding entities operating in conservatorship from the rule's coverage and an endorsement of the proposal.

B. Regulated Entity Public Comments

The eleven Federal Home Loan Banks and the OF (collectively, Banks) jointly submitted the second public comment. *See* Joint Comment of the Federal Home Loan Banks and Office of Finance on Proposed Rule on Indemnification Payments, dated December 21, 2016 (Joint Comment). The Banks addressed several matters related to the 2016 re-proposal, including: (1) the scope of the rulemaking; (2) certain standards and processes relating to the advancement of defense expenses; (3) insurance coverage issues; (4) partial indemnification issues; (5) the treatment of pre-existing indemnification agreements; and (6) potential impacts of the rulemaking. As discussed below, FHFA has decided to adopt some, but not all, of the suggestions it received.

1. Scope of "Prohibited Indemnification Payment"

The Banks raised four issues relating to the scope of the prohibition on indemnification payments. First, though they applauded FHFA's decision to except regulated entities in conservatorship from the rule's restrictions, they argued this would also lead to what they considered a perverse situation where those entities could be permitted to make indemnification payments for first and second tier civil monetary penalties which healthier institutions would be barred from making under the rule. The Banks recommended that institutions not in conservatorship should have the same

breadth of authority to indemnify as entities in conservatorship. This argument for uniform treatment is one that had been raised by commenters – including some Banks – on a prior proposal. FHFA answered the objection and explained its disagreement in the 2016 proposed rule. The Banks' comment letter offers no reason for FHFA to revisit or change its earlier decision declining in general to permit regulated entities not in conservatorship to make indemnification payments for first and second tier civil money penalties. *See* 81 FR at 64358.

Second, the Banks contended that the proposed rule conflicts with the Safety and Soundness Act. Joint Comment p.2. The Banks argued that since the Safety and Soundness Act expressly prohibits indemnification with respect to third tier civil money penalties (12 U.S.C. 4636(g)), the Director may not also prohibit payments relative to first and second tier civil money penalties. FHFA disagrees with the Banks' assertion that a rule prohibiting or limiting indemnification payments with respect to first and second tier civil money penalties conflicts with, or exceeds, authority granted by the Safety and Soundness Act. The Safety and Soundness Act both expressly prohibits indemnification for third tier Civil Money Penalties and expressly grants authority to the Director to "prohibit or limit, by regulation or order, *any* . . . indemnification payment" (12 U.S.C. 4518(e)(1)) (emphasis added). The absence of a specific limitation on the Director's authority relative to first and second tier penalties places them squarely within the Director's broad authority to "prohibit or limit" indemnification payments under 12 U.S.C. 4518(e)(1).

Third, the Banks also argued that indemnification should be permissible for the costs and expenses associated with the first and second tier penalties, whether or not the

regulated entities are in conservatorship. This comment can be read in two ways. If the Banks are suggesting that indemnification of defense fees and costs should be allowed even when a first or second tier civil money penalty is imposed, FHFA rejects the prospect as undermining the intent and effectiveness of the fundamental presumption of impermissibility, and therefore, the regulation itself. If, however, the Banks mean that indemnification of defense fees and costs should be allowed if the defense against civil money penalties is successful, FHFA believes no revision is necessary because this final rule is clear that such indemnification of defense expenses, and in appropriate cases partial indemnification, is permitted.

Fourth, the Banks argue that the prohibitions in the proposed rule are stricter than typical state governance statutes as may have been selected by an institution under FHFA's corporate governance regulation, 12 CFR part 1239. They believe that the Banks should be allowed to follow state law standards for indemnification and advancement of expenses to avoid confusion and conflicts in implementing standards from disparate sources. FHFA agrees that the proposed rule is more restrictive than many state laws, but nonetheless is satisfied that the proposed rule strikes the correct balance by applying federal law to its regulated entities in actions brought by the Agency, as specifically authorized by the Safety and Soundness Act, 12 U.S.C. 4518(e)(1). Since each regulated entity may identify a singular state or model law for corporate governance purposes under 12 CFR 1239, that choice of law would apply to indemnification payments to the extent not inconsistent with federal law and safety and soundness. 12

CFR 1239.3(a)).[7] But the corporate governance rule does not constitute a limitation of FHFA's responsibility and authority to establish stricter standards for the regulated entities when the Agency deems them appropriate. The purpose of the federal statute is to provide the Director authority to prohibit or limit indemnification payments in proceedings brought by the Agency, regardless of what other law would permit. FHFA has carefully considered the Banks' comments and observations, but considers it appropriate to apply federal standards for the federal cases it brings. Finally, FHFA does not accept the Banks' generalized and unsupported assertions of "practical conflicts" and confusion in applying this rule to FHFA-initiated actions. FDIC-insured banks and savings associations successfully operate under the parallel FDIC regulation and have done so for the past 20 years.

2. Standards and Processes Relating to the Advancement of Defense Expenses

The Banks expressed concern that the proposed rule would require both a prior investigation and board findings by the regulated entity or the OF before an affiliated party could be advanced defense fees and expenses. They argued that a prior investigation is excessive, time consuming and unnecessary, that sufficient facts to make the required findings are likely to be unavailable at the early stage when advancement of expenses is sought, and that a board decision to deny the request under such circumstances could trigger litigation against a Bank by the affiliated party. Therefore, the commenters argued that a prior investigation and board findings should not be a precondition for indemnification. The Banks observed that an investigation and board

[7] *See* 12 CFR 1239.3(a) ("The corporate governance practices and procedures of each regulated entity, and practices and procedures relating to indemnification (including advancement of expenses), shall comply with and be subject to the applicable authorizing statutes and other Federal law, rules, and regulations, and shall be consistent with the safe and sound operations of the regulated entities.").

findings would not be required under the proposed rule to permit a third party insurer to advance expenses directly under insurance policies or fidelity bonds purchased by the Banks, and so should not apply even in the absence of those circumstances. Finally, the Banks contend that, in the interests of Bank safety and soundness and to counter potential confusion and conflicts with different legal standards, the advancement of expenses and costs be permitted pursuant to the provisions already contained in a Bank's bylaws, existing indemnification agreements, and state law for governance chosen under 12 CFR 1239.

FHFA is not persuaded by the Banks' position. The FDIC considered such issues in developing its indemnification rule. The FDIC's first proposed rule would have required a board investigation and a more fulsome determination that the affiliated party had a "substantial likelihood of prevailing on the merits." 60 FR 16069, 16075 (March 29, 1995). In response to objections to this standard, the FDIC scaled back its proposal to something more on par with the requirements of FHFA's 2016 re-proposal, which requires a prior board investigation and good faith findings that the affiliated party acted in good faith, believing the conduct was in the best interest of the regulated entity or the OF, and that the safety and soundness of the regulated entity or the OF will not be materially and adversely affected (and, also requiring a repayment of advances by the affiliated party if the defense is unsuccessful). *See* proposed § 1231.4(c)(1); 81 FR at 64360.

Like the FDIC, FHFA considers the foregoing standard to be reasonable. It encourages consistency in interpretation of indemnification standards under similar statutes administered by different agencies, and FHFA's regulation will apply only in

FHFA-initiated matters. As the FDIC observed in its final rule, such matters are first subject to significant investigation by the agency in the context of an extensive regulatory scheme. *See* 61 FR 5926, 5929 (Feb. 15, 1996). At the time of an indemnification or advancement request, substantial factual allegations have been made to focus issues, and nothing inhibits the board from conducting its "due investigation" under the circumstances.

Finally, the Banks' repeated broad assertion that "practical conflicts" and confusion would result from applying these standards instead of disparate and less stringent state standards is unpersuasive for many of the same reasons discussed above regarding the scope of the indemnification prohibition. FHFA again agrees with the FDIC that applying an entity's state law choice for governance issues is inappropriate. *See* 60 FR at 16075 (FDIC rejecting suggestion to use state law); *see also* 61 FR at 5929 (FDIC rejecting proposal to adopt Model Business Corporation Act standards). FHFA considers a single federal standard, under a federal statute, implemented by FHFA as a federal agency, applying only to matters initiated by FHFA, and involving institutions chartered by Congress, to be superior to a regulation deferring to disparate state law standards for indemnification payments. This final rule may be more stringent than state law, but FHFA considers it appropriate given the federal interests involved.

3. Insurance Coverage Issues

The Banks correctly observed that the rule would allow regulated entities to pay insurance premiums for policies that provide reimbursement of costs and expenses, but would not allow them to use the proceeds of the policies to pay or reimburse for civil money penalties or an adverse judgment. They also correctly interpreted the proposed

rule as prohibiting payment of insurance premiums on any policy that would cover civil money penalties or judgments. Such a ban means that costs and expenses could not be insured against through a policy that by its terms *could* cover civil money penalties, even if the Banks agreed to take steps to ensure policy proceeds were not actually used to pay those penalties. The Banks contend that if they are prohibited from purchasing policies that include the broader coverage, they may be forced to forgo insurance policies that would cover even those fines and penalties that are not FHFA-related.

FHFA is not persuaded to change the regulation to permit the regulated entities and the OF to pay premiums for insurance policies with the broad coverage requested by the Banks. The various alternatives they offer do not address the purpose of this provision – to avoid back-door payment of civil money penalties and judgments in favor of FHFA through the use of insurance policies. FHFA is concerned that insurance coverage provided by a regulated entity or the OF for the benefit of its affiliated parties would be enforceable directly by the affiliated party, thereby evading the proposed rule's indemnification restrictions. FHFA believes that its goal is best accomplished by prohibiting any insurance coverage of civil money penalties assessed by FHFA or judgments in FHFA's favor.

However, FHFA is not unsympathetic to the larger concerns implicit in the Banks' comment, namely, that the regulated entities and the OF not be unduly limited from accessing a broad insurance market particularly if they might be required to forego certain insurance policies in order to remain compliant with the regulation. FHFA has determined to counter this concern by expanding the market of available insurance products beyond "professional liability insurance" to also entitle the regulated entities

and the OF to pay premiums on "any commercial insurance policy" so long as the other requirements of the final rule are satisfied. In addition to increasing the types of policies that may be employed, this change has the added benefit of aligning the final rule with both the language of the statute and the FDIC's treatment of the issue. *See* 12 U.S.C. 4518(e)(6); *see also* 12 CFR 359.1(l)(2)(i) (the FDIC described the product that may be purchased as "any commercial insurance policy or fidelity bond.").

Another insurance issue raised by the Banks (though somewhat obliquely) is whether the prohibition on paying premiums for policies that cover civil money penalties and judgments is intended to prohibit coverage of any civil money penalties, or only those imposed by FHFA. FHFA agrees that the language of the proposed rule is ambiguous and could chill the regulated entities from purchasing insurance coverage covering penalties imposed by other state or federal regulators, which is not in keeping with FHFA's intent. The final rule therefore expressly clarifies in § 1231.4(b)(1) that the prohibition on indemnification payments only applies to a civil money penalty when it is "imposed by FHFA."

4. Partial Indemnification and Expenses

The Banks' comments on the partial indemnification provisions of the proposed rule covered three distinct objections: first, that the rule's standard for "exoneration" is too narrowly crafted; second, that the obligation to repay is capable of being prematurely triggered; and third, that the rule does not sufficiently account for the precise allocation of defense expenses when an affiliated party faces more than one charge.

The Banks objected to the exoneration standard in the proposed rule – expressed in the rule as "not exonerated" – as being too narrowly tailored and unlikely to permit, in

keeping with the proposed rule's presumed intent, an affiliated party to retain expenses advanced to it in connection with charges for which it ultimately is not found to be at fault. They expressed concern that an affiliated party often will not receive an affirmative ruling of exoneration with respect to charges against it, and in such circumstances, there would be few if any judicial or administrative processes available at a reasonable cost to obtain such an affirmative ruling. The Banks also included a hypothetical example to demonstrate their concerns, describing a situation where an affiliated party is initially investigated on three different claims and advanced the expenses to defend against them. The Banks argued that if only two of the claims were pursued and the affiliated party ultimately was found liable on only one claim, the proposed rule's exoneration standard would produce an inequitable result by requiring repayment of all of the expenses advanced despite the affiliated party having been found culpable on only one of the three original claims. The Banks therefore suggested it is more appropriate to replace the "exoneration" standard with a more conventional legal standard, namely, one examining "whether the party is found to be liable based on a judgment not subject to judicial review." Joint Comment p.4.

FHFA agrees with the Banks' conclusions and acknowledges that the exoneration standard under the proposed rule could have led to the undesirable outcomes set out in their hypothetical example. In fact, the standard itself is too amorphous to be useful; it resists consistent interpretation from case-to-case and year-to-year, and thus may very often lead to an application of the regulation that is inconsistent with the Agency's intent. The Agency therefore finds that the term "not exonerated" under the proposed rule warrants reconsideration and revision. FHFA has determined to revise § 1231.4(b)(2)(i)

to make the final rule clearer, more in keeping with familiar standards already in the regulation and more definitive in its application. The final rule turns the question of exoneration (or rather, non-exoneration) into one of "culpab[ility] for violating a law or regulation that is the basis for the charges to which the expenses specifically relate" thereby clarifying the standard to be that for which culpability is assessed and unambiguously linking it to the charges at hand. The concept of culpability is also a more familiar benchmark in that it ties in to the standard used for indemnification after settlements (has not "admit[ted]"). *See* § 1231.4(b)(2)(ii). Perhaps even more importantly, the final rule adopts a concept of finality, requiring an order to be final and non-reviewable before a lack of culpability qualifies an affiliated party for partial indemnification. *See* § 1231.4(b)(2)(i).

In making these changes, FHFA acknowledges that it is diverging from the FDIC's parallel provision requiring "a formal and final adjudication or finding in connection with a settlement that the [affiliated party] has not violated certain banking laws or regulations or has not engaged in certain unsafe or unsound banking practices" to describe the standard that qualifies for partial reimbursement. 12 CFR 359.1(*l*)(2)(ii). FHFA's final rule diverges from the FDIC's regulation by: (1) temporarily relieving the financial burden of defense on an affiliated party pending a proceeding's finality; and (2) creating a scope of permissible indemnification beyond that available under the FDIC's regulation. With these changes, indemnification becomes permissible if the party to be indemnified is not held responsible for a violation of law or regulation. In contrast, the FDIC regulation is constructed to prohibit indemnification unless the party is found (presumably via an express determination) not to have violated a law or regulation at

issue. In the potentially very large zone in which there is no determination or admission that the affiliated party has engaged in wrongdoing, but similarly no exoneration, FHFA's final rule permits the affiliated party to keep the indemnification payments for expenses of defense, while the FDIC's regulation requires that he or she repay them. FHFA's changes as reflected in the final rule provide clearer regulatory standards and greater certainty to FHFA, the regulated entities, and affiliated parties, and do not require explanatory hypotheticals. FHFA believes that the balance of interests in this instance is in favor of greater certainty and clarity.

The Banks' second objection to the partial indemnification provisions in the proposed rule concerns the possibility that an affiliated party's obligation to repay advanced expenses would be triggered prematurely upon the issuance of an unfavorable order, even when that order is not final. The commenters argued that such a trigger does not allow for appeal or review, nor any possible changes before the order becomes final, essentially cutting off funding before the legal process is complete. The Banks instead suggested that proposed § 1231.4(b)(2)(i) be changed from "results in an order" to "results in a final order not subject to judicial review." They also argued for a corresponding change to § 1231.4(b)(2)(iii), relating to the issuance of a prohibition order to prevent an affiliated party having to repay advances pending resolution of any request for a judicial stay with respect to such order.

FHFA agrees with the Banks that the obligation to repay advances should not be triggered upon the issuance of an order until the order is final and no longer subject to review. Such a change is consistent with the Agency's intent regarding application of the final rule generally, as well as with the rule changes discussed above and made in the

context of the "exoneration" standard. In the discussion accompanying the 2016 re-proposal, FHFA responded to several Bank commenters' requests to clarify what was meant by "final prohibition order" and in doing so relied on a reference to section 1377(c)(5) of the Act.[8] FHFA's clarification at that time did not adopt the measure of finality sought by the Banks. To account for the Banks' concerns and also to reflect the Agency's intent with regard to when advanced expenses ought to be repaid, FHFA is revising proposed § 1231.4(b)(2)(i) to require that repayment be based on a "final and non-reviewable order." For the sake of consistency, FHFA is also revising proposed § 1231.4(b)(2)(iii) to reference a "final and non-reviewable prohibition order."

The Banks' third objection to the partial indemnification provisions concerns the appropriate apportionment of expenses when multiple charges are at issue against an affiliated party. The commenters correctly noted that the proposed rule would have permitted partial indemnification of defense costs and expenses only when they "specifically relate to" a charge or charges on which an affiliated party is exonerated, if the proceeding results in an order; or on which the affiliated party enters a settlement without admitting culpability. *See* proposed § 1231.4(b), 81 FR at 64360. The Banks contend that this narrow construction is insufficient to account for a precise allocation of defense expenses among multiple charges where each charge may result in a different outcome for the affiliated party. To the extent that this comment suggests partial indemnification should permit an affiliated party to recover the proportion of all costs and

[8] FHFA expressly defined "final prohibition order" as "an order under section 1377 of the [Safety and Soundness] Act (12 U.S.C. 4636a) prohibiting … [an affiliated party] from continuing or commencing to hold any office in, or participate in any manner in the conduct of the affairs of, a regulated entity, which order has become and remains effective as described in section 1377(c)(5) of the Safety and Soundness Act (12 U.S.C. 4636a(c)(5))." 81 FR at 64358.

expenses represented by the charge(s) on which he or she is successful, FHFA already considered and rejected the suggestion in the 2016 proposed rule[9] and finds no reason to reconsider the comment here.

However, in reviving this allocation issue the Banks are asserting a slightly different proposition than the earlier comment, one not necessarily resulting in the same proportional allocation of expenses permitted for partial indemnification. In their latest comment, the Banks recommended that FHFA allow the board of directors of the regulated entity or the OF to determine the weight of each charge and accordingly allow indemnification of expenses for the proportion of the charges otherwise satisfying the rule's standards. According to the Banks, the board is in the best position to conduct such an apportionment. The Banks contend that without a board-driven allocation of costs and expenses, the proposed rule would be a disincentive to settlement of charges, since the affiliated party would not have certainty in advance as to that portion of expenses for which he or she could expect reimbursement or be required to repay.

FHFA does not believe the Banks' comment is sufficiently distinct to warrant a change to the final rule. It remains a proportional allocation, just one determined by the board's collective perception of value instead of one based on a simple arithmetic formula. In reality, the Banks' proposal provides less certainty than a formula-driven proposal and no more certainty than the proposed rule, unless the board's apportionment is known in advance of a settlement or final order. This lack of certainty was among the

[9] As FHFA noted in the preamble to the Proposed Rule: "In many cases the appropriate amount of partial indemnification will be difficult to ascertain with certainty. The value of each charge might not equal each other charge. Services provided often will relate to multiple charges or all charges and cannot conveniently be segregated." 81 FR at 64359.

reasons FHFA rejected the analogous comment to the proposed rule.[10] Moreover, it is far from clear that, as the Banks assert, the board would be in a better position to assign weight to different charges than would the parties involved in negotiating a settlement or a judge receiving evidence. Permitting the board to tip the scales in this manner would improperly substitute the board's judgment for the Agency of the parties involved or usurp the authority of the judge presiding over the matter. FHFA therefore continues to believe, as it noted when it issued the 2016 re-proposal, "that the appropriate amount of any partial indemnification is best determined on a case-by-case basis rather than by applying a predetermined formula." 81 FR at 64359.

5. Treatment of Pre-Existing Indemnification Arrangements

The Banks also objected to the proposed rule's treatment of pre-existing indemnification agreements. They generally restated earlier objections to the text and the effect of the indemnification agreement grandfathering provision in § 1231.4(b)(3), *see* 81 FR at 64360, which would have permitted payment of amounts due under individualized indemnification agreements with a named affiliated party. The commenters argued that the proposed rule did not define an indemnification "agreement" sufficiently to inform affected parties about what would, or would not, be grandfathered. The Banks further protested that individualized indemnification agreements are rare since most state laws would consider a regulated entity's bylaws provisions on indemnification to be enforceable contractual obligations to officers, directors, employees and agents, as exercises of the Banks' express authority under section 7 of the Federal Home Loan Bank

[10] In this view, FHFA again aligns with the FDIC's views as reflected in its corresponding regulation. Even the Banks note that the FDIC also recognized the lack of certainty in determining partial indemnification amounts. Joint Comment p.3 n.2. The FDIC, like FHFA, decided not to constrain partial indemnification determinations with an artificial and predetermined formula.

Act, 12 U.S.C. 1427(k). Consequently, the Banks urged FHFA to consider bylaws provisions on indemnification to be "agreements" entitled to grandfathering under the rule. In the alternative, they asked that FHFA delay the effective date of this final rule for 60 days during which regulated entities could execute individualized indemnification agreements that then will be subject to grandfathering. Finally, the Banks requested that FHFA confirm that those whose agreements are grandfathered will not also be subject to any new limitation that did not exist before the effective date of the final rule.[11]

As the Banks themselves admitted in their comment letter, FHFA has already addressed many of their stated objections in the preamble discussion accompanying the 2016 re-proposal. *See* Joint Comment p.5. At that time, FHFA rejected those comments, and the Banks have not presented any new arguments warranting reconsideration of this Agency's position. FHFA identified indemnification agreements as "specific indemnification agreements entered into by a regulated entity with a named [affiliated party] on or before the day this proposed amendment is published" and clarified that "only agreements of that type … justify grandfathering." 81 FR at 64359. This definition of what constitutes an "indemnification agreement" subject to grandfathering is clear enough that the Banks should need no further explanation. The commenter's observation that the Bank Act offers the Banks express authority to determine indemnification terms and conditions, does not in any way limit the Director's unambiguous authority to introduce additional prohibitions on indemnification pursuant to section 4518(e) of the Act. Finally, the commenters' request for a delay in the Final Rule's effective date, to permit execution of new agreements that would be subject to

[11] In effect, such a confirmation would override the proposed grandfathering date and replace it with the effective date of the final rule, unless extended.

grandfathering but no new rule restrictions, is but a minor variation on comments previously submitted and dismissed. FHFA dismissed those comments in the 2016 proposed rule and in so doing rejected any circumstances leading to a scenario like the one proposed by the Banks that would permit a Bank to immunize "[its] entire corps of managers and directors from the effect of this regulation in perpetuity." 81 FR at 64359. FHFA rejects the Banks' requests to change the final rule in any manner with respect to the treatment of pre-existing indemnification agreements. The final rule retains September 20, 2016 (the 2016 re-proposal's publication date) as the grandfathering date for pre-existing individualized indemnification agreements. *See* § 1231.4(b)(3).

6. Deterrent Effects on Service as a Bank Director

The Banks' final objection to the proposed rule concerns its potential detrimental impact. The commenters contended that because the proposal departs from current corporate governance and indemnification practices, recruiting for, and the continuing service of, directors, officers, and employees could be adversely affected.

FHFA is not persuaded by this objection. Although FHFA recognizes the risk of deterrence, the Banks offer no evidence to demonstrate that the risk is as great as they suggest, and FHFA remains unconvinced that the asserted deterrent effect is likely to materialize. As noted above, FDIC-insured banks and savings associations have been operating under the equivalent FDIC rule for the past 20 years and have been able consistently to recruit well-qualified directors and officers. FHFA believes it has struck the correct balance between traditional state law-based indemnification and a regime that is appropriate for these institutions, specially subject to and created under federal law, and therefore has not made an accommodation for this comment.

IV. Consideration of Differences between the Banks and the Enterprises

Section 1313(f) of the Safety and Soundness Act, as amended, requires the Director, when promulgating regulations relating to the Banks, to consider the differences between Fannie Mae and Freddie Mac (collectively, the Enterprises) and the Banks with respect to: the Banks' cooperative ownership structure; mission of providing liquidity to members; affordable housing and community development mission; capital structure; joint and several liability; and any other differences the Director considers appropriate. *See* 12 U.S.C. 4513(f). The Director considered the differences between the Banks and the Enterprises as they relate to the above criteria and determined that the Banks should not be treated differently from the Enterprises for purposes of this final rule. Any regulated entity in conservatorship (or receivership or a limited-life regulated entity), whether a Bank or an Enterprise, would be outside the scope of the rule.

V. Paperwork Reduction Act

This final rule does not contain any information collection requirement that requires the approval of the Office of Management and Budget (OMB) under the Paperwork Reduction Act (44 U.S.C. 3501 *et seq.*). Therefore, FHFA has not submitted any information to OMB for review with respect to information collection.

VI. Regulatory Flexibility Act

The Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*) requires that a regulation that has a significant economic impact on a substantial number of small entities, small businesses, or small organizations must include an initial regulatory flexibility analysis describing the regulation's impact on small entities. Such an analysis need not be undertaken if the agency has certified that the regulation will not have a significant

economic impact on a substantial number of small entities. 5 U.S.C. 605(b). FHFA has considered the impact of this final rulemaking under the Regulatory Flexibility Act. The General Counsel of FHFA certifies that this final rule is not likely to have a significant economic impact on a substantial number of small entities because it would apply primarily to the regulated entities and the OF, which are not small entities for purposes of the Regulatory Flexibility Act.

VII. Congressional Review Act

In accordance with the Congressional Review Act, FHFA has determined that this action is not a major rule and has verified this determination with the Office of Information and Regulatory Affairs of the Office of Management and Budget (OMB). *See* 5 U.S.C. 804(2).

List of Subjects in 12 CFR Part 1231

Golden parachutes, Government-sponsored enterprises, Indemnification payments.

Accordingly, for the reasons stated in the preamble, and under the authority of 12 U.S.C. 4511, 4513, 4517, 4518, 4518a, and 4526, FHFA amends part 1231 of subchapter B of chapter XII of title 12 of the CFR as follows:

PART 1231 – GOLDEN PARACHUTE AND INDEMNIFICATION PAYMENTS

1. The authority citation for part 1231 is revised to read as follows:

Authority: 12 U.S.C. 4511; 4513; 4517; 4518; 4518a; and 4526.

2. In part 1231, wherever they occur:

a. Revise all references to "entity-affiliated party" to read "affiliated party";

b. Revise all references to "entity-affiliated parties" to read "affiliated parties"; and

c. Revise all references to "entity-affiliated party's" to read "affiliated party's".

3. Revise § 1231.1 to read as follows:

§ 1231.1 Purpose.

The purpose of this part is to implement section 1318(e) of the Safety and Soundness Act (12 U.S.C. 4518(e)) by setting forth the standards that the Director will take into consideration in determining whether to limit or prohibit golden parachute payments and by setting forth conditions for prohibited and permissible indemnification payments that regulated entities and the Office of Finance may make to affiliated parties.

4. In § 1231.2 add definitions for "Indemnification payment" and "Liability or legal expense" in alphabetical order to read as follows:

§ 1231.2 Definitions.

* * * * *

Indemnification payment means any payment (or any agreement to make any payment) by any regulated entity or the OF for the benefit of any current or former affiliated party, to pay or reimburse such person for any liability or legal expense.

Liability or legal expense means—

(1) Any legal or other professional expense incurred in connection with any claim, proceeding, or action;

(2) The amount of, and any cost incurred in connection with, any settlement of any claim, proceeding, or action; and

(3) The amount of, and any cost incurred in connection with, any judgment or penalty imposed with respect to any claim, proceeding, or action.

* * * * *

7 Add § 1231.4 to read as follows:

§ 1231.4 Indemnification payments.

(a) Prohibited indemnification payments. Except as permitted in paragraph (b) of this section, a regulated entity or the OF may not make indemnification payments with respect to an administrative proceeding or civil action that has been initiated by FHFA.

(b) Permissible indemnification payments. A regulated entity or the OF may pay:

(1) Premiums for any commercial insurance policy or fidelity bonds for directors and officers, to the extent that the insurance or fidelity bond covers expenses and restitution, but not a judgment in favor of FHFA or a civil money penalty imposed by FHFA.

(2) Expenses of defending an action, subject to the affiliated party's agreement to repay those expenses if the affiliated party either:

(i) When the proceeding results in a final and non-reviewable order, is found culpable for violating a law or regulation that is the basis for the charges to which the expenses specifically relate; or

(ii) Enters into a settlement of those charges in which the affiliated party admits culpability with respect to them; or

(iii) Is subject to a final and non-reviewable prohibition order under 12 U.S.C. 4636a.

(3) Amounts due under an indemnification agreement entered into with a named affiliated party on or prior to September 20, 2016.

(c) Process; factors. With respect to payments under paragraph (b)(2) of this section:

(1) The board of directors of the regulated entity or the OF must conduct a due investigation and make a written determination in good faith that:

(i) The affiliated party acted in good faith and in a manner that he or she reasonably believed to be in the best interests of the regulated entity or the OF; and

(ii) Such payments will not materially adversely affect the safety and soundness of the regulated entity or the OF.

(2) The affiliated party may not participate in the board's deliberations or decision.

(3) If a majority of the board are respondents in the action, the remaining board members may approve payment after obtaining a written opinion of outside counsel that the conditions of this regulation have been met.

(4) If all of the board members are respondents, they may approve payment after obtaining a written opinion of outside counsel that the conditions of this regulation have been met.

(d) Scope. This section does not apply to a regulated entity operating in conservatorship or receivership or to a limited-life regulated entity.

Dated: September 28, 2018.

Melvin L. Watt,
Director, Federal Housing Finance Agency.
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