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August 5, 2017 **VIA E-MAIL ONLY: regcomments@ncua.gov**

Gerard Poliquin, Secretary of the Board
National Credit Union Administration
1775 Duke St
Alexandria, VA 22314-3428

Re: SW&M Comments on Voluntary Mergers of Federally Insured Credit Unions

Dear Mr. Poliquin:

We are writing to comment on the Notice of Proposed Rulemaking Regarding Voluntary Mergers of Federally Insured Credit Unions (the "Proposed Rule"), dated May 25, 2017. Our law firm has represented primarily credit unions for over 30 years, and we currently represent hundreds of credit union clients nationwide. We are involved in a large proportion of the mergers between credit unions, and the lawyers at our firm have worked on hundreds of mergers involving credit union clients. We believe our perspective on the issues presented in the Proposed Rule may be helpful to the NCUA as it considers making changes to rules governing mergers of federally insured credit unions. Ultimately, we believe many of the proposed changes would significantly deviate from the established norms for corporate governance and mergers among various corporate charters and various jurisdictions. We also believe the Proposed Rule will not effectively further the NCUA's public policy purposes.

<u>Background</u>

We recognize that market forces have driven market consolidation among credit unions. This is partially because of the economy and interest rate environment, but it is also driven by the difficulties and costs imposed on small credit unions through their compliance responsibilities. The ever-increasing "deputization" of financial institutions through BSA and similar areas, as well as the record-keeping requirements now inherent in FCRA, TILA, ECOA, EFTA, etc., do place very real operating costs on credit unions (and other financial institutions).

We also understand the NCUA's position that market participants could affect merger decisions with considerations of the overall financial and operational "package" presented—how are employees, sponsors, and communities treated. However, we believe that such considerations are generally permissible. Indeed, there are multiple constituencies to consider in any corporate merger. Of course, pursuant to their fiduciary duties, credit union directors and officers must consider members first.[1] However, under long-established common law traditions directors and officers of all corporations alike are also permitted to attend to constituencies like employees, community, and sponsors, so long as it is not to the detriment of members/shareholders.[2] Further, the NCUA has long recognized that FCU Boards are gatekeepers, and so they can and should consider multiple factors in their merger deliberations. This is as it should be.

The question of what to do about merger decision-making processes is a question of fundamental corporate governance. We believe that the "internal affairs doctrine" is important here, making disclosure, voting, and similar steps up to the jurisdiction of charter for a merging institution. Accordingly, while the NCUA may believe that there are safety and soundness implications to merger voting at FISCUs, insurance matters such as these are properly dealt with by the NCUA as an insurer through the NCUA's approval process (not by dictating how members vote)—if the NCUA believes there is a safety and soundness concern, the NCUA should be the one acting.

Our understanding of the issue at hand, and the motivation underlying this proposal, is that the NCUA believes that certain potential improprieties or creative evasions of the merger related financial arrangements rules merit significant increases in the process and disclosure from all credit unions. While we agree that evasion of rules is problematic if occurring, we disagree with the solution. That said, we do agree that certain changes to merger rules are necessary or important; though, we believe such changes may be confusing or problematic unless accompanied with changes to or rescission of the regulatory forms currently published in the NCUA's Merger Manual.[3]

Specific Comments

Because there are numerous inter-related revisions proposed, we discuss various areas or revisions in detail below (not necessarily in the order addressed in the Proposed Rule).

1. Revision of Regulatory Requirements Related to Hart-Scott-Rodino Act Premerger Thresholds Will Be Beneficial

   The Proposed Rule discusses the thresholds for merging credit union assets mentioned in 12 C.F.R. § 708b.104(a)(8). We agree with the change to incorporate the sliding scale of Hart-Scott-Rodino thresholds, rather than inclusion of the reference to $50 million previously included in the NCUA's Form 6301. Credit unions should also be aware that certain assets are exempt from the Hart-Scott-Rodino calculation, and so total assets above the threshold may not require an application to the FTC and DOJ (at significant expense). Reference to

[1] Except for institutions chartered by states, like Washington, where fiduciary duties flow to the corporation itself.
[2] Consider the Delaware Supreme Court's note in *Revlon, Inc. V. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1985): "A board may have regard for various constituencies in discharging its responsibilities, provided there are rationally related benefits accruing to the stockholders."
[3] In particular, we note that Forms 6301 and 6305 are sorely in need of updates and clarifications.

"non-exempt" assets may assist credit unions in realizing that they may be able to avoid this additional hurdle to lawfully merging.

2. Instituting Record Date Guidance for FCUs is Advisable, But Should Be General, Rather Than Specific to Mergers

The Proposed Rule recommends specifying record dates for member approval of proposed mergers in 12 C.F.R. § 708b.106(h). We agree with the implementation of record dates for FCUs. Indeed, we have long recommended that FCUs consider the record dates for their votes, but have had to make reference to state law by analogy in the absence of federal rules. However, permitting FCUs to set particular record dates should be inherent in all decisions, not only merger decisions. Accordingly, the ability of a Board to set record dates should be contained in the FCU Bylaws and should apply to all votes.

Additionally, we note that record dates are normally applicable to both voting and notice decisions, and at times are permitted (or required) to be separate. For example, a Board might establish that the members of record as of 50 days before a meeting may be entitled to notice, but members of record as of the date of the meeting can vote. Separate record dates assist with ensuring that printing of notices is from a set list that can be processed effectively prior to printing and mailing, yet allowing for persons who are members as of the mailing date (or vote date) to cast ballots. As drafted, § 708b.106(h) appears to be only related to the persons who are entitled to vote, not the persons entitled to notice under § 708b.106(a).

As to the content of the rule regarding record dates, we believe the NCUA should look to established norms in this area in state laws and the Model Business Corporations Act ("MBCA"). For example, the MBCA allows bylaws to specify record dates for voting groups, and where bylaws do not indicate record dates, the MBCA allows directors to specify such dates. The MBCA states that record dates may not be more than 70 days before the meeting[4]. Delaware law allows directors to fix record dates, which must not be more than 60 days before the meeting. California law allows the Bylaws to provide for record dates, but in the absence of such provisions, allows for separate record dates for notice (no more than 90 days before a meeting) and voting (no more than 60 days before a meeting).[5]

3. Changes Are Not Needed to the Merger Related Financial Arrangements Rule

In general, we have concerns about the proposed revisions in multiple areas of the Proposed Rule regarding merger related financial arrangements. In general, we disagree with this change, as we believe it is unnecessary and substantially departs from effective norms available with other types of institutions.

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[4] See MBCA § 7.07.
[5] See California Corporations Code § 7611.

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- The new defined term "covered person" focuses on compensation, with the highest compensated individuals being covered regardless of their positions of authority. The prior rule focused on control, and therefore on conflicts of interest. Being highly compensated does not grant one control over decisions. By definition, a conflict of interest arises when someone making a decision has two competing interests (i.e., between themselves and the members). Burdening the market for labor with "one size fits all" disclosure rules does not affect control decisions—it merely creates unnecessary disclosure obligations. The existing definitions and coverage of the merger related financial arrangements rules are more effective at targeting conflicts of interest by decision-makers, as opposed to targeting compensation levels that may be changing due to market forces.

- We believe credit unions and the NCUA should take notice that the rule currently in effect is similar to and based (in-part) on the existing OCC/OTS regulations for savings associations, both state and federal. We note, though, that the NCUA opted to implement a notice requirement, rather than the presumptive prohibition in place for savings associations.

  In the context of a merger, state and federal savings associations must consider the impact of executive compensation. Officers, directors, and controlling persons of the disappearing state savings association cannot receive unreasonable compensation in excess of their responsibilities and duties.[6] Material increases are to be scrutinized, and increases in compensation in excess of the greater of $10,000 or 15% gives rise to the presumption of unreasonableness. Sufficient evidence may rebut this presumption.[7] Federal savings associations are subject to identical requirements.[8]

  Executive compensation regulation under the existing rule and during a merger of a state or federal savings association focuses on those who exercise control in the merging institutions. Only officers, directors, and controlling persons are subject to such scrutiny of compensation acquired during a merger. It is only these individuals who must rebut the presumption of unreasonableness directly, proving that there is no conflict of interest and that their compensation is equitable given their responsibilities and duties. Assessing the compensation of all highly compensated individuals is not required by these regulations. This makes sense, as some highly compensated individuals have no role in the merger decision-making process and therefore do not present a conflict of interest.

- As the NCUA is likely aware, our clients normally advise the NCUA of compensation arrangements that may potentially be triggered by the existing rule, even if we do not believe they should be disclosed. From our participation in a large proportion of the

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[6] 12 CFR § 390.332(d)(1)(vi)(C).
[7] Id.
[8] 12 CFR § 563.22(d)(1)(vi)(C).

credit union mergers in the past several decades, we have not observed the types of subversion or evasion that appears to be behind the Proposed Rule. While this is a limited perspective compared to the NCUA's, that also leads us to believe this is not a widespread problem, but rather isolated with either particular market participants or in particular regions of the country.

Also, the NCUA has previously been clear about the scope of the terms compensation and benefits, including the "but for" test for determining whether compensation is related to a merger.

This leads us to believe that if individual credit unions are evading the merger related financial arrangements rule, the NCUA has administrative recourse, whether formal or informal. If the NCUA is aware of a particular continuing credit union's behavior, the NCUA can exert additional scrutiny to those credit unions' applications or pursue individuals and institutions for civil money penalties.[9] Evasions by a few bad actors is not an adequate reason for sweeping industry changes.

- The NCUA has noted that it wants the disclosures in the Notice of Special Meeting to be as succinct as possible (they should not be "voluminous"). However, proper explanation of merger related financial arrangements under the rules requires putting them in context of the applicable executive's history and the institution's financial health. Context of compensation is key, not only to clarity, but also to ensuring that a Board's message is conveyed as intended.

  Please refer to the sample language in Exhibit A, which includes one disclosure that gives the volume of information necessary to convey the financial impact of payments, and the context of those payments for the institutions and the executives involved. The sample disclosure in Exhibit A takes up ¼ of the disclosure when the actual transactions represent less than 10 basis points of net worth for the combined institution.

  In this way, existing disclosure requirements are already voluminous. Requirements to include additional potentially irrelevant information, and requirements to always include information about compensation in the notice, will instead result in even more voluminous disclosures. And where compensation arrangements are complex, Boards, management, marketing personnel, communications consultants, and lawyers alike will want to insert yet more volume to the rest of the Notice. For a disclosure requirement that does not answer the issue of conflicts of interest, this seems to be quite excessive and unnecessary.

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[9] NCUA under § 708b.105 may approve mergers if compliant with rules and not posing an undue risk to the Share Insurance Fund. 12 U.S.C. § 1785(b) does not dictate only these conditions. The NCUA could impose approval conditions based on NCUA's policy objectives in the FCUA, including ensuring that stability in the financial system and service to persons of modest means continue. We believe such a step would be unnecessary, but appears to more closely correspond with the policy objectives represented by the Proposed Rule.

4. Submission of Board Minutes May Assist the NCUA, But Require Internal NCUA Procedures

We are not opposed to submission of minutes as a part of a merger application, as they are a pre-existing record that should be permanently maintained. This is particularly the case considering the fiduciary responsibilities of directors and the heightened attention to a fundamental corporate transaction. We note, however, that in many cases minutes may not (without being accompanied by the board packets that informed the discussion) provide the NCUA with the insight it is looking for. Nonetheless, board minutes may provide analysts with certain information that may inform follow up requests for information or support. But we believe a more fruitful and less burdensome method of achieving the same goal would be to institute procedures where analysts ask for individual information if suggested by the situation.

5. The Proposed Notice of Special Meeting/Voting Period Is Too Long

The NCUA has proposed revising the notice period for special meetings of the members related to mergers from the standard period for special meetings (7 to 30 days) to at least 45 and no more than 90 days. We recommend a standard time period of at least 30 days to ensure maximum member participation without excessive burden to FCUs.

At base, it is not unusual among state laws for the period of notice for merger decisions to be longer than the notice period for more routine shareholder meetings. Indeed, we agree that 7 days is too short a time to allow for the delivery and return of mail ballots, and so does not allow for the full process required for federal credit union merger votes.

The question is whether 45 days as the minimum notice period is the most appropriate, or whether some other period would be preferable.

Data from 12 merger votes in the last 18 months is reflected in the graph below, provided by Turner Warren Hwang and Conrad, a prominent provider of vote processing services on the West Coast.[10]

[10] Turner Warren Hwang and Conrad granted permission to use this data and the accompanying chart.

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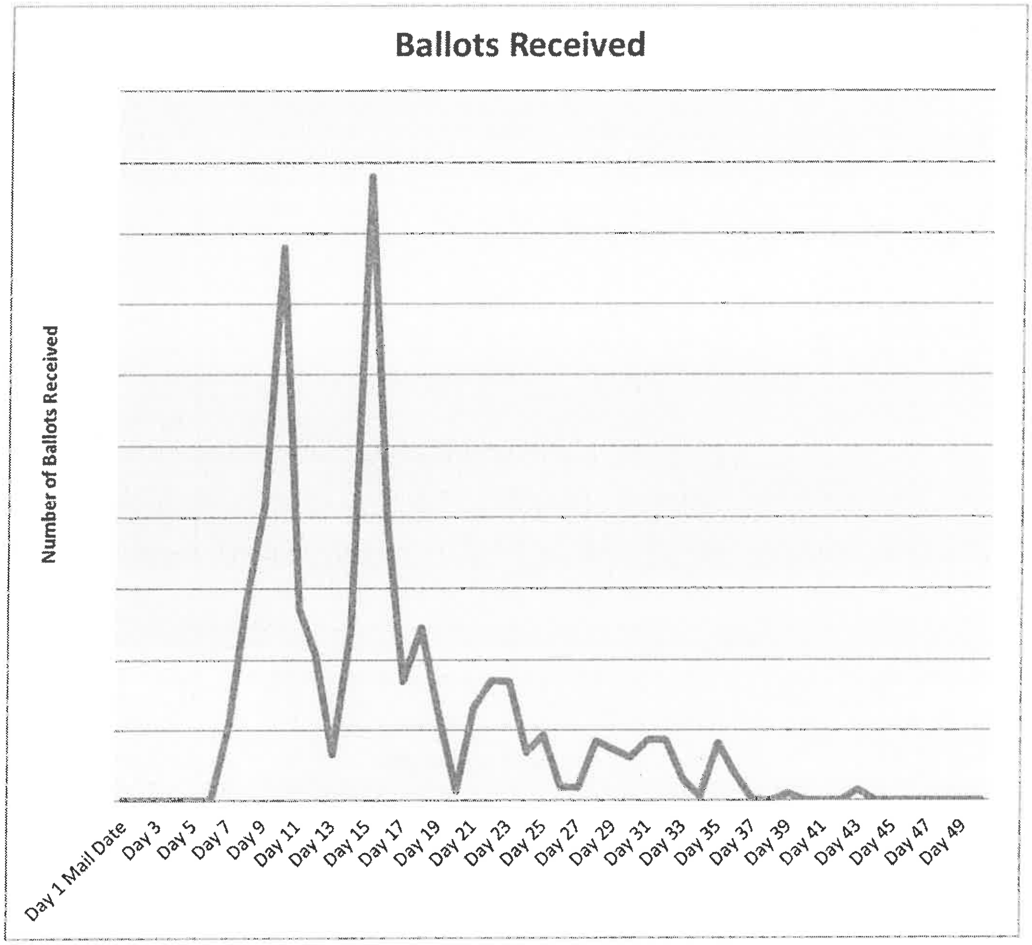

The data, while more limited in time, reflects our experience with merger votes for decades.

Note that on days 10 and 15 the largest number of votes are cast. Regarding the "trailing" votes beyond 30 days, we note that California chartered credit unions are required to provide between 30 and 90 days notice of a merger vote, though most provide approximately 30 days notice.

Beyond not being suggested by actual voting data, a minimum period of 45 days is outside of the norm for voting periods, whether for state chartered credit unions or other types of corporate entities.

Illinois chartered credit unions require notice at least 7 days before the meeting.[11] Pennsylvania chartered credit unions require notice at least 10 days before the date of the meeting.[12] Texas regulations require that credit unions must provide notice within 30 days of

[11] 205 ILCS 305/19-1.

[12] 17 Pa. Cons. Stat. § 1302.

an annual or special meeting where voting is involved.[13] Texas non-profit corporation law provides that notice is required at least 10 days before the meeting and no earlier than 60 days.[14] Washington chartered credit unions also must provide notice within 30 days of a special meeting, or within a reasonable time period provided in the bylaws.[15] Washington corporate law requires notice 10 to 60 days before the meeting.[16] Based on the foregoing, a reasonable time period under Washington law is generally judged to be 10 to 30 days. Corporations in Massachusetts are required to provide shareholders with notice of a meeting concerning a merger at least 30 day days prior to the meeting.[17] Virginia corporations are required to provide notice between 25 and 60 days for mergers and between 10 to 60 days for annual and special meetings.[18] Virginia corporate law indicates that an appropriate minimum notice date is either 10 or 25 days.

Based on our review of state laws and practical experience, a minimum notice period of 10 to 30 days is fairly standard for state corporations and credit unions. Ultimately, while we agree that a 7 day notice period is often too short for members to adequately consider a ballot and return it, we think that notice with a minimum of 30 days prior to the meeting is adequate, proper, and optimal for member participation, while 45 days as a minimum is excessive and unusual.

6. <u>The Proposed Member Communication Rule is Unnecessary, Excessive, and Outside of Norms for Corporate Governance Laws</u>

Perhaps the largest change in the Proposed Rule is the addition of a right for federal credit union members to correspond with each other regarding a merger proposal. This new right is limited to a specific context (mergers), and is only present for federal credit union members in another highly specific context (conversions away from the credit union charter). Whether intended or not, this change telegraphs that the NCUA believes that a merger is a type of "suspect" transaction, with the same pitfalls and dangers to member-owners as conversion to a mutual savings bank. We fundamentally disagree that this is the type of fundamental corporate transaction that should raise those concerns, and do not believe it is necessary to implement the proposed changes.

In other areas, the NCUA's rules highlight certain types of "suspect" transactions, though in the fiduciary duty rules they are termed as "matters affecting the fundamental rights and interests of members." The NCUA has indicated that "matters affecting the fundamental rights and interests of [members] include charter and share insurance conversions and

[13] Tex. Admin. Code § 91.302.
[14] Tex. Bus. Org. Code § 22.156.
[15] RCW 31.12.195.
[16] RCW 23B.07.050.
[17] Mass. Gen. Laws ch. 156, § 46A.
[18] VA. Code Ann. § 13.1-842.

terminations."[19] We note with interest that mergers were not included in this list (and with good reason). In this way, the Proposed Rule not only departs from prior reasoning, but also departs from the NCUA's prior determinations by implicitly placing mergers in this category of transactions.

We disagree that mergers should be so categorized. Rather, mergers are a normal aspect of the lifecycle for institutions. Normal communications rules should apply. However, the NCUA has not developed such rules, resulting in a general absence of communications rights for FCU members.

Normal rules for member communications (or shareholder communications) do exist in many jurisdictions. Indeed, a number of the jurisdictions discussed above, including California, have generalized rules regarding member/shareholder communications for corporations and credit unions alike.

In California, credit union members are permitted to send communications to other members reasonably related to their membership interests. California corporations have a similar standard, requiring that shareholders provide a proper purpose for inspection of a shareholder list.[20] While California state law requires responses within 10 days of certain member requests, it also allows for corporate objections to sharing for improper purposes or to protect private information.

Similar to California, Washington corporations are required to compile a shareholder list and make it available for inspection at the corporation's principal office at least ten days prior to the meeting and throughout the meeting.[21] Washington corporations thus are required to permit shareholders to be able to communicate generally regarding their interests at the shareholder's own expense. Virginia and many other states include corporate provisions similar to Washington.[22]

Thus, the existing rules for corporations across jurisdictions allow for communications between shareholders generally, even while corporations balance individual privacy with corporate transparency. What jurisdictions have not done is create either a) specific communication rights in specific contexts, or b) requirements to call out those communication rights. The NCUA proposal is an extreme outlier among corporate law in U.S. jurisdictions. We do not believe there is reason to so depart from the norm, particularly as such norms apply equally to other types of membership organizations and non-profits. Accordingly, if the NCUA believes that members should have communication rights, those

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[19] 12 C.F.R. 701.33; *See also* 75 FR 81386 (Dec. 28, 2010); *See also* 75 FR 15587 (Mar. 29, 2010).

[20] *See* Cal. Corp. Code § 8330(a): California chartered credit unions are non-profit mutual benefit corporations. Because of privacy regulations, membership lists cannot be shared, but a reasonable alternative is available via use of the credit union's approved mail house. *See* Cal. Corp. Code § 8330(c).

[21] RCW 23B.07.200(2).

[22] VA Code Ann. § 13.1-661(c).

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rights should:

- Be general and provided for in general governance principles;
- Require use of FCU approved channels, at the member's cost;
- Require communication to all members equally (not only some); and
- Be a general regulation or Bylaws right, not to specifically called out in any specific context, but available.

Conclusions

In general, we understand the motivations behind the NCUA's Proposed Rule; however, we have concerns that some proposals made do not further the public policy interests the Proposal attempts to address. Certain changes in the rule are generally beneficial, and we support those changes as noted above. We also support updates to the NCUA's forms as published in its Merger Manual, as a number of them are in need of updates as a result of past revisions to Part 708b.

However, those changes that depart from established norms for corporate governance or corporate law for institutions generally are unnecessary. We do not believe the NCUA needs to reinvent these standards, when tried-and-true solutions exist in the realms of the MBCA, state law, and the regulations applicable to other types of financial institutions, or merely through the enforcement of the NCUA's current rules.

We would be pleased to be available to the NCUA to discuss our experiences under the current Part 708b and Merger Manual, and any of the issues discussed herein. We look forward to working with the NCUA in this area.

Sincerely,

STYSKAL, WIESE & MELCHIONE, LLP

William J. Adler

Timothy I. Oppelt

WJA/TIO

Enclosure
[Exhibit A]

Exhibit A

The following disclosure is a sample of language that would be included in a merger related financial arrangement and has been revised to protect privacy:

> "**Merger-related financial arrangements.** We want to disclose to our members the terms of certain payments proposed to be made to current executives at ABCFCU, as required by the Credit Union's regulator, the National Credit Union Administration. If you approve the merger, ABCFCU's CEO X, Executive Vice President Y, and CFO Z will each be offered a three year employment contract with the Continuing Credit Union. Ms. X has been employed with ABCFCU for 30 years, and has served as an accomplished leader in the role of President/CEO for over 10 years. She has been an integral part of ABCFCU and our ability to serve our members' financial needs, including successfully guiding the organization through an extremely difficult economic climate. Mr. Y has been employed with ABCFCU for 10 years, during which time his oversight of operations of ABCFCU's business has been instrumental to maintenance of compliant and safe products and services for our members. Ms. Z has been employed with ABCFCU for 15 years, overseeing both the accounting and investment functions. During this time, he has ensured that the ABCFCU has successfully maintained the income and electronic services to effectively serve our members.
>
> The Boards of Directors of both ABCFCU and Continuing Credit Union believe strongly that each of these executives brings valuable experience, skills and talents to our combined credit union, and will play an important leadership role after the merger. Accordingly, each will be offered compensation in line with Continuing Credit Union's existing senior management pay structure by increasing their salaries by 10%—post merger salaries of $250,000 for Ms. X, $200,000 for Mr. Y, and $175,000 for Ms. Z. This compensation fits market standards for a leadership position in a credit union of this size and scale, and considers their seniority in the organization and the broad scope of their new responsibilities in a $2 billion credit union serving multiple sponsors. Because we view each of these executives as vital to ensuring a smooth and successful integration of the two credit unions and to representing the interests of ABCFCU members during and after the merger, Continuing Credit Union will also offer each the opportunity to participate in Continuing Credit Union's 401k and a qualified deferred compensation plan with payments of approximately $17,500 (adjusted annually) contributed for three years.
>
> In addition, as a part of each executive's years of service and loyalty to ABCFCU, the Boards of both the ABCFCU and the Continuing Credit Union have mutually determined that it is in the best interest of the members to enter into a Supplemental Employee Retirement Plan effective upon the date of the merger, which would allow each to retire on the expiration of his or her employment contract. These types of retirement plans are typically provided to credit union executives for the purpose

of retention and because the regulatory limits of qualified retirement plans usually result in a lower retirement benefit for executives as a percentage of income replacement. Providing a retirement plan in line with those available at other similar financial institutions will help ensure they continue to serve members after the merger is completed, and recognize their long and meritorious service to the ABCFCU, and subsequent service to the Continuing Credit Union. The estimated target retirement benefit for Ms. X will be approximately [$1,000,000] (gross) with an anticipated value net of tax of about [$500,000] (assuming a federal and state tax rate of 50%); this net benefit equates to approximately [$16,660] for each year of service with ABCFCU through the end of her contract ($1,383 for each month). The estimated target retirement benefit for Mr. Y will be approximately [$800,000] (gross) with an anticipated value net of tax of about [$400,000]; this net benefit equates to approximately [$28,600] for each year of service with ABCFCU through the end of his contract ($2,380 for each month). The estimated target retirement benefit for Ms. Z will be approximately [$600,000] (gross) with an anticipated value net of tax of about [$300,000]; this net benefit equates to approximately [$16,660] for each year of service with ABCFCU through the end of her contract ($1,383 for each month).

Each of these retirement arrangements will assist in encouraging each employee to continue employment with Continuing Credit Union following the date of the merger, as there are forfeiture of benefit provisions should the employee voluntarily leave or be terminated for cause during their terms. The total of the benefits would impact the net worth ratio of the Continuing Credit Union after the merger by approximately 8 basis points, at which point Continuing Credit Union will remain well capitalized and sound. The Boards of Directors of each of ABCFCU and Continuing Credit Union believe this arrangement will help retain the continued service of these employees for the benefit of the combined membership, and help ensure that the legacy of ABCFCU lives on in the Continuing Credit Union."