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RE: Notice of Proposed Rulemaking Regarding Stock Benefit Plans in Mutual-To-Stock Conversions and Mutual Holding Company Structures, 71 Fed. Reg. 41179 (July 20, 2006), No. 2006-29

To The Chief Counsel's Office:

This letter is written on behalf of my clients Joseph Stilwell, Stilwell Value Partners VI, L.P. and other Stilwell entities ("Stilwell"). Stilwell has investments in entities subject to the above-referenced proposed rule and we appreciate the opportunity to submit comments. We oppose its adoption. The proposed rule is a radical departure from Office of Thrift Supervision ("OTS") rules and policy as strictly enforced since at least 1994, as well as basic principles of corporate governance. Unlike every other publicly listed corporation in America, where a shareholder vote is required to adopt a stock benefit plan, the proposed rule would allow thrift insiders alone to vote themselves a plan under the fiction that mutual holding company ("MHC") shares represent a real vote. The proposed change eliminates an important shareholder safeguard despite the clear need for increased scrutiny of stock option plans at publicly listed companies.

We fully recognize that an investment in a Subsidiary MHC is a minority investment, and that a public shareholder's ability to participate in governance is appropriately limited, and that, contrary to several OTS statements, public shareholder rights in Subsidiary MHCs are severely limited. As the OTS has recognized, however, since at least 1994, the ability for thrift insiders to grant themselves stock benefit plans provides far too great an opportunity for insider abuse and it unfairly dilutes investors without their say.

The proposed rule would now allow insiders of MHCs and their Subsidiary MHCs to self-adopt stock benefit plans without public shareholder approval by merely waiting until the first anniversary of the conversion. The proposed rule is an offense to traditional notions of fair play, opens the door to abusive self-enrichment, and is both arbitrary and capricious for at least the following reasons:

- The proposed rule is radical. It will allow insider-beneficiaries of regulated thrifts to self-adopt stock benefit plans. This is an advantage not enjoyed by insiders of any other corporations listed on the major U.S. stock exchanges, whose listing standards require shareholder approval.

- The proposed rule abruptly and inexplicably reverses OTS policy in place since at least 1994. The OTS Director and Deputy Director reiterated this policy just this spring in Congressional testimony. Additionally, in March, this agency represented to the Senate that even though public shareholders of Subsidiary MHCs have a curtailed general corporate governance role, they do "have separate voting rights in connection with stock benefit plans" which enable them alone to vote on their adoption.

- Nothing has changed that would fairly explain or justify a reversal in the policy or rule, and the OTS offers no explanation except that the rule is being proposed in order to "provide clarity," "reduce existing regulatory burdens," and because the "current provisions are unduly restrictive." Indeed, the proposed rule is tucked away in a prolix notice; its meaning is barely intelligible to the untrained eye (several banking law experts noted to us that they found the explanation and presentation abstruse).

- The rationale given for the proposed change -- to reduce regulatory burden -- is not reasonable. It is not a burden to put insider stock benefit plans to a routine shareholder vote. How could it possibly be burdensome to prohibit (a) self-enrichment by insider-beneficiaries, and (b) unratified dilution?

- In this day and age of enlightened corporate governance and heightened regulation and enforcement, the OTS proposes an Orwellian corporate governance rule where a vote is held but the outcome is pre-determined by the insider-beneficiaries who hold a majority of the votes. The OTS erroneously relies on the legal fiction that the MHC shares represent a real vote, when, of course, they do not.

- While investors possess no legitimate expectation to general shareholder rights in Subsidiary MHCs (such as electing alternate directors), they have invested in Subsidiary MHCs in reliance upon the longstanding current rule with the legitimate expectation to vote on stock benefit plans without the MHC voting. Making the rule retroactive is particularly unfair and punitive to existing investors.

If the proposed rule is adopted and retroactively applied, Stilwell will commence a lawsuit to challenge it.

I. THE OTS PROPOSES TO REVERSE ITS CURRENT POLICY

The current regulation, 12 CFR § 563b.500(a)(7), provides:

"(a) You [a converted thrift] may implement a stock option plan or management or employee stock benefit plan within 12 months after your conversion, if you meet all of the following requirements.

> (7) Your shareholders approve each plan by a majority of the total votes eligible to be cast at a duly called meeting before you establish or implement the plan. You may not hold this meeting until six months after your conversion. If you are a subsidiary of a mutual holding company, a majority of the total votes eligible to be cast (other than your parent mutual holding company) must approve each plan before you may establish or implement the plan."

Sections 575.7(b)(1) and 575.7(e) protects public shareholders of Subsidiary MHCs by applying all the provisions of § 563b.500, including the provision above, to all stock issuances by a Subsidiary MHC. On September 17, 2004, the OTS Chief Counsel confirmed in Letter No. P-2004-6 that MHCs may not vote on Subsidiary MHCs' stock benefit plans "regardless of the length of time that has elapsed after a public offering." (OTS Letter No. P-2004-6 from John E. Bowman, OTS Chief Counsel, Sept. 17, 2004, at 1.)

The proposed rule would eliminate this requirement by stripping the last sentence from § 563b.500(a)(7) and adding a new paragraph (c) to § 575.8 which will provide that the restrictions contained in sections 563b.500(a)(4) through (a)(14) will not apply more than one year after the conversion of a mutual savings association. The effect is that the current requirement for public shareholder approval contained in § 563b.500(a)(7) will not be applied after the first year, and Letter No. P-2004-6 will be nullified.

II. SINCE 1994, REQUIRING PUBLIC SHAREHOLDER APPROVAL OF STOCK BENEFIT PLANS HAS BEEN A CORNERSTONE OF EFFORTS TO PREVENT INSIDER ABUSE

A. The 1994 Rule Was Adopted By The OTS In Response To Stock Option Abuse

In 1994, the OTS recognized that thrift conversions "provide an opportunity for an association's insiders to engage in transactions that transfer to the insiders an inappropriate amount of a converting association's value." (59 Fed. Reg. 22725 (May 3, 1994).) The OTS also noted the "controversy and negative media attention" surrounding the "generous compensation packages" that insiders received. (*Id.*) In response, the OTS structured its regulations "to prevent insider abuse by governing the manner and extent to which a savings association's insiders . . . may acquire stock and other benefits in a conversion." (*Id.*) The rulemaking notice for the interim rule (which became the final rule) stated the following:

> "Given that mutual savings associations currently seeking to convert generally are well-capitalized, the OTS has become increasingly concerned that the association's management may be undertaking conversions for reasons other than the need for capital. Some thrift insiders may be sacrificing the interests of their associations and mutual account holders to acquire significant amounts of conversion stock and other benefits as cheaply as possible in the conversion process. In addition, in some cases the issuance of conversion stock to a MRP lessens the opportunity for de-

> positors to obtain conversion stock. Finally, the issuance of stock options at the conversion price, rather than at aftermarket trading prices, which in recent years has been substantially higher than the conversion price, creates the impression that management is structuring an excessive compensation package. While the OTS believes there are valid business reasons for thrifts to adopt MRPs and stock option plans in order to attract and retain qualified management, these plans are now more appropriately implemented subsequent to the conversion and *with shareholder approval*.
>
> . . . The new provisions require that any decision to implement MRPs or stock option plans after conversion be voted on and approved by a majority of the shareholders no earlier than the first annual meeting following the conversion. *The rule further requires that thrift subsidiaries of mutual holding companies obtain a vote of a majority of stockholders, other than the parent mutual holding company, to approve such plans.* [FN14]
>
> *[FN14] In this regard, § 10(o)(8)(B) of the HOLA requires that a mutual holding company, which is generally controlled by the management of its thrift subsidiary, must own more than 50% of its thrift subsidiary. Thus, absent a disinterested stockholder vote requirement, management will be able to ensure approval of its compensation plans.*"[1] (Emphasis added.)

In 2002, the OTS reiterated its policy requiring the ratification of stock benefit plans by disinterested public shareholders:

> "OTS believes management benefit plans that are reasonable, present no safety or soundness concerns, and are *ratified by the shareholders*, are not objectionable." (67 Fed. Reg. 52010, 52014 (Aug. 9, 2002) (emphasis added).)

B. <u>The 2004 Letter No. P-2004-6 Closed An Insider Loophole</u>

As referenced above, on September 17, 2004, OTS Chief Counsel John E. Bowman issued a letter confirming that OTS shareholder ratification regulations require that stock benefit plans of Subsidiary MHCs may not be voted upon by MHCs. Instead, they must be approved by a majority of the public shareholders "regardless of the length of time that has elapsed after a public offering." (OTS Chief Counsel Letter No. P-2004-6, at 1.) He noted, "requiring approval by a majority of the minority shares prevents the mutual holding company from controlling the outcome of every such vote." (*Id*. at 2-3.) This comports with the above-stated policy and prevents insiders from self-adopting, irrespective of an arbitrary time period.

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[1] For the final rule, *see* 59 Fed. Reg. 61262 (Nov. 30, 1994).

C. The March 2006 OTS Written Response To Senate Follow-Up Questions Explicitly Recognizes Subsidiary MHC Public Shareholder Ratification: No "Dilution" Without "Representation"

In the OTS written response to follow-up questions posed by Members of the Senate Banking Committee, this agency made it plain that Subsidiary MHC public shareholders must determine adoption of insiders' plans:

> "While minority public shareholders do not typically have preferential voting rights vis-à-vis a majority and controlling shareholder (such as a MHC), OTS established certain separate voting rights for minority shareholders in the MHC context. *Specifically, minority shareholders have separate voting rights in connection with stock benefit plans and foundations because both types of transactions may dilute the percentage of stock held by existing minority shareholders*. . . . Other corporate actions, including the election of members of the board of directors, do not dilute the minority stockholders' interest, and therefore do not merit the extension of separate voting rights to minority stockholders." (OTS Response to Senate Banking Committee Questions, Regulatory Burden Relief Hearing, Mar. 1, 2006, at 5) (emphasis added).)

D. The May 2006 Congressional Testimony Confirms Shareholder Ratification Rule

Even more recently, in Congressional testimony, this agency explicitly identified the policy of shareholder ratification as an essential element of OTS preventative strategies. On May 11, 2006, OTS Deputy Director Scott M. Polakoff testified concerning the limitations on management benefit programs as being in place in order to prevent self-enrichment, and, more generally, preserve safety and soundness. He assured members of Congress that thrift insiders may only participate in stock benefit plans approved by a "separate shareholder vote." (Statement of Testimony of Scott M. Polakoff before the Subcommittee on Financial Institutions and Consumer Credit of the House Financial Services Committee, May 11, 2006, at 7-9; this, and all following cited testimony, available at www.OTS.gov.) On May 25, 2006, in testimony before another House subcommittee, OTS Director John M. Reich stated: "I want to dispel . . . the suggestion that thrift management unfairly benefits in the conversion process." (Statement of Testimony of John M. Reich before the Subcommittee on Oversight and Investigations of the House Financial Services Committee, May 25, 2006, at 40.) In support, he cited a number of regulatory checks in place to prevent insider self-enrichment. (*Id.*) Director Reich noted that stock benefit plans may not be established until six months after the conversion and that "these plans are subject to a separate shareholder vote." (*Id.* at 41.)

At no point during either Congressional testimony or the follow-up did any OTS official assert that public shareholder ratification in a Subsidiary MHC constitutes a regulatory burden. Indeed, during the Senate hearings on reducing regulatory burden, the current rule was touted by this agency as a necessary regulation to protect public shareholders.

E. Shareholder Ratification Is The Prevailing U.S. Corporate Governance Standard

As this agency's recent Congressional testimony evidences, the conditions underlying the current OTS rule have not changed since 1994. Converting thrifts tend to be well-capitalized; some insiders seek to convert for "reasons other than the need for capital" (and this concern exists especially in the case of Subsidiary MHCs who tend to be well-capitalized); it is unethical for insider-beneficiaries to self-adopt stock benefit plans; equity compensation plans dilute public shareholders. As we are witnessing today, insider abuse of stock option grants at the expense of shareholders is prevalent. The desire to make easy money continues to tempt human beings, and MHC insiders are not immune.

Prevailing U.S. corporate governance standards require shareholder approval of management stock option plans. Recognizing that these plans dilute existing shareholders, the major stock exchanges recently adopted rules expanding requirements for listed companies to put these plans up for a shareholder vote. NASDAQ Rule 4350(i)(1)(A) provides that "each issuer shall require shareholder approval prior to the issuance of designated securities . . . when a stock option or purchase plan is to be established." The NASDAQ commentary to the rule, IM-4350-5, states:

> "Employee ownership of company stock can be an effective tool to align employee interests with those of other shareholders. Stock option plans or other equity compensation arrangements can also assist in the recruitment and retention of employees, which is especially critical to young, growing companies, or companies with insufficient cash resources to attract and retain highly qualified employees. However, these plans can potentially dilute shareholder interests. As such, *Rule 4350(i)(1)(A) ensures that shareholders have a voice in these situations, given this potential for dilution*."
> (Emphasis added.)

The New York Stock Exchange recently adopted its own version of this rule. NYSE Rule 303A.08 states:

> "Shareholders must be given the opportunity to vote on all equity-compensation plans and material revisions thereto, with limited exemptions explained below. Equity compensation plans can help align shareholder and management interests, and equity-based awards are often very important components of employee compensation. *To provide checks and balances on the potential dilution resulting from the process of earmarking shares to be used for equity-based awards, the Exchange requires that all equity-compensation plans, and any material revisions to the terms of such plans, be subject to shareholder approval*, with the limited exemptions explained below." (Emphasis added.)

The Securities and Exchange Commission ("SEC") has "long encouraged" exchanges to "adopt and strengthen their corporate governance listing standards in order to, among other things, restore investor confidence in the national marketplace." (68 Fed. Reg. 39995, 40005 (July 3, 2003).) The SEC viewed the adoption of the NASDAQ and the NYSE rules as a "first step" and noted that they "should have the effect of safeguarding the interests of shareholders, while placing certain restrictions on their listed companies." (*Id.*)

Finally, we note that federal agencies are stepping up enforcement of existing laws to battle stock option abuse. "[F]ederal authorities in the U.S. are probing more than 80 companies over options matters," and further indictments and SEC action are expected. (Mark Maremont and Nick Wingfield, More Questions About Options For Apple, ACS, Wall St. J., Aug. 8, 2006, at A3.) Ironically, on the very day that the Federal Register published notice of the OTS's proposed rule, senior executives of Brocade Communication were indicted for stock option abuse. (Charles Forelle, James Bandler and Steve Stecklow, Brocade Ex-CEO, 2 Others Charged in Options Probe, Wall St. J., July 21, 2006, at A1.) If the proposed rule is adopted, the OTS will have the distinction of retreating in the fight against stock option abuse.

III. THERE IS NO RATIONAL EXPLANATION FOR THE PROPOSED RULE CHANGE

A. The MHC Insiders Control The MHC: "Member Rights" Are Illusory And Provide No Cover For The Defense Of This Rule Change

The current last sentence of § 563b.500(a)(7) requires a majority of the public shareholders of a Subsidiary MHC to approve its stock benefit plans for one simple reason: The non-public, majority shareholder of the Subsidiary MHC is a MHC, controlled by the insiders of the Subsidiary MHC, the same individuals who would primarily benefit from such plans.[2] Therefore, if stock benefit plans were approved on a straight majority

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[2] For all practical purposes, a MHC is exclusively controlled by its directors (or insiders) who are the same people who sit on the Subsidiary MHC's board. It is these insiders, and these insiders alone (not the depositors, or members, of the MHC), who determine how the MHC will vote on the adoption of the Subsidiary MHC's stock benefit plan. *Members are not afforded the right or ability to vote directly on the adoption of plans.* At most, and in theory, MHC members are only afforded the limited right to vote on directors, ratify auditors, and other matters requiring a shareholder vote. In reality, however, there are significant impediments in place which make it difficult for members to exercise their technical right to nominate and elect alternate directors of MHCs – i.e., (a) running proxies, (b) difficulties in identifying other members, (c) privacy laws which may limit the right to obtain depositor lists, and (d) general lack of knowledge of legal rights. As such, it is disingenuous at best to claim that the rights and interests of depositors are represented by the MHCs. (*Contra* Letter from John E. Bowman to Senator Mike Crapo, January 9, 2006, where it is stated that, "The premise of the MHC structure is that depositors (who are members of the MHC) retain control of the institution.") In addition, many MHC members do not have an equity interest
(footnote continued on following page)

vote of Subsidiary MHC shareholders, the plans would always be approved, and the requirement of "separate shareholder approval" touted by OTS officials to Congress as recently as May of this year would be a mere smokescreen. As noted by the Chief Counsel in Letter No. P-2004-6, "requiring approval by a majority of the minority shares prevents the mutual holding company from controlling the outcome of every such vote." (OTS Chief Counsel Letter No. P-2004-6, at 2-3.) To prevent insider self-enrichment, up until now, MHCs have been prevented from approving stock benefit plans on their own vote.

Under the proposed rule, public shareholders would retain the right to vote on stock benefit plans adopted within 12 months after a mutual savings association conversion, but this would not provide any meaningful protection. Nothing would prevent insiders from waiting 12 months and a day to adopt a stock benefit plan, thereby escaping the need to obtain the approval of public shareholders, even if a plan had been put to a vote and rejected by public shareholders during the first 12 months. The insiders of MHCs would thus be entitled to sidestep the NYSE and NASDAQ protections of public shareholders and dilute their equity positions. Stilwell is bewildered as to why the OTS would want to undo the protections that the SEC and major security exchanges consider to be essential.

B. The Six Month Window

The rights of public shareholders are revealed to be even more endangered by the OTS's proposed rule when it is recalled that, under § 563b.500(a)(7), a vote on a stock benefit plan may not be held during the first six months after a conversion, ostensibly to allow the public market for the newly issued stock of the Subsidiary MHC to reach price equilibrium. It makes little sense to take such care to protect the economic interests of public shareholders, and then six months later to abandon the public shareholders entirely. The six month delay is to give the market time to adjust to prevent insider abuse of cheap stock options. Now the OTS proposes that an additional six months is all that is necessary before insiders can abuse their power by giving themselves options. Under the MHC structure, this free ride for insiders has no market check because public shareholders have no right to vote out abusive directors.

The proposed rule conflicts with the larger purpose of 12 CFR Part 563b, and the notice of proposed rulemaking provides no explanation why such a conflict in regulatory purpose should be tolerated, much less embraced. For this reason too, the proposed rule is an arbitrary and capricious use of the OTS's rulemaking authority, and subject to judicial challenge.

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in the Subsidiary MHC, so their concerns and those of the Subsidiary MHC's public shareholders are quite different.

C. As The OTS Recently Acknowledged To The Senate Banking Committee, Shareholder Ratification Is Not Inconsistent With The MHC Structure

Stilwell is aware that while the OTS opposes giving public shareholders of Subsidiary MHCs expanded rights to elect alternate directors of Subsidiary MHCs (*see* Statement of John M. Reich before the Senate Banking Committee, Mar. 1, 2006, at 33-36), the OTS has simultaneously defended the current rule of shareholder ratification of stock benefit plans by the public shareholders of Subsidiary MHCs. (*Supra* Section II.C.)

As the OTS recently noted to the Senate Banking Committee, participation by public shareholders in decision-making at Subsidiary MHCs is limited under the current regulations solely to the adoption of stock benefit plans, which directly affect public shareholders' economic interests. (OTS Response to Senate Banking Committee Questions, Regulatory Burden Relief Hearing, Mar. 1, 2006, at 5.) As the OTS also noted to the Senate Banking Committee, public shareholders have no separate vote on any other matter, and are required to accept the decision of the MHC as majority shareholder, including monetary compensation of management, expansion plans, and strategic transactions with other financial institutions. (*Id*.) We do not advocate for changes to the corporate governance structure of Subsidiary MHCs, but we do oppose changing well established and common sense rules of shareholder ratification of stock benefit plans for no reasonable or clearly articulated purpose.

D. Subsidiary MHC Investors Have An Expectation Of Shareholder Ratification

Director Reich also has testified to Congress that public investors in Subsidiary MHCs are made fully aware of their limited shareholder rights before they invest. (Statement of Testimony of John M. Reich before the Senate Banking Committee, Mar. 1, 2006, at 34-35.) As indicated above, public investors are aware of those limitations, but that knowledge could not extend to the OTS's proposal to make such an abrupt and unexplained departure from its current policy and the mainstream of securities regulatory policy as well, especially since this agency has so recently and explicitly expressed its support of the current rule to Congress and the public. Investors who purchased shares of Subsidiary MHCs before the publication of the proposed rule would be blindsided and diluted by the rule change and insiders (who had expected to submit the matter to a public shareholder vote) could be given a bonanza. It would be doubly wrong for the OTS to apply this rule retroactively.

CONCLUSION

Not only is the proposed rule inherently wrong, it defies common sense. It does not make sense to loosen the rules on management stock options at a time when stock option abuse has become emblematic of corporate greed. It does not make sense to relax stock option regulations when other federal agencies are stepping up scrutiny and enforcement. It does not make sense to give MHC insiders the unique ability to have their thrifts continue as NYSE and NASDAQ listed companies without giving their shareholders the power to ratify benefit plans.

What the OTS is seeking to do opens the entire stock benefit process to abuse. Why is the OTS now seeking to change the stock benefit plan policy that has worked well for 12 years? Ironically, it comes at precisely the same time that other federal agencies are working diligently to stamp out stock option abuses. What the OTS proposes is not only arbitrary and capricious, but also radical and dangerous.

Respectfully,

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Copies to:
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The Honorable John M. Reich
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