April 30, 2008

Mary Rupp
Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314-3428

Re: ANPR Parts 708a and 708b (Mergers, Conversions and Termination of Insurance)

Dear Ms. Rupp:

The National Association of State Credit Union Supervisors (NASCUS)[1] appreciates the opportunity to provide comments to the National Credit Union Administration (NCUA) concerning NCUA's Advanced Notice of Proposed Rulemaking (ANPR) on Parts 708a and 708b.

Initially, we express concern with the ANPR's overly broad application of NCUA's regulatory authority to state-chartered credit unions. We can discern no issue of safety and soundness that would justify NCUA's extension of these proposals to state-chartered, federally insured credit unions. Adoption would be an unfortunate precedent.

State regulators take seriously their obligations to ensure that state-chartered credit unions are managed in a manner consistent with the state laws, regulations and public policy decisions of state legislatures that give rise to and inform a state credit union's corporate existence. As NASCUS noted in past comment letters on these subjects, the question is not "whether some board somewhere may be unduly influenced in a merger proposal" but rather which regulatory authority bears responsibility to evaluate the circumstances surrounding mergers and conversions from a corporate governance perspective. See NCUA Proposed Rule 708b Disclosure of Merger Related Compensation-NASCUS Comments, June 22, 2007.

We start by discussing the larger issues NASCUS has identified in the ANPR. Although our comments address specific issues, our failure to challenge any assertion relating to state-chartered, federally insured credit unions should not be construed as acceptance or

[1] NASCUS is the professional association of the 47 state credit union regulatory agencies that charter and supervise the nation's 3,400 state-chartered credit unions.

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endorsement of that which we believe to be an unnecessary incursion to areas of state regulation by NCUA.

NCUA's statutory authority must be read narrowly in context of the role of state regulators and the dual chartering system.

As administrator of the National Credit Union Share Insurance Fund (NCUSIF), NCUA is authorized by Congress to promulgate rules and regulations for administration of the insurance fund. However, state regulators remain the primary regulatory authority of state credit unions. Furthermore, as state credit unions are state corporations, state law and regulation are primary sources of state credit union powers, governance and membership. NCUA's role should be narrowly tailored for safety and soundness considerations. That is a basic principle of the dual chartering system.

The ANPR on its face seems to apply to all federally insured credit unions. As many of the issues addressed apply to governance and member's legal rights, NASCUS questions such a broad mandate for NCUA. For legal authority, NCUA cites:

> <u>12 USC 1766(a)</u>
> The Board may prescribe rules and regulations for the administration of this chapter (including, but not by way of limitation, the merger, consolidation, and dissolution of corporations organized under this chapter).

This provision is found in Title I of the Federal Credit Union Act (FCUA) and should apply only to federal credit unions.

> <u>12 USC 1785(b)</u>
> (b)(1) Except as provided in paragraph (2), no insured credit union shall, without the prior approval of the Board:
>> (A) merge or consolidate with any noninsured credit union or institution;
>> (B) assume liability to pay any member accounts in, or similar liabilities of, any noninsured credit union or institution;
>> (C) transfer assets to any noninsured credit union or institution in consideration of the assumption of liabilities for any portion of the member accounts in such insured credit union; or
>> (D) convert into a noninsured credit union or institution.

This provision is found in Title II of the FCUA and would apply to federally insured credit unions. Specifically, it refers to the NCUA Board's authority concerning mergers and conversions of insured credit unions with "noninsured credit unions or institution." Noninsured credit union is defined in Title I of the FCUA as a credit union the member accounts of which are not insured by NCUSIF. <u>12 USC 1752(7)</u>. The term institution is undefined. We find no legislative history that Congress intended this provision to be used to undermine the basic division or responsibilities of the dual chartering system, and therefore it should be read narrowly. NASCUS notes that the term "institution" is not used throughout the FCUA to apply to state-chartered credit unions. Repeatedly the

FCUA refers to “federal credit unions,” “state credit union” and “insured credit union.” 12 USC 1785. The inference is that where Congress intended a provision to apply to a state-chartered credit union, Congress said so unambiguously.

What does it mean to be a “member owner of a credit union?”

The insurance power held by NCUA does not provide a basis for answering this question. At best, the description of shares in a federal credit union as “equity”[2] provides a basis for regulatory definition by NCUA for federal credit unions. The absence of any similar description in the insurance powers greatly limits NCUA’s ability to impose its ownership concepts on state-chartered credit unions. Given that many state credit union statutes pre-date any NCUA authority over state-chartered credit unions, in some cases by 40 years, it seems unlikely that Congress intended NCUA to arbitrarily set aside state corporate and credit union law for a one-size-fits-all approach to member rights.

We could discuss each example cited by NCUA of ownership of the credit union by its members. We prefer, however, to simply point to the complete absence of any citation by NCUA to any federal law, case, ruling or interpretation supporting an application of this interpretation to state-chartered credit unions. We see no basis for the NCUA approach which obliterates nearly a century of state originated financial institution law and two centuries of law deferring to states on such important matters of corporate governance. We suggest that the attempt by NCUA to create a body of federal common law applicable to the organic powers of state-chartered credit unions cannot survive even the most rudimentary analysis of NCUA’s authority.

Unintended consequences of regulation

NASCUS is also concerned about unintended consequences of regulation. Through past NCUA rulemaking, NASCUS has commented that certain proposed rules regarding notification of members, and mergers and conversions could set precedents for situations beyond the immediate purpose of the rule. NASCUS cautions that overly broad, loosely defined concepts of ownership and fiduciary duty, unsupported by relevant state law, will result in more uncertainty, not less.

What are the “best interests of the members?”

The ANPR repeatedly references the “best interests of the member.” 73 Fed. Reg. 5461, 5463, 5464 (2008). From a regulatory perspective, however, how should best interests be quantified? No one disputes that it is in the best interest of the members to be provided timely and accurate information in order that they may make informed decisions during member votes. Furthermore, it is appropriate that regulatory entities exercise subjective discretion regarding members’ best interest in terms of safe and sound management of a credit union. Finally, statutory authority at the state and federal levels empowers

[2] 12 U.S.C. §1757 (6).

regulators to regulate against unjust enrichment of insiders.[3] Beyond these narrow areas however, NASCUS questions the wisdom and ability of trying to define rigidly by regulation what is an amorphous concept at best.

How, from a regulatory perspective, does one measure the "best interest" of the members? Convenience? Services? Rates? Dividend payments? How does NCUA propose to give effect to determining if a merger or conversion is in the "best interest" of the members?

NASCUS contends that provided disclosures to members are accurate and sufficient, regulators should remain neutral and permit the membership to determine what represents their best interest.

The ANPR

Below, NASCUS responds to specific sections and requests for comments in the ANPR.

1. Credit Union Merger or Conversion into a Financial Institution Other than an Mutual Savings Bank (MSB)

- States are the proper rulemaking authority for state-chartered credit union corporate issues.

Conversion to, or merger into, another charter is an action fundamental to the corporate organization of a credit union. As such, any rules should be issued by the chartering regulatory authority. To the extent that NCUA proceeds with rulemaking, it should limit its rules to those entities it charters: federal credit unions. State-chartered, federally insured credit unions should properly look to their state regulators and state legislatures for authority in this area. NASCUS notes in fact, that many states, as a matter of public policy, do not provide for credit union conversion or merger into a non-credit union charter. By continuing to regulate broadly in this area and occupying the field, NCUA creates uncertainty as to the enforceability of various state laws.

2. Management's Duties

NCUA cites FCUA provisions relating the NCUA Board's responsibility to act in the best interest of credit union members to reach the conclusion that a credit union board owes a fiduciary duty to credit union members. However, the ANPR lacks any citation to support NCUA's authority to define a duty for state-chartered credit unions.

- Fiduciary duty is defined by state law.

[3] NASCUS believes that unjust insider enrichment analysis is best left to state regulators for state-chartered credit unions and should be a flexible standard rather than rigid formulaic guidelines.

The ANPR asserts that "[a] credit union's board of directors has a fiduciary duty to act in the best interests of its members." 73 Fed. Reg. 5464 (2008). NASCUS questions NCUA's authority to establish a fiduciary duty standard for state corporations.

The corporation laws of states generally agree that directors owe fiduciary duties to the corporation.[4] The duty owed by directors to the corporation flows from the principle that the board of directors is responsible for the management of the business of a corporation. Congress granted NCUA limited authority to regulate state-chartered, federally insured credit unions for safety and soundness issues, and arguably, to a limited extent, the discretion to set voting requirements for conversions to an MSB. Nothing in the FCUA indicates NCUA was empowered to preempt state corporation law to establish fiduciary duties for state-chartered credit union boards.[5]

Finally, it is instructive that the ANPR acknowledges, rightly, that credit unions must look to state law to understand the scope of the board's fiduciary duty. 73 Fed. Reg. 5464 (2008).

Proponents of NCUA defining fiduciary duty for federally insured credit unions take an overly broad view of the FCUA. Provisions in the FCUA do not define fiduciary duty. References to the best interests of the members are not generally defined, but rather appear as broad concepts tethered to specific actions. As one example, 12 USC 1790a(e) has been cited as referencing the best interest of the members.[6] However, this provision is narrowly tailored to NCUA's approval of new board members in limited situations. Furthermore, the provision, in speaking to the public's interest as well as the credit union's, cannot fairly be said to be contemplating a fiduciary duty standard specifically, as no such duty would exist to members of the public. 12 USC 1790a. NASCUS also notes that NCUA authority to assess penalties for breach of fiduciary duty does not give rise to an authority to define fiduciary duty. NCUA's authority should be read no differently than the Securities and Exchange Commission authority on insider trading, looking to state law for the underlying fiduciary duty as context for the federal prohibition.[7] NASCUS also notes that the Federal Deposit Insurance Corporation (FDIC) follows the state law concept of fiduciary duty. In 1999, rejecting an application

[4] Model Bus. Corp. Act §8.30(a) (2002) ("A director shall discharge his duties as a director (1) in good faith, (2) with the care an ordinary prudent person in a like position would exercise under similar circumstances and (3) in a manner he reasonably believes to be in the best interests of the corporation.")

[5] The US Supreme Court, in 1983, in finding a violation of federal securities rules relied on state fiduciary duty laws for the underlining breach. See Dirks v. SEC, 463 U.S. 646 (1983).

[6] 12 USC 1790a(e) reads: "The Board shall issue a notice of disapproval with respect to a notice submitted pursuant to subsection (a) if the competence, experience, character, or integrity of the individual with respect to whom such notice is submitted indicates that it would not be in the best interests of the depositors of the insured credit union or in the best interests of the public to permit the individual to be employed by, or associated with, such insured credit union.

[7] Bainbridge, Stephen M., Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibitions (1995) Washington and Lee Law Review, http://findarticles.com/p/aricles/mi_qa3655/is_1999501/ai_n8730752printed March 2008.

for a bank conversion from mutual to stock form, the FDIC, finding a breach of fiduciary duty wrote:

> … the FDIC Board has considered applicable state law. Pennsylvania corporate law recognizes a duty of care that requires corporate boards to perform their duties "with such care, including reasonable inquiry, skill and diligence, as a person of ordinary prudence would use under similar circumstances." 15 Pa. Cons. Stat. Ann. § 1712 (1998). Regarding directors' duty of care, relevant Delaware court precedent has provided that directors would be expected to inform themselves as to the existence and availability of alternatives to the course of conduct under consideration. The more significant the proposed corporate action, the greater would be the requirement that directors investigate and consider alternatives. See, e.g., Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).
>
> - FDIC rejecting Nesquehoning Bank application (April 5, 1999)

There is no justification for NCUA to attempt to define a national standard of fiduciary duty for state credit unions.

- No nexus between "unique" structure of credit unions and need for national standard of fiduciary duty.

The ANPR cites "confusion" for boards of directors in determining what are their proper fiduciary duties and the "unique interests, concerns, and structures of credit unions" as motivation for creating a federal, NCUA-determined standard for fiduciary duty. <u>73 Fed. Reg. 5464 (2008)</u>. As discussed above, NCUA lacks legal authority to preempt state laws that establish fiduciary duty for state corporations such as a state-chartered credit union. Furthermore, if "confusion" is indeed an issue, that issue is easily resolved. Make clear that a credit union board is expected to fulfill its fiduciary duty under state law just as state credit unions comply with state consumer protection law, state investment regulations, state lending regulations, state laws regarding compensation of a credit union board and numerous other state laws and regulations that state credit unions have complied with for nearly 100 years.

3. <u>Insider Enrichment</u>

NASCUS shares NCUA's concern regarding insider enrichment. Nothing in NASCUS' opposition to this proposed rule diminishes NASCUS' or state regulators' commitment to the principle that the actions of state-chartered, federally insured credit unions should be based on sound business decisions of the credit union management, board and members (where applicable). However, NASCUS questions the need for additional rulemaking.

Currently many states and NCUA have the authority to act when credit union decisions appear tainted by unjust insider enrichment. In addition, NASCUS notes that the occurrence of credit union to non credit union conversions remains limited. Given that limited nature, NCUA should more clearly articulate what it sees as shortcomings with the current discretionary regulatory authority to address these instances.

It is NASCUS' opinion that while the goals of the ANPR are laudable, a more nuanced regulatory approach that allows state regulators to review conversion proposals for state-chartered, federally insured credit unions is a better approach than the addition of new layers of regulation.

4. Member Right to Equity

The ANPR seeks comments on several approaches for "balancing" net worth ratios among merging credit unions. 73 Fed. Reg. 5464 (2008). NASCUS believes that in the case of mergers, implementing rigid regulatory guidelines may unnecessarily burden credit unions, preventing them from making business decisions in the best interest of the credit union (whether the merging institution or surviving entity). Furthermore, NASCUS questions the source of NCUA's authority to mandate balancing equity for state-chartered, federally insured credit unions.

In requesting comments, the ANPR cites 12 U.S.C. 1761b and 1763. Both provisions, found in FCUA's Title I, apply only to federal credit unions. The ANPR does reference Part 707, but that is of limited instruction.[8] Part 707 implements Truth in Savings, the purpose of which is to standardize disclosures about the costs and benefits of accounts at financial institutions in order that the public may make informed decisions when choosing their financial services provider.[9]

Beyond suffering from a defect of statutory authority in regard to member equity, the ANPR also suffers from practical defects. As noted above, a rigid regulatory rule seems unworkable given the need for business flexibility. For example, any regulatory requirement to pay out dividends to balance the net worth of merging credit unions fails to account for numerous intangible costs and benefits accruing to one side or another in a merger. For example, if credit union "A" (net worth 16 percent) is to be merged into credit union "B" (net worth 10 percent), but credit union "B" has numerous branches, products and services that outnumber credit union "A", how does NCUA propose to balance out this transaction through regulatory formula to ensure "fairness?" Paying out the members of credit union "A," to balance the institutions' net worth, benefits those members while then allowing them to enjoy the benefits of credit union "B" – benefits that have been paid for over the years by credit union "B" members. This seems inequitable.

[8] Part 707, Truth in Savings, applies to state-chartered, federally insured credit unions by way of incorporation through Part 741.217. NASCUS has long urged NCUA to consolidate rules applicable by way of the NCUSIF into a single section of the Rules and Regulations to ease regulatory burden on state-chartered, federally insured credit unions.

[9] Part 707.1(b) states "The purpose of this part is to enable credit union members and potential members to make informed decisions about accounts at credit unions. This part requires credit unions to provide disclosures so that members and potential members can make meaningful comparisons among credit unions and depository institutions." 12 CFR 707.1(b).

Given that all mergers are different, nuanced and inherently fact specific, it is doubtful a rigid regulatory formula is appropriate.

5. Communications to Members

It has long been NASCUS' position that members should be provided with accurate information to help them make fully informed decisions during membership votes. NASCUS agrees with NCUA that communications to members, all communications, must be as the ANPR states, "accurate and not misleading." 73 Fed. Reg. 5465 (2008).

As a general response to the ANPR's request for comments on member communications, NASCUS notes that NCUA already claimed authority to act on misleading information in the cases of credit union to MSB conversion and termination of insurance. See 12 CFR 708a.7(c) and 12 CFR 708b.303. Furthermore, the ANPR itself seems to indicate that NCUA has acted when it has found misleading information. It is unclear how additional regulation will add to the understanding in this area. The examples of inaccurate communication listed in the ANPR seem to be so fact specific as to render dubious the ability of additional regulation to better resolve these issues.[10] In addition, NASCUS notes that in mergers involving state-chartered, federally insured credit unions, it is properly the state regulator that has the authority to define and vindicate member rights.

NASCUS agrees that NCUA, as administrator of the NCUSIF, does and should have the authority to address any communications that purport to represent that the NCUSIF endorses a transaction. Should NCUA proceed with rulemaking to address that narrow aspect of member communications, NASCUS recommends that NCUA consider that the statement "The NCUA does not endorse this transaction" can very easily be misunderstood by members as a statement that NCUA *opposes* the transaction. NASCUS believes that any regulatory mandated statement be neutral on its face to inform members that the NCUA reviews transactions to ensure all regulatory requirements have been met, but otherwise does not comment on the business decision presented.

6. Hostile Mergers

The ANPR correctly points out the limitations of a regulatory rule concerning communication directly with the membership of a credit union. 73 Fed. Reg. 5465 (2008). Should NCUA consider rulemaking, it should clearly state the authority upon which any proposed rules are based. NCUA should also consider what effect, if any, a rule would have that prohibits such communications by credit unions, while leaving unaffected such communications by non credit union entities outside NCUA's

[10] See 73 Fed. Reg. 5465 (2008). A credit union questioned as to whether it is able to continue to operate rent free branches, or a credit union questioned as to whether it could gain access to a network. In both cases, one wonders what a specific regulation would say? That a credit union must have a documentation of the likelihood of post conversion/merger activity that is promised?

jurisdiction. What if misleading communications were generated not by the credit union itself, but by a portion of the membership? Would that trigger regulatory intervention?

7. Right to Request a Recount

The member vote to merge or convert a credit union is a fundamental issue of corporate structure. The authority to regulate the terms and conditions of a vote belongs to the chartering authority. Any NCUA rulemaking on vote recounts should be limited to federal credit unions. State laws and regulations are the proper source for vindicating member rights for state-chartered credit unions.

Conclusion

The ANPR identified many thought provoking issues confronting the credit union movement and its state and federal regulators. Where NASCUS has disagreed with NCUA, or questioned NCUA rulemaking authority, it does so respectfully and with the intention to help develop regulation that is effective, narrowly tailored to reduce unnecessary burden, and consistent with the spirit of dual chartering and the distinct roles of NCUA and state regulators. In many areas identified in the ANPR, NASCUS shares NCUA's concerns. However, as noted in the introduction, the long-term implications of many of the proposed regulatory solutions require a thorough analysis and more vetting. In addition, NCUA should explain any nexus between safety and soundness and the issues discussed in the ANPR to justify imposing additional regulation on federally insured, state-chartered credit unions.

NASCUS appreciates the opportunity to comment on NCUA's ANPR. Please do not hesitate to contact NASCUS to discuss our comments further.

Sincerely,

- signature redacted for electronic publication -

Brian Knight
Senior Vice President, Regulatory Affairs