



April 6, 2010

## **NCUA Proposed Rule on Fiduciary Duties at Federal Credit Unions, and Mergers and Conversions of Insured Credit Unions**

### **EXECUTIVE SUMMARY**

- The National Credit Union Administration (NCUA) Board has adopted a proposed rule for several related areas, to clarify the fiduciary duties of directors, and to provide additional provisions for insured credit union conversions and mergers, which are intended to protect member rights and ownership interests.
- There is a proposed uniform fiduciary duty standard for federal credit union directors. Directors will also be required to have or gain an understanding of basic finance and accounting principles. In addition, federal credit unions would not be permitted to indemnify its employees for “grossly negligent, reckless, or willful” misconduct for decisions that affect the fundamental rights of its members.
- There are proposed procedures for an independent entity to tally, record, and certify the votes for a credit union conversion into a mutual savings bank, a credit union merger into a bank, or a credit union merger with another credit union. These procedures are intended to protect the “secrecy and integrity” of the voting process.
- For a credit union merger into a bank, the proposed merger definition includes a transfer of “substantially all” its assets. There are additional proposed related due diligence requirements for directors to: 1) obtain an independent valuation of the credit union; 2) determine any compensation for the diminished or loss of ownership rights for credit union members; and 3) disclose other pertinent merger-related information.

- For a credit union merger with another credit union and the termination of federal deposit insurance, there are additional proposed requirements for: 1) credit unions with a net worth ratio (NWR) that is at least 500 basis points greater than the NWR of the continuing credit union; 2) any material merger-related financial compensation; and 3) a six month time limit on the merger conversion of federal share insurance to nonfederal insurance.
- Comments are due to NCUA by May 28, 2010; please submit your comments to CUNA by May 14, 2010.
- Please feel free to e-mail your responses to Senior Vice President and Deputy General Counsel Mary Dunn at mdunn@cuna.coop. You may also contact Mary Dunn at 800-356-9655, ext. 6736, if you have questions. Click [here](#) to access the proposed rule

## **BACKGROUND**

The proposed rule is related to an Advance Notice of Proposed Rulemaking and Request for Comment (ANPR) from January 2008. In the ANPR, NCUA asked if it should adopt proposed rules for a merger of a federally insured credit union to a financial institution other than a mutual savings bank, along with related rules about mergers and conversions. At the time, CUNA did not support the suggested rules in the ANPR, because credit unions faced significant regulatory burden from the NCUA and other regulators. CUNA did note that some guidelines were appropriate for specific circumstances such as a “hostile merger” situation. In addition, CUNA has supported and worked with the NCUA to determine if appropriate fiduciary duty guidelines could be developed.

## **BRIEF DESCRIPTION OF THE PROPOSED RULE**

### **Fiduciary Duties**

Proposed Standard – Under the proposal, the federal credit union board of directors may delegate operational functions, but not the responsibility for these operations. Furthermore, the proposal would require directors to:

- Carry out their duties in good faith, in a manner reasonably believed to be in the best interest of the membership, and with care that an ordinarily prudent person would provide in a similar situation. “Good faith” would require that a director disclose material facts to other directors or to members who may vote on a particular interest. This duty of care would also require directors to inform themselves of all material information reasonably available to them prior to making a decision.

- Administer the credit union affairs fairly and impartially, without discrimination for or against a specific member.
- Understand the balance sheet and income statement and ask, as appropriate, questions of management and auditors. This understanding would need to be achieved within three months after election or appointment to the board of directors.
- Direct the credit union's operations in accordance with applicable law and sound business practices.

#### Advice and counsel

- Directors may retain staff, counsel, accountants, financial advisors, and other consultants and may rely on information obtained from them if they believe it to be reliable, provided that they reasonably believe these individuals are reliable, competent, and merit confidence. This would include determining whether any of these individuals would have a conflict of interest in the outcome of a transaction.

#### No indemnification for fundamental rights decisions

- The proposal would also—with respect to decisions affecting members' "fundamental rights and interests" such as charter conversions and termination of National Credit Union Share Insurance Fund (NCUSIF) deposit insurance coverage—prohibit indemnification of officers and directors for misconduct that is grossly negligent, reckless, or willful.

### **Conversion of Insured Credit Unions into Mutual Savings Banks**

#### Independent entity to tally and certify votes

- The proposal would add a definition of "conducted by an independent entity" that would prevent credit union staff from accessing interim vote tallies during the balloting and would ensure that members learn the results of the membership vote. The proposal would also add a definition of "secret ballot," which would prohibit credit union staff from determining how a member voted and prohibit staff from assisting members in completing ballot or handling completed ballots.

#### Other disclosures

- In addition, the proposal would require disclosure of the estimated costs of conversion (with separate line items for printing, postage, advertising, consulting fees, professional fees, legal fees, staff time, cost of holding the special meeting, cost of holding the vote, and other related expenses), its affect on the availability of facilities, and that NCUA does not approve or disapprove of the proposed conversion. The proposal would require converting credit unions to submit copies to NCUA of correspondence with any other agency that is related to the conversion, which must be included with the certification of the

member vote. The proposal also recommends that converting credit unions not use employees to solicit member votes.

### **Merger of Insured Credit Unions into Banks**

Merger Definition – The proposal would define “mergers” to also include any conversion in which the credit union does not actually open its doors as a converted, stand alone bank but instead transfers all or substantially all of its assets to the preexisting bank after its conversion. Prior approval for the merger must be obtained from NCUA, the Federal Deposit Insurance Corporation, the regulator of the continuing bank, and the state regulator if the credit union is state-chartered.

Due Diligence and Independent Appraisal – Directors must conduct due diligence to determine if the merger is in the credit union members’ best interests. As part of this process, the directors must obtain the value of the credit union, either through a public auction process or independent appraisal process conducted by a “qualified appraisal entity” who has significant experience and no financial relationship with the bank, credit union, or their legal counsel. If the appraisal method is used, the credit union must publish an advance notice of the merger and must review and retain comments.

### **Merger Approval Process**

- Majority of Board – The merger must then be approved by a majority of the board of directors who have determined that the merger partner is the best choice for the members. The directors must then provide notice to NCUA that they intend to proceed with the membership vote. This must include certain merger-related compensation information, a certification that the merger is in the best interest of the members, a description of the due diligence process, and that the merger satisfies statutory requirements.
- NCUA Regional Director Approval – If disapproved by the NCUA Regional Director, the credit union may appeal within 30 days of this decision, and the NCUA Board must then act on the appeal within 120 days. If approved by NCUA, the credit union will then schedule a special meeting for the vote and send notice 90 days before the meeting and another notice, along with the ballot, 30 days before the meeting. The notice must include information on the merger value, and possible merger payment to members, and a means in which members may communicate with each other about the merger.
- Majority of Members – The merger must then be approved by a majority of the members, as long as at least 20 percent of the members participate in the vote. The vote may be conducted in

person or by mail. The board of directors of the merging credit union must certify the voting results to the NCUA Regional Director within ten days after the vote. The Regional Director will review the methods and procedures in connection with the voting and approve or disapprove within 30 days after receiving the certification. The credit union may appeal a disapproval within 30 days after receiving the notification, and the NCUA Board must then act on the appeal within 120 days. If approved, the credit union must complete the merger within one year, although the Regional Director may extend this time period for another six months for good cause after receiving such a request.

- Independent entity to tally and certify votes – Same as a credit union conversion into a mutual savings bank.

Economic Benefit Prohibition – Directors or senior officials may not receive any economic benefit in connection with the merger, other than reasonable compensation and benefits in the ordinary course of business. For any incentives given to members to encourage voting, information about the incentives must indicate that these are available regardless of how the member votes.

### **Mergers of Insured Credit Unions with Other Credit Unions**

Higher Net Worth Ratio – The proposal would require that the merger plan submitted to NCUA include information about any share adjustment that may result if one credit union has a higher NWR than the other. This must also include the factors considered in determining the amount, or determining no adjustment is necessary, if the merging credit union has a NWR greater than 500 basis points, as compared to the continuing credit union.

Material Increase in Compensation – The proposal would also require disclosure of any material increase in compensation or benefits received by a director or senior management official. “Material” is defined as an increase that exceeds the greater of 15 percent of the individual’s annual compensation or \$10,000.

Independent entity to tally and certify the votes – Same as a credit union conversion into a mutual savings bank.

Insurance conversion requirements – There are several proposed changes to the merger-related termination and conversion of insurance provisions. For a conversion of federal share insurance to nonfederal insurance, the proposed rule states that NCUA’s approval is contingent on a six month period to complete the conversion and merger. For the termination of federal share insurance for state credit unions, the proposed disclosure explicitly lists the name of the private share insurer.

## QUESTIONS TO CONSIDER REGARDING THE PROPOSED RULE

### General Questions

1. Do you have any comments on the proposed secret ballot provisions in the voting process?

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2. Do you have any comments on the proposed independent entity to receive, store, and certify the vote results?

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3. What effect will the proposed rules have on regulatory burden and due diligence costs? Are there any unique issues for smaller credit unions?

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4. In addition to the specific questions for each subpart, we welcome any general comments or feedback.

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### Duties of federal credit union directors

1. Should the NCUA have a uniform fiduciary duty standard for credit union directors? Are there any other rules that should be included?

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2. Do you agree with a prohibition on indemnification for decisions related to the fundamental rights of members? What effects may this have?

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3. Could the proposed rules have any impact on the number of volunteers for credit union director positions? Do you foresee any issues with Directors' and Officers' insurance coverage?

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4. Do you find that a maximum period of three months is a reasonable amount of time for new directors to obtain familiarity with the financial and accounting statements of a credit union? If no, what recommendations do you have?

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5. Currently the NCUA's Office of Small Credit Union Initiatives provides training for small credit unions. With the proposed rules for financial literacy, should the NCUA provide additional training resources for credit unions of all sizes?

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6. NCUA mentioned that directors should be familiar with the balance sheet and income statement. Are there any other financial statements or materials that a director should be familiar with?

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7. Are there any issues with retaining professionals that will help the director manage the credit union?

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A credit union conversion to a mutual savings bank

1. Should the NCUA clarify the rules on a credit union conversion to a mutual savings bank, or should the current rules remain?

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2. The NCUA would like credit unions to provide member vote certification and any conversion-related correspondence with other agencies. Do you agree?

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3. The proposed rules limit but do not prohibit a converting credit union's use of their employees to solicit member votes. Do you agree with this limitation?

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A credit union merging into a bank

1. Should the NCUA clarify the rules on a credit union merger into a bank, or should the current rules remain?

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2. Do you agree that the proposed rules should apply for both one-step and two-step mergers? In a one-step merger, a credit union directly merges into a bank. In a two-step merger, a credit union converts into a mutual savings bank first, and then merges into a bank.

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3. Should there be further clarification on the all or broader "substantially all its assets" standard in the merger definition?

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4. Should there be an independent 3<sup>rd</sup> valuation for the credit union? If so, do you believe that the independent appraisal or public auction methods are appropriate? Are there any specific methods that you recommend? Are there any concerns with the either method?

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5. For the public auction method, the proposed rule requires purchase quotations from “at least three banks, two or more of which must be stock banks.” Do you think the proposed definition is sufficient?

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6. For the appraisal method, NCUA’s proposed definition of a “qualified appraisal entity” is listed below. Do you agree with this proposed definition? Is it too restrictive?

“An entity that has significant experience in the valuation of depository institutions and that has no past financial relationship with the merging credit union, the continuing bank, or any law firm representing the credit union or bank in connection with the merger.

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7. Do you agree that a majority of at least 20 percent of the credit members should have participated in the vote for the merger?

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8. According to the NCUA, the two important considerations of a proposed merger are the “economic advisability of the transaction” and whether the transaction meets the “convenience and needs of the members.” Is the standard appropriate, or should there be additional clarification?

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A credit union merging with another credit union, and the termination of federal deposit insurance

1. Should the NCUA clarify the rules for mergers between credit unions, and the termination of federal deposit insurance, or should the current rules remain?
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2. Do you agree with the disclosure of material merger-related financial arrangements? If so, do you agree that the “greater of 15% of the individual’s compensation or \$10,000” is a reasonable standard for a material increase? For such disclosures, do you agree with the definition of “a senior management official” that includes a chief executive officer, an assistant chief executive officer, a chief financial officer, any other senior executive officer as defined by the FDIC Act?
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3. Should there be a disclosure about any adjustment, such as a merger dividend, for a credit union with a NWR that is at least 500 basis points greater than the NWR of the continuing credit union? Should the number of basis points be different?
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4. For such high NWR mergers, should management be required to disclose the basis of its calculation for share adjustments and, whether an adjustment or no adjustment was necessary?
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5. Should the NCUA clarify the rules for the termination and conversion of federal deposit insurance, or should the current rules remain?
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6. For a merger-related conversion of insurance from federal share insurance to nonfederal insurance, the proposed rule would provide that NCUA approval is

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7. For a merger-related termination of federal share insurance for state credit unions, do you agree with the proposed disclosure language that explicitly lists the name of the private share insurer?

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