

## OFFICE OF THRIFT SUPERVISION

### Denial of Reconsideration Request Regarding Stock Repurchase Notice

**Order No.: 2004-34**

**Date: June 28, 2004**

**Docket Nos.: H-3977, 17079**

Bank Mutual Corporation, Brown Deer, Wisconsin (Holding Company), the holding company for Bank Mutual, Milwaukee, Wisconsin (Savings Association), submitted to the Office of Thrift Supervision (OTS), a request to reconsider the denial of its written notice (Notice), regarding the Holding Company's proposed repurchase, in the open market, of up to 3,938,788 shares (five percent) of its common stock. OTS denied the Notice, in OTS Order 2004-18, dated April 12, 2004.

#### **Background**

The Savings Association completed its mutual holding company reorganization on November 1, 2000. In the reorganization, the Savings Association formed a mid-tier holding company (Mid-Tier), which completed a minority stock issuance in connection with the reorganization. The Mid-Tier adopted the Bank Mutual 2001 Stock Incentive Plan (2001 Plan), and the Mid-Tier's shareholders approved the 2001 Plan in 2001.

The Savings Association and its mutual holding company (MHC) completed a "second-step" conversion to stock form on October 29, 2003, pursuant to the OTS Mutual Holding Company Regulations and the OTS Mutual to Stock Conversion Regulations. In approving the second-step stock conversion, OTS imposed a condition requiring that following the conversion, the Holding Company be subject to the OTS stock repurchase regulations as if it were the Savings Association. The Holding Company's common stock was initially issued and sold at \$10.00 per share. As of April 1, 2004, the common stock's price closed at \$11.24 per share. As of June 23, 2004, the common stock's price closed at \$11.11 per share. The number of the Holding Company's common shares outstanding was 78,783,849, as of April 30, 2004.

The Holding Company proposes to engage in the repurchases in order to have shares available for any exercises of stock options under the 2001 Plan. After the conversion, the Holding Company assumed the obligations of the Mid-Tier, including the 2001 Plan. Without the requested repurchases, the Holding Company would have to issue new shares of stock in order to honor exercises before October 29, 2004, of stock options issued under the 2001 Plan, and the Holding Company indicated that such stock issuances would dilute the value of existing outstanding shares.

The Notice requested permission pursuant to 12 C.F.R. §§ 563b.510 and 563b.515 to repurchase up to 3,938,788 shares of its common stock, which represents five percent of the 78,775,779 shares outstanding on December 31, 2003. The Holding Company stated it intended to use the repurchased shares to fund any potential exercises of stock options under the 2001 Plan. Specifically, the Holding Company stated that it intended to repurchase up to 1,870,025 shares, after April 29, 2004 and prior to October 29, 2004, to hold as treasury shares in the event any stock options were exercised under the 2001 Plan.

At December 31, 2003, the Holding Company had outstanding 3,298,590 options to purchase shares of its common stock under the 2001 Plan. Of these options, the Notice indicated that 1,159,799 were immediately exercisable, 710,226 would become exercisable before the one-year anniversary date of the conversion, October 29, 2004, and 1,420,495 would become exercisable thereafter.

### Discussion

Section 563b.510 provides that recently converted savings associations may not repurchase any of their stock during the first year after conversion, subject to certain exceptions.<sup>1</sup> One exception, set forth at 12 C.F.R. § 563b.510(a)(1), provides that a converted savings association (or its holding company) may, in extraordinary circumstances, make open market repurchases of up to five percent of the outstanding stock in the first year following conversion, provided the party files a notice with OTS, and OTS does not disapprove the repurchase. Section 563b.510(a)(1) provides that OTS will not approve such repurchases unless the repurchases meet the standards set forth at 12 C.F.R. § 563b.515.

Section 563b.515(c) provides that OTS will not object to a repurchase program if: (i) the repurchase program will not adversely affect the financial condition of the savings association; (ii) the information submitted is sufficient for OTS to evaluate the repurchases; (iii) the association demonstrates extraordinary circumstances and a compelling and valid business purpose for the repurchases; and (iv) the repurchase program would not be contrary to other applicable regulations.

In the Notice, the Holding Company provided the following reasons as to why it believed there were extraordinary circumstances and a compelling business purpose: (1) it had no treasury shares, and therefore would need to use authorized and unissued shares to satisfy any exercises of options under the 2001 Plan, which would result in a dilution of ownership to its existing shareholders and a decrease in earnings per share; (2) OTS had approved previous notices filed by other savings associations or their holding companies, to make purchases for similar plans that existed before a second-step conversion, based on the potential for dilution<sup>2</sup>; (3) there had been significant changes in

<sup>1</sup> OTS conditioned approval of the Savings Association's and MHC's second-step mutual to stock conversion on the Holding Company being subject to 12 C.F.R. § 563b.510 as if it were a savings association.

<sup>2</sup> See, e.g., OTS Order Nos. 2003-13, 2003-26, and 2003-29.

equity market conditions, including additional volatility resulting from recent acts of terrorism, that have caused the Holding Company's stock to trade at approximately 8 percent below its high following its conversion; (4) in order to comply with Securities and Exchange Commission (SEC) Regulation 17 C.F.R. § 240.10b-18, as amended, the Holding Company might need a longer period of time to make its stock repurchases; (5) the Holding Company's tangible net worth as a percentage of assets was over 22.0 percent and because of the current low interest rate/investment return environment, it believed that repurchases would provide the best improvement in its financial performance ratios; and (6) the Holding Company's 2004 Plan, submitted to shareholders for approval in May 2004, would lead to the need for up to approximately an additional 5.7 million shares and possible additional dilution.

The Holding Company's request for reconsideration of the Notice is based on the following reasons: (1) the Holding Company believes it has demonstrated that the repurchase program contained in the Notice is justified by extraordinary circumstances and supported by a compelling business purpose consistent with the most recently published OTS guidelines; (2) the Holding Company believes it was not apprised of any changes to or reversals of such OTS guidelines; and (3) even if the Holding Company had been notified of such changes in the OTS guidelines or position in July 2003, the Holding Company believes such notification would have come too late for it to react to the change and to reconsider its second-step conversion or to avoid the loss of treasury shares available to fund options previously issued under the 2001 Plan. In addition, the reconsideration request provides certain additional assertions: the exercise price of the outstanding stock options was adjusted to \$3.21 per share on October 29, 2003, making exercises more likely; options for 77,591 shares were exercised from October 29, 2003, to March 31, 2004; the increase in the conversion offering range resulted in a unanticipated level of capital; and the Holding Company's closing stock price of \$10.42 per share, on April 16, 2004, allegedly indicates an extraordinary market weakness.

OTS has reviewed the Notice and the request for reconsideration and, on reconsideration, concludes that the reconsideration request fails to demonstrate that extraordinary circumstances and a compelling and valid business purpose exist for the proposed stock repurchases.

As an initial matter, although the Notice addressed the proposed repurchase of up to 3,938,788 shares of the Holding Company's stock, the Notice explicitly stated that the Holding Company did not intend to purchase more than 1,870,025 shares of common stock before October 29, 2004. Because the regulatory restriction is inapplicable after October 29, 2004, approval is not needed for repurchases effected after that date. The reconsideration request did not address this issue. Accordingly, based on this fact alone, the reconsideration request has not demonstrated extraordinary circumstances or compelling business reasons for any repurchase exceeding 1,870,025 shares. With respect to the proposed repurchase of up to 1,870,025 shares, we address each of the Holding Company's assertions below.

### **Dilution and Expense; Prior Approvals**

The Holding Company's claim that existing shareholders will suffer dilution in their ownership from the use of authorized and unissued shares does not constitute either extraordinary circumstances or result in a compelling business purpose for the repurchases. All employee stock benefit plans have the potential to result in dilution. The Holding Company's prospectus, dated July 31, 2003, for the mutual to stock conversion disclosed the possibility of dilution and a reduction in earnings per share. The Notice and reconsideration request assert that the risk of dilution upon exercise of the options under the 2001 Plan is an extraordinary circumstance, because: following a second-step conversion there are no treasury shares outstanding; there were exercises of options under the 2001 Plan for 77,591 shares, for the period from October 29, 2003, to March 31, 2004; the number of exercisable options that may be exercised before October 29, 2004 is unable to be predicted; and the adjusted exercise price for the options of \$3.21 per share provides a significant spread between the exercise price and the current market price that is an incentive to exercise the options.

The Holding Company has not shown that the exercise of options for 77,591 shares demonstrates either extraordinary circumstances or a compelling business purpose. To the extent that the Holding Company is asserting that many more shares are likely to be exercised by October 29, 2004, it is pure speculation and falls short of demonstrating extraordinary circumstances and a compelling business purpose for the stock repurchase. In addition, OTS recognized the potential for dilution in its denial of the Notice, and before, when OTS staff required the Holding Company to amend its prospectus for its second-step conversion to fully disclose the possible dilution of shareholders' interests in funding the exercise of options with authorized but unissued shares.

The Notice and the reconsideration request indicate that OTS did not object to certain other applications for stock repurchases made in the first year following a conversion (OTS Order Nos. 2003-13, 2003-26, and 2003-29), which involved stock repurchases to fund exercises under a stock option plan adopted before the conversion. In addition, the Holding Company believes that these three prior approvals in 2003 provided guidelines and that it satisfied those guidelines.

When OTS considered the other applications, during 2003, those applicants indicated that they did not have notice, before their mutual-to-stock conversions, of the fact that the existence of a pre-existing stock plan and the lack of any existing treasury shares after completion of the second step conversion would not provide extraordinary circumstances and a compelling business justification for repurchases. Because of this lack of notice and for the reasons set forth in those approval orders, OTS approved those applications.

To address the lack of notice, and to implement OTS' position that, for subsequently filed applications, funding of pre-conversion plans would not constitute extraordinary circumstances, OTS staff advised subsequent applicants for second-step

conversions, during the application review process, of OTS' position that the need to provide shares for the exercise of a stock option plan adopted before a second-step conversion and the lack of treasury shares does not demonstrate extraordinary circumstances and a compelling business purpose.

The reconsideration request acknowledges that OTS staff requested the Holding Company to disclose the possibility of dilution. However, the Holding Company's counsel claims that they were not advised of OTS' position that the need to provide shares for the exercise of stock options under a stock option plan adopted before a second-step conversion and the lack of treasury shares does not demonstrate extraordinary circumstances and a compelling business purpose. While the Holding Company's counsel may not remember being advised of OTS' position, there is ample evidence that OTS' staff did provide such information in a discussion with the Holding Company's counsel in connection with OTS' review of the conversion application in July 2003.

The reconsideration request asserts that, even if OTS had advised the Holding Company and the Savings Association of the policy regarding stock repurchases, the timing of the notification would have come too late for the Savings Association to reconsider its decision to proceed with the second-step conversion. The Holding Company asserts that, even if OTS had notified management in July 2003 that OTS had changed its position with respect to repurchases in the first year following conversion, the Savings Association had already progressed too far in the conversion process to take this into account and to reconsider the conversion.

OTS does not believe that the change in the manner in which the Holding Company could fund option exercises under the 2001 Plan, for a limited time period, a very minor component of the conversion, would have been sufficient reason for the Savings Association to change its decision to complete a second-step conversion. Also, OTS does not believe that the Holding Company's argument provides a valid reason why OTS should reverse its original decision to deny the repurchase request, because the Holding Company has not provided any evidence to demonstrate that the Savings Association would not have proceeded with the second-step conversion, if it had received earlier notice of OTS' position.

### **Equity Market Conditions**

The Holding Company has not provided any evidence that there have been any significant changes in the equity markets that are extraordinary or that would provide a compelling business justification to engage in the proposed stock repurchase. The Holding Company's common stock has been trading above the conversion issuance price of \$10.00 per share and closed at \$11.11 per share on June 23, 2004. While there may have been a decrease from the previous high for the Holding Company's stock, the Holding Company has not provided sufficient evidence to demonstrate that the current

market conditions for the Holding Company's stock provide an extraordinary circumstance or a compelling business purpose for the proposed stock repurchases.

### **SEC Rule 10b-18**

The reconsideration request claims that the Holding Company was not aware of the amendments to SEC Rule 10b-18 at the time of the second-step conversion, because the amendments occurred after the second-step conversion. In addition, the Holding Company claims that the effects of the amendments to SEC Rule 10b-18 are an extraordinary circumstance, because the Holding Company believes such amendments will make it more difficult to comply with the amended rule. However, the Holding Company has not demonstrated that the plans to proceed with the transaction would have been changed, if they were aware of such amendments earlier. Further, the Holding Company has not demonstrated that it would not be able to comply with the requirements of SEC Rule 10b-18.

### **Stock Repurchases Effect on Financial Condition**

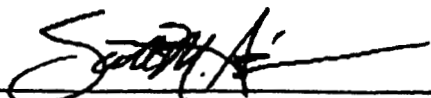
The Notice and the reconsideration request assert that, in the current interest rate environment, the best use of the Holding Company's excess capital is the proposed stock repurchases, which will enhance its financial performance ratios. The Holding Company further argues that OTS did not consider the impact of the Holding Company's stock resolicitation and the unanticipated additional capital raised from the resolicitation. OTS concludes that the Holding Company has not demonstrated that the proposed stock repurchases would have a significant effect on its financial condition as compared to other uses for its capital, which it described in its prospectus of July 31, 2003, and in its business plan filed with OTS. OTS also notes that, although an offering resolicitation is not routine, OTS regulations require that the conversion stock be sold at its fair market value. OTS required the Holding Company to resolicit the offering to ensure that the transaction complied with that requirement. Because the conversion transaction is required by regulation to satisfy this requirement, the resolicitation does not constitute an extraordinary circumstance.

### **Additional Dilution from Proposed 2004 Plan**

The Notice indicated that the shareholders would vote on the Holding Company's 2004 Stock Incentive Plan (2004 Plan) in May 2004. Because the existing shareholders approved the 2004 Plan on May 3, 2004, it appears that the shareholders did not object to the additional dilution that may result from the adoption of the 2004 Plan and any additional dilution that may result from the use of authorized and unissued shares during the first year after the conversion. Also, after the one-year anniversary period expires, on October 29, 2004, there will not be any restrictions on issuer repurchases under the OTS Conversion Regulations, at 12 C.F.R. Part 563b. Accordingly, OTS concludes that this assertion of additional dilution by the Holding Company does not constitute extraordinary circumstances or a compelling business purpose.

Based on the facts presented in the Notice and the reconsideration request, OTS concludes, on reconsideration, that the Holding Company has again failed to provide evidence to OTS to demonstrate that "extraordinary circumstances" and a "compelling business purpose" exist with respect to the Notice. Accordingly, the reconsideration request is hereby denied.

By order of the Director of the Office of Thrift Supervision, or his designee, effective June 28, 2004.



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