COVINGTON & BURLING LLP

June 18, 2014

MEMORANDUM

To: Charles P. Dana, General Counsel
Farm Credit Council

From: Keith A. Noreika

Re: FCA's Proposed Standards of Conduct Regulation

Attached you will find an outline detailing our research regarding federal bank regulatory obligations that might be viewed as comparable to the FCA's existing and proposed Standards of Conduct regulations ("Standards of Conduct")[1] as applied to directors and employees of federally insured depository institutions as well as to such organizations' third-party vendors and agents. In sum, we have not been able to find any equivalent in federal banking regulation to the Standards of Conduct, either for directors and officers of banking organizations or for such organizations' third-party vendors and agents.

As you will see in the attached outline, there is no equivalent requirement for directors and officers of insured depository institutions, bank holding companies and non-bank affiliates of such companies, that is in any way comparable to Standards of Conduct requirements that directors, officers and employees of an FCA System institution disclose their own business dealings made in the ordinary course. The disclosures required by such individuals in banking organizations is governed by applicable state corporate governance laws, federal securities laws and certain banking regulations, all of which take a much narrower approach of requiring disclosure only with respect to certain transactions, at the time such transactions are contemplated by the banking organization.

With respect to third-party vendors and agents, again, there is no comparable regulation to the Standards of Conduct with respect to such actors in federal banking regulation. The oversight of banking organizations' use of such third-parties is heavily scrutinized by the federal banking agencies through the Bank Service Company Act, 12 U.S.C. § 1867(c), which allows the federal banking agencies to examine directly the third-party vendor as if it were part of the regulated banking organization itself. This is an area that has been of particular, recent

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[1] *See* 12 C.F.R. part 612; Farm Credit Administration Proposed Rule, *Standards of Conduct and Referral of Known or Suspected Criminal Violations; Standards of Conduct*, 79 Fed. Reg. 9649 (Feb. 20, 2014).

focus of the federal banking agencies. In 2013, both the Office of the Comptroller of the Currency, and the Board of Governors of the Federal Reserve System, issued guidance to banking organizations under their supervision concerning how such organizations should supervise third-parties who perform services on behalf of such regulated banking organizations.[2]

Although the federal banking agencies heavily supervise and scrutinize directly the third-party's actions, they place most of the consequences of any failure to maintain proper standards by the third-party on the regulated banking organization itself, rather than on the third-party. The federal banking agencies' enforcement authority over third-parties is limited to situations in which the third-party has acted with recklessness or intent to violate an applicable legal requirement where the effect of doing so has or likely will endanger the safety and soundness of the regulated banking organization. 12 U.S.C. § 1831(u)(4).

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[2] *See* OCC Bulletin 2013-29, *Third-Party Relationships* (Oct. 30, 2013) (available at http://www.occ.gov/news-issuances/bulletins/2013/bulletin-2013-29.html); Board of Governors of the Federal Reserve System, *Guidance on Managing Outsourcing Risk* (Dec. 5, 2013) (available at http://www.federalreserve.gov/bankinforeg/srletters/sr1319a1.pdf).

Standards of Conduct Outline

I. Disclosure Standards Applicable to Directors and Employees Not Equivalent to Similarly Situated Bank Officers.

A. There is no equivalent in federal bank regulatory law requiring directors of banks to disclose if they have any type of business or other dealings ("business dealings") with a customer of the bank or a shareholder of the bank where such business dealings are unrelated to the bank's contractual relationship and business opportunities with the customer or shareholder.

B. Banks – both federally and state-chartered banks – are subject to local corporate governance requirements. There is no federal corporate governance law applicable to banks. *Atherton v. FDIC*, 519 U.S. 213 (1997).

- National banks may elect to be governed by Delaware law for corporate governance matters. 12 C.F.R. § 7.2000.

- Such banks' directors are subject to ordinary fiduciary duties of care and loyalty; these are standards created by case law, based on the facts-and-circumstances of each situation, and have no precise statutory or administrative contours.

- Duty of loyalty means:
  - Directors may not "stand on both sides" of a transaction;
  - Directors may not derive any personal benefit through self-dealing with the corporation; and
  - Directors may not usurp corporate opportunities.

- "Interested director transactions" will not constitute a breach of the duty of loyalty, however, if:
  - all material facts of the director's (or officer's) interest in the transaction are disclosed to the disinterested directors who approve it;
  - all material facts of the director's (or officer's) interest in the transaction are disclosed to the shareholders who approve it; <u>or</u>
  - the transaction is "fair as to the corporation" at the time it was approved by the board or shareholders [DGCL Section 144].

- Sometimes, Delaware courts speak of a somewhat distinct, but intertwined, duty of disclosure or duty of candor:
  - The duty of disclosure/candor takes various forms and has not been well-articulated by Delaware courts;
  - The duty is, in some circumstances, an obligation on directors to disclose information to a corporation's shareholders and, in other circumstances, an obligation to disclose information to other directors:
    - The duty to disclose to other directors has been described as part of directors' "unremitting obligation to deal candidly with their fellow directors";

- In either case, only facts material to the determination under consideration need be disclosed.

C. Publicly traded banks are also subject to federal securities law disclosure requirements.

- o Such banks are subject to state corporate law fiduciary duties (see above).

- o <u>Plus</u>, they are subject to SEC reporting rules (Reg. S-K, Item 404 and Item 406).
  - ▪ Item 404(a) requires corporation to disclose transactions between the corporation and any "related person" exceeding $120,000.
    - A "related person" is a director, executive officer, nominee for director, 5% shareholder, or immediate family member thereof.
    - There is an exception for transactions involving indebtedness involving banks where amounts are not past due, made in ordinary course of business, etc.
    - There is also an exception for transactions where rates or charges involved are determined by competitive bids, public utility laws, etc.

  - ▪ Item 404(b) requires corporation to describe its policies and procedures for review and approval of transactions under 404(a), and identify any transactions that did not require review under such policies or where such policies were not followed.

  - ▪ Item 406(a) requires disclosure of whether the corporation has adopted a code of ethics (and if not, why not) applying to its principal executive officer, principal financial officer, principal accounting officer or controller or persons performing similar functions, where "code of ethics" means a written policy covering, among other things, the handling of conflicts of interest.

  - ▪ Item 406(c) requires the corporation to file its code of ethics with the SEC, post on its website or undertake to provide it upon request.

- o <u>Plus</u>, such banks are subject to applicable stock exchange rules (NYSE, Nasdaq, etc.):
  - ▪ NYSE Listed Company Manual, Section 303A requires:
    - Each listed company must have a board consisting of a majority of independent directors:
      - o The board must determine independence;
      - o No director is independent unless the board determines the director has no "material relationship" with the company (either directly or as a partner, shareholder or officer of another entity that has relationship with company); and

        - A director is not independent if he or immediate family member has received more than $120,000 in direct compensation from company (other than director fees and deferred comp.), or involved in certain transactions with company over certain thresholds.

    - Each listed company must adopt and disclose a code of business conduct and ethics for directors, officers and employees:
        - The code must include provisions re: conflicts of interest, corporate opportunities, confidentiality, fair dealing, protection and proper use of a company's assets, compliance with laws and reporting of illegal or unethical behavior;
        - Each company may determine its own policies; there are no required bright-line rules/test; and
        - Any waivers of the code for directors or executive officers must be approved by the board; any such waiver must be promptly disclosed to shareholders.

- Nasdaq Corporate Governance Requirements, Rule 5600 et. seq. requires:
    - Each listed company must have a board consisting of a majority of independent directors.
        - The rules and standards are very similar to those for NYSE (see above).

    - Each listed company must adopt and disclose a code of conduct for directors, officers and employees.
        - The code must comply with the definition of "code of ethics" set out in Section 406(c) of SOX Act and regulations of SEC [i.e., Item 406 of Reg. S-K (see above)];
        - Any waivers of the code for directors or executive officers must be approved by the board; any such waiver must be disclosed to shareholders.

    - Each listed company must provide prompt notification to Nasdaq after an executive officer becomes aware of non-compliance by the company with the requirements of the Rule 5600 Series.

    - Each listed company (other than an LP) must conduct appropriate review and oversight of all related party transactions for potential conflict of interest situations on an ongoing basis [i.e., those to be disclosed pursuant to Item 404 of Reg. S-K (see above)].

D. Regulation O – restrictions on, and disclosure requirements concerning, banks' lending to insiders. 12 C.F.R. part 215.

- Regulation O governs national banks and state member banks' lending to "insiders". Insiders include any executive officer, director, principal shareholder, or any related interest of such individuals.

- Places restrictions on lending to insiders. Must be on market terms and loans over a certain amount must be approved by the board of directors. In addition, there is an aggregate limit on the total amount of extensions of credit that may be made to insiders.

- As a practical matter, executive officers, directors and principal shareholders must disclose to their institution their interests in any company over which they have a controlling influence, defined as the ability to control 25% or more of any class of voting securities of the company, the ability to control the board of directors, the ability to otherwise exercise a controlling influence over the company (e.g., through a substantial total equity stake), or their ownership of 10% or more of any class of voting securities of the company in certain instances. This disclosure is required so the institution can keep track of extensions of credit to related interests so that the substantive and record-keeping requirements of Regulation O can be satisfied.

- The public has limited rights to request information from a bank subject to Regulation O that require such bank to disclose certain extensions of credit made to insiders and related interests.

II. Conflicts of Interest Standards Applicable to Third-Party Vendors.

A. There is no equivalent in banking regulation to standards of conduct applicable to third-party vendors.

B. Bank vendors are subject to regulation, examination and supervision under the Bank Service Company Act. 12 U.S.C. § 1867(c).

- The performance of bank services is subject to regulation by the federal banking agencies, whether performed by the bank or a third-party vendor, as a matter of federal law.

- The federal banking agencies have the authority to examine and supervise those activities wherever performed.

- The regulated banking entity must notify its federal bank regulator of a third-party service relationship within 30 days of the earlier of the making of such contract, or the first performance of services by the third-party vendor.

- Note that the bank regulators' jurisdiction is <u>only</u> over the performance of the services themselves and over the bank itself; the Bank Service Company Act gives the federal banking regulators no rights per se with respect to the third-party contractor. The federal banking agencies' enforcement authority over third-party contractors of insured depository institutions is very limited. *See infra* Part II.F.

C. Third-party vendors are not otherwise subject to federally imposed ethics or conflicts of interest rules.

- Attorneys are subject to their own applicable rules of ethics.

D. Banks are required to stringently monitor and evaluate their relationships and contracts with third-party vendors from a risk perspective.

- OCC 2013-29: The OCC's 2013 guidance takes a risk-based approach to banks managing their relationships with third-party vendors. Relevant to the discussion here, the bank's auditor is supposed to monitor the bank's risk-management process by ensuring, among other things, "that conflicts of interest or appearances of conflicts of interest do not exist when [the bank is] selecting or overseeing third parties." The guidance does not impose any specific disclosure requirements on third-party vendors or agents.

E. With respect to the Standards of Conduct for agents/vendors in the FCA's proposed rulemaking, we are not aware of any similar standards applicable to privately or publicly held banks that would come from state corporate law, SEC or stock exchange listing requirements.

F. Federal bank regulators' enforcement authority extends to independent third-party contractors to a bank in narrow circumstances. 12 U.S.C. § 1831(u)(4):

- In order for the bank regulator to have enforcement jurisdiction over the third-party contractor, the independent third-party must "knowingly or recklessly" participate in a "violation of law or regulation", a "breach of fiduciary duty", or "any unsafe or unsound practice" – and that conduct must have caused or be likely to cause "more than a minimal financial loss to, or significant adverse effect on, the insured depository institution."

- Thus, even if there were some type of requirement imposed on third-party vendors to disclose conflicts of interest to insured banks, the federal bank regulators would have no authority to enforce them if the circumstances of such a third-party's failure to comply did not satisfy the strict requirements of Section 1831(u)(4) discussed immediately above.